FOR PROFESSIONAL INVESTORS – 14 February 2023

Chi on China

CHINA'S STRUCTURAL GROWTH (II) – THINKING OUTSIDE THE GROWTH BOX

… A riddle, wrapped in a mystery, inside an enigma.

Winston Churchill

SUMMARY

- China's potential growth rate could average above 5.0% a year for much longer than most players expect if Beijing's new reform tactics work. This may sound a brave assumption, but the growth constraints of labour and capital on growth may not be binding for another 15 years.
- The world should reassess China's growth outlook based on its new structural reform direction, with greater bias on supply chains security, high-value manufacturing and hard-tech developmentand less focus on soft-tech and tertiary production.
- Ironically, de-globalisation could give countries with large populations, like China, an unforeseen fillip by boosting output through internal expansion and specialisation. A fair assessment is needed for China's long-term growth, and the market has probably not priced in the upside potential.

As argued in part I of this report[1], growth challenges and risks due to reform fatigue and diminishing marginal returns on investment have prompted some observers to declare an end to China's burgeoning GDP growth[2]. The conventional wisdom is that China's GDP growth will slow to 3.0% in a few years' time[3], raising doubt on the structural underpinning for investing in Chinese assets. However, the market might have overlooked some upside catalysts for potential growth surprises. If China gets its new development strategy right, it could make the economy more productive and rebalance growth towards more domestic consumption at the same time.

[1] "*Chi on China: China's Structural Growth (I) – From Opportunities to Challenges with Risks*", 20 January 2023 (here).
[2] "*China and the Middle Income Trap*", by David Hicks, AMCHAM Shanghai, 18 June 2019 (here).
[3] For example, see *"China's Low-Growth Era. Is 3 per cent the new normal?",* by Robin Wigglesworth, Financial Times, October 18, 2022, and "*Revising Down the Rise of China*", by Ronald Rajah and Alyssa Leng, Lowey Institute, 14 March 2022 (here).

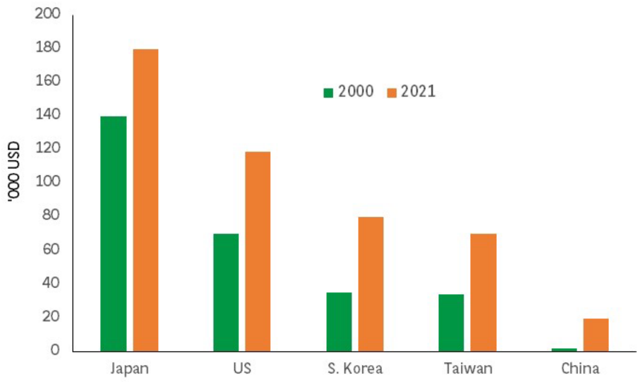
GROWTH CONSTRAINTS NOT YET BINDING

Evidence shows that the growth constraints of labour and capital on China's economy might not be binding for another 15 years[4].

Firstly, despite a decline in the labour force (which nevertheless remains very large – nearly 2.5 times the total population in the US), there are natural demographic dynamics – urbanisation and changes to the retirement and regional migration policies etc. – that can expand the labour force even under the prevailing static framework[5]. China could find more than 200 million workers in the next 15 years to offset the expected loss of 200 million workers between 2030 and 2045.

Secondly, despite excess capacity, China's capital stock per worker is still significantly smaller than the major economies and its Asian peers (Exhibit 1). This reflects an irony that China suffers from both under-investment and excess capacity at the same time. We have long argued that the coexistence of these two conflicting forces lays bare a serious structural flaw of capital misallocation[6], which has been slow in correcting despite years of financial reform.

Exhibit 1: Real capital stock per worker*



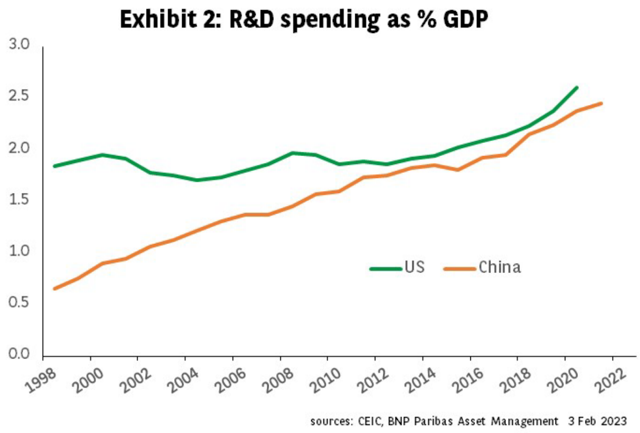
* in constant (year 2000) US dollars   sources: CEIC, UBS, BNP Paribas Asset Management 3 Feb 2023

The low capital stock argues that China's economic inefficiency might not necessarily due to excessive investment but to the state sector's soft budget constraint that misallocated capital to a few giant inefficient state industries. These state firms have created excess capacity that has dominated the economy and stymied private-sector 'animal spirits', resulting in under-investment in other (productive) parts of the economy.

Hence, China has room to accumulate more capital, but it needs to allocate it efficiently. Spending more on research and development (R&D) will help increase total factor productivity. And China is catching up quickly. In 2000, it only spent 0.9% of GDP on R&D, compared to 2.0% in the US. By 2020, the latest data available shows China's R&D spending at 2.3% of GDP versus 2.6% in the US (Exhibit 2). Furthermore, China is now producing more science, technology, engineering and math (or STEM) PhDs than the US[7].

[4] "*Chi in China: China's Growth beyond the Middle-Income Trap*", 24 July 2019 (here).
[5] "*Chi on China: What Don't We Know About China's Demographic Pains?"* 22 May 2019 (here).

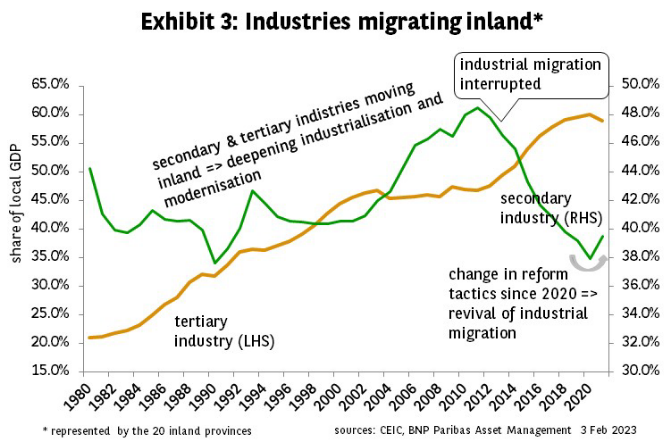
[6] "*Chi on China: The Conundrum of China's Excess Capacity*", 14 September 2016 (here).
[7] "*U.S. Universities Fall Further Behind China in Production of STEM PhDs*", by Michael T. Nietzel, Forbes. August 7, 2021 (here).



A SHIFT IN REFORM TACTIC

Beijing has recognised two errors in its past reform strategy: Debt-fuelled investment-driven growth is not sustainable; the 2013 reforms designed to boost tertiary output and e-commerce have backfired and created moral hazard. It thus undertook a tactical shift in its structural reforms under its broad 'dual circulation' strategy[8] in the second half of 2020, favouring 'hard tech' over 'soft tech' development[9] and engagimg the private sector as a driver for innovation. This move could revive the migration of industrial output towards the cheaper and more resourceful inland provinces to create new growth momentum in the long-term.

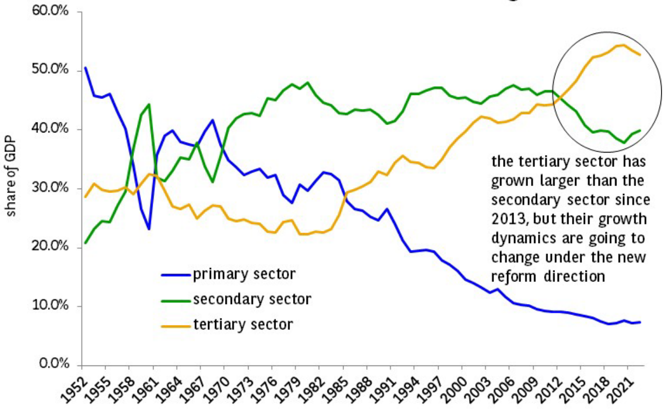
China started a slow structural rebalancing of its domestic sector in 2005, with lower costs and improving infrastructure driving industrialisation to inland provinces[10] (Exhibit 3). This process resulted in a regional division of labour, with the costly eastern region moving from manufacturing to high value-added services industries and the cheaper inland regions picking up low value-added manufacturing. The approach was expected to generate inherent growth momentum that could keep China's GDP growth at an annual average of 5%-6.0% for much longer than the market expected.



[8] See "*Chi on China: China's 'Dual Circulation' Strategic Pivot to Counter External Exigencies and Global Demand Shift*", 16 September 2020 (here).
[9] Hard tech refers to the production of hardware and components that caters for the country's strategic and high-tech development. Soft tech refers to the e-commerce development that caters for non-strategic consumption demand.
[10] See "*Chi on China: Structural Rebalancing – Part II, the Domestic Sector*", 16 July 2013, and "*Chi on China" Mega Trends of China (6): Evolution of China's Growth Model*", 6 April 2018.

However, the process was interrupted in 2013 (see Exhibit 3) when the then reform policy focused on shifting the economic growth drivers from investment and manufacturing to services and consumption. This led to a rise in the GDP share of the tertiary sector at the expense of the secondary sector (Exhibit 4). Overall GDP growth also slowed, reflecting Beijing's policy goals at the time to favour growth quality over growth quantity.

Exhibit 4: China's economic re-balancing



sources: CEIC, BNP Paribas Asset Management 3 Feb 2023

Under the latest reform approach since 2020, industrial migration to the interior provinces is likely to resume, with high-value-added industries leading the way. Data shows that this resumption is already happening (see Exhibit 3 and 4). This trend will revive GDP growth momentum and raise productivity in the longer-term.

NOT NECESSARY A ZERO SUM GAME

The scale of China's economic reach will continue to create fear and suspicion by the West. Notably, China has now replaced the US as the world largest trading power. More than 120 nations count China as their largest trading partner, while only 57 have such relationship with the US[11]. China economic power undoubtedly enhances its soft power[12], especially in the developing world.

Nevertheless, in assessing the overall balance of power, the US does not have to lose out to China's advances. Politically, the US has two friendly neighbours, while China shares a border with 14 countries and is engaged in territorial disputes with many neighbours. The US also has an energy advantage – the shale oil revolution in the past 10 years has transformed it into a net energy exporter. However, China is the world's largest energy and commodity importer.

Crucially, the US commands unrivalled financial power from its large international financial institutions underpinned by the rule of law and the global role of the dollar that dominates the global payments system. China's efforts to develop deep capital markets and a legal system that commands international credibility are still work-in-progress, and its renminbi is not yet convertible on the capital account.

The Sino-US competition will go on and create global disruptions at times. However, this does not have to be a zero sum game.

[11] "*China Is the Top Trading Partner to More Than 120 Countries*", by Ambassador Mark Green, Wilson Centre, January 17, 2023 (here).
[12] "*The Benefits of Soft Power*", by Jodeph S. Nye Jr., Working Knowledge. Harvard Business School, August 2, 2004 (here).

Many observers also suspect that China's moves to increase state control over its economic development is a move to prioritise its geopolitical objectives over economic development. Some even worry that China would return to the development model of the chaotic Mao Zedong era. These fears are overdone.

Arguably, the increased role of the state in the economy and a shift toward self-reliance in technology is China's response to a changing, and increasingly hostile, external environment. Such a shift would likely have happened anyway disregarding the Sino-US relations, owing to China's enormous population. Recognising the potential of its massive internal market, China's leaders have long sought to increase domestic demand as a hedge against external changes. And that hedging strategy finally came in the form of the dual circulation policy in 2020.

DE-GLOBALISATION MAY NOT HURT

Counterintuitively, the unfolding of the de-globalisation trend may not necessarily hurt China's long-term growth. Research shows that in a world of restricted cross-country trade and migration, countries with large populations – whose development is often hampered by both internal and cross-border migration policies – could develop opportunities to increase economic output through internal trade and specialisation[13].

The irony is that if barriers to migration grow high enough, populous countries could outpace smaller countries in innovation, even if the latter are richer. With long-run growth driven by technological improvements, it can translate into a major economic advantage for countries with larger populations because a larger population implies more talent and higher returns for innovation. This argument highlights America's success due to its migration policy, which gives it an advantage of a growing population despite its economic maturity.

Granted, China is facing strong demographic headwinds, notably a falling birth rate. However, the effects of this decline on growth is not imminent. Arguably, China's large population still gives it a significant advantage over many countries in terms of human capital for at least the next 15 years, as argued above. If China makes the most of this advantage – as it seems poised to do – and gets its reforms right, it could escape the middle-income trap.

Hence, de-globalisation, and America's strategic competition policy towards China, will prompt China to continue hedging its bets by shifting resources to its science and technology sectors – as it is doing under the dual circulation policy framework. In the worst decoupling scenario, the world's two largest economies will end up dominating their own technology-supply systems, each with its own rules and standards.

This is a distinct possibility, as China's rise creates both opportunities and challenges for the global system. Nevertheless, while China's large population affords it a potential advantage in a de-globalised world, it will still be better off by engaging with the advanced economies, including the US. This is because even though it has a large domestic market to fall back on, ties to other parts of the world through trade, investment and sharing of knowledge and ideas invariably accelerate technological progress.

The external element of China's dual circulation policy emphasises the opening up of its economy and capital markets. From an investment perspective, China's growth story has further to go. And this upside growth potential is currently not priced in by financial markets.

[13] "*The Geography of Development*" by Klaus Desmet, Dávid Krisztián Nagy and Esteban Rossi-Hansberg, Journal of Political Economy, University of Chicago Press, 2018, vol. 126, issue 3, 903 – 983.

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