

China's Economy Has Peaked. Can Beijing Redefine Its Goals?

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Executive summary

Nothing in economic development is certain, but China's economy has probably already peaked in size as a proportion of the global economy, reaching the peak in 2021. China now faces a structural economic slowdown as the financial system constrains economic growth rather than facilitating it. These economic pressures are directly linked to the end of an unprecedented credit and investment expansion during the previous decade. The resulting credit crunch has produced a collapse in property investment and slower local government infrastructure investment. Moreover, GDP growth has almost certainly been overstated in the official data both in both 2022 and 2023. The costs of years of low-return investments now prevent Beijing from redirecting the financial system, making it difficult to unleash improvements in efficiency or "new quality productive forces."

However, nothing about Beijing's behavior in response to this structural slowdown is inevitable, as China's leaders can adjust their economic objectives and potentially ease tensions with the rest of the world by publicly acknowledging a slower growth trajectory.

Introduction

The phrase "peak China" is having a moment in discussions of the global economy, even though the phrase is usually accompanied by a question mark to indicate skepticism about the premise.¹ The debate over whether China is "peaking" typically focuses on Beijing's perceived power and international influence, and whether China's nascent decline or continued ascendance will change Beijing's behavior and policymaking.² At the foundation of this discussion, however, are the fundamentals of China's economic performance and the prospects for China's future economic growth.

The decline of China's economy over the past three years, linked to the collapse of the property sector and weakness in local government infrastructure investment, has raised new questions about whether a return to the previous growth rates is possible, or whether China is facing a structural economic slowdown. The question is not only significant in foreign conversations but within China as well. In Chinese social media discussions, the phrase "garbage time of history" has begun to circulate surrounding China's current economic prospects, to the consternation of the domestic censors.³

This article makes three arguments related to this debate. First, while nothing in economic development is certain, as a proportion of the global economy, China's economy probably peaked in 2021. Second, nothing about Beijing's behavior in response to China's structural economic slowdown is inevitable. Beijing's own economic objectives and expectations about China's trajectory are the most important influences on its policymaking, and these

¹ See, for example, *The Economist*, May 13, 2023, <https://www.economist.com/weeklyedition/2023-05-13>.

² For just a few examples, Hal Brands and Michael Beckley, *Danger Zone: The Coming Conflict With China* (New York: W.W. Norton, 2022); and Evan Medeiros, "The Delusion of Peak China," *Foreign Affairs* (May/June 2024), <https://www.foreignaffairs.com/china/delusion-peak-china-united-states-evan-medeiros>.

³ Amy Hawkins, "'Garbage Time of History': Chinese State Media Pushes Back on Claims Country Has Entered a New Epoch," *The Guardian*, July 17, 2024, <https://www.theguardian.com/world/article/2024/jul/18/garbage-time-of-history-chinese-state-media-seeks-to-shut-down-claims-country-has-entered-a-new-epoch>.



goals can change. Third, if China's economic slowdown continues, Beijing can ease tensions with the rest of the world by publicly acknowledging such trends.

China's current expectations about its own economic growth—to achieve socialist modernization by 2035, a goal that is widely interpreted by Chinese officials to mean a doubling of the gross domestic product (GDP) from 2020 levels by that date⁴—are unrealistic. Beijing's tendency to engage in gradualism may prevent near-term downgrades of such economic goals. However, a China that is no longer trying to overtake the United States economically—or Chinese leaders who realize that surpassing the United States is highly improbable—can refocus its development objectives on slower but more sustainable consumption-driven growth, while reducing trade frictions with the rest of the world. China's politics currently prevent these expectations from shifting, but the Party can always redefine the country's economic goals. Similarly, Western policymakers who define the economic challenge from China as foundational—based on a flawed view of China's economic prospects—ironically limit their options in responding to Beijing's policy choices and risk overshooting with restrictions that end up blowing back on their own economies.

Peaking and proposed measurement

Peaking is a relative concept—for China to “peak,” its economy must be growing and then declining in importance and influence compared to other economies. China's *absolute* pace of real GDP growth has slowed since reaching 14 percent in 2007, but since then China has still grown faster than the rest of the world. In addressing whether or not China is peaking economically, this article argues the relevant metric should be China's importance within the global economy as a whole, not in a narrower comparison to the United States, the world's largest economy in GDP terms at \$27.3 trillion in 2023.

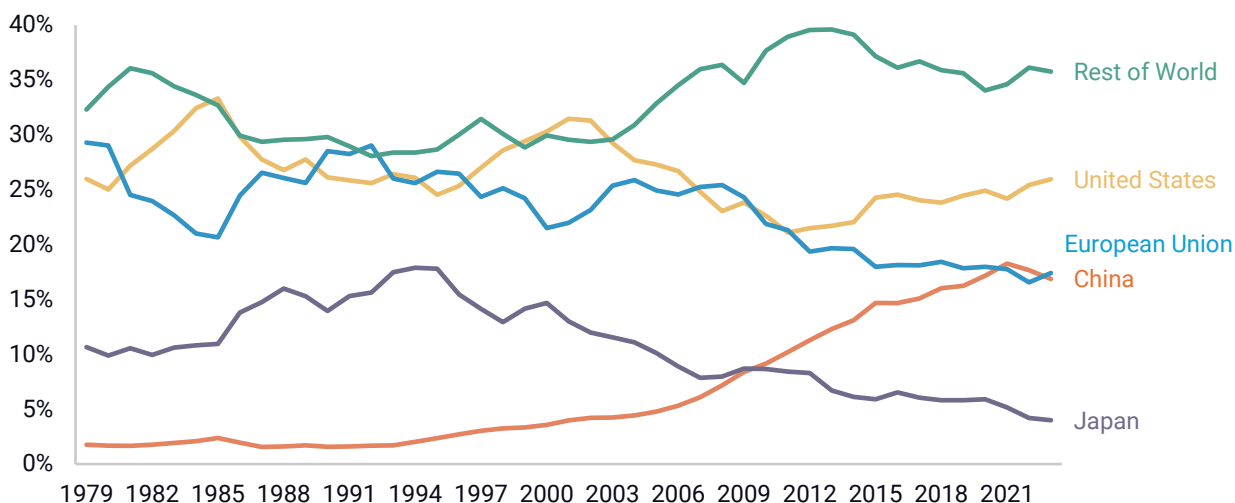
Figure 1 shows the simplest representation of trends in that metric, with China's economy rising from 3.6 percent of global GDP in 2000 to 18.3 percent in 2021, before dropping to 16.9 percent of global GDP in 2023, at \$17.8 trillion. The chart also highlights two potential future paths for China's economy: the trajectory of the US economy, which has averaged 26.2 percent of the world over the past four decades, and that of Japan, which rose from 4 percent of global GDP in 1960 to a peak of 18 percent in 1994, before dropping all the way back to 4 percent in 2023.

⁴ Xi Jinping's stated goals of doubling GDP between 2021 and 2035 were stated in the context of the announcement of the 14th Five-Year Plan, as referred to in Shunsuke Tabeta and Iori Kawate, “Xi Raises Prospect of Doubling China's GDP by 2035,” *Nikkei Asia*, November 4, 2020, <https://asia.nikkei.com/Economy/Xi-raises-prospect-of-doubling-China-s-GDP-by-2035>.

FIGURE 1

Relative shares of global GDP: China, United States, Japan, the European Union, 1979–2023

Percent



Source: World Bank

Notably, these measures are in US dollar terms. Changes in exchange rates and relative prices among economies can influence these comparisons. In addition, China's exchange rate is not an exogenous market-determined price, but instead it is actively managed by the central bank as a policy instrument. For several years after the Asian financial crisis, China's central bank intervened in order to keep the currency weaker against the dollar and other currencies, which improved China's export competitiveness. Since the start of capital outflows from China in 2015, the central bank has mostly pushed in the other direction, strengthening the exchange rate in order to prevent expectations of further currency depreciation from catalyzing outflows and placing pressures on the domestic financial system.

In the future, China's currency is likely to weaken, given the need to manage pressures from domestic debt by reducing Chinese interest rates. All else being equal, lower interest rates will contribute to capital outflows from Chinese households and corporates and will likely lead to a depreciation of the yuan. As of June 2024, China has the world's largest money supply (of domestic currency issued in RMB), measured at \$42 trillion in US dollar terms, and it continues expanding by around \$3–4 trillion in new RMB created every year, generating powerful incentives for Chinese households and corporates to diversify into foreign assets.⁵ Capital controls prevent this outflow from occurring all at once, but most people can still move their funds abroad over time, producing a gradual outflow and depreciation pressures on the currency. Thus, using market exchange rates and China's GDP in US dollar terms is more important when analyzing the question of whether China

⁵ To be clear, the domestic money supply is completely distinct from China's \$3.2 trillion in foreign exchange reserves, which are an asset of the central bank accumulated by intervening in foreign exchange markets to manage appreciation pressures on the currency.

is peaking in global economic influence, as the exchange rate itself is a measure of China's policy capacity.

Purchasing power parity (PPP) is a different type of adjustment used to compare price levels across economies in order to assess an economy's size. Using most PPP-related measurements, China has already overtaken the US economy in GDP terms. In determining China's growing global economic influence, however, PPP adjustments are less useful, for the following reasons:

- PPP adjustments are generally used to compare emerging economies with developed economies, rather than to assess which major economy is rising or falling in global influence.
- PPP adjustments are difficult to measure over time, as they require constant updates to various prices to determine the relevant conversion factors for cross-country comparisons.
- Analyses of cross-border financial flows or trade flows, where exchange rates are important prices, are less suited to PPP-based comparisons.⁶

Even if China's currency has greater purchasing power because some goods are cheaper in China's economy than they are in the United States, for example, justifying an adjustment in the size of China's economy in PPP terms, China's market for those products would not be attractive to US investors, who would measure their returns in US dollars. Similarly, China's influence in global markets for commodities or consumer goods would be measured in terms of Chinese firms' purchasing power relative to that of other customers, measured in the same terms, usually in US dollars.

The case that China's economy has peaked

The case that China's economy has peaked as a share of the global economy rests upon two arguments. First, the decline in China's economic growth is structural in nature rather than cyclical. Second, while Beijing has some capacity to improve the country's long-term economic trajectory through policy changes, political and financial constraints prevent Beijing from pursuing these necessary reforms.

In discussing long-term growth in any economy, it is important to distinguish between *potential growth* and *expenditure-side GDP components*. Potential growth represents the "speed limit" for a country's possible economic growth independent of the short-term fluctuations in the business cycle. Therefore, if an economy is growing below potential, counter-cyclical stimulus measures are a logical response. The drivers of potential growth are related to the inputs into the economy—the labor force and gross capital formation—as well as the total factor productivity (TFP) of those inputs (or the potential productivity growth of those inputs). There are several estimates of China's long-term growth potential in the literature, generally ranging from around 2 to 5 percent. Many of these estimates are based on the theory that China's growth will converge toward global growth rates as

⁶ Tim Callen, "PPP Versus the Market: Which Weight Matters?" *Finance and Development*, 44 (March 2007), <https://www.imf.org/external/pubs/ft/fandd/2007/03/basics.htm>.

the economy develops, while others focus on the determinants of TFP growth over time, including research and development, governance, and innovation.⁷

This article, however, will primarily discuss the expenditure-side components of GDP growth rather than potential growth. One of the primary arguments made here is that for most of this decade, China will actually grow at rates *below potential* because of the necessary adjustments to the financial system after an unprecedented credit expansion. Therefore, over the next decade, it is more important to consider the ultimate sources of economic growth: household consumption, investment, government spending, and net exports. These are the components of GDP using an expenditure-side accounting, as the sum of all of these levels of spending patterns is equivalent to the total size of an economy.⁸

The headwinds confronting China's economy are legion, and the arguments for a structural slowdown in China have been litigated thoroughly during the past few years. Demographic pressures are obvious, as China's total population began declining in 2022 and the working-age population has been declining since 2013.⁹ There are no available examples of any other economy with a declining working-age population growing at faster than 3 percent over any five-year period once the labor force had declined (in part because countries with declining working-age populations are rare). The external economic environment for China is now far less accommodative than it was in the past, with multinational businesses actively de-risking and reducing their reliance upon China within global manufacturing supply chains and as a driver of consumer demand.¹⁰ Furthermore, China's new development strategy requires expanding overseas market share in critical industries, which is already generating additional tensions with its trading partners.

However, the primary reason that China's economic slowdown is structural in nature is one that Beijing acknowledges: the credit and investment-led growth model has reached a dead end. The case that China's economy faces a long-term slowdown led by investment activity can be simply stated as four propositions:

1. China was an investment-led economy during the past two decades, with a higher rate of investment growth than any other peer country in recent history (gross fixed capital formation was still officially 42 percent of GDP in 2023).

⁷ See, for example, Roland Rajah and Alyssa Leng, "Revising Down the Rise of China," Lowy Institute, March 2022, <https://www.lowyinstitute.org/sites/default/files/RAJAH%20LENG%2C%20Revising%20Down%20Rise%20of%20China%2C%20PDF%20v3.pdf>; Alicia Garcia-Herrero, "Can Chinese Growth Defy Gravity?" Bruegel Institute, Policy Brief, June 20, 2023, <https://www.bruegel.org/policy-brief/can-chinese-growth-defy-gravity>; Bai Chong-en and Zhang Qiong, *A Research on China's Economic Growth Potential* (London: Routledge, 2020).

⁸ This is in contrast to how China usually reports GDP on a quarterly basis, using the production-side approach in which the value-added of the primary, secondary, and tertiary sectors are calculated. China usually releases expenditure-side GDP component data only on an annual basis and with a considerable delay.

⁹ "China's Working Population Fell Again in 2013," *Wall Street Journal*, January 20, 2014, <https://www.wsj.com/articles/BL-CJB-20448>; and Farah Master, "China's Population Drops for Second Year, with Record Low Birth Rate," Reuters, January 17, 2024, <https://www.reuters.com/world/china/chinas-population-drops-2nd-year-raises-long-term-growth-concerns-2024-01-17/>.

¹⁰ Agatha Kratz et al, Rhodium Group, "China Diversification Framework Report," June 2024, <https://www.businessroundtable.org/china-diversification-framework-report>.

2. The primary drivers of the investment growth during the past two decades were property construction and infrastructure investment. Both depended heavily upon steady flows of credit from the financial system.
3. Both property and local government infrastructure investment have now declined sharply and will not recover to their previous levels, as China's financial system cannot continue financing investment at the same rate as it did in the past.
4. Nothing else has replaced these sectors as meaningful drivers of growth, nor is there anything likely to do so given the constraints of China's financial system.

The last point is the most controversial, of course, and will be discussed later in this article. Both advanced manufacturing-led growth and consumption-led growth face meaningful constraints and are unlikely to generate the same pace of economic growth as China has seen in the past decade. Property construction represented around 23–27 percent of GDP from 2011 to 2021, and local government infrastructure investment was around 14 percent of GDP in 2021, including the upstream and downstream effects of these industries.¹¹

The financial system now constrains China's growth

It is impossible to separate the rapid growth of China's economy since the global financial crisis in 2008 with the astronomical growth of China's financial system. China saw the largest single-country credit expansion in over a century, adding \$24 trillion in *new* assets over the eight years from 2008 to 2016, around one-third of *global* GDP.¹² Banking system assets now total \$59 trillion as of June 2024, over three times the size of China's economy and around 56 percent of global GDP.¹³ In comparison, China's real GDP grew by \$6.1 trillion between 2008 and 2016, and a further \$7.1 trillion between 2016 and 2023. China has by far the largest single-country banking system in the world in terms of assets. US banks hold around \$23.4 trillion in assets,¹⁴ but the US has a far more diversified financial system than China. That volume of lending by Chinese banks was extended primarily on the basis of government guarantees rather than the potential financial returns of the underlying investments. As a result, this credit explosion generated significant numbers of loans that may have been made to "safe" state-owned companies, but they constantly require loan rollovers and extensions. **A financial system this large and this impaired can no longer generate the same pace of credit and investment growth as it did in the past.**

¹¹ These calculations replicate work done in Kenneth Rogoff and Yuanchen Yang, "Peak China Housing," National Bureau of Economic Research, Working Paper No. 27697, August 2020. Rogoff and Yang's approach is to calculate the total economic footprint of the property sector using the coefficients in the official input-output tables, yielding an estimate of 29 percent of GDP in 2016. Data for that year have since been revised, and the 23–27 percent figure used above reflects the range of outcomes from the same calculations in the years from 2011 to 2021, before a sharper slowdown in 2022. For infrastructure investment, the same approach is used, but the National Bureau of Statistics stopped providing the level of infrastructure investment in nominal terms in 2017. To calculate the impact on the economy, the nominal annual growth rates in infrastructure fixed asset investment were added to the 2017 full-year totals and extended through 2021.

¹² Calculated using data from the People's Bank of China, "Balance Sheet of Other Depository Corporations," multiple years.

¹³ Global GDP data sourced from the World Bank.

¹⁴ Data from "Assets and Liabilities of Commercial Banks in the United States," July 2024, Federal Reserve, <https://www.federalreserve.gov/RELEASES/h8/current/>.



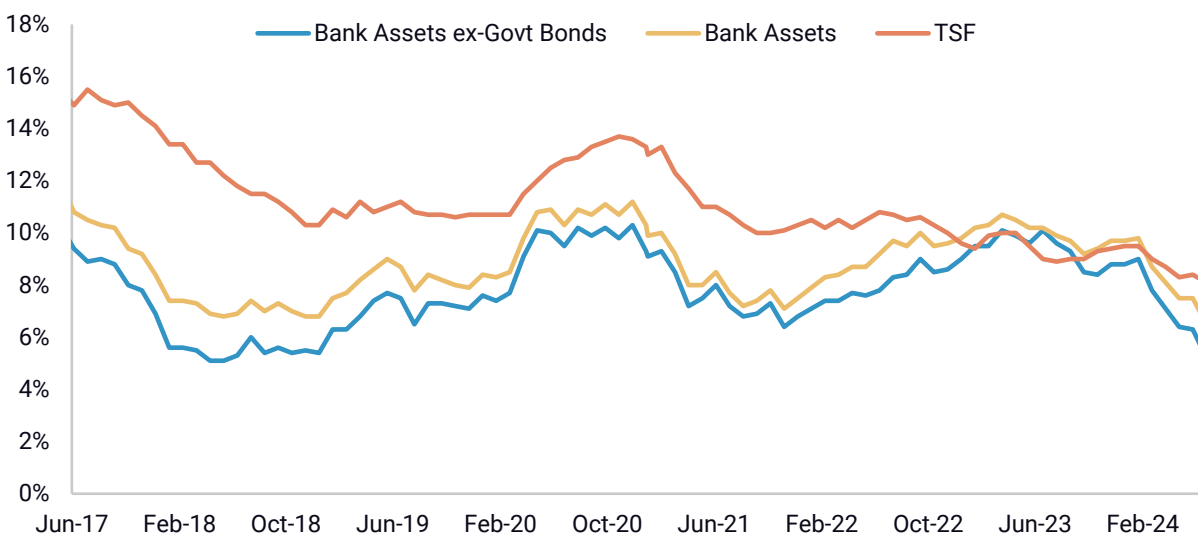
Banks are constrained in terms of their capital levels, which depend upon continued profits, and this impacts asset growth. Bank profit margins and credit growth in China have already slowed significantly. China's overall credit growth averaged 18 percent from 2007 to 2016. Its slowdown in credit growth began in earnest with the deleveraging campaign from 2016 to 2018, and since then credit growth has averaged just over 9 percent. Banks' average net interest margins on lending have fallen from 2.77 percent in 2012 to 1.54 percent in the first quarter of 2024, according to data from China's banking regulator.

During the past three years, the effects of cutting credit growth in half have materialized in the form of a collapse in property investment, a slowdown in local government investment, and rising local government fiscal pressures. Currently, as of June 2024, the pace of credit growth measured via total societal financing (TSF) is only 8.1 percent, total bank asset growth is only 6.5 percent, monetary growth (M2) is 6.2 percent, and bank assets, excluding government bond purchases, are rising by only 5.2 percent. All of these figures are at or approaching all-time lows (see Figure 2).

FIGURE 2

Measures of aggregate credit growth, June 2017–June 2024

Percent, year-on-year



Source: People's Bank of China

Looking ahead, it is impossible to think about the long-term growth of China's economy without thinking about the long-term development and growth rates of China's financial system. A financial system can only grow at rates widely disconnected from the real economy it is financing if it is "deepening" or expanding access to financial services, or if new credit risks are being generated—usually these two developments go hand in hand. When the inevitable correction in credit occurs, bad loans are written off, lending standards are tightened, asset prices fall, and defaults and bankruptcies emerge. Then the financial system's growth will slow relative to the real economy. This process is already underway in China. **Beijing is resisting these developments, as they are politically and economically painful. But just because the Chinese authorities are resisting this slowdown, they still cannot maintain the same pace of credit growth as they did in the**

past. The slowdown in investment growth is linked to the slowdown in credit, and in an economy where gross fixed capital formation still represents 42 percent of GDP, weakening investment growth has a significant impact on the country's overall long-term economic growth.

The challenges of redirecting the financial system

The most conventional answer to this argument is that China can offset the decline in overall investment growth by accelerating productivity growth and lending to more efficient sectors of the economy rather than legacy industries. Discussions of the “new quality productive forces” in China's economy acknowledge the need for faster productivity growth in dealing with limited resources.¹⁵ China's TFP growth over the past decade is the subject of extensive academic debates, but most analysts place it close to the International Monetary Fund's estimated level of 0.7 percent, which the Fund expects to continue to decline.¹⁶

State-directed financial systems do not change patterns of credit allocation on a dime. As overall credit growth slows, directing credit to more productive sectors requires cutting off state-owned borrowers who had previously relied upon the banking system to continue operating. Local governments that had been financing quasi-fiscal infrastructure investments via these loans will not see overall construction and investment activity remain at the same level if the loans are suspended. Under these circumstances, investment will collapse. As a result, to the extent possible localities still use their own city and rural commercial banks to keep credit flowing to the same projects and companies as in the past to prevent defaults, bankruptcies, unemployment, and slowing economic growth.

China's financial system is extremely large, but it is also generally unprofitable, thus creating problems for cleaning up the banks and redirecting credit flows toward more productive uses. Total profits of the banking system were 2.4 trillion yuan in 2023 according to National Financial Regulatory Administration data (China's banking regulator) on an asset base of 417.3 trillion yuan for a total return on assets of only 0.57 percent.¹⁷ Every year, China's leadership calls upon banks to lend to state-owned enterprises and local governments in order to support investment growth and the overall economy. Banks must maintain a certain level of equity capital relative to their assets, measured via capital adequacy ratios (CARs). Maintaining rapid credit growth therefore requires that banks add large volumes of new capital every year, usually around 2 to 3 trillion yuan,¹⁸ and in a

¹⁵ See, for example, Arthur Kroeber, “Unleashing ‘New Quality Productive Forces’: China's Strategy for Technology-led Growth,” Brookings Institution, June 4, 2024, <https://www.brookings.edu/articles/unleashing-new-quality-productive-forces-chinas-strategy-for-technology-led-growth/>.

¹⁶ “People's Republic of China: 2021 Article IV Consultation,” International Monetary Fund, January 28, 2022, pp. 13–14. <https://www.imf.org/en/Publications/CR/Issues/2022/01/26/Peoples-Republic-of-China-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-512248>.

¹⁷ “Supervisory Statistics of the Banking and Insurance Sectors-2023 Q4,” National Financial Regulatory Administration, <https://www.cbirc.gov.cn/en/view/pages/ItemDetail.html?docId=1153099&itemId=983>.

¹⁸ Estimated based on recent years of annual growth of bank assets and an assumed 10 percent capital adequacy ratio.

banking system as large as China's the profits of the banking system are one of the most important sources of new capital to keep the banks and the entire economy growing.

Changing patterns of lending requires cutting off former borrowers and therefore declaring losses on bad loans. This process reduces overall bank profitability and the prospects for future bank asset and credit growth. Concerted attempts to clean up the banking system, remove old sources of bad debt, and change patterns of lending require large-scale recapitalization from central government funds. **Until this recapitalization of the banking system occurs—and there are no signs of it on the horizon—Beijing has little chance of unleashing “new quality productive forces” within the economy.**

Local government borrowing still represents around one-third of the total activity and assets of the banking system.¹⁹ There are few signs that the financial system has shifted its lending patterns. This is primarily because of authorities' fear of the political consequences of doing so, in the form of defaults, bankruptcies, and unemployment. A detailed examination of all local government special revenue bond (SRB) prospectus documents in eight provinces in 2021 and 2022, representing 38 percent of the total SRBs issued in those years, reveals that only 3 percent of the proceeds were channeled to China's “new infrastructure” priorities, such as data centers, green technologies, and artificial intelligence (AI).²⁰ Property-related projects absorbed around five times the volume of local investment relative to Beijing's stated industrial policy priorities, even when Beijing was de-emphasizing support for the property sector.²¹ The point here is not to downplay Beijing's industrial policy ambitions and their potential consequences but to highlight that the financial system is a highly constrained policy instrument in responding to political directions to change lending patterns.

The net result is that the financial system has become less efficient in generating growth over time as more of the declining flow of new credit is channeled into less productive uses. Local governments are approaching the point of default in order to repay the banks so that the banks can continue to lend to local governments and their infrastructure investments can continue, even if the pace of such investments slows as a result of this round-tripping. China cannot “extend and pretend” with bad loans while maintaining the same pace of economic growth because the process of pretending prevents the extending. Failure to recognize bad loans requires more new credit to service old debt, therefore reducing the banks' capacity to fund new investments.

Local governments are now facing the consequences of years of excessive borrowing and high interest payments, with local government financing vehicles (LGFVs) often paying commercial interest rates (averaging 5.4 percent according to our surveys of LGFV financial reports) to complete public works projects that usually provide returns averaging just over 1 percent.²² Beijing's proposed solution, under the frequently reported but still unpublished Circular No. 35 from September 2023, is to force local banks to absorb the

¹⁹ This is based on a rough estimate of LGFV debt reflecting around 100 percent of GDP, as documented in Allen Feng and Logan Wright, “Tapped Out,” Rhodium Group, June 1, 2023, <https://rhg.com/research/tapped-out/>.

²⁰ Endeavour Tian and Logan Wright, “Tracking China's ‘New Infrastructure’ Investment,” China Markets Research, Rhodium Group, September 28, 2023.

²¹ Ibid.

²² Feng and Wright, “Tapped Out.”

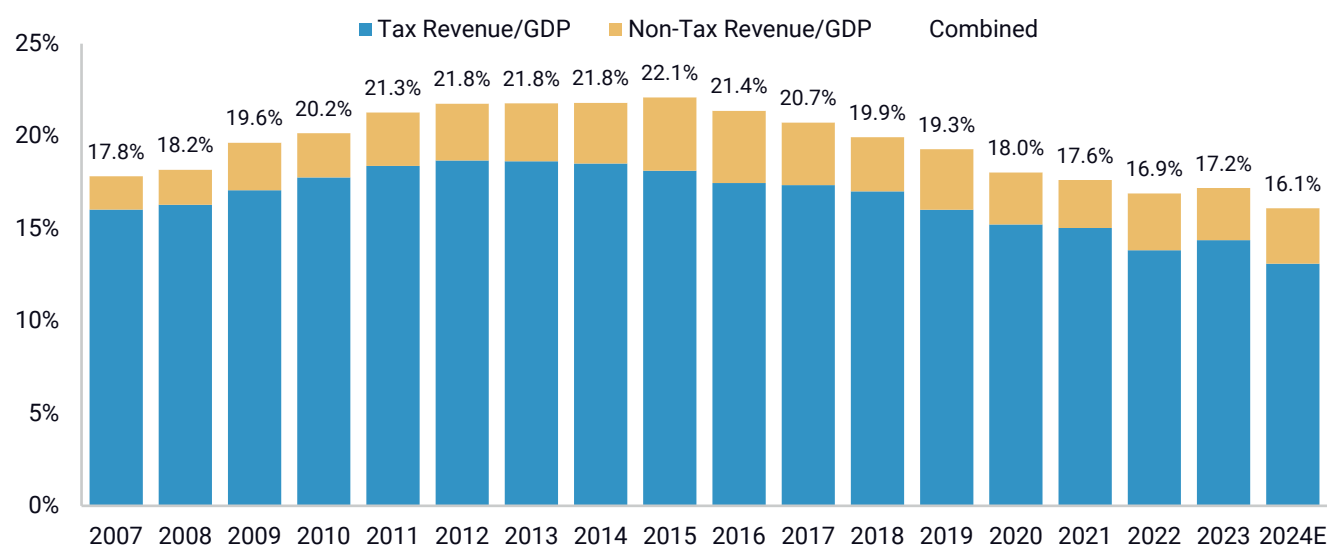
costs of restructuring local government debt.²³ But without an explicit recapitalization, this will simply produce problems on both sides: local banks will be unprofitable and unable to lend, while localities will still struggle to maintain investment growth.

China's fiscal constraints require a far more extensive discussion, but they are also directly linked to the slowdown in investment-led growth and credit growth. China does not collect a large volume of taxes on consumption or household income, choosing instead to tax production, business profits, and trade. The largest drivers of tax revenue are value-added taxes (where revenue-sharing formulas encourage localities to boost output within their jurisdictions) and enterprise income taxes. The recent slowdown in investment-led growth has also depleted China's tax base. Tax and non-tax revenues have fallen from 22.1 percent of GDP in 2015 to just over 16 percent so far this year (see Figure 3). As the property sector has caused land sales revenue to decline, local governments also cannot maintain the same pace of spending growth. This not only prevents the use of fiscal policy as a tool to stimulate the economy but also reduces Beijing's capacity to use the declining fiscal resources to restructure the financial system. The net result is maintaining the existing patterns of lending in place rather than redirecting credit to industries associated with "new quality productive forces."

FIGURE 3

China tax and non-tax revenue as a proportion of GDP, 2007–2024 (Est.)

Percent



Source: Ministry of Finance; 2024 estimates assume the current year-to-date trends will continue for the full year.

These problems within the financial and fiscal systems cannot be wished away or resolved easily. They are intrinsically linked with the end of years of rapid investment-led growth in China. The property sector benefited the most from China's unprecedented credit expansion, and it has now collapsed, with annualized new starts down 64 percent from

²³ The existence of Circular No. 35 has been reported in the domestic media, including Cheng Siwei, Ding Feng, and Zhang Yuzhe, "一揽子化债进行时" (Time for Implementation of a Basket of Debt Measures), *Caixin*, October 23, 2023, <https://weekly.caixin.com/2023-10-21/102119033.html>.

their peak in 2021.²⁴ Local government investment is also slowing and will continue to do so. Moreover, as will be discussed below, Beijing cannot grow out of these problems, as it did in the early 2000s, because a structural slowdown in investment is usually deflationary, and stronger *nominal* GDP growth is necessary to reduce debt burdens over time.

There are potential future drivers for China's economic growth, but, by necessity, they must be far less credit-intensive than the model China has used during the past two decades. **The financial system itself is now constraining China's economic growth rather than facilitating it.** In addition to demographics and the changing external environment, financial constraints are the primary reason why China's economic slowdown is structural in nature and why China's economy is likely to grow at rates below potential over the next decade.

Measurement problems: China's GDP growth has been overstated

In assessing whether China's economy has peaked relative to that of the rest of the world, the most common measure for cross-country comparisons is GDP. There have been extensive academic discussions on the problems of GDP measurement in general, and in China in particular.²⁵ China's leadership clearly views the country's economic performance measured through GDP growth as a source of political legitimacy, helping to reinforce internal and external perceptions of China's inexorable rise. That fact alone has raised questions about the reliability of the series. Questions about GDP data have circulated for decades, ever since Thomas Rawski's investigation of the relationship between electricity output and GDP growth during the Asian financial crisis.²⁶ More recent arguments have focused on the disconnect between local government data and national GDP.²⁷ However, concerns about the accuracy of China's GDP data have grown over time rather than dissipating.²⁸

The credible lines of criticism of China's GDP data over the past decade are that the officially published rates of growth are far too stable to be accurate from 2014 to 2019 and far too high to be plausible in 2022 and 2023. (In 2020 and 2021, there was clearly a sharp slowdown resulting from the COVID pandemic and a subsequent recovery. These growth rates may also be distorted, but the trend is at least plausible.) From 2014 to 2019, a period of six years, China's quarterly year-on-year GDP growth rates never varied outside of a range of 5.8 percent to 7.6 percent. This apparent stability in headline growth occurred despite a sharp slowdown in property construction in 2014 that required interest rate cuts in 2014 and 2015, acute capital outflows in 2015 and 2016, a recovery in 2016 and 2017 that involved higher market interest rates, a sharp decline in credit growth and industrial output in late 2018 and a return to interest rate cuts, and a modest

²⁴ Annualized starts in residential property from the National Bureau of Statistics, reported via CEIC.

²⁵ Daniel Rosen and Beibei Bao, *Broken Abacus? A More Accurate Gauge of China's Economy* (Washington: CSIS, 2015), and Carsten Holz, "The Quality of China's GDP Statistics," *China Economic Review* 30 (2014), pp. 309-338; Logan Wright and Daniel Rosen, "China's GDP: The Costs of Omerta," Rhodium Group, August 2019, <https://rhg.com/research/chinas-gdp-the-costs-of-omerta/>.

²⁶ Thomas Rawski, "What is Happening to China's GDP Statistics?" *China Economic Review* 12 (2001), pp. 347-354.

²⁷ Wei Chen et al., "A Forensic Examination of China's National Accounts," Brookings Papers on Economic Activity, Spring 2019, https://www.brookings.edu/wp-content/uploads/2019/03/ChenEtAL_web.pdf.

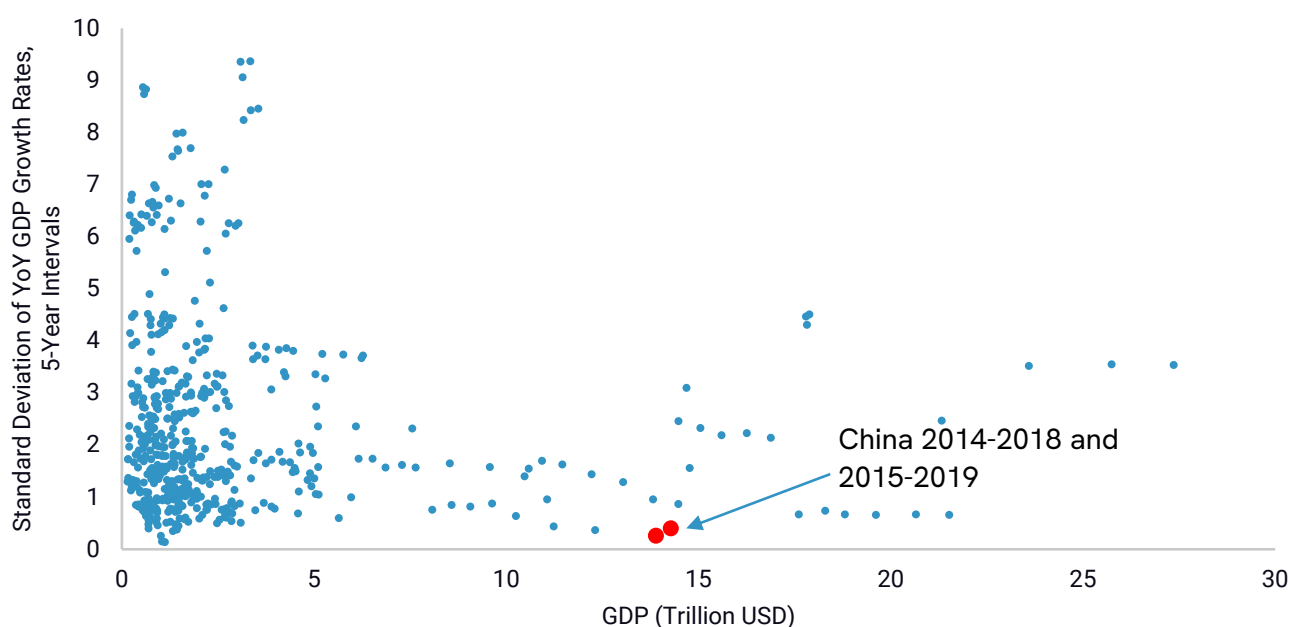
²⁸ Greg Ip, "Why You Shouldn't Trust China's Growth Data," *Wall Street Journal*, March 6, 2024, <https://www.wsj.com/world/china/why-you-shouldnt-trust-chinese-growth-data-c65d1a8c>.

recovery in 2019. In Figure 4, we take the top twenty economies in the world using data since 1990, with the standard deviation of every available five-year range of quarterly GDP growth rates in percentage points representing one dot on the y axis and GDP in US dollar terms on the x axis. Either one must believe that Beijing perfected management of an economy by completely smoothing two business cycles over this timeframe or that China's reported growth rates from 2014 to 2019 are distinct outliers, revealing some of the lowest levels of volatility in any five-year period for any major economy.

FIGURE 4

Volatility of reported GDP growth, compared to the size of the economy in GDP, world's 20 largest economies, 1990–2023

Standard deviation in percentage points, trillion USD



Source: Bloomberg, World Bank. *One data point is recorded per year, although the measures of volatility involve ranges of five years of quarterly year-on-year growth rates.

More recently, the problems in the 2022 and 2023 GDP growth rates are far more severe, overstating growth rather than smoothing it. Officially, China reported 3.0 percent real GDP growth in 2022, despite the fact that significant proportions of the economy were under strict lockdowns to prevent the spread of COVID-19 during large portions of the year, retail sales fell outright, and investment in the property sector was collapsing. In 2023, the decline in property investment continued, net exports and government spending were drags on growth, and household consumption growth remained relatively low. Beijing provided little direct assistance to households to facilitate spending, and Chinese households added to savings and paid down mortgage debt instead of spending more. Yet China officially reported 5.2 percent real GDP growth in 2023, barely slowing from the pre-pandemic pace of 6 percent in 2019, even though the property sector was experiencing a boom in 2019 and was collapsing in 2023.

Table 1 outlines our estimates of the actual growth rates of the expenditure-side components of GDP growth in 2022 and 2023: consumption, investment, government spending, and net exports. We estimate that real GDP growth was closer to a contraction of -0.3 percent to -0.8 percent in 2022, and there was only modest growth of 1.5 percent to 2 percent in 2023.

TABLE 1

Contributions of expenditure-side components to real GDP growth, official data and Rhodium estimates, 2022 and 2023

	2017-2021 Official	2022 Official	2022 Rhodium	2023 Official	2023 Rhodium
Real GDP (%)	6.0%	3.0%	-0.3 to -0.8%	5.2%	1.5 to 2.0%
Consumption (pp)	2.4	0.4	-0.5	4.3*	2.0 to 2.5
Investment (pp)	2.1	1.5	-0.5 to -1.0	1.5	-0.5 to 0.0
Government (pp)	1.0	0.6	0.2	n/a	0
Net Exports (pp)	0.6	0.5	0.5	-0.6	-0.6

*The official distribution of household and government consumption has not yet been released; their combined contribution to GDP growth was 4.3 percentage points.

Table 2 outlines the multiple alternative indicators that inform our assessment of the pace of consumption and investment growth in 2022 and 2023. There is no significant divergence in our estimates of net exports from the official data. Our calculations of government consumption and spending, while not significantly different from the official levels, are based on the actual levels of fiscal spending as reported by the Ministry of Finance, based on the central government budget and local government fund budgets.

TABLE 2

Discrepancies between official consumption and investment growth rates and alternative indicators, 2022 and 2023

Year and Expenditure Component	Rhodium estimates	Discrepancies between official and alternative data
2022 Consumption (Official contribution to GDP growth 0.4 pp, nominal expenditure component growth rate of 2.8 percent)	-0.5 pp/-2 percent	<ul style="list-style-type: none"> Official retail sales growth declined by 0.2 percent. China's official household survey data showed that real per capita consumption growth declined by 0.2 percent, and by 1.7 percent in the urban areas. Widespread lockdowns in China and restrictions on employment and income prevented millions of people from spending money, while there were no direct government transfers to boost incomes. Alibaba's total online Taobao and Tmall sales, reflecting around 17 percent of the volume of total retail sales, declined by 6.5 percent. Household deposits in the banking system rose by 17.8 trillion yuan, or 17 percent in stock terms and 15 percent of GDP. Consumer confidence and intentions to consume, as indicated within PBOC consumer surveys, fell to all-time lows, and intentions to save rose to all-time highs.
2022 Investment (Official 1.5 pp/4.8 percent)	-0.5 to -1 pp/ -1 percent to -3 percent	<ul style="list-style-type: none"> New housing construction fell by 39.8 percent, by far the largest drop in history. Cement output declined by 10.8 percent. Refinery runs for petroleum products fell by 3.4 percent. Steel output declined by 2.1 percent. Full-year sales revenues for property developers declined by 28 percent, or 4.6 trillion yuan, around 4 percent of GDP. This is the primary source of funding for property construction. Land sales declined by 53.4 percent. Komatsu construction equipment average working hours fell by 14 percent. Unsaturated polyester resin (UPR) capacity utilization rates fell by 38 percent. UPR is a key construction component for pipes and roofing as well as for manufacturing. Asphalt capacity utilization rates declined by 22 percent. At some points during the Shanghai lockdown from March to early May, overall national freight volume declined by 40–50 percent, based on Baidu mobility indices.
2023 Consumption (Official 4.3 pp*/9.5 percent%)	2.0 pp/+5 to 6 percent	<ul style="list-style-type: none"> Retail sales growth was only 7.2 percent in 2023 despite being flattened by unorthodox adjustments to 2022 growth

		<p>rates. Actual retail sales growth was likely closer to 5 percent.</p> <ul style="list-style-type: none"> Households continued deleveraging, adding 16.6 trillion yuan in deposits (13 percent of GDP) and reducing mortgage debt by 630 billion yuan. Per capita income growth was only 6.3 percent, and there are no indications that households were spending down their savings. Individual income tax revenues collected by the Ministry of Finance declined by 1 percent for the full year. Domestic consumption tax revenues fell by 3.5 percent for the full year. Domestic consumption taxes cover a small range of goods, but they usually track overall consumption trends. The government budget in 2023 included a target of 6.8 percent nominal GDP growth based on fiscal deficit targets, but actual nominal GDP growth was only 4.6 percent, even though real GDP growth supposedly met its targets. Consumer confidence indices remained extremely weak throughout the year. Consumer prices remained below zero most of the year, rising only 0.2 percent for the full year. Alibaba online sales via Taobao and Tmall continued declining by 5.4 percent. 9.5 percent would be the fastest annual rate of household consumption growth since 2011, and no indicators outside of catering point to double-digit consumption growth in 2023. Even official consumption growth at this rate should have only produced 3.7 percentage points of GDP growth, not 4.3 percentage points.
2023 Investment (Official 1.5 pp/2.0 percent)	-0.5 to 0.0 pp/ -1 percent to 0.0	<ul style="list-style-type: none"> Property construction continued to decline, with new starts down 20.4 percent. Producer prices fell by 3.0 percent, contrary to expectations of a strong recovery contributing to inflationary pressures. Cement production continued to decline by 0.7 percent. Retail sales of decorations and construction materials (categories related to housing) fell by 7.8 percent. Komatsu construction equipment working hours declined by 2 percent. Official measures of private fixed asset investment fell by 0.4 percent. Credit growth measured via PBOC total societal financing (TSF) hit an all-time low of 9.5 percent for the year, implying slower investment.

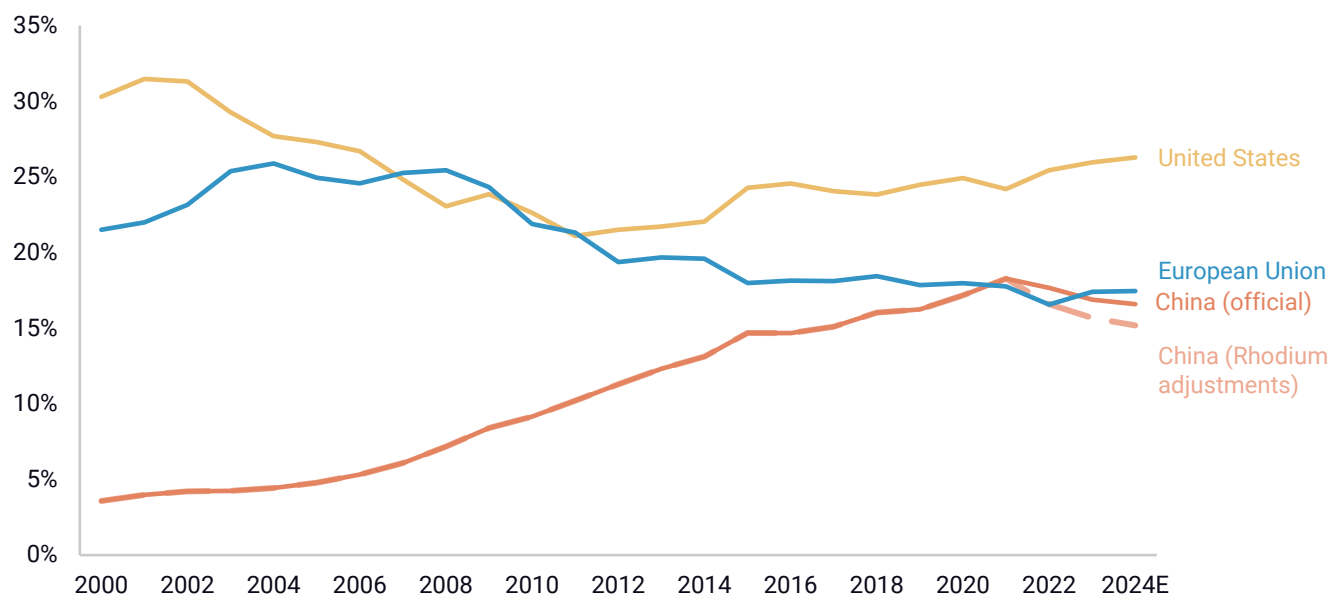
*Percentage points refers to the contribution in growth rates (1 percentage point of 3 percent GDP growth). Percent refers to the annual or y/y changes in levels of the data provided.

The divergence between real and nominal GDP growth, or the GDP deflator, was 1.8 percentage points in 2022 and -0.5 percentage points in 2023. If we leave those GDP deflators unchanged, based on our estimates of the actual pace of China's economic growth, the extent of the probable overstatements of China's GDP in 2022 and 2023 alone is sufficient to reduce the estimated size of China's economy by around \$1.1 to \$1.2 trillion, meaning the actual size of China's economy in 2023 was around \$16.6 to \$16.7 trillion, or close to 15.9 percent of the global economy (Figure 5), and declining further in 2024.

FIGURE 5

Relative shares of global GDP after implied adjustments in 2022 and 2023 Chinese growth rates, 2000–2024 (estimated)

Percent



Source: World Bank. Simple 2024 estimates were made using IMF forecasts for global growth (3.2 percent), and current year-to-date nominal growth rates for growth in the European Union (3.5 percent), China (4 percent official rate and 2.5 percent for Rhodium adjustments), and the United States (5.2 percent).

If our estimates are reasonably accurate, it is extremely unlikely that China will regain its previous peak as a proportion of the global economy. Global growth has generally averaged around 5.1 percent in nominal terms over the past thirty years—of course, that includes significant contributions from China as well. Assuming global growth only averages 4 percent in nominal terms in the future, China will need to average around 5.5 percent nominal GDP growth—faster than its rates during the past three years—and will not resume its 2021 level of global GDP until 2036. Even assuming the unadjusted NBS-published growth rates, China will not retake its 2021 levels until 2030. This assumes there

is also no further depreciation in China's exchange rate relative to the US dollar, which is improbable.

Ultimately, Beijing needs nominal GDP growth to a greater extent than it needs real GDP growth for the sustainability of its financial system, beyond narrower comparisons to the global economy. Nominal growth generates corporate profits, household incomes, consumer spending, creates incentives to invest, and pays down debt over time. But declining savings and investment rates, and persistent deflationary pressures from continued supply-side support and credit to producers remain a threat to financial stability in China by exacerbating debt problems and also placing pressures on nominal growth rates.

These are merely our estimates of the likely divergence between China's economic performance and the official data from the National Bureau of Statistics, but they are likely conservative in the scope of their adjustments. In the face of multiple alternative indicators, particularly those linked to activity within the property sector, it is difficult to take China's headline GDP growth rates at face value, particularly for the past two years. The collapse in property investment—a sector that represented around 23–27 percent of China's economy for most of the last decade—had a far larger impact on the economy than that indicated via the official growth rates, and nothing else has emerged to offset that impact.

Alternative growth models and their limitations

Beijing has long been aware that the credit and investment-led growth model would end at some point. The authorities have taken active steps to limit the growth of the property sector for years, and, starting early in his third term Xi Jinping promoted the concept of “common prosperity” as a goal for China's economic development, implying a clear shift from the existing patterns of growth. The problem for Beijing is that alternative growth drivers imply much slower economic growth in the future, even if they are more sustainable than merely continuing to accumulate debt.

Advanced manufacturing-led growth

Beijing has offered two paths as potential answers to China's ongoing slowdown. The approach generating the most attention is a renewed emphasis on industrial investment in the advanced manufacturing industries, particularly the so-called “new three” of electric vehicles, solar cells, and lithium-ion batteries. This is sometimes framed alongside China's concept of “dual circulation” and its push for greater self-sufficiency, insulating the economy from Western sanctions and export controls on key technologies. In this vision, China will develop a range of highly competitive exporters, similar to Germany's *Mittelstand* industries, and will continue to expand its global export market share. Investment in these industries will generate the necessary productivity growth to power the entire economy forward at 4–5 percent rates.

The primary problem with this strategy is simply mathematical: none of these industries alone, or in combination, are likely to offset the impact of the declining property or infrastructure construction, which, at their peak, together represented around 40 percent of China's economy. China already has the world's largest auto market, but even so, total

auto industry revenues in 2023 only reached 10.1 trillion yuan or around 8 percent of GDP, including exports. Not all of the industry reflects innovative electric vehicles. And electric vehicle manufacturing offers fewer benefits to auto parts suppliers and manufacturers, simply because they feature fewer parts than conventional vehicles. So far this year, the domestic auto market is stagnating, with aggregate domestic sales revenues falling by 1.1 percent, while exports have been rising by 31.5 percent. Revenue growth is slowing as prices are falling due to a price war and domestic overcapacity. The auto industry, even including associated industries such as batteries, will need to more than double in size to even approach the importance of the property sector. The solar industry, in total, generated around 2.5 trillion yuan in investment in 2023, or around 2 percent of GDP, and the energy storage industry produced around 800 billion yuan in investment, or less than 1 percent of GDP. Investment in these industries will certainly expand, and they will have greater upstream and downstream effects on the economy, but in aggregate, the “new three” will still remain far smaller relative to the size of China’s economy than are property and local government infrastructure spending.

More importantly, however, it is very difficult to grow *relative to the rest of the world* while pursuing a manufacturing-led growth strategy. As Michael Pettis points out, if investment is powering China’s economy, for China’s economy to grow faster than the rest of the world, China’s investment growth will need to continue to expand relative to global investment. China already represents an estimated 28 percent of global investment (and only 12 percent of global consumption).²⁹ That investment-led *relative* growth can only occur if other countries voluntarily reduce their own investment activity or if they are driven out of business by Chinese investments and gains in market share. In fact, with the de-risking and diversification push away from China-centric supply chains, the opposite is occurring around the world, with new investments underway.

Moreover, if manufacturing is the most important driver of growth relative to domestic consumption, this intrinsically implies external demand from the rest of the world will be stronger than domestic demand. The only alternative method to grow faster than the rest of the world while pursuing manufacturing-led growth is to consistently expand market share in global exports, which is extremely difficult as China is already the world’s largest exporter. Its push to expand exports further is already generating trade defenses in both the developed and emerging economies, amidst growing global warnings about China’s overcapacity. A manufacturing-led growth strategy will not only require maintaining China’s current investment growth rates—already under pressure from falling credit—but also overcoming significant trade tensions.

Consumption-led growth and its limits

The second alternative is for Beijing to finally take more decisive steps to rebalance China’s economy toward domestic consumption and away from investment and exports. This has been an explicit goal of China’s leadership ever since the 2004 Central Economic Work Conference, yet imbalances have persisted. In a sense, the rebalancing of the economy finally began in 2022 and 2023 at much slower rates of overall GDP growth,

²⁹ Michael Pettis, “What Will It Take for China’s GDP to Grow at 4–5 Percent Over the Next Decade?” Carnegie Endowment, December 2023, <https://carnegieendowment.org/china-financial-markets/2023/12/what-will-it-take-for-chinas-gdp-to-grow-at-4-5-percent-over-the-next-decade?lang=en>.

given the collapse of the property sector, as consumption has continued growing while investment has declined.

There are obvious reasons why China's economy cannot quickly rebalance away from investment and exports while maintaining the same rates of economic growth. Consumption growth is slower and remains limited by income growth and the level of income inequality, as wealthier households consume a smaller proportion of their incomes. Data from Gan Li's China Household Finance Survey consistently show that the wealthiest 10 percent of Chinese households hold around 60–65 percent of overall savings.³⁰ Data from China's official household survey suggests that even if the entire rural population of China were suddenly to cut its savings rates in half, this would only result in 0.6 percent of GDP in additional annual spending.³¹ Constraints on rebalancing are more fundamental, and they are linked to the level of household income and the distribution of that income.

Any meaningful effort to rebalance China's economy will require structural reforms of the fiscal system. Household income as a proportion of GDP is low, at only 61 percent of the economy, according to China's flow of funds data.³² Fiscal policy does not prioritize transfer payments to households to improve incomes, and it does very little to change the unequal distribution of wealth. It is unreasonable to expect consumption growth to dramatically accelerate from its current pace without significant transfers of wealth from government to households.

At the current pace, consumption growth has only accounted for an average of 2.4 percentage points of GDP growth over the past seven years, even according to the official data. Corrected for distortions, the picture is likely worse. In 2024 so far, consumption growth is slowing further, with official retail sales rising by 3.7 percent, a pace likely this year to produce only around 1.5 percentage points of GDP growth.

The experience of other countries that have crossed the threshold of \$12,000 in GDP per capita, as China did sometime between 2021 and 2023, does not suggest that an acceleration in consumption growth is around the corner, even if China remains somewhat exceptional and does not converge entirely toward the long-term averages in other economies. The top ten economies in the world only averaged 2.3 percent in real consumption growth in the first decade after reaching the \$12,000 GDP per capita level, and they averaged 1.8 percent during the following decade. The strongest pace of real household consumption among these economies was in South Korea, averaging 3.9 percent in the decade after hitting \$12,000 in GDP per capita (Figure 6).

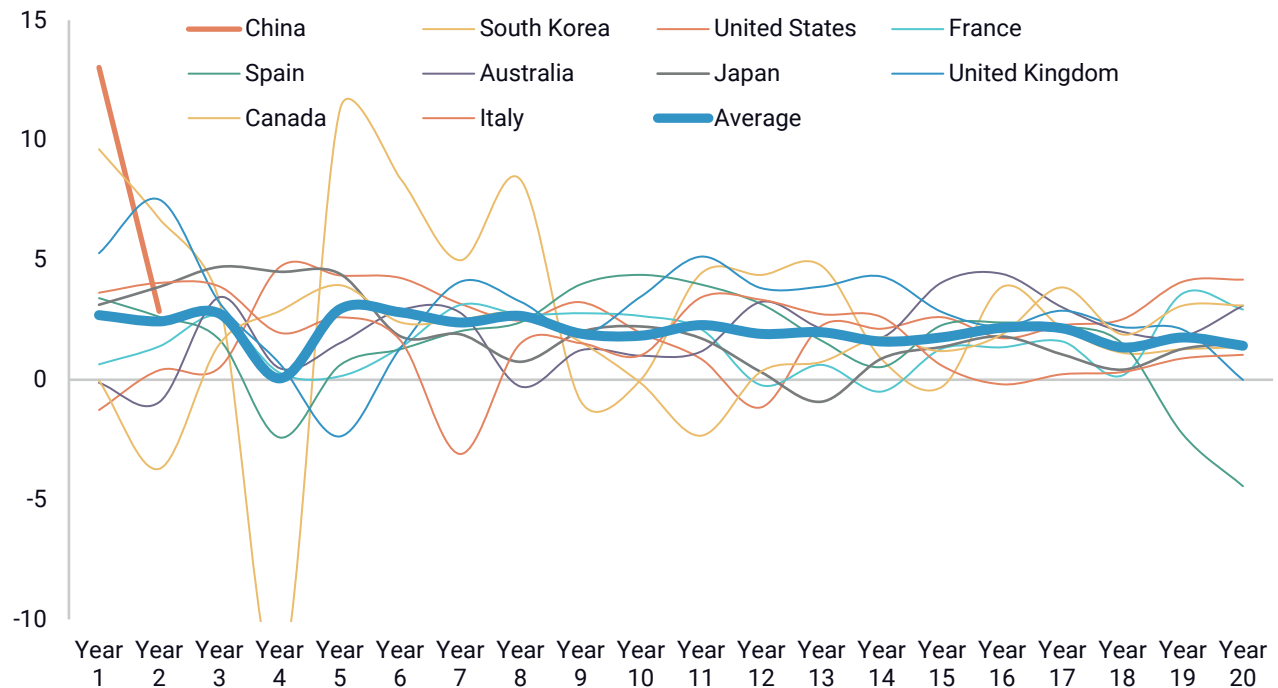
³⁰ A summary of Gan Li's recent findings on inequality can be found in Logan Wright et al., "No Quick Fixes: China's Long-Term Household Consumption Growth," Rhodium Group, July 18, 2024, <https://rhg.com/research/no-quick-fixes-chinas-long-term-consumption-growth/>.

³¹ Ibid.

³² Ibid.

FIGURE 6

Average real household consumption growth in the top ten economies in the world, twenty years after reaching \$12,000 in GDP per capita
Percent, year-on-year



Source: OECD, World Bank

All of these economies had expanding working-age populations in the first decade after reaching \$12,000 in GDP per capita, while China's working-age population has contracted since 2013. If trends in household savings change, for example, there may be reasonable arguments why China's future consumption growth will meaningfully outpace that of the ten largest economies in the world. But all of these arguments will require structural reforms to the fiscal system that are not yet evident. A more reasonable range of China's household consumption growth for the next decade is likely roughly in line with its income growth, generating around 3 to 4 percent in real consumption growth, or around 1.5 percentage points in GDP growth per year.³³ Consumption growth will probably outpace investment growth as the financial system continues its multi-year correction. But consumption growth itself is likely to continue its gradual decline, limiting the scope of China's future GDP growth.

³³ Ibid.

International comparisons to China's predicament

Many analysts have tried to contextualize China's economic predicament with comparisons to other economies. Usually these comparisons focus on one aspect of China's economic development, such as investment-led or export-led growth, or the boom and bust in the property sector. The experience of no single economy is readily comparable to China's recent experience, in part because no economy saw the same scale of growth in credit nor the implicit guarantees that extended the credit boom. Nonetheless, there are a few cases in recent history that are worth considering relative to China's current position. The worrisome comparison for China is usually Japan's experience, with its persistent deflation and slower economic growth as policymakers struggled to maintain credit demand. The experience of South Korea offers a slightly more constructive outlook with respect to the sustainability of export-led and manufacturing-driven growth.

Japan's "balance sheet recession" and property bubble

Performance of the Japanese economy is most frequently compared to China's current economic performance. Last year, the journal *The International Economy* solicited short opinions from over twenty economists and analysts comparing China's current position to that of Japan.³⁴ The similarities are obvious, as Japan also struggled with a bubble economy focused on real estate accompanied by demographic headwinds. As the bubble burst and property values declined, Japan's savings rate together with investment continued to drop, and monetary policy became increasingly ineffective as corporate credit demand was weak even though interest rates were near zero. This created what Richard Koo labels a "balance sheet recession" caused by the need to pay down corporate debt over time to cover losses from declines in asset prices.³⁵ Koo's argument is that under these conditions, only fiscal policy could restore aggregate demand, and eventually, in the late 1990s, the Japanese authorities opened the fiscal taps to stabilize the economy. Nonetheless, the experience of Japan's "lost decade" is a scenario Beijing hopes to avoid, given the resultant financial instability in Japan in the late 1990s and the decline in Japan's global economic weight since the mid-1990s.

Many Chinese analysts have examined Koo's arguments and are already using the phrase "balance sheet recession" to describe China's economic problems, particularly related to the property sector.³⁶ However, there are two significant differences between China's current economic headwinds and those in Japan. First, China can still use monetary policy to generate credit demand—it is its fiscal policy that is more constrained under the current system. Beijing is reluctant to cut interest rates further because of the pressure it would place upon bank profitability, on the continued pace of asset and investment growth, and on the exchange rate via capital outflows. Second, the weakness in investment in China is not being generated by balance sheets or the need to pay down debt rather than to invest. The slowdown is occurring primarily because the financial system cannot

³⁴ "Could China Become Like Japan in the Early 1990s?" *The International Economy* (Winter 2023), http://www.international-economy.com/TIE_W23_ChinaLikeJapanSymp.pdf.

³⁵ Richard Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession* (New York: Wiley and Sons, 2012).

³⁶ Wang Qushi et al., "Macroeconomic Policy in Response to Damaged Balance Sheets," CF40 Policy Brief 22-2, July 2022.

expand at its previous rates to generate investment—local governments would probably still invest more if they had the funds available and Beijing’s limits on debt growth were eased.

The similarities to Japan’s circumstances are significant as well. Given the rapid decline in birth rates in recent years, China’s demographic pressures may end up worse than those in Japan. Both China and Japan suffer from impaired or “zombie” financial institutions that are insolvent but not illiquid, and so they continue to throw more good money to bad projects rather than being formally restructured. China currently appears to be facing a similar version of Japan’s “liquidity trap” in which more liquidity in the banking system is channeled into financial assets rather than new lending or economic activity.³⁷

But the most significant threat to China would be a repeat of Japan’s persistent deflationary pressure, reducing incentives for companies to invest and grow and adding to debt servicing costs over time. The acute pressures in China’s financial system make this a highly relevant problem, as China’s nominal growth rates have continued slowing in recent years, averaging only 4.5 percent even in the official data since the end of 2021, and producer prices have also trended sharply lower since 2021. Without stronger credit growth, which the banking system cannot generate in its current state, or much stronger household consumption growth, it seems it will be difficult to escape Japan-style deflationary pressures.

South Korea’s manufacturing-led growth

Another frequent comparison is South Korea’s experience, focused on export-led growth, state-directed credit, industrial policies directed to large conglomerates, and management of exchange rates over time.³⁸ South Korea’s experience has generally been considered a success story, with GDP per capita rising above \$32,000 in 2022, around half of US levels. Korean economic growth suffered following the Asian financial crisis and the global financial crisis in 2008, but overall innovation in export-oriented sectors has helped to maintain high productivity growth, and it has maintained higher rates of GDP growth. Korean investment relative to GDP was similar to China’s levels, but it was lower, at around 35 percent for most of the 1980s and 1990s during the Asian financial crisis, before falling into the 30 percent range. The Korean economic experience during the past two decades suggests a transition to higher-productivity investment and stronger household consumption is possible, even if investment growth slows.

At the same time, this will still involve slower overall economic growth, as South Korea’s economy did not maintain the same growth rates as it had in the 1990s. Average GDP growth from 2001 to 2015 was 4.2 percent, compared to 8.8 percent from 1980 to 1996 during its period of rapid investment.³⁹ South Korea’s economy has similarly struggled to transition away from export-led growth toward a more sustainable driver of domestic

³⁷ For more on Japan’s liquidity trap, see Paul Krugman, “It’s Baaack: Japan’s Slump and the Return of the Liquidity Trap,” *Brookings Papers on Economic Activity* 2 (1998), https://www.brookings.edu/wp-content/uploads/1998/06/1998b_bpea_krugman_dominquez_rogooff.pdf.

³⁸ Luiz Carlos Bresser-Pereira et al., “South Korea and China’s Catching Up: A New Developmentalist Analysis,” *Brazil Journal of Political Economy* 40 (April–June 2020), <https://www.scielo.br/j/rep/a/p9tZnCmvpMTSsz4FBsgRwZzQ/?lang=en>.

³⁹ Data sourced from Bloomberg.



demand and productivity growth, with productivity notably weakening in the services sector.⁴⁰ This is broadly similar to China's current predicament, in which cycles in external demand influence export-led growth, while productivity growth remains weak and the transition to a services-led economy has been slowed by an ongoing industrial policy focus on manufacturing-led investment. At the same time, South Korea's experience has also been marked by occasional intervention in foreign exchange markets to manage exchange rates in order to maintain export-led growth. All of these factors have reduced the country's global share of GDP, from 2.0 percent in 2005 to 1.6 percent in 2022, and they do not suggest a path for China to gain relative to the rest of the global economy over time.

There is always a desire to find a basic roadmap to understand China's likely economic path forward. Given the importance of investment-led growth, the real estate bubble, and the demographic headwinds, the Japanese experience is an important reference point (as will be discussed below). **But the reality is that China's credit expansion and its aftermath are *sui generis*, and this is a problem for Chinese policymakers as well as for analysts given there are simply no precedents for a single country adding around one-third of global GDP in new credit in just eight years. Policymakers always look competent in credit expansions, but few have good answers when credit conditions shift significantly, as they have in China during the past six years.**

Can Beijing adjust its goals?

Investment-led growth has been the predominant model for the entirety of the careers of China's current generation of officials. Changing it would be completely unprecedented in a political system that naturally gravitates toward gradualism. All governments attempt to grow their economies and to improve standards of living for their citizens. The question that China's experience raises is why *rapid growth remains* so politically significant, even after three decades of unprecedented development. The pattern in which China has pursued rapid growth—to expand investment relative to household consumption—has left significant gains in household welfare on the table, and millions of China's rural residents behind.⁴¹ China's economic record has been remarkable from a very low base after years of policy-led impoverishment in the 1950s and 1960s, but development from rebalancing the economy much earlier could have raised living standards by much larger margins. If China's consumption level relative to the rest of the economy was closer to that of Japan or the European Union, for example, that would imply around a 36 percent rise in annual household spending compared to current levels. Achieving such a scale of growth in household consumption is now far more difficult given the hidden debts within the financial system and China's declining fiscal capacity.

It is frequently cited that China wants to overtake the United States as the world's largest economy within some timeframe, although Chinese officials almost never discuss this publicly. In PPP terms it has already achieved that feat—but that presumably is not enough

⁴⁰ Jong-Wha Lee, "The Republic of Korea's Economic Growth and Catch-Up: Implications for the People's Republic of China," Asian Development Bank Institute, Working Paper No. 571, April 2016, <https://www.adb.org/sites/default/files/publication/183353/adb-wp571.pdf>.

⁴¹ See, for example, Scott Rozelle and Natalie Hell, *Invisible China: How the Urban-Rural Divide Threatens China's Rise* (Chicago: University of Chicago Press, 2020).

for Beijing for some of the reasons discussed earlier in this article. Based on current trends, however, China's economy overtaking that of the United States in U.S. dollar terms seems unlikely to occur in the lifetimes of any of China's current Politburo members (China's GDP is currently only 63 percent of US levels).

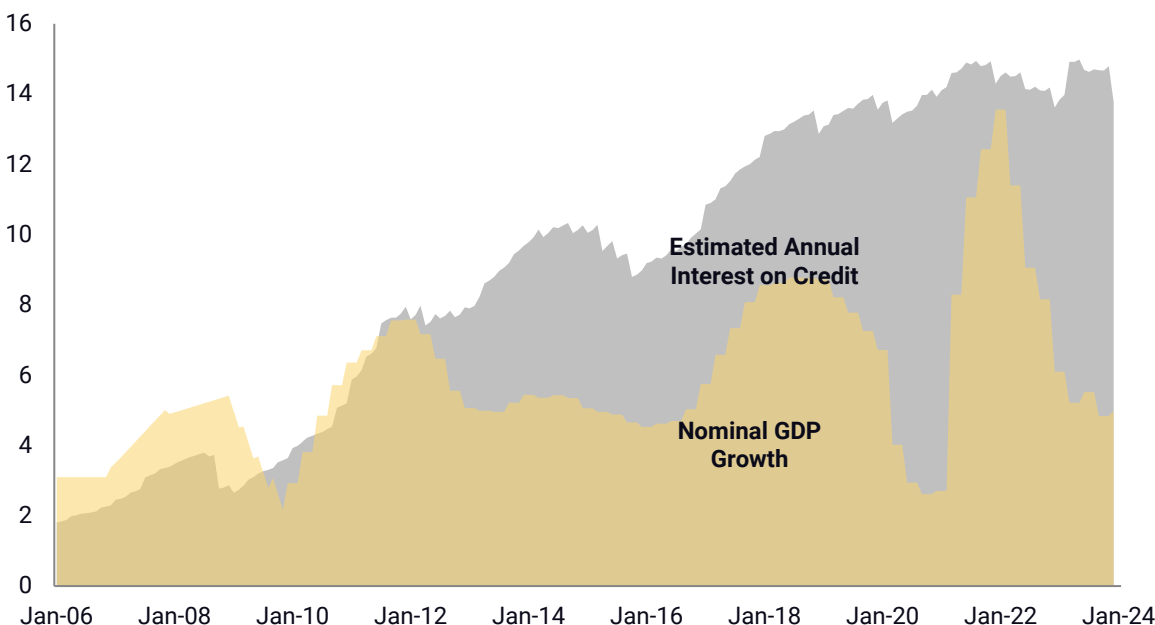
The slowdown in credit and investment has driven the slowdown in China's property sector and the expansion of local government debt. **These are not exogenous problems; rather they are endogenous to the pattern of growth in China during the past two decades.** As credit expanded rapidly after the financial crisis, property was the most important asset class that benefited—China saw limited goods price inflation but considerable asset price inflation. As a result, after years of construction activity in excess of fundamental demand, there is no case that the property market will ever return to its previous pace of construction and as a driver of economic growth because there is already more than enough housing available in China. Future demand will be driven by upgrades and replacements. "Solving" the problems of local government debt and the resultant non-performing loans within the banking system involves changing future patterns of credit allocation within the financial system and therefore the entire structure of China's economy.

The case that China can continue expanding its share of global economic activity depends upon either rapid expansion of productivity growth or an entirely different economic structure and drivers of growth—either manufacturing investment or household consumption. Manufacturing-led investment requires a more efficient financial sector and an expansion of export market share from an already high level, despite political resistance. Consumption-led growth involves a redistribution of income and government-led transfers to households. But the fiscal system must be reformed to facilitate those resources, and consumption-led growth is still likely to be slower than previous rates of growth. China cannot grow out of its debt problems as nominal GDP growth (even within the official data) has been slower than the aggregate interest on credit within the economy since 2012 (Figure 7). Time cannot heal these wounds, as time is opening them further.

FIGURE 7

Estimated aggregate annual interest on credit vs. annualized nominal GDP growth (unadjusted), 2006–2023

Trillion yuan



Source: People's Bank of China, National Bureau of Statistics

It remains unclear whether Chinese officials, particularly Xi Jinping, actually view China's economic headwinds as severe. In the December 2023 issue of this publication, Minxin Pei raised the question of whether Beijing shares the views of local officials regarding the extent of the economic problems China is facing.⁴² While there is no longer a plausible case that China's headline economic data are accurate, given the overstatements in 2022 and 2023 and the fact that nothing has replaced the property sector as a driver of growth, there is also scant evidence of a second set of macroeconomic statistics available only to China's leadership, particularly for headline GDP. Chinese leaders may honestly believe that the economy has slowed, but only by a percentage point or two, and therefore they may believe that no wrenching changes in the economy are necessary.

This view may explain the limited reforms on offer at this year's Third Plenum as well as the remarkable changes in economic policymaking over the past two to three years, or since the imposition of the COVID-19 restrictions in 2022 and the reluctance to ease those controls, despite mounting evidence of the economic consequences of maintaining them. Local government debt and China's declining fiscal capacity are known persistent problems. But Chinese policymakers are simply not addressing them at present. Beijing frequently argues that problems in the economy are linked to the low confidence of households and businesses.⁴³ Confidence has certainly suffered since the lockdowns were

⁴² Minxin Pei, "How China Responded to its Economic Slowdown in 2023," *China Leadership Monitor*, no. 78 (December 2023), <https://www.prcleader.org/post/how-china-responded-to-its-economic-slowdown-in-2023>.

⁴³ See, for example, the quotes in Daisuke Wakabayashi and Claire Fu, "A Crisis of Confidence Is Gripping China's Economy," *New York Times*, August 25, 2023, <https://www.nytimes.com/2023/08/25/business/china-economy-confidence.html>.

imposed in 2022. But there is little evidence that confidence is a more important constraint on consumption and investment growth than household incomes and the availability of credit.

The opposing view is that if Xi Jinping and Chinese leaders are truly animated by comparisons with the US economy that are currently moving against China, then increasingly desperate measures to support the economy may be on offer. Even based on the official GDP data, US nominal growth outpaced Chinese nominal growth in 2022 and 2023 and will likely do so in 2024 as well. Add in the depreciation of China's exchange rate, the US dollar measure of China's economy has barely changed at all since 2021 and is unlikely to do so in 2024. These narrow bilateral comparisons should be irrelevant in driving economic policy choices, but if Beijing does attach importance to surpassing the United States, this may explain the insistence on China's manufacturing and export-led growth push that is intrinsically incompatible with economic trends in the rest of the world.

Shifting the narrative

The intellectual bubble surrounding China's economy will take longer to burst than the actual bubbles in property and local debt. We actively searched for the first published use of the phrase "lost decade" in association with Japan's economy, and the first reference we could find was in July 1998, almost nine years after the peak of Japan's equity market and long after the strains in the real estate market were evident.⁴⁴ A commentary from Brink Lindsey and Aaron Lukas containing that reference could be used almost word for word to describe the current discussion on China's economy, simply by replacing "Japan" with "China":

"Today, the verdict is in: the revisionists were dead wrong, both in their assessment of the Japanese "threat" and in their recommendations for US policy. Japan has not attained worldwide dominance; on the contrary, it has suffered a "lost decade" of economic stagnation. The "Japan, Inc." model has not eclipsed Western-style capitalism; instead, there is an emerging consensus on both sides of the Pacific that the Japanese model has failed. . . . Meanwhile, the United States, far from declining, is enjoying record-setting prosperity because it largely ignored the revisionists' advice.

Japan's problems are now obvious. To revive its fortunes, it must move to a system under which capital is allocated, not according to established relationships or government policy, but in response to clear and undistorted market signals. In sum, Japan needs to abandon the very elements of its system that the revisionists singled out as its greatest strengths."⁴⁵

Similarly, commentaries discussing China's structural slowdown are becoming more frequent, but they remain outside of mainstream opinion, which points to only a modest slowdown in Chinese growth.

⁴⁴ If any readers can find earlier citations, please contact this author.

⁴⁵ Brink Lindsey and Aaron Lukas, "Revisiting the 'Revisionists': The Rise and Fall of the Japanese Economic Model," Trade Policy Analysis No. 3, Cato Institute, July 1998, <https://www.cato.org/trade-policy-analysis/revisiting-revisionists-rise-fall-japanese-economic-model>.

Ironically, were Beijing to publicly acknowledge China's economic decline rather than project an artificial sense of stability, it would actually smooth the path for China to grow its economy at a faster rate over the next decade. **China's leaders have a political problem, in that they frame their economic objectives in a fashion that inherently conflicts with those of the rest of the world.** Some members of the Politburo may realize this, but such a recognition is not apparent in official documents such as the 2024 Third Plenum Resolution. Manufacturing-led growth without stimulating domestic demand implies that China can grow only by taking market share from other countries—it is bound to generate trade defenses in response. Politically generated growth targets that are focused on global supremacy at the expense of sustainable domestic demand-led economic growth and spending by Chinese consumers naturally raise questions about the potential priorities of China's leaders should the country actually become a dominant global economic power. Conversely, a shift in public messaging about the need for domestic rather than external demand may reduce trade conflicts and international tensions and would actually open up more possibilities for Beijing to pursue industrial policy objectives in high-tech industries. More realistic macroeconomic data would help Beijing in calibrating policies as well.

Similarly, the rest of the world, including the United States, can more effectively compete with China by framing the economic challenge differently. A China that has peaked economically is not a challenge to the survivability of liberal and market-oriented economic systems. Instead, China represents a set of narrower but important risks that emerge from China's economic slowdown, including spillovers from systemic overcapacity and financial excess. Other significant risks from China are political or military in nature, but they should be grounded in an understanding that China's economy is fading rather than rising in global influence. Disaggregating political and military risks from China's economic challenge offers more options to limit those threats, using narrower measures with fewer economic spillovers and, consequently, less domestic political resistance.

Framing the challenge from China as foundational or existential counterintuitively limits the choices available to Western policymakers. This is because in a world of limited policy bandwidth and hard choices, small but incremental competitive gains might not seem to be commensurate to the challenge China presents. The result of overemphasizing China's economic capacity is not only to unfairly give credit to Beijing's propaganda but to channel policymaking toward more dramatic but economically costly policy options—such as broad-based restrictions on financial flows. These measures can damage the credibility of liberal market systems by making it seem that the West needs to adopt Chinese methods in order to compete. But that is simply not the case, as China's economic peak is already in the past. Smaller policy actions that minimize risks and improve the competitive landscape can be more easily implemented, and at lower cost, with less political fanfare and resistance. De-risking supply chains is a prime example, as this process of reducing reliance upon Chinese manufacturing capabilities is well underway.

China's economy peaking in global influence also offers Beijing a new opportunity to realistically redefine its goals and to become less confrontational with the rest of the world's economic and political interests. But we are under no illusions that such a redefinition is probable. If these views are read by China's leaders, their likely response would be to simply reject the premise in its entirety that China has peaked, and to dismiss

it as the argument of just one more Western analyst downplaying China's clear record of past policy successes based on ulterior motives.

But there are no simple solutions for Beijing's plight. Economic activity is the sum of consumption, investment, government spending, and net exports. Growth from investment has already collapsed. Growth from consumption is already slowing. Growth from government spending is exhausted by local debt burdens. Growth from net exports is facing political resistance. The exchange rate is under pressure to depreciate. For China's economic trajectory to reverse course and grow again relative to the rest of the world, several of those basic premises must change. Ironically, Beijing will have more success changing China's current economic predicament by publicly acknowledging it rather than by clinging to a politically motivated narrative that China's economy cannot fulfill.



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