November 2022

Why the Consensus Still Overestimates China

Xi Jinping aims to make China a developed nation within 10 years, which implies a growth rate of around 5 percent, and the consensus still thinks Beijing can hit that target. We disagree. China has been sustaining rapid growth mainly through a debt fueled bubble in the property market, which is now deflating.

Without the property boom, China's long term growth rate is more like 2.5 percent, thanks to high debt, bad demographics, and declining productivity. If China's rapid rise for the last four decades changed the shape of the world economy, so will its retreat to a pedestrian rate of growth in the next decade. For one, it means that China would not achieve its ambition—to pass the United States as the world largest economy—before 2060, if ever[1].

1. The Main Hurdles Are Debt and Demographics

China now has a per capita income of around $12,500, a stage when many aspiring economies have slowed rapidly. Of the 38 advanced economies today, all grew past the $12,500 income level following the second world war. But after passing that income threshold, only 19 grew at 2.5 per cent or faster for the next 10 years. The chart below summarizes the debt and demographic challenges faced by those "19 developing stars", versus China today.

Chart 1. China Versus Other Aspiring, Middle Income Countries: Vital Statistics at $12,500 income level

	Avg. GDP growth in next decade	WA Population growth	Total Debt (% GDP)
China	?	-0.2%	274
*19 Developing stars**	3.5	1.2%	169
Korea	5.5	1.1%	145
Japan	3.2	0.9%	211
Singapore	7.1	3.0%	157

Source: Haver Analytics, IMF, UN, World Development Indicators, Breakout Capital Calculations. Note: WA= Working Age

** 19 countries are Andorra, Australia, Austria, Cyprus, Germany, Greece, Hong Kong, Japan, Korea, Latvia, Lithuania, Luxembourg, Netherlands, New Zealand, Norway, Singapore, Slovak Rep, Spain, and U.S..*

[1] *This forecast assumes that the US grows at 1.5 percent and China at 2.5 percent, with similar rates of inflation in the US and China and a stable dollar-renminbi exchange rate.*

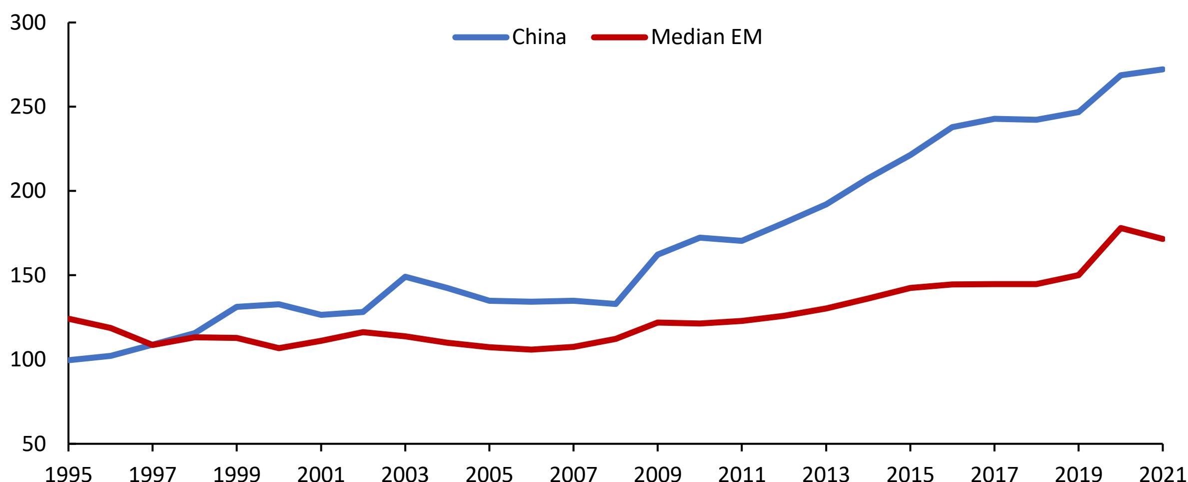
Note: Rockefeller Capital Management does not have any investment or trading authority over the positions held by Breakout Capital and its clients.

Simply put, China's challenges are unprecedented. No country has ever grown past China's current income level at even a 2.5 percent pace with such huge debt and demographic burdens, and that includes past Asian miracles like Japan, Korea, and Singapore. In that light, China's aim of sustained 5 percent growth starts to look historically improbable, to say the least.

2. Deeper Debt Hole

China was already a middle-income country with a shrinking working age population and massive debt by 2015. The country sustained reasonably fast growth in part through the astonishing boom in its tech sector, but mainly by continuing to funnel credit into the property sector, which now accounts for about a quarter of the economy[2]. Two decades ago, China's debt levels were pretty typical for a developing country, now they are the extreme outlier.

Chart 2. Total Debt as a Percent Share of GDP



Source: Haver Analytics, IMF, Breakout Capital Calculations

3. Baby Bust

Around 2015 China started scrambling to slow the baby bust, replacing its one child policy with a two- and then three-child policy, to no avail. Its demographic decline is worse than other Asian miracles at a similar level of development, and among the worst in the world.

[2] Property sector accounts for total final demand which includes total real estate activity (direct) and additional demand in upstream sectors (indirect).

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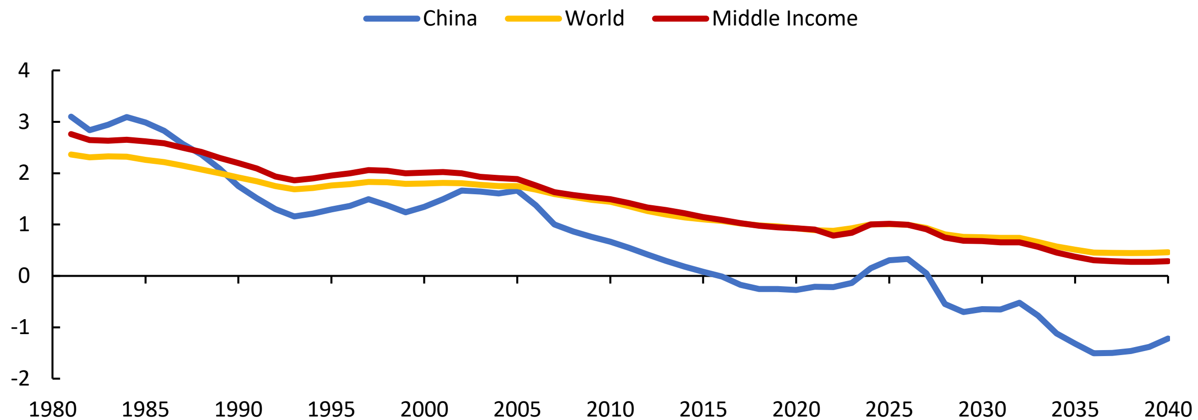
Chart 3. Growth of Working Age Population (aged 15-64) in Percent, YOY

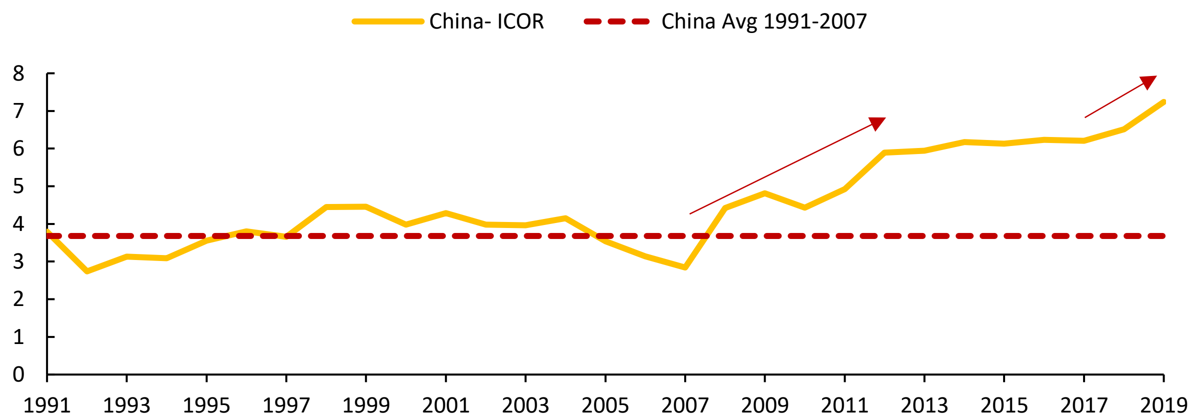


Source: Haver Analytics, UN, Breakout Capital Calculations

4. Wasted Capital

In the midst of a debt mania historic in scale, it's impossible for lenders and investors to funnel all that credit into productive projects, and in China much of the debt went into dubious property or infrastructure projects. The efficiency of capital (as measured by incremental capital output ratio in the chart below) collapsed. China now has to invest $8 to generate $1 of GDP growth, twice the level a decade ago, and the worst of any major economy.

Chart 4. China's Incremental Capital Output Ratio (ICOR)



Source: : IMF; Macquarie Research

5. Productivity Meltdown

It's true that productivity is falling worldwide, which weighs on productivity in China. But one reason for the productive decline is rapid aging, which diverts resources away from productive investment

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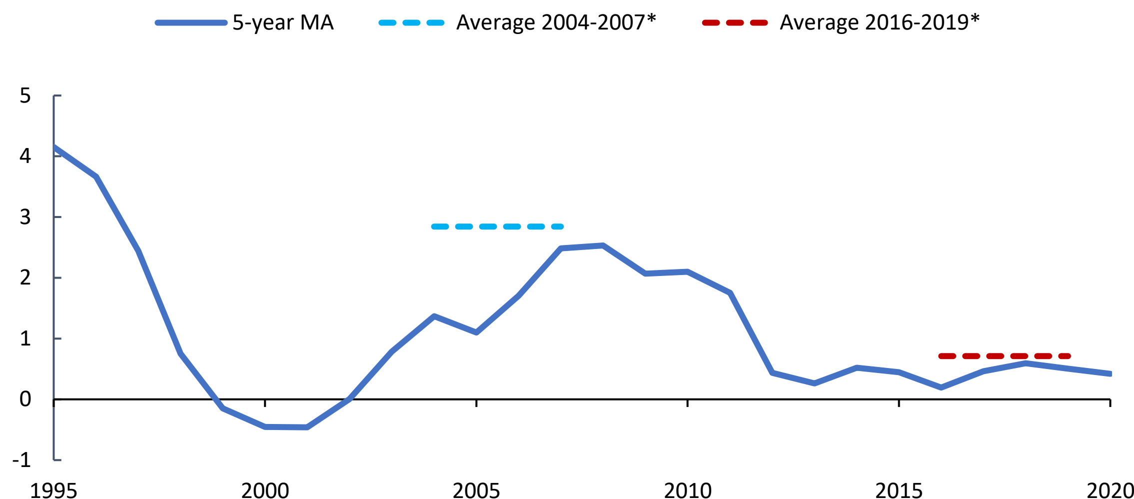
toward social services. Another is rapidly rising debt, and the resulting waste. Both problems are particularly acute in China, where basic productivity growth has fallen to just a quarter of what it was before 2008

Chart 5. China's Growth of Total Factor Productivity (percent yoy growth, 5-year moving average)



Source: The Conference Board (April 2022 Database), Breakout Capital Calculations.
Note: China calculations are based on an average of the two estimates available. * Averages are based on the TFP growth levels.

6. How We Get to 2.5

Recall that long term growth is a sum of population and productivity growth—with productivity broken down into physical and human capital (skills and education), which are readily measured, and an x factor called "total factor productivity", which measures how efficiently workers are using new capital.

With total factor productivity growing at barely half a point, and the working age population shrinking at a similar rate, China begins its quest for growth at zero, a standing start[3]. To hit its 5 percent GDP growth target, then, China would need to sustain the same growth rate in physical capital that kept growth alive in the late 2010s. Given the scale of the housing bust, we think it's far more likely that capital growth retreats sharply, bringing overall economic growth down to around 2.5 per cent.

If anything, we think 2.5 per cent is an optimistic forecast that downplays the historical evidence and the current risks to growth, including growing tensions between China and its major trade partners, growing government interference in the most productive private sector — technology — and mounting concerns about the debt load.

[3] Human capital has been and is expected to be a negligible contributor to GDP growth at around 0.2 percent.

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Breakout Briefings

Our Worldview in Charts

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For more information, please contact:

Cheryl Galante, Head of Investor Relations
Main 212 497 5100 | Direct 646 216 8400
cgalante@breakout-capital.com

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