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NEWSLETTER

Peak China?

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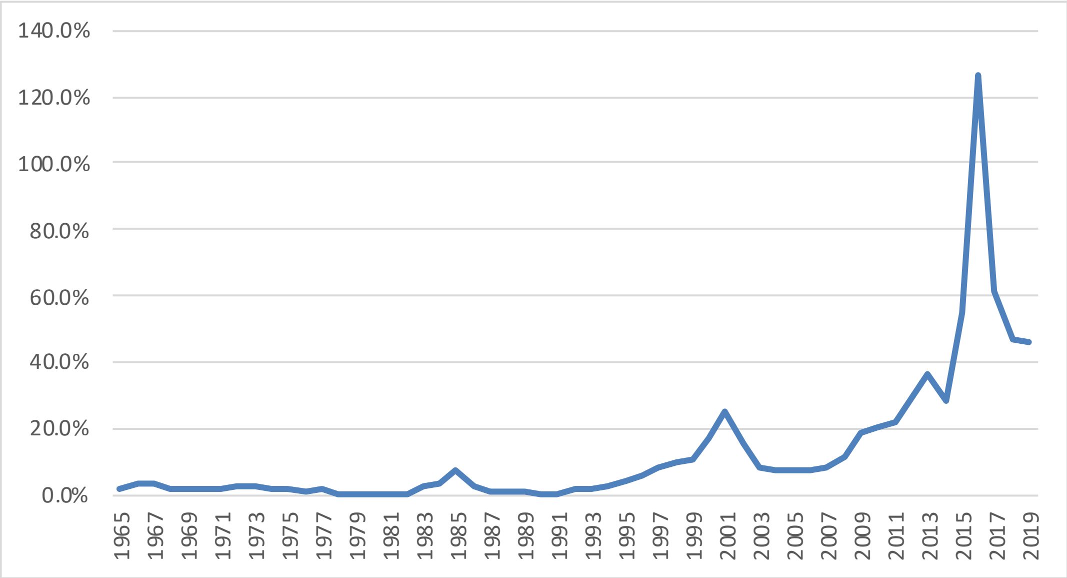
If official GDP numbers are to be believed, China's economy grew by 2.3% in 2020 while the rest of the world shrank. The RMB also appreciated in 2H 2020 leaving the average exchange rate for the year flat on 2019. While 2020 was an exceptional year, China has in fact accounted for about 45% of the world's nominal USD denominated growth since 2012. It is this extraordinary dependence on China for growth that has led to the prevalent Sino-centric view from policy makers, corporates and investors. In the 5 years to 2016 for example, China's economy expanded by USD3.7 trillion while the global economy as a whole expanded by just USD2.9 trillion (driven by low nominal growth and a strong Dollar). It is highly likely, in the view of capital dialectics, that 2021 will see the perceived peak of China's importance to the global economy.

Chart: China's five-year rolling contribution to global growth (%)



Purely on a cyclical basis, 2021 is likely to see a sharp rebound in economic growth around the world. In addition, the rise in the RMB's real effective value is starting to meet with resistance from China's policy makers. It therefore seems logical to expect that the rest of the world will outperform China in 2021 in terms of nominal dollar GDP growth. The "peak China" call though is not cyclical but structural.

There are two elements to the coming relative decline of China in terms of global economic importance: the absolute deterioration of China's economic growth and the predicted dramatic rise of the emerging world beyond China.

In the February Monthly "The case for emerging markets: Beyond China", we draw readers attention to the fact that during the five years to 2019 (pre-COVID), a group of no less than 39 countries, with a combined population twice that of China's, was growing as fast or nearly as fast as China was. India of course accounts for half of the population in that grouping and tied with China for 11th place in the five-year growth ranking. But outside of India, there is a grouping of near equal population size rivaling the two Asian giants. Nearly half the world's population is therefore living in fast growing economies. As India and this grouping grow over the coming decades, their weight in global GDP will rise and their contribution to global growth increase commensurately. The table below highlights some of the more populous countries that have been enjoying rapid growth in the years running up to COVID.

Table: Selected emerging, populous and fast growing economies.

Country	5 yr avg growth	Pop (m)	GDP (USDbn)
Ethiopia	8.9	112	96
Bangladesh	7.4	163	302
Vietnam	6.8	96	262
Philippines	6.6	108	377
Tanzania	6.2	58	63
Myanmar	5.8	54	76
Kenya	5.6	52	96
Indonesia	5.0	270	1120
Egypt, Arab Rep.	4.8	100	303
Pakistan	4.5	216	278
Total	6.2	1229	2973

In contrast, we see China's growth as being in structural decline. In fact, Capital Dialectics is of the view that there is a strong chance that China's economy is smaller in nominal dollar terms in 2030 than at the end of 2020. There are four reasons for this:

1. China's employment will likely shrink over the coming twenty years by between 15 and 20% driven by a) a decline in working age population and b) lower participation rates (from a very high base) as dependency ratios deteriorate. This trend will worse in the subsequent 20 years.
2. Capital stock growth is slowing and will slow further unless investment to GDP rises from its already elevated level. Even if investment rates rise, there will likely be an off-setting deteriorating in the efficiency of capital.
3. Total factor productivity has declined sharply, even using official data. Allowing for some GDP growth exaggeration, TFP could be negative already.
4. China's real effective exchange rate has risen sharply and, as we explore in our next monthly, the exchange rate has become vulnerable on several counts, including, ironically, the ratio of reserves to the stock of hot money in the country that for now at least is free to leave.

Putting these four factors together, we conclude that a decade of 2 to 2.5% real GDP growth (which in the face of a decline in employment averaging 1% per year might even be ambitious), off-set by a reversion to 2010 levels of the real exchange rate, will leave China's economy at about the same size as it is now. In addition, there is the real possibility that we see a large one-off downward revision to historic growth numbers going back over the past decade. Why?

As spectacular growth numbers have become harder to achieve, and as alternatives to the official data have become increasingly prevalent and credible, the authorities have orientated policy goals away from economic growth targets. The legitimacy of the regime is being linked to softer goals around equality and national rejuvenation. Nevertheless, as the statistical jerrymandering around the COVID-impacted economy demonstrates, superior GDP performance is still a key part of the propaganda war – both domestically and internationally. 2020 saw significant downward revisions to 2019 data to produce a mirage of growth. Economic growth in the 2020s will be easier to achieve if the past is revised down. Such a move would also serve to diminish the perceived threat China poses to US economic hegemony and consequently to its neighbors.

By way of comparison with China, employment in India could well grow faster than the 0.9% compound annual growth in working age population, because participation rates in the formal economy are currently so low. Furthermore, TFP growth is substantially high in India than China currently and has been on an improving trend. On a PPP basis we expect India's economy to be larger than China's within 20 years, driven by a 2% differential in employment growth and a 2% differential in productivity.

In sub-Saharan Africa, the working age population is likely to rise at a 2.3% Cagr over the next 20 years and that growth will likely continue over the subsequent 20 years as well. While SSA's WAP is likely to grow from 670m now to 1.6 billion in 40 years, China's WAP will shrink from 1 billion to just 700 million. With a working age population 2.3x China's in 2060, a productivity growth differential of 3% would be sufficient to make SSA larger than China's economy on a PPP basis by 2060.

Data from SAFE tells us that over the course of 2020 foreign investors bought a total of USD 144bn (through to September) of Chinese financial assets. These portfolio flows are chasing higher currency adjusted returns. What our analysis of the past few months seems to point to is that investor appetite for Chinese financial assets is reaching its crescendo just as China's growth prospect wane. Long term investors seeking growth markets would perhaps be better focusing their attention on the economies that have demonstrated an ability to match China's growth in recent years and where the demography is supportive not challenging as it is in China. As China's share of the global working age population falls from the current 20% to 15% in 2040 and then to about 10% in 2060, so its share of global GDP is likely to stabilize and then decline. China's contribution to global growth in the coming 10 years will likely fall well below 20%. China's impact on the world is perhaps in the process of peaking.

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