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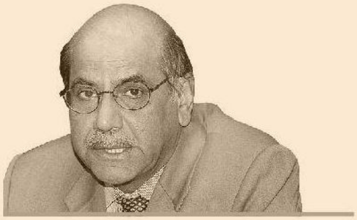
How serious is China's economic slowdown?

Losing this engine, which has been shoring up global growth, may be more disruptive than we imagine

The outcome of the ongoing US-China trade war is closely linked to the assumptions regarding China's economic growth trajectory. A China capable of sustaining a 6-6.5 per cent gross domestic product (GDP) growth rate over the next decade is unlikely to make significant policy changes to resolve the trade war. Its effort would be to offer tactical concessions in the form of enhanced purchases of US goods, improved access to the Chinese market and providing assurances of an even playing field to foreign investors and companies vis-à-vis Chinese entities. Structural changes demanded by US negotiators would likely be resisted. The latest round of US-China trade talks in Beijing concluded on January 9. Statements from the American and Chinese sides suggest that while China has conveyed its readiness to increase its purchases of agricultural products and energy from the US, they were still far apart on structural issues relating to intellectual property, industrial policy and cybersecurity issues. A Reuters report, quoting US sources, said that the "two sides were further apart on Chinese structural reforms." There was also no announcement that these talks will be followed by a more senior level engagement in Washington which would have been expected if progress achieved warranted them. We may have to await President Trump's next tweet to know what happens next.



SHYAM SARAN

China's economic growth has steadily declined from 10.6 per cent in 2010 to 6.9 per cent in 2015 and 6.5 per cent in 2018. This deceleration is reflective of a complex transition which the economy is going through. One, China's demographic dividend, which drew upon a large and growing working-age population in relation to the dependent population, peaked around 2012 and has been declining since. This is the well-known Lewis turning point. Two, exports which have been a major driver of growth, are now flat. Having become the world's largest exporter, China will find it harder to expand its global market share, currently 17 per cent, particularly when its major markets are putting up protectionist walls. Three, total factor productivity (TFP), which was fairly high in the catch-up phase of development, has now declined from an estimated 3 per cent in the 2008-11 period to only 1 per cent currently. Thus, the slowdown in China's economy is not due to cyclical factors but the result of the structural transformation taking place. Unless there are new drivers, GDP growth is likely to decline to progressively lower rates converging with other advanced economies. "China will not be exempt from the iron law of regression to the mean in the long run." This mean is said to be 2-3 per cent per annum.

But how long will this long run be? It is only through significant technological advancement that descent to the mean can be pushed further into the future. Future growth will intrinsically depend upon whether China makes the grade as a generator of intellectual property rather than its user. The Made in China 2025 initiative, which is aimed at making China a leader in advanced technologies, is critical to sustaining Chinese growth momentum and, therefore unlikely to be modified to assuage American and Western concerns.

Despite the commitment to realising a high-tech future, China seems unable to undertake a relatively speedy transition to higher value-added economic processes. This is apparent, for example, in the continuing overcapacity in steel, cement and coal industries. China's debt overhang is estimated to reach 275 per cent of GDP this year. It has now become clear that there is a significant foreign exposure in this debt. Total foreign debt currently stands at \$1.9 trillion of which the short-term component is 62 per cent. Of this \$1.2 trillion will need to be rolled over this year. Interestingly, a substantial part of this foreign borrowing is reportedly on account of lending for projects under the Belt and Road Initiative, some of which have questionable viability. The commitment to deleveraging this mounting risk to economic stability has been repeatedly compromised in order to shore up flagging growth, which, it is feared, may have political and social consequences. In 2018 alone the Chinese Central Bank cut banks' reserve requirements on four occasions and recently local governments have been permitted to launch a new tranche of bonds to revive investment in infrastructure projects. Growth in consumption has declined from 12 per cent per annum in the recent past to about 8 per cent at present despite a steady increase in per capita incomes. The efficiency of investment is steadily declining. It now takes 4 yuan of investment to produce just one yuan of output.

At the annual Economic Work Conference held last month, the Chinese Communist Party leadership acknowledged that "the external environment is complicated and severe and the economy faces downward pressure." This obviously points to the trade war with the US, the intensifying protectionism in developed country markets and the growing restrictions on Chinese acquisitions of high-tech firms in the West. But this adverse external environment is only adding another layer of risk to an already vulnerable domestic situation. Will the Chinese leadership be able to manage both these risks simultaneously and successfully? These dynamics are likely to play out in 2019.

China's economic trajectory over the next decade will determine the shape of the new international order which is in the making. If China is successful in managing the twin risks and continue to grow at rates higher than the long-term mean, it will emerge as the world's largest economy by 2030 — perhaps double the size of the US economy with India a distant third. It would have avoided the middle-income trap and joined a select group of high-income advanced economies. More importantly, it will be the only country in history to achieve this status while remaining a one-party authoritarian state. It has already begun to alter the rules of the game which an international order must operate under. Its influence in this regard will only increase. If the Chinese economy stalls under the weight of these multiple risks then we will confront a different kind of challenge but no less serious. The world has become addicted to an expanding Chinese economy shoring up global growth. Losing this engine of growth may be more disruptive than we imagine.

The writer, a former Foreign Secretary of India, is currently Senior Fellow, Centre for Policy Research