

WILL THE CHINESE DRAGON KEEP FLYING?

Challenges and scenarios
regarding China's long-term
growth path

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In 2020, Beijing adopted the informal goal of doubling GDP by 2035, implying an average growth rate of 4.7% in 2021-35. Achieving this would also mean China would leave the *middle income trap* behind and reach high-income status in a few years' time. At first sight all this looks plausible, given the average growth rate of 8.7% in 2002-2020. However, growth in China has slowed materially since 2010, while challenges to its growth path keep rising. We analyse these challenges – drawing lessons from Japan and South Korea – and provide three illustrative scenarios for China's future growth trajectory. The main challenges are in the areas of:

- Geopolitics/supply chains: With China emerging as a global autocratic power and main strategic rival, its initially gradually improving relationship with the West has turned around and geopolitical tensions are rising. US-China tensions have persisted under the Biden-administration, with Biden putting more effort on rebuilding traditional alliances to broaden pressure on China. Following the trade war and the pandemic, there is a risk that the shift of supply chains out of China will accelerate. In general (except for some specific goods), we expect such shifts to occur gradually – given the high stakes for globally operating firms – creating time for China to adjust and diversify.
- Efficiency/technology/productivity: Beijing's regulatory crackdown on internet-related firms and the shift to *common prosperity* has taken investors by surprise. We do not view the regulatory crackdown as a 'general attack on tech', as Beijing still sees high-tech manufacturing as a key driver of its technological advance. The question is whether China's institutional framework will keep generating sufficient productivity growth. Past experiences of Japan and Korea suggest that China's 'mixed' development model – with some modernisation – could work for some years to come. Beijing also has to manage the expected fall of the population and the labour force, and an education/ skills gap, while urbanisation has further to run.
- Debt: Recent debt distress at firms like Evergrande are a reflection of China's high debt and past lending policies, certainly in real estate. China's high debt levels do put a longer-term constraint on growth, even though a debt-driven hard landing at the macro level is not our base case. As China's debt mainly consists of loans in local currency by Chinese banks to Chinese firms, a debt crisis is unlikely to be triggered by foreign investors. Still, Beijing's more tolerant attitude vis-à-vis defaults – as the implicit guarantee framework is left behind – shows that creditors should be aware that sometimes defaulting is also a form of deleveraging.
- Climate: China is the world's largest CO2 emitter, but also the largest investor in clean energy. Its huge climate ambitions (peak carbon in 2030, net zero before 2060) will impact individual sectors and regions, particularly regions lagging in the energy transition. Beijing will likely tolerate some slowing of growth if needed to reach its climate goals, but – as indicated by a recent power crunch and subsequent easing measures – not at all costs. We think that potentially painful trade-offs will become more evident later on in the transition process. At the same time, investments into the energy transition could also generate GDP growth, for instance if China becomes a global leader in producing and exporting electronic vehicles or other products that are needed in the global energy transition.

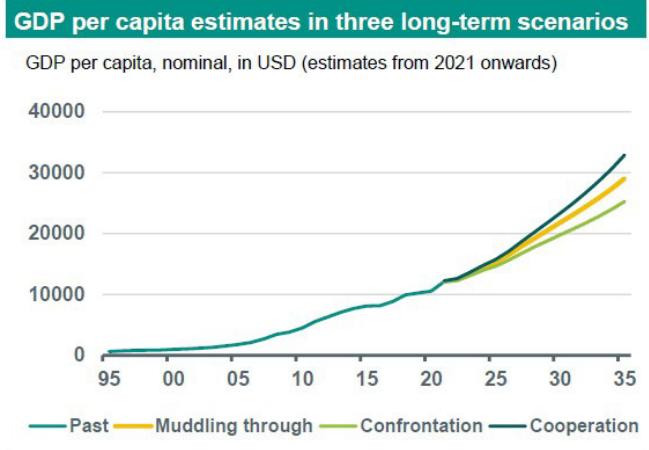
China's future growth path will depend to a large extent how effective China will be in managing these challenges. Our analysis results in three potential scenarios for China's long-term growth trajectory:

- A Muddling through. This long-term qualitative scenario assumes that China will be able to manage its key challenges reasonably well and that the economy will resume its gradual slowdown from 2022 onwards. In this scenario, average growth in 2021-2035 will be a bit below the annual 4.7% needed to reach Beijing's informal target of doubling GDP by 2035. However, China will reach high-income status in 2023, according to the World Bank's current classification standards.

- B Confrontation.** This scenario assumes the stance of a Western alliance versus China hardens, trade/tech tensions flare up and strategic competition turns into strategic confrontation. The trade-off between safeguarding growth, on the one hand, and financial stability/environment on the other will become tougher. All of this implies a sharper slowdown of the Chinese economy compared to the *Muddling through* scenario. Annual growth would average 3.3% in 2021-2035. Beijing would not reach its informal goal to double GDP by 2035. GDP per capita would be around 15% lower in 2035 compared to *Muddling through*. The direct effect would mean a 0.2 pp reduction in global GDP growth per annum, but there are more important second-round effects.
- C Cooperation.** In this scenario, the need to cooperate with China on global – particularly climate – issues triggers a turn for the better in relations with the West. China would benefit from similar tailwinds as Japan and Korea did last century, although the incentive to cooperate now is to fight climate change, not communism. This would help China to continue moving up in the tech value chain, and to strengthen its role in producing goods that are needed globally to support the energy transition. The improved external environment would help to simplify the management of domestic issues. Growth would hold up better than in the *Muddling through* scenario, averaging 5.2 in 2021-35. Beijing would more than reach its informal goal to double GDP by 2035, while in 2035 GDP/capita would be 15% higher compared to *Muddling through*.



Source: ABN AMRO Group Economics, EIU



Source: ABN AMRO Group Economics, EIU

1. INTRODUCTION

The People's Republic of China is this century's *Wirtschaftswunder*. Since WTO accession in 2001, China has shown impressive economic growth rates averaging 8.7% in 2002-2020 and a tenfold rise of GDP per head. The country has turned into the key global manufacturing hub, has become the main engine of global trade, has shown an impressive catch-up in technology and is an important stakeholder in the global climate debate. Although growth has come down from the double digit levels seen a decade ago, China is still outperforming other key economies and has come relatively strong out of the pandemic, despite recent growth wobbles. If all goes well, China is on its way to surpass the US as the largest economy in nominal GDP terms around the end of this decade. The authorities have adopted an informal target of doubling GDP by 2035.

But will 'all go well'? There is a wide spectre of challenges to China's longer-term growth path. With China's economic, technological, political and military rise, tensions with the US and other western nations have risen and China risks getting more isolated. That, combined with vulnerabilities shown during the pandemic, could have consequences for its role in global supply chains. More recently, the intensification of a regulatory crackdown on internet-related sectors, against the background of a shift to 'common prosperity' (see § 3.2 and box 4), has spooked investors and raised questions about the future of China's private sector. In addition, debt debacles at large companies (Evergrande, Huarong) brought the question of whether China's debt is a ticking time bomb back into the spotlight. Another challenge stems from China's climate ambitions that could over time collide with economic growth targets, as illustrated by a recent power crunch.

In this publication we will analyse whether China can indeed double its GDP by 2035, keep growth at sufficient levels to achieve that goal, and whether it will be able to become substantially richer in terms of GDP per capita. We will look at the path that two other large Asian nations have followed from a 'developing' to a 'developed' economy: Japan and South Korea. Subsequently, we explore the most urgent challenges that will determine whether China can follow a similar path in terms of economic development. Finally, using an illustrative scenario analysis, we will explore what would happen if China succeeds, or fails in this respect.

2. COMPARING CHINA'S LONG-TERM DEVELOPMENT PATH WITH JAPAN AND SOUTH KOREA

At the end of 2020, China's Communist Party adopted a long-term economic development plan aimed at doubling GDP by 2035. Although Beijing did not present longer-term quantitative growth targets, this would imply an average annual real GDP growth rate of 4.7% in 2020-2035. It would also mean China would leave the so-called middle income trap behind (see box 1) and reach high-income status in a few years' time. At first sight, all of this looks plausible, with an average growth rate of 8.7% in 2002-2020. However, growth in China has slowed materially since 2010, while longer-term challenges to its growth path are rising. The key question is whether China can continue to diversify and move up the value chain to maintain growth at these elevated levels. Rephrasing this issue: can China (more or less) follow the trajectory of two other large Asian nations that went from being developing to developed countries in the 20th century – Japan and South Korea.

Box 1: The Middle Income Trap

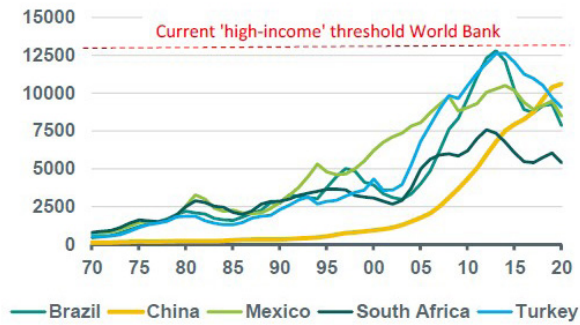
The concept of the 'middle income trap' was introduced by the World Bank in 2007¹. It refers to a situation in economic development in which a country's GDP per capita has been rising as it develops, but remains stuck in a range that is categorised as 'middle income' by the World Bank. Put simply, the main factor explaining this phenomenon is that the initial drivers helping a country develop and get richer will at some point 'run out of steam'. Some emerging economies have been successful in broadening their growth model from the export of commodities to exports of manufactured goods. However, because of their success, wages in these sectors start rising and these countries lose their competitive edge in such sectors compared to low-income newcomers. Only if a country keeps diversifying its growth model while moving up the value chain, does it become possible to move from the 'middle income' to the 'high income' category.

This lack of diversification explains why key emerging economies such as Brazil, Indonesia, Mexico, South Africa and Turkey have not escaped the middle income trap so far. Some emerging economies (including Russia and Argentina) reached high-income status for a time, but were not able to maintain that status. Only a selected number of countries with middle-income status in 1960 have succeeded in reaching high income status since, including five East Asian nations (Hong Kong, Japan, Singapore, South Korea and Japan) and a number of South and East European countries that have entered the European Union. Barring a serious crisis, however, China is on its way to reach high-income status in the coming years.

¹ Gill I, Kharas H., *An East Asian Renaissance: Ideas for Economic Growth*, Washington D.C., World Bank, 2007

Gross national income per capita

USD, Atlas method



Source: Refinitiv, Worldbank

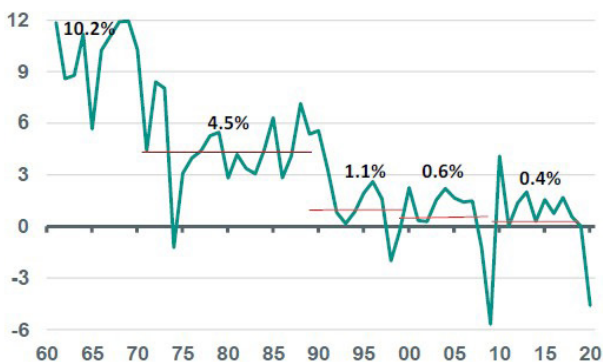
COMMON DRIVERS OF DEVELOPMENT IN JAPAN AND SOUTH KOREA

Common denominators of the rapid economic development of Japan and South Korea (see boxes 2 and 3 for more background) were active government policies directed at heavy industrialisation and the promotion of a high-tech export sector that could compete on foreign markets. That included the building-up of large conglomerates with strong ties to the government and a gradual approach towards trade liberalisation. Both countries also invested heavily in technology and research and development to remain 'cutting edge'. While Japan had certain economies of scale given the size of its domestic market, both countries needed a development strategy built on exports, and therefore had to remain competitive, able to serve the waves of globalisation. Later on, both countries started tweaking their growth model towards domestic demand.

Both countries turned democratic and adopted the market economy, although with all kinds of safeguards to protect domestic industry, certainly in the initial phases of development. They also benefited from good relations with the US and the rest of the West. For Japan, this changed to some extent in the 1980s, when the country's strong rise in high-tech manufacturing and growing US-Japan trade imbalances led to US criticism on Japan's trade practices culminating in the 1985 Plaza Accord and so-called 'voluntary export restraints'. Another commonality during the phase of rapid growth was that a combination of loose monetary policies, the build-up of debt and a loss of competitiveness triggered a severe crisis, although the aftermath of that was much longer in Japan than in South Korea.

Japan: From the Golden Sixties to the Lost Decades

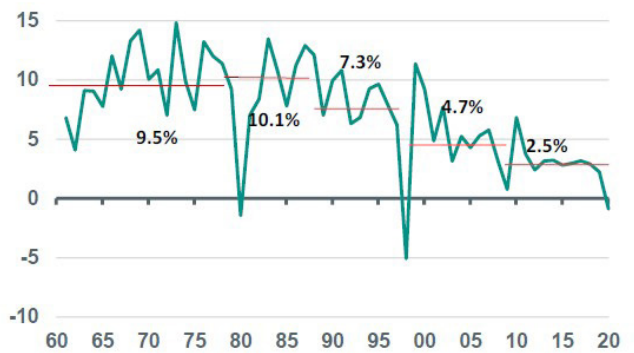
Japan, annual real GDP growth, % (lines represent 10 yr averages)



Source: Refinitiv, ABN AMRO Group Economics

South Korea: The Miracle on the Han River

South Korea, annual real GDP growth, % (lines represent 10 yr averages)



Source: Refinitiv, ABN AMRO Group Economics

Box 2: Japan's post-war Economic Miracle

From the Golden Sixties ...

From the ruins of the Second World War, Japan entered a long episode of rapid economic development, built on specific development policies by the Japanese government and the US Marshall Plan. In the post-war period and during the start of the Cold War, the US was keen to keep Japan in the democratic and capitalist camp to prevent Soviet dominance in the Pacific region. Japan was disarmed, its government system was turned into a democracy and thanks to political and economic reforms, the foundations were laid for Japan to become a key global manufacturer of electronics and consumption goods. Key elements of Japan's Economic Miracle were an export-led growth strategy, heavy industrialisation, loose monetary policies, the building of conglomerate groups (*keiretsu*) with strong ties to the government, a balanced approach to trade liberalisation (with policies aimed at supporting exports and regulating imports) and a strengthening of the social security system. Similar to present-day China, Japan launched an Income Doubling Plan in 1960, that was ultimately reached in seven years instead of the targeted ten years. After the post-war recovery, the Japanese economy grew by an average 10% in the Golden Sixties, and by 4.5% in the 1970s and 1980s.

... to the Lost Decade(s)

In the 1980s, frictions between Japan and the US started rising, as Japan's rapid economic growth was seen as potentially harmful to US interests, and the US bilateral trade deficit with Japan surged. The Plaza Accord of September 1985 resulted in a sharp appreciation of the Japanese yen, triggering a recession of the export-oriented economy. As a result, the Bank of Japan (BoJ) began aggressive monetary easing. This led to rapid credit expansion and the creation of bubbles. When the BoJ finally started tightening in late 1989, this resulted in a collapse of asset prices in the early 1990s and sparked a broad economic and banking crisis. This crisis was not tackled decisively, resulting in zombie banks continue to lend to zombie firms. This had longstanding repercussions for Japanese growth, with the Asian financial crisis in the late 1990s exacerbating this. Average growth in Japan fell from 4.5% in the 1980s to 1.1% in the 1990s. In the 2000s, Japanese growth rates did not improve, averaging 0.7% in 2001-2010 and 0.4% in 2011-2020. Alongside other crises such as the global financial crisis in 2008-09, the earthquake and tsunami in 2011 and the covid-19 pandemic in 2020-21, structural factors reducing potential growth were a drop in productivity growth, partly reflecting a lack of reforms, and demographic issues raised by an ageing population.

SIMILARITIES WITH CHINA'S DEVELOPMENT MODEL SO FAR ...

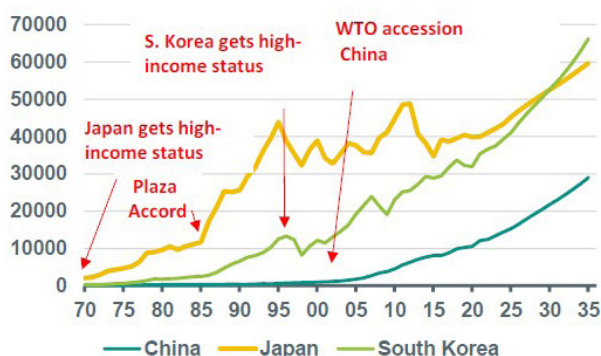
At first sight, China's development strategy over the past few decades shows many similarities with those of Japan and South Korea. After WTO accession in 2001, China followed an export-led strategy, with manufacturing supported by government policies and with strong ties between 'national champions' and the government. Later on, China also realised the importance of shifting its growth model towards domestic demand, and the need to invest in technology to remain competitive and to keep moving up global value chains. China's development also went hand in hand with the build-up of a sizeable debt burden, although that is mainly in domestic hands and denominated in domestic currency (unlike South Korea in the 1990s), with the capital account being still relatively closed. Similar to Japan in the 1980s,

the country's rise is causing frictions with the leading power (US), particularly since 2018 (start of US-China tariff war).

China's economic progress made since its WTO accession in 2002 looks quite comparable to that of Japan and South Korea in the second half of the previous century, although Japan slowed faster than China after the initial 'take-off' phase and China slowed faster than South Korea. Economic growth in China averaged 10.7% in 2002-2011 and 7.0% in 2012-2019. That compares to 10.2% for Japan in the 1960s and 4.5% in the 1970s and to 9.5% for South Korea in the 1960s/1970s and 10.1% in the 1980s. In terms of real GDP growth per head, China has outperformed Japan already since the 1980s and South Korea since the start of this century, when China entered the WTO (see chart).

Japan took off first, followed by South Korea and China

GDP per head, USD, current exchange rates



Source: EIU, Refinitiv, ABN AMRO Group Economics

Real GDP growth per head

Real GDP growth per head (% p.a.)



Source: EIU, ABN AMRO Group Economics

Box 3: South Korea – The Miracle on the Han River

The decades-long post-Korean war economic boom ...

Together with Taiwan, Singapore and Hong Kong, South Korea is classified as one of the Four Asian Tigers, reflecting its impressive development between the 1960s and the 1990s thanks to a strategy of export-led industrialisation. Turning from a mainly agricultural and poor country in the aftermath of the Korean War (1950-53) to a key global manufacturer of electronic components and devices, South Korea has served as one of the role models for many developing countries. Like Japan, South Korea was initially quite dependent on foreign aid, mainly from the US. After a period characterised by import substitution in the first years following the Korean war, the foundations for South Korea's development strategy were laid in the early 1960s. Even more so than in Japan, South Korea's industrialisation strategy had to be export-led, given its relative small domestic market. As a key element of this strategy, the leadership supported the rise of *chaebols*, corporate groups mainly run by families, that partly thanks to many political affiliates turned into 'national champion' conglomerates that were able to compete on foreign markets. Later on, improving the business environment and investing in research and development and innovation have also become key ingredients of the country's development strategy. The success of this strategy led to an average growth rate of around 10% in the 1960s, 1970s and 1980s.

... was severely disrupted by the Asian Financial Crisis in the late 1990s

In the late 1990s, the combination of rapid growth and loose lending policies – coupled with crony capitalism favouring chaebols, an unsustainable exchange rate policy and inadequate supervision and liquidity management – made South Korea one of the victims of the Asia financial crisis. A specific problem was the build-up of large (and mostly hidden) FX-denominated short-term debt by South Korean corporates. All this went hand in hand with rising current account deficits. When market sentiment turned, foreign investment flows dried up, the won depreciated sharply and FX reserves dwindled. This triggered a broad crisis hitting corporates and banks, leading to a deep economic contraction (1998: -5.1%). With the help of the multilateral institutions (a USD 58 bn rescue package was approved end 1997, the largest in the IMF's history at the time) and the adoption of more prudent monetary and fiscal policy and supervision (including the restoring of foreign exchange buffers), South Korea managed to overcome this crisis. Since then, economic growth remained relatively high, averaging 4.7% in 2001-2010 and 2.5% in 2011-2020.

... BUT THERE ARE ALSO IMPORTANT DIFFERENCES

Looking ahead, the main differences between the development path of China with that of Japan and South Korea are 1) China's much larger size, implying greater economies of scale at home and being an even bigger strategic competitor to the US, and 2) its different political system. Both aspects will likely prevent China from getting a similar 'ally status' as Japan or South Korea, with the risk that China becomes more isolated on the global level. All of this takes place in a world that seems at times to be turning its back on globalisation, as the pandemic has accentuated the vulnerabilities in global supply chains.

3. THE MAIN CHALLENGES TO CHINA'S LONG-TERM GROWTH PATH

Whether China will be able to maintain growth at relatively high levels (and to double GDP in real terms by 2035) is a complex, multifaceted issue. In this publication, our focus is on the main challenges that China faces in the coming years. We have divided these into six – partly interdependent - factors: geopolitical, efficiency, technology, other productivity related factors, debt and the environment¹.

¹ There are obviously more factors that have the potential to affect longer-term growth, such as a further opening of financial markets and capital account liberalisation, but these are beyond the scope of this publication.

3.1 GEOPOLITICS: CHINA'S PRESENT EXTERNAL ENVIRONMENT IS MORE CHALLENGING THAN IT WAS FOR JAPAN AND KOREA

GLOBALISATION SUPPORTED EXPORT-LED GROWTH IN JAPAN, SOUTH KOREA AND CHINA

...
For both Japan and South Korea, building alliances with the US and other market-oriented western countries has been a key plank in their post-war development strategy. For China too, its initial rise was supported by improving relations with the US and other Western nations, despite different political systems and recurrent struggles over fair competition and human rights issues. China's accession in late 2001 to the WTO marked an important step towards multilateralism, even though China has since kept its 'non-market economy status'. WTO entry helped China to become the key global production hub and contributed to a jump in bilateral trade between China and western countries.

... BUT THE TIDE IS TURNING, PARTICULARLY FOR CHINA

However, China's geopolitical situation has become much more challenging in recent years, as the country emerges as a global and autocratic power, and strategic competitor to the US (alongside other developed economies). Tensions with the US escalated during the Trump presidency (2016-2020), culminating in a bilateral tariff war and a tightening of restrictions on strategic exports and investment, mainly for reasons of strategic competition and national security. After some easing in tensions with the

conclusion of the so-called Phase 1 trade deal in January 2020, China's role in the (origins of the) covid-19 crisis and its handling of Hong Kong and the Uyghurs has since ignited tensions. All of this has also negatively contributed to China's image, not only in the US but also in other developed countries (see chart).

US-CHINA TENSIONS PERSIST UNDER BIDEN; NOW MORE STRUCTURAL RATHER THAN TRUMP-STYLE MARKET/MACRO SHOCKS

US-China tensions have persisted under the Biden administration, in line with our expectations, with the 'being tough on China' attitude becoming bipartisan. Democrats are also concerned about strategic competition and certainly about human rights issues, and the US administration is currently reviewing its stance following an evaluation of China's commitment to the Phase-1 trade deal. That said, in our view US-China tensions have become more of a structural issue under President Biden, rather than taking the form of macroeconomic and/or market shocks that were typical during the Trump era. Another difference is that Biden is aiming for a multilateral approach versus China, illustrated for instance by the conclusion of a recent security pact with the UK and Australia. At the same time, Biden also recognises that cooperation with China is needed, for instance on climate-related issues. Relations between China and other Western nations (e.g. EU, UK, Australia, Canada) are also under strain. After the EU imposed (Uyghur related) sanctions on China, for the first time since 1989, China reacted furiously. This spat caused a delay in the ratification of the EU-China investment deal signed in late 2020.

CHINA'S TREATMENT OF HONG KONG HAS PUT THE SPOTLIGHT ON TAIWAN

In the slipstream of China's crackdown in Hong Kong, tensions regarding Taiwan – a key pivot state partly reflecting its dominant role in the

global production of semiconductors – have risen. Reunification with Taiwan is an explicit long-term goal of the Chinese Communist Party. A future Chinese 'intervention' in Taiwan in whatever form is a 'fat tail' risk that cannot be neglected. It would put political and economic relations between China and the West under severe strain.

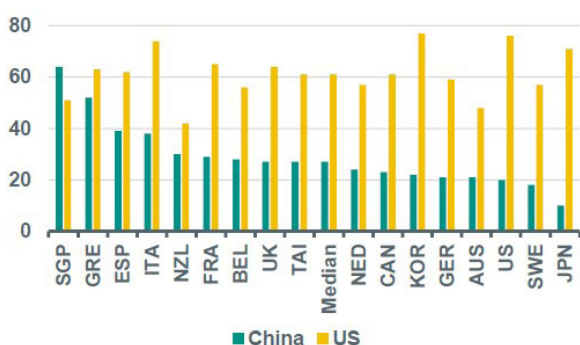
COLD WAR 2.0?: DESPITE POLITICAL TENSIONS, NO MAJOR SIGN OF GLOBAL SUPPLY CHAINS MOVING OUT OF CHINA YET

A related question is whether the combination of trade and tech tensions, vulnerabilities to (China centered) supply chains that came to light during the pandemic – including a surge in container freight tariffs from China – and growing criticism of the use of certain products where human rights issues are at stake could lead to a further shift of supply chains out of China over time. Reference is sometimes made to the concept of *Cold War 2.0*, referring to the relationship between the former Soviet Union and the West. This is a bit misplaced in our view, as economic and trade ties between the US/West and China are far bigger than those between the US/West and the former Soviet Union (see chart).

What is more, while US-China trade has come down following the trade war and the pandemic, it has bounced back, even if not quite recovering back to pre-trade war levels. Meanwhile, bilateral trade between China and the eurozone has picked up following the pandemic disturbances, and is now clearly above 2019 levels. All of this suggests that there is no general evidence yet of a strong movement of supply chains out of China. This could partly reflect a pandemic-related global shift in consumer demand from services to goods, and pandemic-specific demand for medical and computer goods and products that can be bought online (in which China has a competitive edge).

Attitude versus China and US in advanced economies

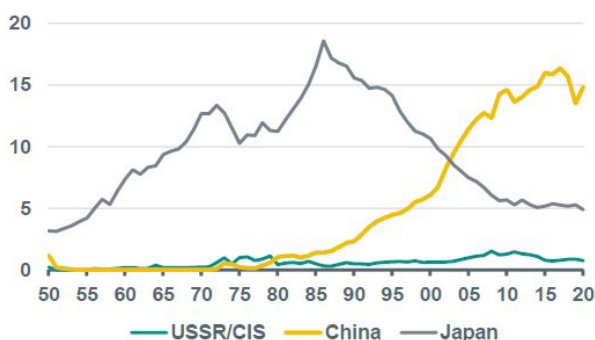
% of respondents who have a favourable view of ... (June 2021)



Source: Pew Research Center

Cold war 2.0? – US-China stakes much higher

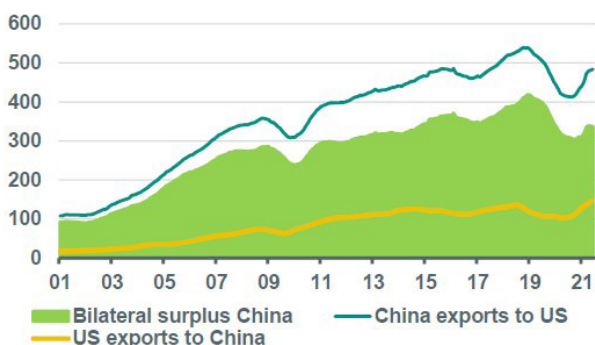
Trade shares with the US, %



Source: Refinitiv, ABN AMRO Group Economics

China-US trade has recovered from trade war,

USD bn, 12 months' rolling sum



Source: Refinitiv Eikon Datastream, ABN AMRO Group Economics

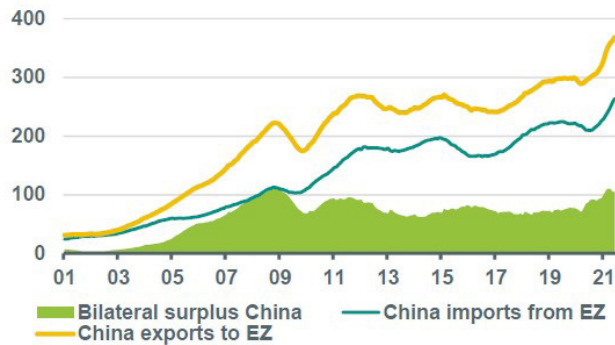
Of course, all of this could change over time, as the pandemic and resulting distortions in global trade and transport have highlighted the importance of having reliable supply chains, certainly for critical products such as semiconductors or medical supplies. What is more, there are more interests at stake than just bilateral trade, with for instance many US companies producing in China for the domestic, US and global markets (partly explaining the wide bilateral trade imbalance). Unbundling these ties would be costly to both the US and China. Hence, given the high stakes for globally operating companies, we assume such shifts would occur gradually rather than abruptly, giving time for China to adjust and diversify into other destinations. China's participation in the Regional Comprehensive Economic Partnership signed in late 2020, which account for around a third of global GDP and population, and its recent application to the CPTPP may be seen as preludes in that respect.

3.2 EFFICIENCY: WHAT WILL THE REGULATORY CRACKDOWN/SHIFT TO 'COMMON PROSPERITY' MEAN FOR THE PRIVATE SECTOR?

Another issue is whether China's institutional framework, with a central role for the government and limited market forces driving capital allocation, will continue to facilitate sufficient productivity growth. This question has become all the more relevant given that reforms of Chinese SOEs – which are on average less productive and more debt-ridden than private firms – are going slow. What is more, under Xi's leadership, Beijing has become more active in steering outcomes within the private sector that are deemed undesirable in the eyes of the CCP. Since end 2020, in line with the strategic goals of the 14th Five-Year Plan, Beijing has intensified

China trade with eurozone on the rise as well

USD bn, 12 months' rolling sum



Source: IMF, Refinitiv Eikon Datastream, ABN AMRO Group Economics

and broadened a regulatory crackdown vis-à-vis the private sector (see box 4) for reasons of national security, fair competition and consumer protection. That crackdown started with the most underregulated parts of the private sector (fintech firms and online platforms) and was broadened to other sectors (such as online education and entertainment) which have practices that are not in line with the goal of *common prosperity* according to Beijing.

While this remains an important issue over the longer-term, some nuance in this respect seems warranted:

1. As mentioned previously, Japan and South Korea in the past also adopted a mixed government model, with a major role for the government, alongside market mechanisms – certainly in their first phases of development.
2. Given that China's market economy is relatively young, it is natural that some market outcomes are disorderly, triggering some form of official reaction.
3. Notwithstanding China's centralist model, its private sector is quite dynamic. Over the past fifteen years, industrial production growth in the private sector outpaced that of the state-owned sector. In addition, private investment is over the longer term holding up well with public investment growth (see charts).
4. China's activism is not entirely unique. Even in advanced economies, we have seen more signs of government activism following market failure (think of the government's role after the global financial crisis, the covid-19 crisis or in the long-term energy transition).

All told, there are a number of reasons why China's model has been quite effective and efficient, as well as tailored to its development phase. We think that, with some modernisation, this model could work for some years to

Industrial production – gross value added



Source: Refinitiv

Fixed asset investment



Source: Refinitiv

come. That said, as recent developments have shown, there is a risk that poor communication of a tightening in regulation triggers market shocks, damaging longer-term policy credibility (particularly among foreign equity investors), and potentially undermining private sector confidence and dynamism.

3.3 TECHNOLOGY: WILL MORE REGULATION FOR (FIN)TECH IMPAIR CHINA'S TECHNOLOGICAL ADVANCE?

Technological progress was a key factor explaining the rise of Japan and South Korea, and it has been a key factor driving China's development too. In 2015, the government

adopted the Made in China 2025 plan aimed at upgrading China's manufacturing industry, bolstering production in high-tech goods and services, and becoming the global leader in key technologies such as artificial intelligence and robotics, 5G, semiconductors, aerospace, green energy and electrical vehicles. This plan is shaped by the typical Chinese way of rolling out comprehensive industrial policies and supporting national champions that have the potential to compete globally and gain foreign market share.

Following the intensification of trade and tech tensions with the US, in particular since 2018 (the second year of the Trump-administration), the Made in China 2025 plan has been downplayed

Box 4: China's Regulatory Crackdown and Shift to Common Prosperity

China's regulatory crackdown has taken investors by surprise...

Over the past year, Beijing started a regulatory crackdown on internet-related companies, triggering quite some market volatility. The crackdown started in November 2020, when the authorities presented new rules for fintech firms and halted a large IPO of Ant Group, the financial company affiliated with e-commerce giant Alibaba and owner of the online platform Alipay. Later on, Alibaba was fined and Ant Group was ordered to restructure, but it soon became clear that these actions were not just a personal vendetta against founder Jack Ma. In the course of 2021, Beijing broadened the crackdown to other fintech firms and online platforms (as well as bitcoin), but also to sectors such as online education and entertainment/gaming. For reasons of national security and data protection, the government also tightened rules for mergers and acquisitions and foreign IPOs, including banning Variable Interest Entities that Chinese firms often use to circumvent regulation.

...but is part of a strategic plan and fits with Beijing's shift to common prosperity

While the measures announced have occasionally taken investors by surprise due to a lack of clear communication, they are part of a broader strategic plan to improve regulation of the often underregulated internet-related parts of the economy. The sense of urgency for this has risen during the pandemic, as this highlighted the importance of internet services. Other concerns lay in the areas of national security and data protection, antitrust issues and improving competition. In its 14th Five-Year Plan covering 2021-25, the government launched the concept of *dual circulation*, thereby stressing the importance of reducing China's dependence on foreign technology and critical imports (e.g. semiconductors) and improving the functioning of domestic markets. The crackdown goes hand in hand with other goals, such as reducing social inequality and supporting family values. China's Communist Party is putting more focus on traditional socialist goals and promoting common prosperity, a term first mentioned by Deng Xiaoping in the 1980s. Recently, president Xi Jinping pledged to 'reasonably adjust excessively high incomes, and encourage high-income groups and companies to give back more to society'.

No general attack on 'tech': high-tech manufacturing is still Beijing's favourite

We expect the regulatory campaign to continue, but investors will likely get used to this process and communication from Beijing should improve. The campaign will affect not only internet-related sectors, but also other sectors: particularly consumer services and public services such as education, healthcare, media and entertainment. The sector least likely to be affected by the regulatory campaign is high-tech manufacturing, the sector which receives the most government support. In our view, this regulatory crackdown is not so much a "general attack on tech," but rather an attempt by the Chinese leadership to shift resources to high-tech manufacturing which it sees as the key driver of China's technological advance

Regulatory crackdown has impacted equity prices

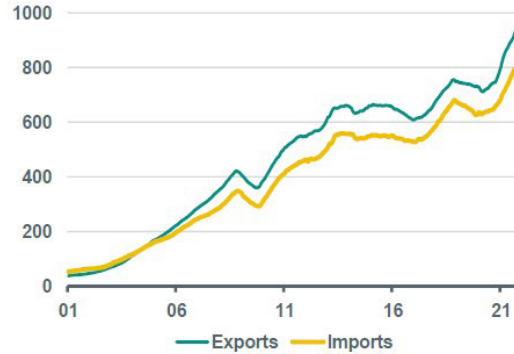
Stock price, indices, 28 Oct 2020 = 100



Source: Bloomberg, ABN AMRO Group Economics

High-tech manufacturing key driver Chinese growth

Exports/imports of high-tech goods, USD bn, 12 months rolling sum



Source: Refinitiv, ABN AMRO Group Economics

by Beijing in its external communications. However, in the 14th Five Year plan (covering 2021-25), technological advance is still one of the key strategic goals. For instance, Beijing aims to increase spending on research and development by 7% annually until 2025. That said, ramping up these goals is also vital for China to succeed, given that, as a share of GDP, R&D spending has stagnated over the past few years and is still lagging Japan, South Korea and other leading developed economies. Likewise, China's ranking on the global innovation index has improved materially in recent years, but fell back in 2020. All in all, investing in key technologies remains an important policy priority for China to keep moving up value chains and to maintain high productivity growth, but risks stem from a more complex and hostile external environment – with more restrictions on exports of strategic (tech) products to China.

Will the strengthening of regulation for the internet sector, which is an important driver of technological progress in China, prove an important hurdle in this respect? In our base

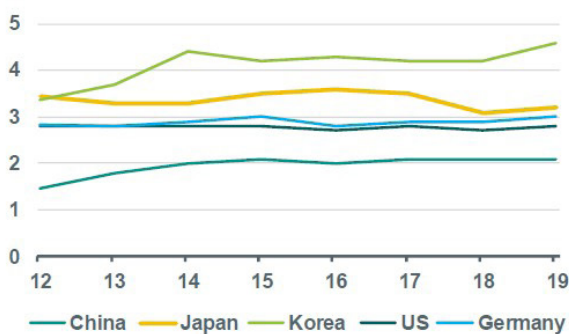
case, we do not really think so. Beijing wants to develop into a global tech leader and therefore does not want to choke the development of this sector. However, as laid out in the 14th Five-Year Plan, we think Beijing wants technological process to be driven by high-tech manufacturing (including robotics, AI, electric vehicles) and not by online consumer and public services. All in all, we do not see this regulatory crackdown as a 'general attack' on tech, and expect high-tech manufacturing to remain Beijing's favourite (see box 4).

3.4 OTHER PRODUCTIVITY-RELATED FACTORS: DEMOGRAPHICS/AGEING, EDUCATION AND URBANISATION

The so-called Cobb-Douglas production function stipulates that economic growth is a function of (growth in) the input factors labour and capital and 'total factor productivity', which captures factors such as efficiency, technological advances and improvements in human capital. A common factor in the rise of Japan and South Korea in the second half of the last century – and that of China

China needs to catch up in terms of R&D spending ...

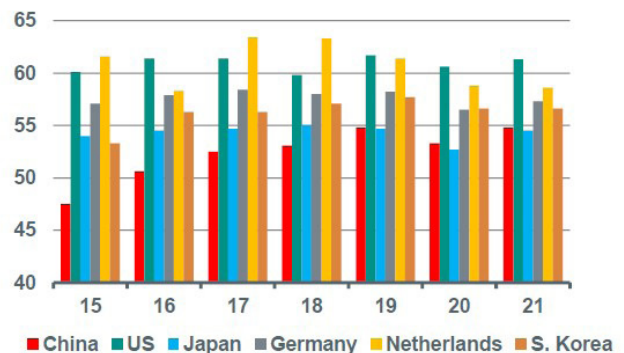
R&D spending, % of GDP



Source: Refinitiv

... which would help closing the innovation gap

Innovation indices



Source: Refinitiv

this century – is strong productivity growth in the early stages of the process, naturally coming down as catch-up effects fade over time. Over the past few decades, productivity growth in China was higher than in Japan and South Korea (as both countries took off much earlier), but over time a convergence in productivity growth is expected (see chart). For China – faced with slowing population growth, ageing and hence a shrinking labour force – keeping productivity growth high will be a crucial factor supporting GDP growth. We already looked at technological progress before; hereafter we will explore some other productivity related factors: demographics, education and urbanisation.

A. DEMOGRAPHICS, AGEING AND THE LABOUR FORCE – WILL CHINA GROW OLD BEFORE IT GETS RICH?

A feature of development in advanced economies including in Japan and South Korea has been falling population growth as average wealth increases and female labour participation rises. China is following the same pattern with annual population growth falling from around 2% in the early 1980s to currently around 0.5%. China’s population is expected to peak in 2026-27 and gradually decline thereafter. Birth rates have fallen rapidly, also reflecting the rising costs of raising children. This trend has been aggravated by official government policy, such as the adoption of the one-child policy in the late 1970s. Beijing eased this policy in 2016 (allowing two children per family) and in 2021 (three children), but that will not help to change the picture much, certainly not without taking other measures. Recent policy measures – such as the crackdown on online education – show that Beijing aims to reduce costs related to raising children.

In terms of production capacity, future growth of the labour force is even more important than that of the total population. In China, the combination of ageing and a drop in birth rates has already driven a stagnation in the labour force in recent years. The EIU expects the labour force to fall more sharply in the course of this decade than the overall population. Of course, this will also depend on other government measures. Beijing is said to be mulling a rise in the retirement age, which is still low by international standards (currently 60 for men, 55 for female civil servants and 50 for other female workers).

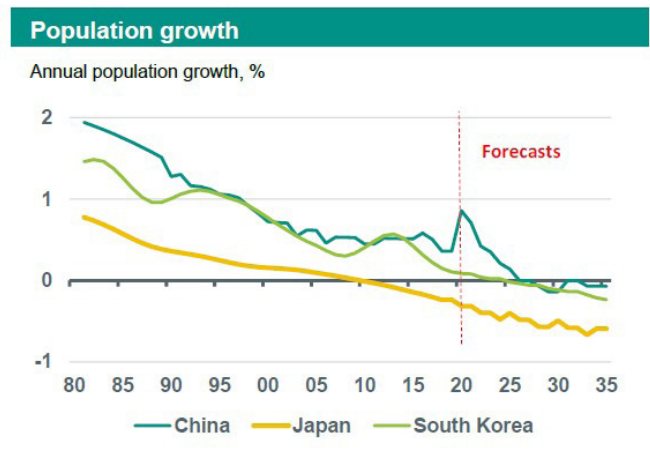
B. EDUCATION

The expected drop in China’s population and labour force, makes productivity gains all the more important. Advances in human capital are not only a direct source of productivity growth, but are also needed to drive other structural changes such as developing the services economy and moving up in value chains towards high tech sectors. In that respect, China lags Japan and South Korea, who rank among the country’s with the highest levels of education and whose workforces were also clearly higher educated than China’s at similar stages of development. According to a 2020 OECD study². China’s young workforce was the least educated in the survey sample (lagging emerging markets like Brazil, Turkey and Indonesia), with over 60% of the 25-34 years old having an education below the upper secondary level. That implies that, unless China succeeds in upgrading the skills of its workforce – by investing in education or by immigration - a scarcity of skilled people could prove a bottleneck for China’s transition over time.

² OECD, Education at a Glance 2020.

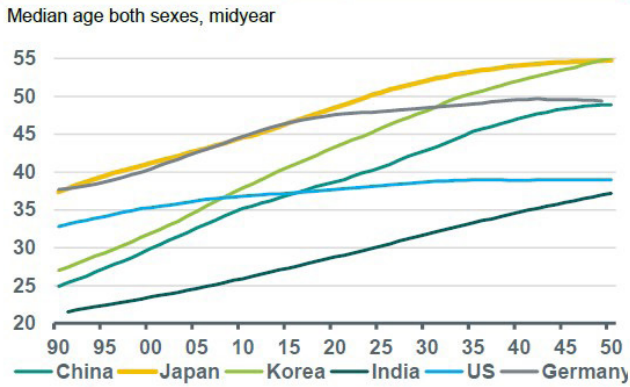


Source: EIU



Source: EIU

The Middle Kingdom is getting older



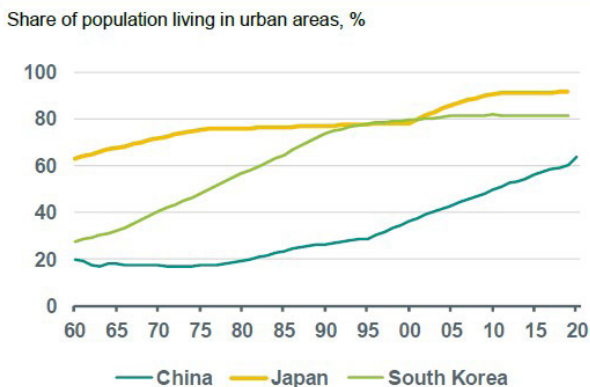
Source: Bloomberg, US Census Bureau

C. URBANISATION

Strong productivity growth in Japan, South Korea and China goes hand in hand with a process of urbanisation, implying the transfer of workers from low-value added (agricultural) sectors to higher value-added industrial and services sectors concentrated in urban areas. Japan saw a rapid urbanisation in the 1950s and 1960s and is currently one of the most urbanised countries worldwide. South Korea's urbanisation mainly took place in the 1970s and 1980s. China's urbanisation drive took off particularly in the late 1990s, but the country's urbanisation rate (2020: 64%) is still lower than in Japan, South Korea and other developed countries. China's urbanisation rate is also substantially lower compared to Japan and South Korea when they were at similar levels of GDP per capita in PPP terms.

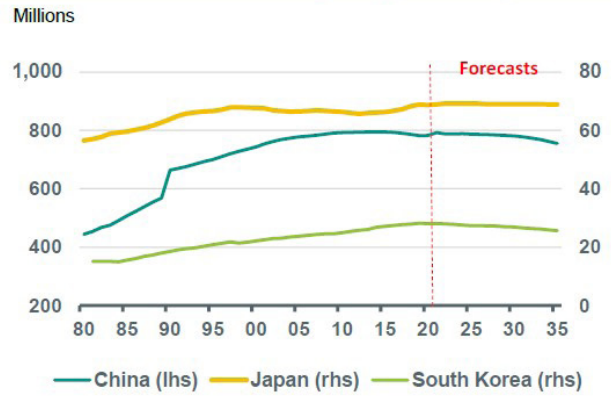
For a long time, China's urbanisation has been held back by country-specific factors, including the so-called *hukou* household registration system (a legacy of the planned economy). However, the 2020 census results published in May 2021 show that China's pace of urbanisation has picked up, thanks to an easing of the *hukou* system in many cities other than the largest

Urbanisation ratio



Source: Refinitiv

The labour force has already stopped rising



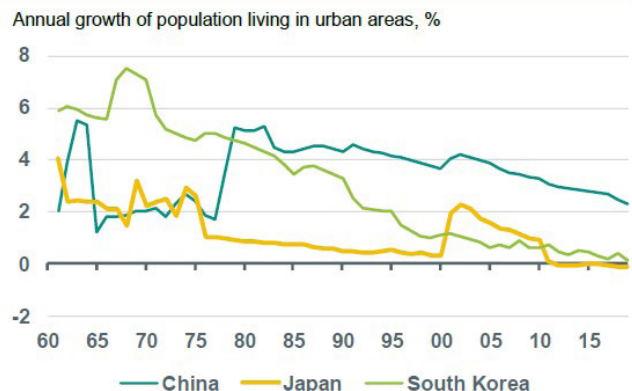
Source: EIU

ones and thanks to recent efforts to redevelop rural areas bordering existing cities into urban areas. A more structural driver of urbanisation in China is the *Go West strategy* adopted twenty years ago, that was beefed up with the *Belt and Road Initiative* launched in 2013. All in all, in the coming decade China's economy (and its demand for housing and commodities) has still a lot to gain from further urbanisation, even though the urbanisation pace is naturally coming down (while a post-pandemic shift to working from home may take away some of the need of further urbanisation). Estimates for China's urbanisation rate by 2030 range from 70 to 75%.

3.5 DEBT-RELATED FACTORS: IS CHINA'S DEBT A TICKING TIME BOMB?

Another factor that could impact China's longer-term growth trajectory relates to the country's ongoing high and still rising indebtedness. According to BIS data, China's overall debt ratios have risen sharper than the global average since the global financial crisis, with the ratio of total outstanding credit to GDP more than doubling from 139% at end-2008, to 290% by end-2020. After the authorities changed course

Pace of urbanization



Source: Refinitiv

by focussing more on deleveraging, debt levels stabilised in 2017-2019, but the pace of leveraging up increased again in the pandemic year 2020 – in line with the global pattern. While China’s total debt ratio was comparable to the emerging markets’ average at the start of this century, it is now close to the average ratio in advanced economies. We should add that (particularly for advanced economies), the rise in global debt levels should also be seen against the background of generally lower interest rates.³

China’s total debt-to-GDP ratio is still much lower than Japan’s (total debt around 420% of GDP by March 2021), and is more comparable to that of South Korea. In Japan, general government debt accounted for more than 50% of outstanding credit in 2020. In China, the share of the general government in total debt is much lower (23% in 2020). Non-financial corporations account for the bulk (55% in 2020) of outstanding credit in China. That said, state-owned enterprises are an important subgroup in this category, which implies that the Chinese government has significant contingent liabilities.

As the Chinese economy recovered quickly from the pandemic shock last year, since end-2020 the authorities shifted the policy priority from macro-economic stabilisation to financial deleveraging again. One of the policy targets adopted for 2021 is to cap credit growth at the level of nominal GDP growth, implying a stabilisation of the debt ratio. The government has also tightened financial conditions for the real estate sector and the shadow banking system. As a result of all of this, the credit cycle has started turning since late 2020, to the point that the authorities are now shifting back again to a moderate, ‘piecemeal’

³ Also see our previous Flagship publication, [Does debt still matter](#) (July 2021).

monetary easing to safeguard growth.

Recent debt distress at firms like Evergrande (see box 5) are a reflection of China’s high debt and past lending policies, certainly in real estate. This raises the question (again): is China’s debt a ticking time bomb? In fact, the government’s ‘three red lines’ policy aiming, at reducing leverage in real estate, has actually added to Evergrande’s woes. We expect Beijing to balance fighting moral hazard versus financial stability/social unrest in resolving this specific crisis.

In general, we think that China’s high debt levels do put a longer-term constraint on growth, even though a debt-driven hard landing at the macro level is not our base case. The debt of China Inc. mainly relates to loans in local currency by Chinese banks to Chinese firms (unlike South Korea in the 1990s, China’s external debt ratios are low and its foreign reserve buffers very high). Therefore, the likelihood that a debt crisis will be triggered by foreign investors is low. This leaves Beijing time to engineer an orderly solution, should the situation get out of hand. That said, Beijing’s more tolerant attitude vis-à-vis defaults – as the implicit guarantee framework is left behind – shows that creditors should be aware that sometimes defaulting is also a form of deleveraging (as illustrated by Evergrande, Huarong and the likes).

3.6 ENVIRONMENTAL FACTORS: THE LONG MARCH TO PEAK CARBON AND CARBON NEUTRALITY

Last but not least, another key challenge for China’s long-term growth path relates to environmental issues. Mirroring its economic rise, China has developed into the world’s largest CO2 emitter: its share in global emissions has

China’s total debt in international perspective (1)

Outstanding credit to real economy, % GDP



Source: BIS

China’s total debt in international perspective (2)

Outstanding credit to real economy, % GDP



Source: BIS

Box 5: Evergrande's debt debacle – fighting moral hazard and systemic risk

Distress at China's large real estate developer Evergrande, with ratings downgraded to very low levels and rumours of non-payment of outstanding debt obligations, has fed systemic risk fears, with spill-overs to the wider real estate sector. This triggered market corrections in China and beyond. While the problems will not be solved overnight, and this could cause further reverberations in global markets and add to growth risks, we assume that Beijing will seek a balance between reducing moral hazard and safeguarding financial stability/preventing social unrest. Containing systemic risks has always been an important anchor for Beijing in managing risk events, and it would not seem very logical to steer this case purely from the perspective of 'reducing moral hazard'. Although curtailing a big company with malpractices also seems to fit with Beijing's regulatory crackdown and its shift to a *common prosperity* goal, punishing 'the Chinese middle class' (including home owners) does not. All in all, it looks likely we will see some form of 'mixed solution', with debt restructurings vis-à-vis creditors with a low priority according to Beijing (to deal with the moral hazard issue) on the one hand, and intervention to limit systemic risks on the other. Beijing has the tools to interact and engineer a longer-term solution, both in financial terms but also in governance terms. Indeed, a similar mixed solution was found for the asset management company Huarong earlier this year, although that was a state owned company while Evergrande is a private firm.

risen from around 5% in the 1970s to 30% in 2018. Correcting for China's size, according to the recent IPCC report, the country ranks 7th in per capita terms following three Gulf States, Canada, the US and Germany. What is more, in absolute terms China is not only the largest polluter, but also the world's biggest investor in renewable energy. In 2020, Chinese investments in renewable energy capacity were almost three times as large as the runner-up US.

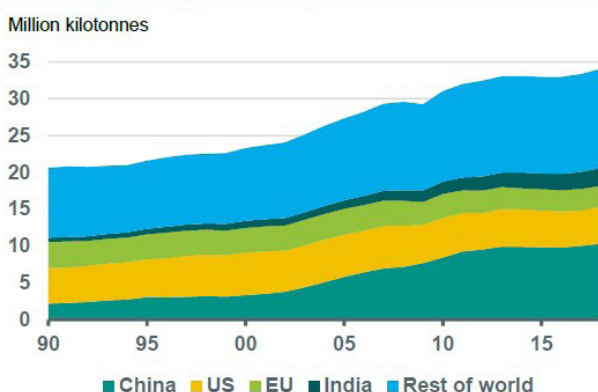
According to the plans presented, the leadership is taking seriously its responsibility for China's role in the global climate debate, at least on paper. In September 2020, President Xi Jinping announced that China's goal is to bring carbon emissions to a peak in 2030 and become carbon neutral before 2060. Building on previous development plans, energy and climate targets form an important pillar of China's 14th Five-Year plan. This plan presents an 18% reduction target for CO₂-intensity, and a 13.5% reduction target for energy intensity by 2025. More specific plans are being developed for various sectors and regions. In July 2021, China launched the world's biggest carbon emissions trading system (ETS). According to data from the Tsinghua University of Energy, Environment and Economy, conventional energy will account for roughly 80% of China's energy mix in 2025 (with coal

responsible for 52%). However, if China is to live up to its environmental ambitions, the share of conventional energy will need to drop dramatically by 2060 (to 13%), and by then wind, solar, nuclear and hydro will need to be the major sources of power generation in China.

China's huge climate ambitions will have a big impact on individual sectors and regions, particularly those regions that are lagging in terms of the energy transition. The key question is what the impact will be of structural shifts in environmental policies on long-term economic growth. The lack of a long-term numerical growth target in the 14th Five-Year Plan suggests that growth *quality* rather than *quantity* has gained further in importance, and that Beijing would tolerate some slowing of growth if needed to reach its climate ambitions. At the same time, investments into the energy transition could also generate GDP growth, if for instance China becomes a global leader in producing and exporting electronic vehicles or other products needed for the global energy transition.

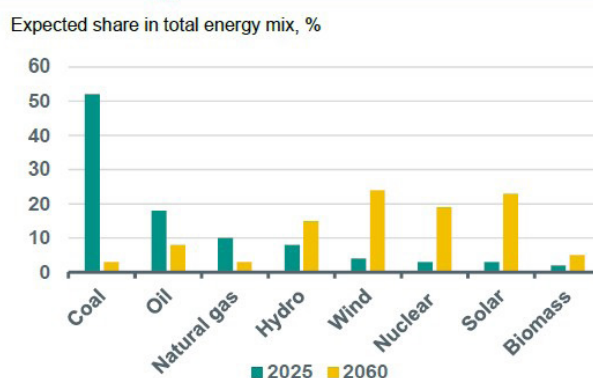
All in all, China's energy transition implies both downside and upside risks to longer-term growth. What is more, we think that potentially painful trade-offs will become more evident later on in the transition process. The government still

China's growing share in global CO₂ emissions



Source: Refinitiv

China's energy transition



Source: Visualcapitalist.com, Tsinghua University, EIA.

has to live up to its 'social contract' to maintain economic progress, and to manage vested interests. Should Beijing succeed in facilitating further economic progress, realising a further increase in GDP per capita and better living conditions for the expanding middle class, policy makers will get more leeway to make more painful choices in the next phase. The way the Chinese ETS market has been shaped – without hard targets, but with the architecture in place to do more over time – is in a way symbolic of the fact that only the first steps have been taken in the long march to peak carbon and carbon neutrality.

4. LONG-TERM SCENARIOS: MUDDLING THROUGH, CONFRONTATION, COOPERATION

As highlighted in the previous chapter, China faces many challenges on its longer-term growth path. Macro-economic, financial or geopolitical shocks could lead to a sharper deceleration in the Chinese economy, or even a hard landing, which could have major repercussions for world trade and the global economy, as well as for commodity markets. At the same time, there are also upside risks. To analyse the potential consequences of these downside and upside risks, we work with qualitative scenarios. We compare a 'middle-of-the-road' *Muddling through* scenario with two alternative scenarios: *Confrontation* and *Cooperation*. We should add that these scenarios are illustrative and informal (our explicit forecast horizon does not go beyond two years).

SCENARIO A: MUDDLING THROUGH

This longer-term (illustrative) scenario assumes China will manage its key challenges in the areas of geopolitics, efficiency/productivity, technology, debt, and the environment, relatively well. The government will continue to balance safeguarding economic growth versus financial stability and environmental change, with preventing a sharp slowdown as an important policy constraint. Strategic competition between China and the US/west will continue, but geopolitical and trade/tech tensions will not get completely out of hand. Although there will be further shifts of certain supply chains out of China (for various reasons), the country will not be completely isolated from the west. Cooperation on key global areas such as climate change will continue. Eye-catching debt dramas

(like Evergrande or Huarong) will continue to pop up from time to time, but China can avoid an overall debt crisis culminating in a hard landing, or in a debt crisis similar to those Japan and South Korea faced in the 1990s. China's campaign to strengthen the regulatory framework in underregulated sectors and the shift to *common prosperity* will continue. Although causing market volatility from time to time, this will not completely stifle private sector dynamism, nor will it lead to a complete dry-up of investment flows into China. High-tech manufacturing will continue to drive China's technological advance.

In this scenario, even though China will obviously not be immune to – and will contribute to – short-term cyclical and market volatility, we assume that annual growth will resume its gradual slowdown from 2022 onwards. Such a gradual slowdown fits with China's development phase and the shifting policy mix, with more attention on quality rather than quantity of growth. This implies an average estimated growth of 5.8% in 2021-2025 (5.1% in 2022-2025), 4.0% in 2026-2030 and 3.2% in 2021-2035, leading to an average growth rate of 4.3% in 2021-2035. The latter estimate is somewhat below the 4.7% real GDP growth needed to realise Beijing's informal goal to double GDP by 2035. In this scenario, China would reach high-income status in 2023, taking into account the World Bank's current country classification and assuming that we will not see a sharp CNY depreciation versus USD⁴. After that, GDP per capita would keep on rising, although the gap in GDP/capita terms between China and Japan would not narrow until 2035, while the gap with South Korea would even widen a bit.

SCENARIO B: CONFRONTATION

In the long-term (illustrative, informal) *Confrontation* scenario, China will be faced with an (even more) hostile external environment, as well as a bigger negative fallout from its own domestic policies. We assume the stance of a Western alliance versus China hardens, trade/tech tensions intensify again (possibly in relation to geopolitical risks flaring up) and strategic competition turns into strategic confrontation. This would entail a further decoupling of trade flows between China and the US/the west, with China being forced to shift its export base faster to other (less wealthy and less sophisticated) emerging and developing economies. This would hinder the country's ambitions to grow richer by moving up global (tech) value chains.

⁴ The World Bank uses gross national income per capita, measured according to the Atlas Method. In practice, for China this is closely aligned with measuring GDP in nominal (USD) terms.

Illustrative long-term growth scenarios for China

Annual real GDP growth, % (estimates from 2021 onwards)



Source: ABN AMRO Group Economics, EIU

Efforts to become more independent and reduce (critical) imports will intensify. The more difficult external environment will also complicate the management of domestic issues, and the trade-off between safeguarding growth, on the one hand, and financial stability and environmental policy on the other, will become tougher.

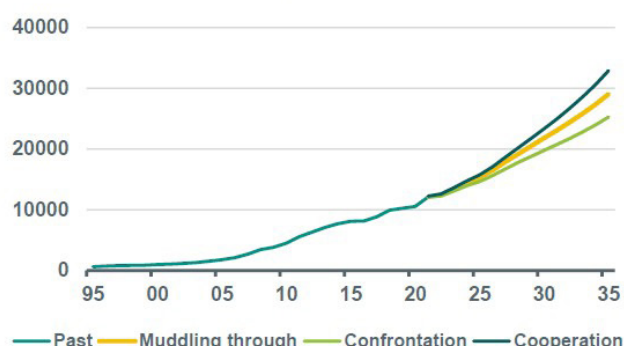
All of this implies a sharper slowdown of the Chinese economy compared to *Muddling through*. In this scenario, annual growth would average 4.9% in 2021-2025 (4.2% in 2022-2025), 2.8% in 2026-2030 and 2.3% in 2021-2035, leading to an average growth rate of 3.3% in 2021-2035. Beijing would therefore not reach its informal goal to double GDP by 2035. China would still reach high-income status in a few years' time, but in 2035 GDP/capita would be almost 15% lower compared to *Muddling through*.

With an estimated share in global GDP of around 20%, the direct effect of a sharper deceleration compared to *Muddling through* would mean a 0.2 pp reduction in global GDP growth per annum. However, looking only at this direct effect would be too simplistic. There are also indirect effects. For instance, exporters of capital goods and commodities will likely suffer from a sharper slowdown in China, while other high-tech manufacturers (including Japan and South Korea) could profit from a further shift of global (tech) value chains out of China. Moreover, the net effect on global growth will also depend on what will happen with China's current account surplus⁵. A shrinking surplus would be growth-positive for the rest of the world and vice versa. A precise calculation of these longer-term direct and indirect effects is not within the scope of this report, but could be part of future research.

⁵ Whether China will remain a current account surplus country or not is beyond the scope of this paper.

GDP per capita estimates in three long-term scenarios

GDP per capita, nominal, in USD (estimates from 2021 onwards)



Source: ABN AMRO Group Economics, EIU

SCENARIO C: COOPERATION

In the long-term (illustrative, informal) *Cooperation* scenario, the need to cooperate with China on global issues – particularly on environmental issues – drives a turn for the better in relations between China and the US/ the west. Leaders decide to agree to disagree on controversial issues, while sticking to the status quo in sensitive geopolitical areas. Instead, they aim to focus on strengthening cooperation, while safeguarding or even strengthening economic and financial ties. In some ways, China would in this scenario benefit from similar tailwinds as Japan and South Korea did last century, although the incentive to cooperate now is to fight climate change, rather than communism (arguably the main reason the US/West aided the development of Japan and South Korea). This would allow China to continue moving up tech value chains and to strengthen its role in producing goods that are needed globally to support the energy transition, such as electronic vehicles and goods needed to generate clean energy. The improved external environment would help to simplify the management of domestic issues, and the trade-off between safeguarding economic growth on the one hand, and financial stability and environmental policy on the other, will become easier to tackle.

In this scenario, China's long-term economic growth would hold up better compared to the *Muddling through* scenario. This implies an average estimated growth rate of 6.3% in 2021-2025 (5.7% in 2022-2025), 4.8% in 2026-2030 and 4.4% in 2021-2035, leading to an average growth of 5.2% over 2021-2035. Beijing would therefore comfortably achieve its informal goal to double GDP by 2035. In this scenario, China would also reach high-income status in 2023, but in 2035 GDP/capita would be almost 15% higher compared to *Muddling through*.

China: long-term qualitative (informal) scenarios

	Muddling through	Confrontation	Cooperation
<i>Real GDP growth estimates (%, annual average)</i>			
2021-2035	4.3	3.3	5.2
2021-2025	5.8	4.9	6.3
2022-2025	5.1	4.2	5.7
2026-2030	4.0	2.8	4.8
2031-2035	3.2	2.3	4.4
<i>GDP/head estimate (2035, nominal, USD)</i>			
	29.000	25.200	32.900

Source: ABN AMRO Group Economics, EIU.

5. CONCLUSION

Whether China will be able to maintain growth at relatively high levels (and to double GDP in real terms by 2035) is a complex, multifaceted issue. How successful China will be in managing a number of partly interdependent challenges in the areas of geopolitics/supply chains, efficiency/technology/productivity debt and climate, will be crucial for the country's longer-term growth trajectory. After having analysed these challenges, we present three potential long-term scenarios for China's longer-term growth path.

The *Muddling through* scenario assumes that China will be able to manage its key challenges reasonably well and that the economy will resume its gradual slowdown from 2022 onwards. In this scenario, average growth in 2021-2035 will be a bit below the annual 4.7% needed to reach Beijing's informal target of doubling GDP by 2035. However, China will reach high-income status in 2023, according to the World Bank's current classification standards.

The *Confrontation* scenario assumes the stance of a Western alliance versus China hardens, trade/tech tensions flare up and strategic competition turns into strategic confrontation. The trade-off between safeguarding growth, on the one hand, and financial stability/environment on the other will become tougher. All of this implies a sharper slowdown of the Chinese economy compared to the *Muddling through* scenario. Annual growth would average 3.3% in 2021-2035. Beijing would not reach its informal goal to double GDP by 2035. GDP per capita would be around 15% lower in 2035 compared to *Muddling through*. The direct effect would mean a 0.2 pp reduction in global GDP growth per annum, but there are more important second-round effects.

In the *Cooperation* scenario, the need to cooperate with China on global – particularly climate – issues triggers a turn for the better in relations with the West. China would benefit from similar tailwinds as Japan and Korea did last century, although the incentive to cooperate now is to fight climate change, not communism. This would help China to continue moving up in the tech value chain, and to strengthen its role in producing goods that are needed globally to support the energy transition. The improved external environment would help to simplify the management of domestic issues. Growth would hold up better than in the *Muddling through* scenario, averaging 5.2 in 2021-35. Beijing would more than reach its informal goal to double GDP by 2035, while in 2035 GDP/ capita would be 15% higher compared to *Muddling through*.

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