CHINA AND THE WORLD ECONOMY

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China's long-term growth rate is expected to stabilize within a range of 5% to 5.5%, down from 9% one decade ago, as it completes its transition from a developing to a middle-income country. Future economic growth will be derived from rapid productivity growth rather than an expanding labor force, which has begun to shrink because of demographic factors. China's GDP could overtake that of the US during the upcoming decade, although its per capita income is likely to remain more than 75% below that of the US.

Summary and Major Conclusions:

- The Chinese economy has rebounded strongly from its policy-induced downturn earlier in the year. Following its worst quarterly decline in three decades, China's economy expanded at a 3% annual rate in the second quarter.

- China's economy is unique in the speed of its recovery from the world recession, which touched bottom in May. The lockdown of China's economy was unlike that of any other country, resulting in a swift containment of the coronavirus in February and a reopening of its factories only slightly thereafter.

- Unlike the US and other developed countries, China is heavily dependent upon manufacturing. Because of the greater ease of social distancing in manufacturing activities, GDP rebounded faster than in countries more reliant on services and retail.

- Whereas all countries adopted aggressive stimulus measures, China's spending was more targeted to production and investment. In particular, China's spending on infrastructure provided a more significant boost to output, because of its large multiplier effect.

- The medium-term outlook for economic growth is favorable, implying GDP growth above the country's long-term potential. The Chinese economy is in the early stages of a traditional business cycle recovery, during which time GDP grows at its fastest rate.

- Economic policy is supportive of growth. Although policymakers will begin to remove stimulus as 2021 unfolds, economic growth typically lags changes in fiscal and monetary policy by approximately one year. My forecast assumes growth in GDP of 8% in 2021 and 6% in 2022.

- Although GDP growth will naturally decelerate over the next decade, China will continue to have one of the world's fastest growing economies for many years to come. Long-term trendline GDP growth could average 5.5% over the next five to ten years, comfortably above global GDP growth estimated at 3.3%.

- Above-average growth in China will continue to be powered by massive investment in technology. Productivity growth could strengthen, a result of rapid technological innovation, heavy investment in infrastructure, and continued advances in the population's educational attainment.

- Large pent-up demand for consumer goods and services should boost growth, as China's standard of living continues to increase. Comprising only 40% of GDP, consumption should increase at a rapid pace, reinforced by large household savings.

- There are several factors favoring China as the world's leading manufacturing country. Whereas Chinese wages have risen at a rapid rate, these increases have been matched by rapid gains in productivity.

- With a population of over one billion and rapidly growing household income, China will continue to be an attractive destination for investment. Technical innovation is the most important determining factor regarding a country's future competitiveness, and China has made enormous progress in this area over the past decade.

- The risk of a large-scale migration of supply chains out of China is exaggerated. Leading multinational companies have thousands of tightly integrated suppliers in their supplier ecosystems that would be difficult to unwind quickly. Consequently, migrating from one country to another can be a daunting task.

- Nearly 65% of global 5G phones are sold in China, while the country's 5G infrastructure has the largest geographic coverage in the world. China is the world leader in robotics with more than 35% of world installations. China also accounts for 35% of global semiconductor demand.

- Major risks to China's economy include a massive public and private debt burden, a fragile banking sector, vulnerability to political and social unrest, and increasingly contentious confrontation with the US.

- Frictions between China and the US over trade and technology could result in a broad escalation in the trade war between the two countries. There is also a growing risk of a real estate bubble occurring within the next several years.

Following a steep decline in the early months of this year, the Chinese economy rebounded strongly in the spring and summer and is on track for positive GDP growth for all of 2020, the only major country to post growth this year. This week's *Economic Perspective* provides an update of economic and policy conditions within China and a forecast for economic growth in 2021 and 2022.

COULD YOU BEGIN WITH AN UPDATE ON ECONOMIC CONDITIONS IN CHINA?

The Chinese economy has rebounded strongly from its policy-induced downturn earlier in the year. Following its worst quarterly decline in three decades, China's economy expanded at a 3% annual rate in the second quarter. The Chinese economy is on track for further growth of 10% (annualized) in the third quarter and full-year GDP growth of 3%.

WHAT ACCOUNTS FOR CHINA'S SIGNIFICANTLY BETTER ECONOMIC PERFORMANCE IN RECENT MONTHS?

China's economy is unique in the speed of its recovery from the world recession that touched bottom in May. China's superior economic performance can be attributed to several key factors:

- The lockdown of China's economy was unlike that of any other country. Beijing's draconian actions resulted in a swift and comprehensive containment of the coronavirus in February and a reopening of its factories only slightly thereafter.

- Unlike the US and other developed countries, China is heavily dependent upon manufacturing. Because of the greater ease of social distancing in the manufacturing sector, GDP rebounded faster than in countries more reliant on services and retail.

- Consumer spending has lagged in most major countries worldwide, but comprises only 40% of China's GDP, compared with more than 60% for the world economy and 70% for the US.

- Whereas all countries adopted aggressive stimulus measures, China's spending was more targeted to production and investment. For example, US fiscal policy stimulus was designed to act as a bridge to spending through income support programs whereas China's spending on infrastructure provided a direct boost to output.

- Policymakers also propped up key industries and sectors early in the pandemic, limiting the downside to GDP and precipitating the subsequent V-shaped recovery.

- The pandemic hit at a time when China's real estate cycle was in an uptrend, thereby supporting its economy once the country reopened. Home sales increased by 40% in August, providing support to future construction activity.

IS CHINA'S ROBUST RECOVERY BROADLY BASED OR HEAVILY DEPENDENT UPON CERTAIN KEY SECTORS?

China's economic recovery has been concentrated in several sectors, while some other sectors have lagged. As a generalization, China's economic recovery has been led by supply-side rather than demand-side forces. The manufacturing and investment sectors have led the recovery, while consumer spending and services have lagged. Industrial production rose at a 5.5% annual rate in August, which compares with less than 1% growth in retail sales.

Investment in the real estate and industrial sectors and export trade have also contributed to growth. The composition of China's economy has also worked to China's advantage: Private consumption comprises only 40% of GDP compared with 30% for manufacturing. The comparable data for the US is 70% and 12%, respectively.

WHAT SHOULD INVESTORS EXPECT FOR 2021 AND 2022?

The medium-term outlook for economic growth is favorable, implying GDP growth above the country's long-term potential. There are several factors that support of this conclusion:

- The Chinese economy is in the early stages of a traditional business cycle recovery, during which time GDP growth is typically at a peak.

- As the epicenter of world manufacturing, China's export machine should benefit from a recovery in world trade.

- Economic policy is supportive of growth. Although policymakers will likely begin to remove stimulus as 2021 unfolds, economic growth typically lags changes in fiscal and monetary policy by approximately one year.

My forecast assumes real GDP growth of 8% in 2021 and 6% in 2022. These growth rates compare with estimated 3% growth this year and slightly greater than 6% growth in 2019.

LOOKING BEYOND CHINA'S CYCLICAL RECOVERY IN THE MEDIUM TERM, WHAT ARE THE LONGER-TERM PROSPECTS FOR GROWTH AND PROSPERITY?

China will continue to have one of the world's fastest-growing economies for many years to come. However, in textbook fashion, the rate of economic growth in China has been in a gradual but steady decline as the country matures and transitions from a developing economy to a middle-income economy. In fact, China's long-term growth pattern has closely followed those of Japan and South Korea when those countries matured during the second half of the 20th century to become fully developed economies.

A continued moderation in China's blistering growth rate since 2000 seems reasonable. Its economy has advanced to a more mature phase of development: Its industrialization phase has nearly run its course, and economic sector leadership is in the process of shifting from manufacturing, exports, and capital formation to consumption and services, far less dynamic sources of growth.

China's GDP increased at an average annual rate of 10% from 2000 through 2012. Growth has gradually decelerated to an average rate of 7% since 2012, stabilizing at a rate of 6% in 2019. My forecast assumes that China's GDP will increase at an average annual rate of 5.5% over the five years ending in 2028, which compares with projected global GDP growth of 3.3%. There are several factors that support continued above-average GDP growth:

- Above-average growth in China will continue to be powered by massive investment in technology.

- Productivity growth should strengthen, a result of rapid technological innovation, heavy investments in infrastructure, and continued progress in the population's educational attainment.

- GDP growth will benefit from China's ongoing transition from producing basic and intermediate goods to advanced high-value-added consumer and capital goods.

- Continued secular demand for housing should continue to be a growth engine for the Chinese economy for many years.

- Large pent-up demand for consumer goods and services will boost growth as China's standard of living continues to rise. Comprising only 40% of GDP, consumption should increase at a rapid pace in line with 8% growth in wage income.

The bottom line is that the Chinese economy remains in a long-term slowdown from spectacular growth rates in recent decades, but will still be the primary contributor to global growth over the next five years. However, whereas China's GDP could leapfrog that of the US in the next decade, its level of ***per capita income*** is likely to remain 75% below that of the US.

IS CHINA VULNERABLE TO A DECLINE IN MARKET SHARE IN WORLD MANUFACTURING?

On the surface one can find reasons why China could be at risk to a loss in market share in world manufacturing in coming years. The most important of these factors include the ongoing confrontation between China and the US; the increase in protective tariffs aimed at China; rapidly rising labor costs; and independent decisions by countries to diversify supply chains away from China.

However, a closer examination of these issues suggests that a large decline in China's market share is unlikely. There are several factors favoring China as the world's leading manufacturing country over the next five years, at a minimum:

- **Productivity**: Whereas Chinese wages have risen at a rapid rate, these increases have been matched by rapid gains in productivity, thereby bolstering China's competitive advantage. China's unit labor costs in US dollar terms have been flat in recent years following a nearly 40% increase in the ten years ending in 2015.

- **Proximity to End Markets**: With a population of over one billion and rapidly growing household income, China will remain attractive as a destination for foreign direct investment.

- **Complex Supply Chains**: Large multinational companies have thousands of tightly integrated business firms in their supplier ecosystems that would be difficult to unwind quickly. Consequently, the process of migrating supply chains from one country to another can be a difficult and drawn-out process.

- **Massive Factory Base**: China has another advantage over all other countries: The massive base of factories and parts suppliers established on the mainland.

- **Infrastructure**: China's robust transportation network and modern industrial infrastructure is attractive to foreign producers.

- **Technology and Innovation**: Technological innovation is the most important determining factor regarding a country's future competitiveness, and China has made enormous progress in this area over the past decade.

- **High Value Added**: Rising labor costs mean that China will lose market share in many highly labor-intensive industries such as textiles, apparel, and footwear. Vietnam, Thailand, Cambodia, India, and Mexico will likely gain market share in these and other low-cost products. Conversely, China will continue to move up the manufacturing value chain in high-end consumer and capital goods.

The key point is that China will remain attractive as a manufacturing destination for many countries, despite recent challenges, and should continue to maintain its competitive advantages in many industries.

COULD YOU ASSESS CHINA'S PROGRESS IN TECHNOLOGICAL INNOVATION?

China has become a leader in many cutting-edge technologies, including robotics, 5G networking, artificial intelligence, supercomputing, mobile payments, audio-visual technology, bullet trains, and digital communications. Nearly 65% of global 5G phones are sold in China, while the country's 5G infrastructure has the largest geographic coverage in the world. China is also the world leader in robotics with more than 35% of world installations, well ahead of the US at only 10% and Germany at 5%.

China also accounts for 35% of global semiconductor demand. The Chinese Communist Party is determined to maintain a leadership position in these crucial technologies with an emphasis on education, scientific research, and patents. China currently holds 22% of patents filed with the International Patent Cooperation Union. Its patents have grown by more than 125% over the past five years, compared with 44% for South Korea and less than 2% growth in the US.

China's spending on basic research and development has increased at a 14% annual rate since 2015. Finally, the percentage of engineering students in Chinese doctoral programs is 35%, far exceeding the 15% share in the US. Pulling it all together, China has emerged as a technological giant as it strives to position itself as a dominant world economic and military power in future decades.

WHAT ARE THE KEY RISKS TO THE OUTLOOK?

Major risks to China's economy include the country's massive public and private debt burden, a fragile banking sector, vulnerability to political and social unrest, and increasing confrontation with the US. Similar to other countries, China is also at risk to a resurgence of coronavirus infections, albeit most likely on a regional basis.

Frictions between China and the US over trade and technology could result in a broad escalation in the trade war between the two countries. There is also a growing risk of a real estate bubble occurring within the next several years. Finally, China's long-term growth potential could suffer as the government's economic reform program stalls and state-owned enterprises (SOE) continue to grow in importance at the expense of more efficient and profitable private business firms.

COULD YOU SUMMARIZE THE PRIMARY TAKEAWAYS FROM YOUR ANALYSIS OF CHINA?

China is leading the world economic recovery and will be the only major country to achieve positive GDP growth in 2020. China's GDP is on target to expand by another 8% in 2021 and 6% in 2023. China's long-term growth rate is expected to stabilize within a range of 5% to 5.5% as it completes its transition from a developing country to a middle-income country. Future economic growth will be derived from rapid productivity growth rather than an expanding labor force, which has begun to shrink because of demographic factors.

In its quest for world domination, China will continue to invest heavily in technology, with a special emphasis on leadership areas such as robotics, 5G telecommunication systems, and semiconductors. Although China's role as the world's factory could diminish somewhat in coming years, multinational firms are expected to continue to invest heavily in the mainland. China's GDP could overtake that of the US during the upcoming decade, although its ***per capita income*** is likely to remain more than 75% below that of the US.

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