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EXECUTIVE SUMMARY

# Where Is China's Economy Headed?

by Hanming Fang

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## Introduction

The growth of the Chinese economy over the last four decades has been a transformative global economic event. China has evolved from one of the world's poorest countries to one whose total output (adjusted for purchasing power) overtook that of the United States. Between 1980 and 2012, China averaged an astonishing annual growth rate of about 10 percent, and its relations with the West improved greatly. But now, after years of slowing economic growth and fracturing relationships with Western partners, China's economic path over the next 10 to 15 years is less certain.

In this paper, Hanming Fang examines how three key forces—China's internal political economy, its external relations, and traditional economic factors—will drive China's potential for growth and determine how close the country comes to realizing that potential. He argues that developments in China's domestic political economy will be the most important determinant, and he presents a wide range of possible growth rates over the next 10 to 15 years, depending on whether the country embraces market-oriented reforms and improves its relations with the US-led West.

## The Main Forces Affecting China's Future Economic Growth Path

Fang argues that the growth trajectory of China's economy over the next ten to fifteen years will depend in large part on three sets of forces and how they interact with one another:

**First, China's internal political economy will determine the relationship between the state and the market.** Fang observes that the Chinese Communist Party (CCP)'s primary objective is to maintain its political power, which makes prioritizing economic growth a secondary objective to preserving regime stability. In response to perceived internal and external threats, the CCP has turned to more-centralized economic policies and tightened regulation of firms in order to expand its political control.

**Second, China's relationship with the US-led West will determine China's access to foreign technology, finances, and markets.** Fang states that US-China relations are at a 40-year low for a number of reasons, including US trade sanctions initiated by President Trump and continued by President Biden; the threat the US perceives China to pose to the established global order (such as to the dollar's global dominance); and tensions that often accompany a rising power challenging an established power (the so-called Thucydides Trap). Trade sanctions imposed on China by the US and other Western countries have limited China's access to foreign technology, finances, and markets. Citing national security concerns, the US Congress and the Trump and Biden administrations have taken actions, and are considering further actions, to decouple the US economy from China's, including through (a) new restrictions on trade in response to what the US calls China's unfair trade practices and cybersecurity threats, and (b) restrictions on Chinese military entities' access to advanced technologies. Such actions weaken China's access to the global economic system and further inflame tensions between the two countries. In response to perceived external threats, Fang argues that China is likely to turn further inward as the CCP doubles down on preserving its domestic power through a more centralized economy.

**Third, China's economic growth prospects are also weakened by fundamental economic and demographic challenges.** Fang notes that while China faces serious economic challenges such as an aging population and declining workforce, a real estate bubble, and drastic income inequality, these challenges can be addressed by the right reforms. However, he argues, the risk is that necessary reform efforts may be blocked by vested interests (such as executives and workers of state-owned enterprises, local governments, and the military) spurred by perceived external threats to China's national security and perceived internal threats to social stability.

## Traditional Economic Factors Impacting China's Future

Fang also describes three important traditional economic factors that will have substantial impacts on China's future economic growth:

### *Total Factor Productivity Growth*

Fang observes that between 1978 and 2022, China's economic growth was invariably associated with total factor productivity (TFP) growth. During the fast growth period of 1978–2007, China's TFP growth rate averaged more than 4 percent per year. In the last fifteen years of growth slowdown, however, the TFP growth rate averaged only 1 percent annually. In addition, the periods with the fastest TFP growth coincide with the rapid growth of town and village enterprises in the mid-1980s, the reform of state-owned enterprises in the mid-1990s, and the explosion of Chinese foreign trade and inbound foreign direct investment following China's WTO entry in 2001.

Fang further argues that China's productivity performance—at comparable levels of development to other East Asian "miracle economies" such as Japan, Taiwan, and South Korea—appears to have underperformed by a wide margin. He says that China is not really a miracle economy when it comes to productivity. Instead, China's historically strong productivity performance appears more to reflect its low starting point, the deep inefficiencies plaguing its centrally planned economy, and the large catch-up dividends unleashed over the ensuing decades by gradual market-oriented reforms. Finally, Fang suggests several ways for China to increase its TFP, including by improving the efficiency of resource allocation or reallocation, lowering barriers to labor and capital mobility across regions, and encouraging bottom-up innovation rather than its currently favored top-down approach.

### *A Declining Labor Force and Aging Population*

Fang notes that China's workforce peaked in 2014–2015 with about 801 million workers and has been declining ever since, to 780 million in 2021. He believes that this workforce decline is unlikely to be a major drag on the Chinese economy, though, since younger workers are much better educated and skilled than the current generation of retirees. Further, he says that raising retirement ages—currently just 50 to 55 for women and 60 for men—could bring more near-retirees back to the workforce, and also that automation and artificial intelligence can replace some lost labor. He suggests that China could also raise fertility rates by making children less expensive to raise and by investing in rural education.

Fang is more concerned about the fiscal pressure that rising life expectancy and declining fertility will place on China's pay-as-you-go pension system, particularly for rural Chinese households with less accumulated wealth.

### *The Need to Boost Both Productivity and Domestic Consumption*

While debate remains in China about whether the country's future economic growth should be driven by consumption or investment, Fang says both are needed. He states that economic growth ultimately comes from TFP and factor input growth and that investment focusing on innovation, new production capacity, and human capital—including health—must be part of future sources of growth for the Chinese economy. At the same time, he argues that domestic consumption as a share of GDP must increase to make growth sustainable, as it is no longer plausible to expect Chinese export growth to make up for weak domestic consumption.

Fang notes that returns to capital in China have declined by more than half since 2008 after staying stable and consistently above 20 percent before that point. He argues that this decline is a sign of wasteful investment and that the main culprit is local governments, who became drivers of investment following the CCP's 2008 decision to give them the ability to borrow. As a result, local governments became creative at engineering financial products that allowed them to binge-borrow and invest, crowding out private-sector investment.

### Potential Outcomes for China's Growth

Fang argues that in a best-case scenario, if China focuses on its internal market-deepening reforms, thereby increasing its TFP growth rate to 4 percent annually, then the Chinese economy could grow by 6 percent annually. However, if China instead stops its market-oriented reform in favor of centralized decision making, top-down planned resource allocation, and marginalizing private businesses, then TFP and economic growth could grind to zero. Much of the eventual outcome will depend on whether the US and China can improve their relationship, but China's souring relations with the West, along with increased perceived internal threats, have led the CCP to prioritize solidifying its political and economic control, rather than pursuing such reforms. These dynamics have put the country on a path to sacrificing economic growth in the name of regime stability.

## ABOUT THE AUTHOR


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Hanming Fang is the Joseph M. Cohen Term Professor and chair of the department of economics at the University of Pennsylvania. He is an elected fellow of the Econometric Society. His main research areas are public economics, labor economics, and the Chinese economy. His research on health insurance market received the Kenneth Arrow Award for the best health economics research from the International Health Economics Association in 2010. He is an expert on the Chinese housing market, health care, population aging, and political economy. He is a co-founder of VoxChina – a nonprofit web platform that provides research-based analysis of the Chinese economy. He is a research associate of National Bureau of Economic Research (USA) and served as its acting director of the Chinese Economy Working Group (2014-2016). He has published widely in top journals in economics, served as a co-editor for Journal of Public Economics and International Economic Review, and served on the editorial board for several other journals, including the top economics journal, American Economic Review. Fang served on the faculty at Yale University and Duke University before joining Penn in 2009.

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