AEI

10 Years Late on China's Economy

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Key Points

- China's economic performance has received much attention in 2023, but there are no surprise developments at all. No crisis, no rise to global leadership. The country has been on the same path for at least a decade.
- This path was paved by strategy errors starting no later than 2009. These harmed wealth creation and innovation and blocked necessary land and labor reforms. As a result, economic growth will continue to ebb.
- Policy tinkering will accomplish little. Sharp change would matter, but there is no sign of it. The implications include falling commodities prices, industrial opportunities for competitors who reform, and a need to revamp American thinking.

The year 2023 has minted China experts by the hundreds. According to them at the start of the year, China was about to boom. By midyear, it was in crisis.[1] Both wrong. But the far more enduring error has been failing to recognize China's serious economic weaknesses, which date back at least to 2012. "Experts" should not dramatically identify trends many years after these trends were visible. Instead, they should have been criticizing China's flawed strategy and ensuing policy choices, missteps more than a decade old.

China remains on the path it has been on all that time—moving slowly but inexorably toward stagnation. There's no economic or financial crisis. But unless pro-competition and pro–property rights reforms quickly and decisively reappear, we already know where the economy will be in 2033 and beyond: large but not growing, old and not rich, and ineligible for global leadership.

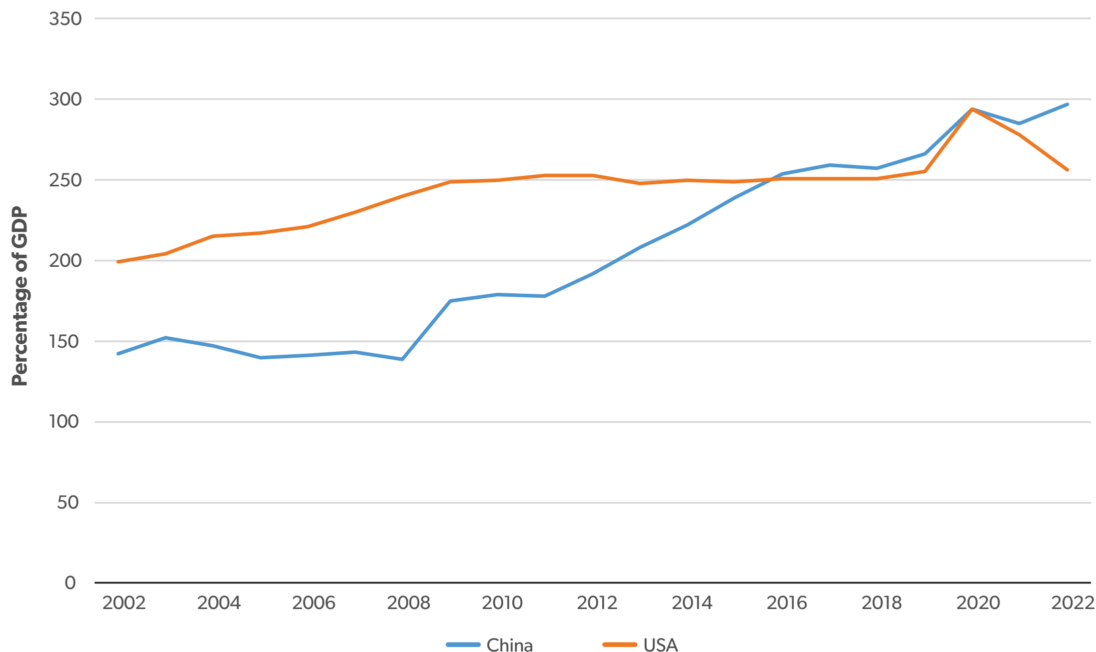
2009: Probably the Pivotal Year

Harmful deterioration in the economic performance of the People's Republic of China (PRC) was clear by 2019. Clear deterioration was evident by 2013. Deterioration should have been anticipated in 2009. Policy turned in a dubious direction, from which it was never righted, in 2003.[2] It may be surprising to some that none of these years is 2023.

In late 2002 and 2003, a new government associated with Communist Party General Hu Jintao initiated a jump in fixed asset investment. From 1995 to 2002, fixed investment growth never reached 18 percent. From 2003 to 2010, it was always above 20 percent. Volume in 2010 was more than five times that in 2002, creating the oft-discussed imbalance between investment and consumption.[3] Some macroeconomic results were appealing, though, and reforms associated with World Trade Organization accession continued through 2005. Chiding was possibly more appropriate than serious concern.

Serious concern became warranted during 2009. In late 2008, in response to the global financial crisis, Beijing announced a much-praised fiscal stimulus program. It did not amount to much, and (already fast) fixed investment accelerated only mildly. The considerably smaller amount of government expenditure actually

Figure 1. Outstanding Credit (China and US)



Source: Bank for International Settlements, "Credit to the Non-Financial Sector," September 18, 2023, https://www.bis.org/statistics/totcredit.htm?m=2669.

decelerated.[4] The spending response was modest, which was unsurprising given demand-side weakness.

Unfortunately, far more money nonetheless sloshed around. Outstanding local currency loans jumped 31 percent in 2009, from 19 percent growth in 2008. Narrow money, or "M1," also rose 31 percent, from 13 percent in 2008.[5] Simple bill financing soared, and a huge amount of money was borrowed. The impact on debt was as expected.[6]

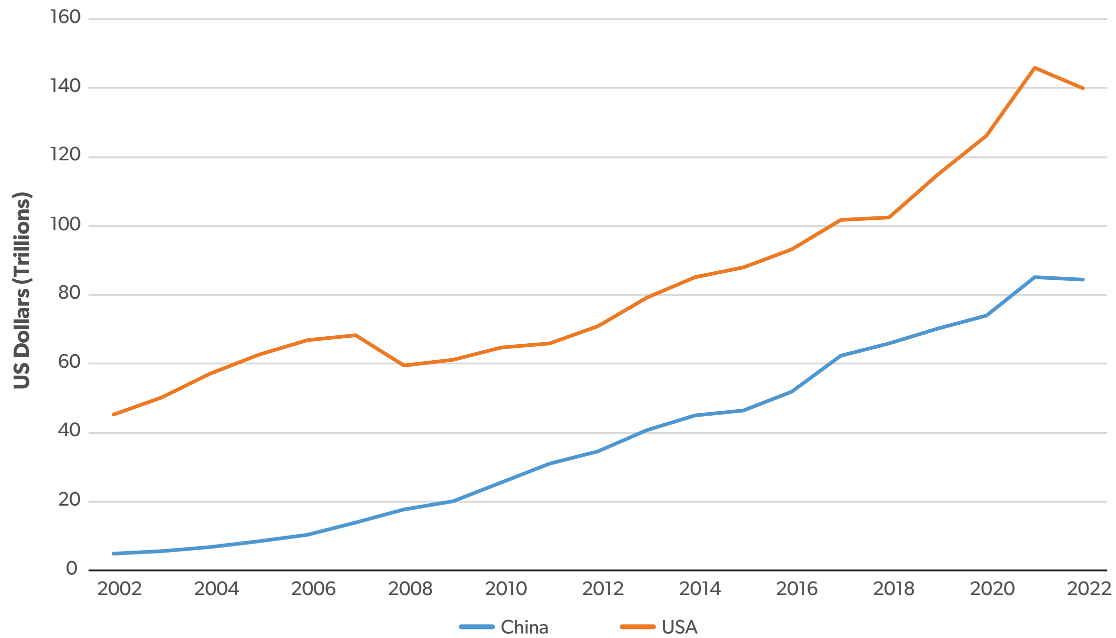
The debt surge may have been needed to avert a crisis, though official data showed nothing like a crisis (Figure 1). The borrowing was perhaps something to be accepted, certainly not praised. Yet praised it was, by people failing to see beyond the next few years.[7] The financial system was notoriously inefficient at allocating capital, and it had to channel far more funds than before, in a much worse environment. Of course it did poorly.[8] Given the PRC's savings rate and control of the financial system, there was no drama. But the scale of loans meant the entire economic trajectory shifted.

From 1995 through 2008, the PRC's outstanding credit rose by 40 percentage points of its gross domestic product (GDP). It rose 39 points in 2009 alone.[9] Borrowing that year easily outmatched any year on record, including during the pandemic. If leveraging had halted a few years later, long-term damage would have been moderate. But it resumed in 2012, as Xi Jinping became general secretary (mocking those who hailed Xi as a reformer).[10] Remarkably, the pace of debt accumulation doubled in his first decade versus the previous decade. Whether lost capital caused worse performance, fading growth prompted sustained loose policy, or there was just less data fraud, China's reported performance unmistakably started to weaken just as Xi arrived.

2012: You Should Have Seen It

By late 2012 and into 2013, some people who had praised the PRC for years were now glad Hu was being replaced by Xi, because they belatedly realized pro-market reform had ended and now for no reason at all believed it would return.[11] The failure of this reform to appear was a clear signal macroeconomic performance would deteriorate indefinitely. Yet when recognized, deterioration was typically framed as expected and largely harmless.[12] In fact, the era of Chinese dominance, anticipated by many after the global financial crisis hit, was ending before it began.[13]

Figure 2. National Wealth (China and US)



Source: UBS, *Global Wealth Databook 2023*, 2023, https://www.ubs.com/global/en/family-office-uhnw/reports/global-wealth-report-2023.html#deeperdive.

There were multiple indicators for this. GDP and variants win attention, but a separate data series and method—national wealth—shows the same trend. The Federal Reserve measures wealth in the US. There is sparse China measurement, but Credit Suisse (now UBS) created a series for both China and the US. Its US numbers are close to the Fed's, while its China numbers have been revised sharply higher over time. Even so, the US-China comparison plainly shifts in 2012.

Because wealth is not commonly used as an indicator, it may be hard to interpret the PRC's performance in isolation. Comparison to the US shows China barely above 10 percent of America's wealth in 2002 and a $40 trillion gap (Figure 2). While the gap narrowed only slightly in 2012, to $36 trillion, the PRC approached half of US wealth. At the time, it looked like faster growth and a now much more sizable base would allow the PRC to slash further into the American lead. This was a reasonable and widespread forecast—in 2011. It's not what happened.

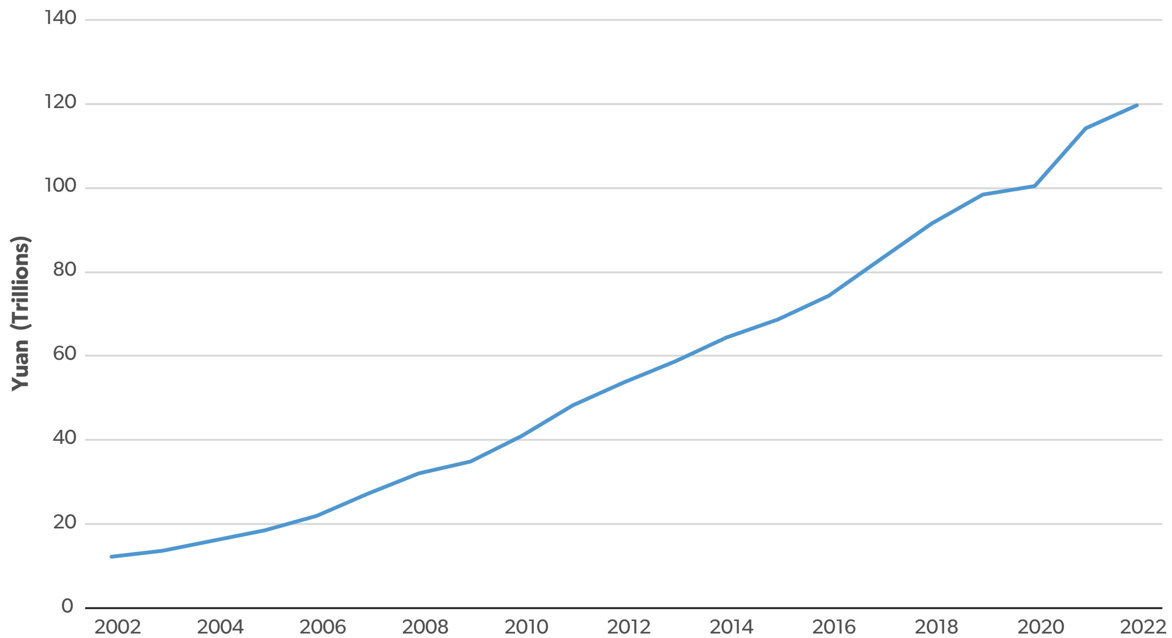
The fall in the wealth ratio decelerated, which was unavoidable. The extent of deceleration was not, as parity had barely moved any closer by 2022. More striking, the absolute wealth gap expanded considerably at China's expense, setting a record in 2021, with 2022 as the second-largest gap. In absolute terms, China's wealth declined in 2022, but it was still 20 percent higher than in 2019. Unless the numbers are badly flawed, this is hardly a crisis. The challenge, instead, is loss of sources of growth. Most simply, Xi is often hostile to wealth accumulation.[14]

What about GDP? It's more popular, if harder to measure than commonly thought. Inflation adjustments to GDP can be difficult to calculate but, when statistical authorities are arms of the Communist Party, are easy to manipulate.

Purchasing power estimates can be worse. Purchasing power parity is based on assumptions about open markets that do not hold in China.[15] The final comparison of one value for China to one value for the US is an odd endeavor. The two economies are large, and enormous variation is suppressed. The scale also means estimation takes a great deal of time and so becomes outdated. For these reasons, trends are clearest in unadjusted, nominal GDP.

From 2002 through 2012, China's nominal GDP rose by a factor of 4.4 (Figure 3). The speed was cut in half through 2022, and the last truly strong year

Figure 3. Chinese Nominal GDP



Source: China Statistics Press, *China Statistical Yearbook 2022*, http://www.stats.gov.cn/sj/ndsj/2022/indexeh.htm; and Chinese National Bureau of Statistics, "Statistical Communiqué of the People's Republic of China on the 2022 National Economic and Social Development," press release, February 28, 2023, http://www.stats.gov.cn/english/PressRelease/202302/t20230227_1918979.html.

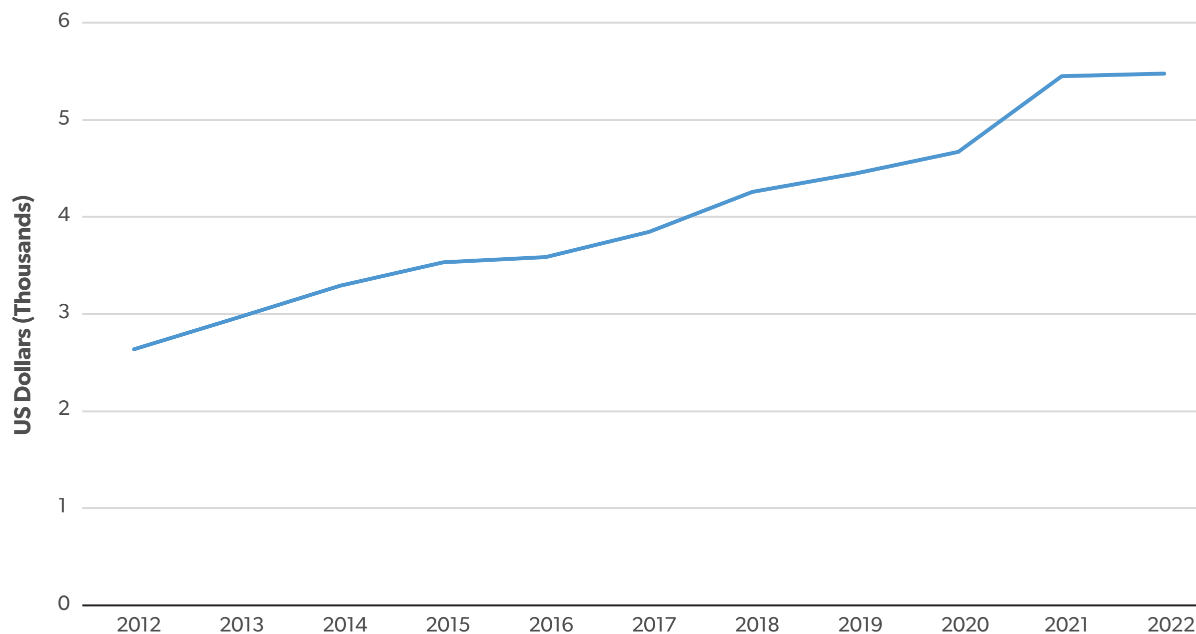
for nominal GDP was 2011. As with wealth, GDP was inevitably going to slow, but it did not have to slow so early and sharply. The PRC is far from rich, and other East Asian fast risers maintained fast growth for longer. Beijing curbed its own success with the One-Child Policy, the 2009 debt burst, and Xi's attack on open markets. If there is no outright and effective reversal of these policies, nominal GDP growth can only continue to ebb. There is not a magical 4 percent floor below which China can never go.

Using the PRC's official exchange rate and comparing to nominal American GDP[16] largely matches the wealth picture. The absolute gap does not shrink much from 2002 to 2012, but the ratio of Chinese to American GDP climbs steeply. That catch-up continues through 2014, but only because the yuan rose against the dollar. The 2022 nominal GDP gap in favor of the US is about the same as in 2012 and larger than in 2014. The ratio continued to rise in China's favor, but slowly. Though it's certainly not guaranteed, if the US can maintain long-term performance, China's trend means it will never reach parity (and will eventually slide due to population decline).

A third cut at macroeconomic trends is provided by personal income. This is not GDP per capita, which is an accounting result wrongly treated as meaningful—just try spending it. Personal income is the actual money people have, directly measured. Of course, the PRC is not rich, and the amounts reflect this, but personal income is a distinct indicator showing a familiar pattern over the past decade.

Aggregated Chinese income data start only in 2012 (Figure 4). That year, Chinese incomes were less than 7 percent of American incomes, with an absolute gap of $38,000. By 2022, the proportion was approaching 10 percent, while the gap widened to $51,000. The coming population decline works in China's favor, as per capita results can more easily improve. Still, the income gap could expand for decades, and the ratio would take centuries to reach parity even if the PRC does not continue to slow relative to the US. On its own terms and compared to America, then, China's macroeconomic

Figure 4. Chinese Disposable Income per Capita, Contemporary US Dollars



Source: Chinese National Bureau of Statistics, "Yearbook," http://www.stats.gov.cn/english/Statisticaldata/yearbook; and Chinese National Bureau of Statistics, "Statistical Communiqué of the People's Republic of China on the 2022 National Economic and Social Development," press release, February 28, 2023, http://www.stats.gov.cn/english/PressRelease/202302/t20230227_1918979.html.

performance began to weaken in the early 2010s, not the early 2020s.

Where Growth Is(n't) Coming From

In the data for the first quarter of 2023, which are the latest available, the PRC's outstanding credit rose sharply to a new high of over 300 percent of GDP. This still does not indicate a crisis. China's debt is funded from domestic savings, which exceed $35 trillion.[17] The financial system is controlled by the state; institutions cannot freeze credit just because borrowers are poor risks. What the high debt burden represents is several trillion dollars in low-return debt repayments annually and outright capital loss in the trillions over time due to lack of payment and (implicit) write-downs. This is hardly unique to the PRC, but as a much poorer country than the US, the PRC now has a worse debt burden.

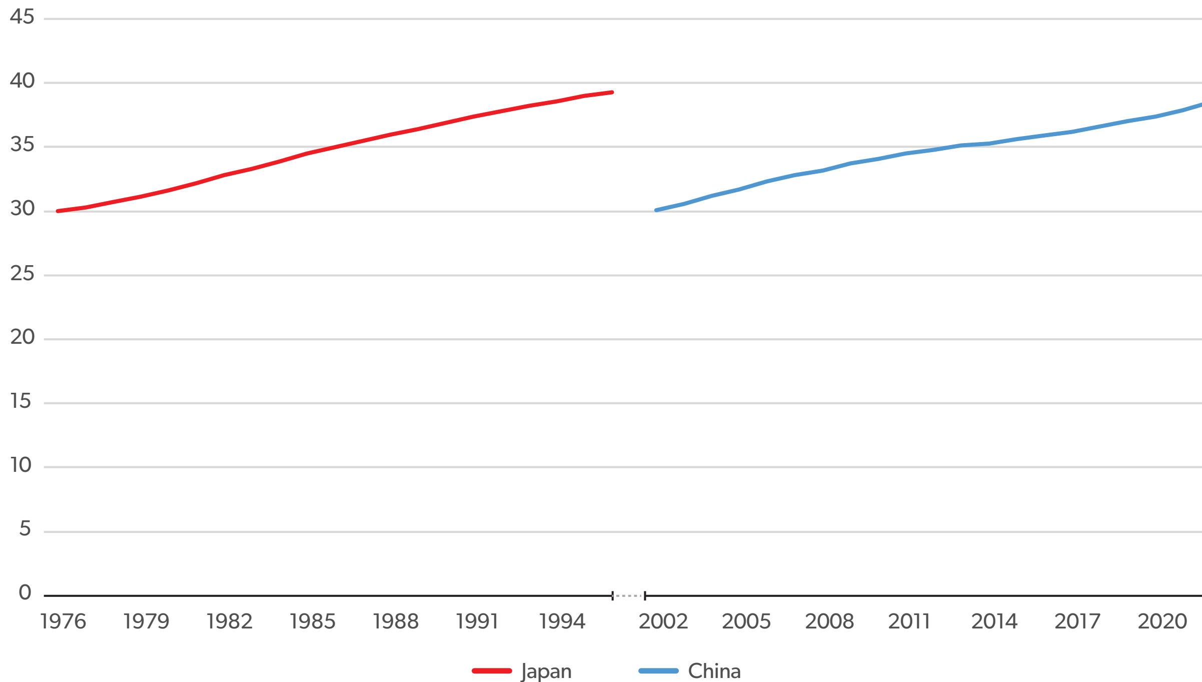
Looking ahead, the failure to curb the 2009 lending spree responding to the financial crisis is thus far being repeated in the response to the pandemic. China's current debt level is about the same as Japan's was in late 1999. The latter never caused an acute Japanese crisis, but it did help push growth toward zero. Just before the pandemic, Japan was headed for credit at 400 percent of GDP.[18] Even if the PRC does better in limiting the loss of productive capital in the next 20 years, serious damage has already been done. And there's a worse Japan comparison.

It's now widely known that the PRC's demographics are a problem. More than that, they will eventually crush China's economic growth. The UN, hardly an aggressive forecaster, has the population plunging by 500 million in the second half of the century.[19] That may prove overstated, but recent trends are harsher than generally expected just a few years ago.[20]

Before deep population contraction, aging will continue to shrink the labor force and require greater transfers to the elderly away from commercially productive investment. Even for China, demographic change is too slow to cause an acute crisis. As for stagnation, it's merely a question of when.

Median age illustrates the nature of the threat. Japan suffered an acute financial shock in 1990. That was over

Figure 5. Median Age, Two Decades in China and Japan



Source: UN Population Division, Data Portal, https://population.un.org/dataportal/home.

by 1993. In 1994, Japan saw roughly the same median age as China did in 2022 (Figure 5). And in 2021, Japan's nominal GDP in dollar terms was the same as it had been in 1994.[21] What happened well after the 1990 shock was a lost generation, not a "lost decade," with still no end in sight.

While Japan's worst pace of aging was faster than the PRC's to this point, the UN projects the latter to worsen in the coming decades. If accurately reported, China's GDP could flatline in a decade and stay flat indefinitely thereafter.

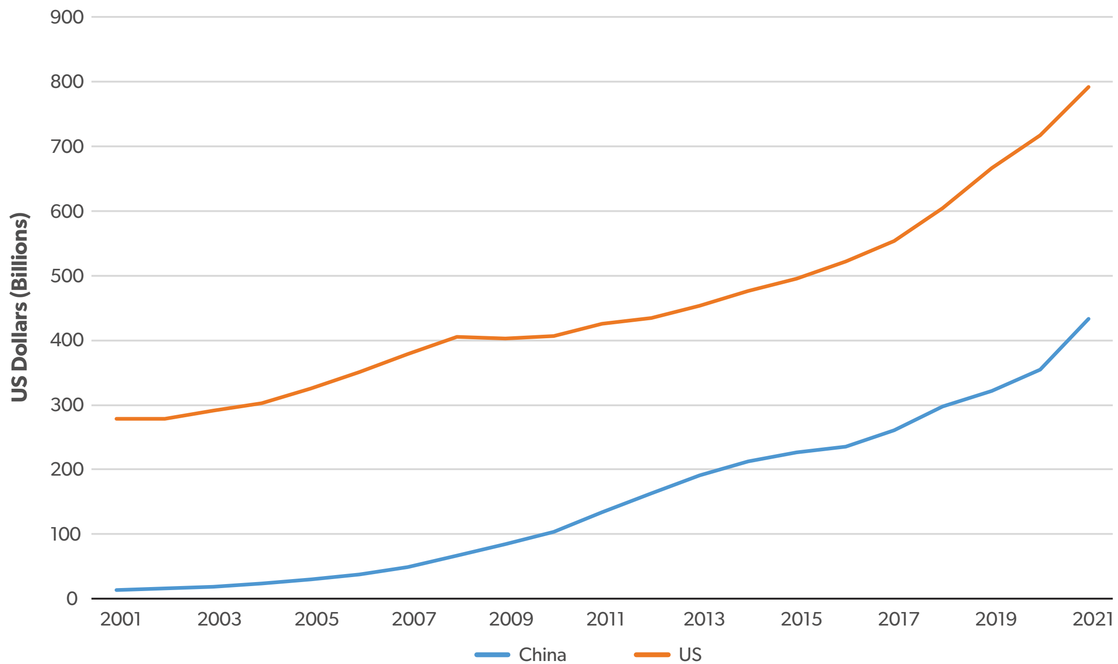
Land should play an important growth role in large countries and poor countries. The PRC is both. For 25 years, however, Beijing has distorted or barred formation of land markets. The most vital manifestation is that while all rich countries see private ownership of rural land, rural Chinese cannot own their most valuable asset. Rural per capita disposable income was $3,000 in 2022.[22]

Various state resource monopolies also inhibit the growth contribution of land. From 2002 to 2022, China's crude oil production rose 21 percent. American output more than doubled.[23] It's impossible to know how much of the difference is due to inescapable geology, because the US surge was led by small private operators that the PRC effectively disallows.

Unlike capital and labor, land could help the economy going forward. Local land reform in 1977 was the first step in escaping mass poverty. Credible and more complete land rights for private entities would cause rural income and the overall size of the economy to soar. But also unlike capital and labor, land reform is on and off, and there is no sign policy will be switched on.

The final contributor to growth is innovation. The PRC is certainly far more innovative than in 2002, when it was not at all innovative. Measuring this progress, though, is harder than for income or activity. The value of advanced technology exports—meaning not consumer electronics—has risen from almost nothing in the early 2000s, but growth the past five years is not especially impressive.[24] The same is true for citations of Chinese research in external publications.[25] This is not surprising. Xi has targeted as dangerous multiple elements of the private sector, foreign and especially domestic.[26] The private sector is indirectly responsible for much pioneering research and directly responsible for most technology exports.

Figure 6. R&D Spending (China and US)



Source: Chinese National Bureau of Statistics, "Yearbook," http://www.stats.gov.cn/english/Statisticaldata/yearbook; and US National Center for Science and Engineering Statistics, "National Patterns of R&D Resources | 2020–2021," https://ncses.nsf.gov/data-collections/national-patterns/2021#data.

The broadest innovation indicator is research and development (R&D) spending. This has the serious flaw of being self-reported when China has emphasized R&D under Xi, all but guaranteeing it will be published as expanding regardless of what actually happened. Fraudulent data on general fixed asset investment and scattered fraudulent technological advances[27] bear out the possibility that R&D spending is being exaggerated. If nonetheless taken at face value, spending appears somewhat similar to wealth and GDP, in which China catches up fast, then more slowly (Figure 6). The similarity to macroeconomic results is not a coincidence.

Again, a small base made the pace of China's R&D rise fast but also made it impossible to sustain. Spending ratios with the US narrowed sharply, then slowly. If dollars matter more than ratios, the widest gap in absolute terms is the latest two years, 2020 and 2021. In terms of what's next, the GDP share of China's R&D spending has approached the levels of rich countries.[28] If the PRC were still rapidly growing, this would mechanically translate to a further rise in R&D. As it is, an aging middle-income country devoting a higher GDP share to research than most rich countries is hard to credit, and true spending may plateau. Or, if causality runs from R&D to growth, it seems recent spending is not enough to overcome debt and demography.

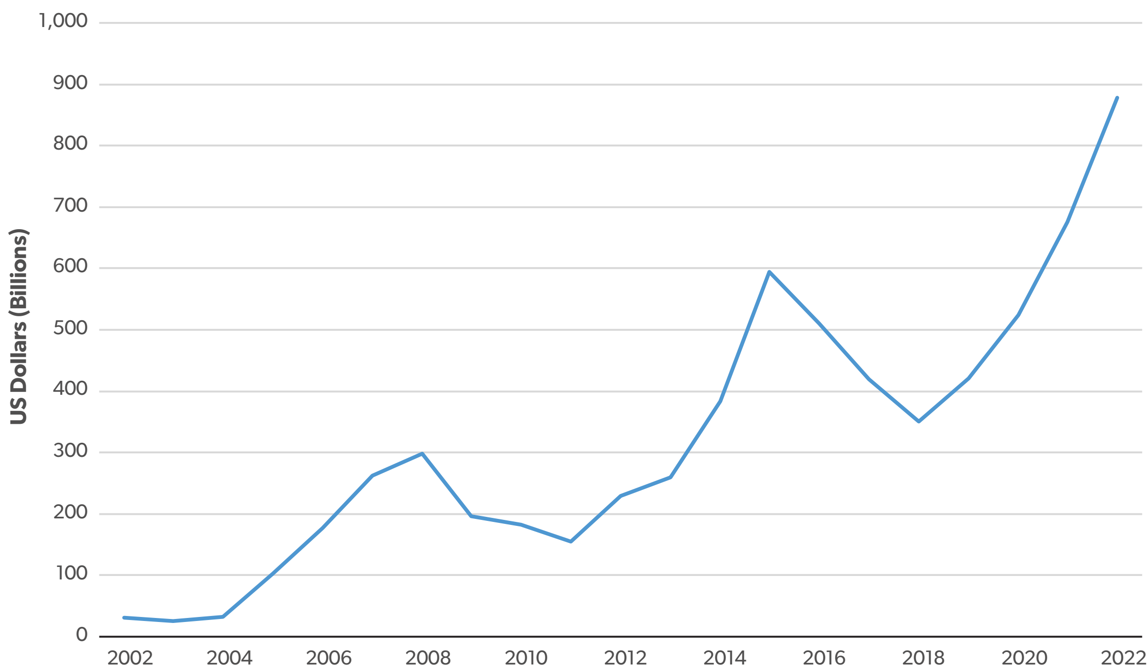
Wild Policy Reversal?

The "reform era" has seen monumental policy shifts. They altered what seemed to be established trends in 1978, 1989, 1992, 2003, and 2009. Could it happen again? Yes.

As noted, allowing full private ownership of rural land cannot cancel the effects of demography and debt, but it would make China considerably richer and larger before stagnation sets in. Giving much more rein to private-sector innovation could even fight off stagnation with higher productivity, until labor force decline becomes stark in the second half of the century.

Of course, there is little sign of either step. They would require Xi to reverse 11 years of choosing state control over growth and economic efficiency, years that have just been discovered by some proclaiming the reform era has ended. The reform era ended no later than 2009. Beijing has tried to encourage larger families and

Figure 7. China's Goods Trade Surplus



Source: Chinese National Bureau of Statistics, "Yearbook," http://www.stats.gov.cn/english/Statisticaldata/yearbook.

financial deleveraging, since these do not involve loss of state control. Deleveraging has failed to this point, with the debt burden still climbing. Nor have births increased, which in any case would not help until the 2040s.

For changing China's economic trajectory, only fundamental reform matters, and it would have to be brought back from the dead. For trying to rescue bad stock market recommendations made at the end of 2022, say, policy stimulus might be relevant. Even there, the bar is higher than many analysts seem to realize. Monetary stimulus is already occurring; the stock of outstanding bank loans is expanding much faster than nominal GDP.[29] Moreover, annual loan increments, already into the tens of trillions of yuan, dwarf proposals for several trillion yuan in rescue lending.

On the fiscal side, the main question is why Beijing would run sustained large deficits. The 2009 stimulus was touted as fiscal, but it was monetary. The central government itself has never opted to borrow on a large scale, instead using lending by state banks and investing by state corporations to expand supply. Further, the basic Keynesian story relies on consumption, which has never led the PRC's economy. It's thus unclear where large amounts of fiscal stimulus would go.

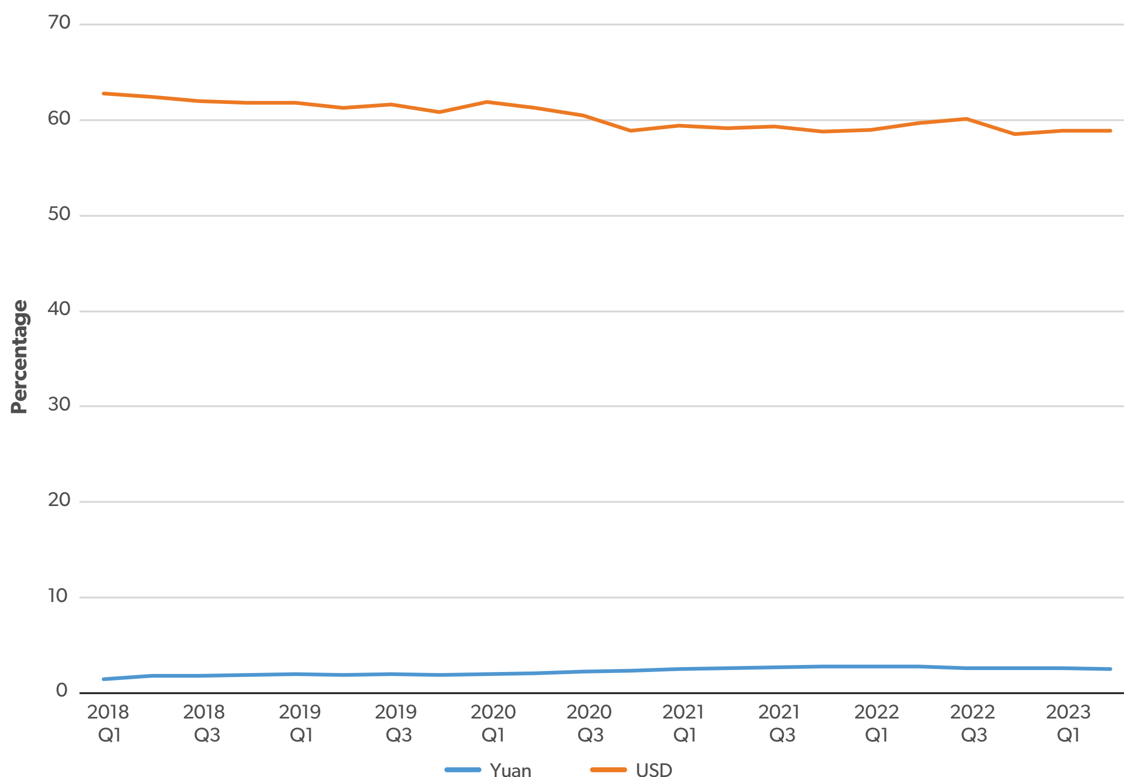
Robust individual sectors such as electric vehicles matter to firms and investors but are not enough to push forward an economy of China's size. The PRC is well down the path of stagnation, and the necessary policy turnoffs have long been ignored. In the 2030s, the economy will stop growing, and the longer term is bleaker than that.

A Few Implications

It would be helpful if latecomers to recognizing the PRC's stagnation would quickly speed past their "discovery" to its many implications. The following merely sets out an (excessively) ambitious list, and there are plenty of other important issues to consider.

Some commentators worry a slowing and eventually stopping PRC hurts the global economy. It's unclear that "global growth" is meaningful, as if all or even most participants partake in it. It is clear that the view of China as a global growth boon is misleading. The PRC raises the average of global growth; its *contribution* varies greatly by country. China in fact detracts from GDP growth in the rest of the world as a whole, through trade (Figure 7).

Figure 8. Share of Allocated Foreign Exchange Reserves (Yuan and Dollars)



Source: International Monetary Fund, "World Currency Composition of Official Foreign Exchange Reserves," 2023, https://data.imf.org/regular.aspx?key=41175.

GDP can be represented in multiple, equivalent ways. One way has trade deficits entering as a negative. China's world-beating trade surplus translates to loss of GDP for many partners. The PRC did not report services trade until recently, and even a comprehensive trade imbalance represents the maximum shift in production. Any efficiency gains at all mean the net shift to the PRC will be smaller. Still, China's goods trade surplus is so large that it almost surely signifies one or more trillion dollars lost to the rest of the world's GDP over the past decade. Whether a slow China harms other economies depends first on its trade surplus.

Second, it depends, obviously, on who you are. A slow China means less demand for commodities and fewer opportunities for some multinationals. From Saudi Arabia to Brazil, exporters of crude oil and mundane metals such as iron ore may never again have it as good as in the 2010s. Similarly, the golden age has ended and will not return for companies that did well catering to the PRC's industrial expansion. There will be plenty of time to adjust, but there may be few places to turn.

Winning countries and companies will be able to move into the industrial space China vacates. There will not be much in the next few years, but opportunities will arise. Mexico and Vietnam are popular current choices, while a young labor force and port access could eventually boost Nigeria, for example. India should not be viewed as a whole; it has too many inland states with poor infrastructure. Some Indian states could thrive, if labor force participation increases. The global corporate side is primarily about early identification of where Chinese competitiveness is slipping. Firms willing to return to sectors long dominated by China could see major rewards.

Some developments will apply more broadly. The PRC is by far the top importer of commodities and exporter of consumer goods. It has fortified commodities prices while suppressing consumer prices, and both effects will slowly unravel as growth fades further.

Another price effect will be on exchange rates. To now, the dominant factor has been Beijing's unwillingness to liberalize domestic and external finance, reducing the appeal of holding large quantities of yuan

(Figure 8). If Beijing privatized some banks and made the yuan easier to convert, it could rise in importance even as China stagnates. Otherwise, it will eventually retreat from even today's minor role.

US Policy Responses

On the economic side, American policy toward China gets either a failing grade or an "I," for "incoherent." The US still has not decided whether the PRC will be more or less dangerous as it weakens. The renowned Washington, DC, consensus on China is to speak loudly and carry a tiny stick.

During the Trump administration, American money poured into China. Of that, the Biden administration restricted a fraction so small it will not disclose the amount.[30] The top congressional initiative on technology control was ignored by Trump's Department of Commerce, then dropped by Biden's Department of Commerce.[31] The major Biden administration initiative on technology control has left gaping holes in the form of license exceptions.[32]

The first US step should be to stop aiding China with technology and money. Justified concerns about China's economic predation, internal repression, and external interference and even the possibility of war have not generated this basic response. The chief reason is lobbying by technology, finance, and other companies insisting they must retain access to commercial opportunities the PRC offers. Some opportunities are already set to vanish—see, for example, the coming displacement of foreign semiconductor sales by Chinese competitors. Others will fade as the slowdown progresses. American policymakers can show foresight by starting to reject shortsighted demands from business in favor of national interests.

A second set of responses is strategic. If there is no change in the long-term American trajectory, China cannot swamp the US economically or in any areas ultimately dependent on its stock of wealth, such as military spending and broad technological development. Xi and his subordinates appear quite aware of this. They are no longer seeking to maximize growth but instead to foment greater dependence on China and, if possible, control key sectors valued by others.[33]

The American counter to this should be partial decoupling, creating at least a handful of supply chains independent of any Chinese participation. Since partial decoupling is more aggressive than simply not aiding the PRC, it can be contingent on Beijing's behavior. If Xi's government stops engaging in widespread anticompetitive behavior, such as coercive intellectual property transfer, decoupling need not occur. If China's anticompetitive behavior continues, corporate and other arguments against partial decoupling would be confirmed as willfully blind.

Beyond interactions with the US, China's diplomacy will offer more rhetoric and fewer resources. Beijing will talk up its support of poorer countries while curbing the scope of the Belt and Road Initiative[34] and other programs. Countries possessing highly valued resources, such as Indonesia, will continue to benefit from Chinese largesse as long as they are willing to accept it.

Washington has to decide when and where a more selective Chinese approach matters. Should the US even try to court Brazil, given its metals, energy, and food exports to the PRC? If American priorities are ever set, it might help motivate more decisive steps. It's no accident that proposed and progressing efforts to move economic activity out of China feature Mexico, given bipartisan endorsement of free trade among Canada, Mexico, and the United States. The refusal, otherwise, to discuss trade beyond nonbinding principles is an increasingly painful missed opportunity.

The US should be able to ratify open-trade accords with small economies, since these will have little impact on the American economy. For larger partners, sector-specific deals can be struck. Otherwise, China's slow deterioration as an appealing commercial partner will be eclipsed by America's inability to move forward.

Just because your opponent starts stumbling does not mean you automatically win the competition. You still have to try.

About the Author

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Notes

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