Have We Reached 'Peak China?'

Thinking through China's future growth potential and its impact on the world

By Drew Bernstein

Commentary on China's place in the world tends to fall into two equally breathless camps.

Is China an unstoppable economic, scientific, and military behemoth destined to dominate the shape of the 21st century? Or is it a sclerotic, overly centralized system teetering under its internal contradictions? Neither of these caricatures adequately captures the reality of this massive, complex economy.

I recently spoke with Logan Wright, who leads China market research at the Rhodium Group, about how to think about the next phase of China's development. In September, he published a dense research paper that delved into whether China's economy has peaked, with a strong focus on the limits imposed by the financial system. His perspective, grounded in studying the intricacies of China's banking and currency regimes, was sobering without being alarmist.

Logan spent two decades in China, being one of the first Westerners to study its fixed-income and interbank market while in Beijing. In the first half of the 2000s, he said it was surprisingly easy for a young Westerner to gain access to officials at China's central bank. He attributes the lack of nuanced understanding of China's challenges today partly to the restrictions on data and access over the past decade.

"It's hard to explain to people just how open the Chinese system was and how open they were to be speaking to foreigners, including foreigners like me who spoke bad Chinese and had no influence whatsoever," Logan recalled. "Walking into a government office and getting a meeting was hard. But it was not hard to ask someone for coffee or lunch. They understood that this was a process of engagement."

However, there was a dramatic change following the ascension of Xi Jinping and the early anti-corruption campaigns.

"Suddenly, those same people I've been talking to for years, it's much harder to get meetings. You had to meet at third locations like conferences where they wouldn't have to write up reports. It was a hardening of the security system that became a huge obstacle to doing research," he explained.

Defining Peak China

Logan firmly believes that China's growth has already peaked when defined as the country's share of nominal global GDP, which he thinks is the most precise metric of its impact on the world's economy. He also believes the deceleration was underway much earlier than most experts think.

"What I think other commentators get wrong is how much the economy has already slowed and the impact collapse of the property market and local government infrastructure in particular," he said. These two sectors have historically contributed about 40% of China's GDP, including their upstream and downstream impacts on the economy. "This is not a gradual slowdown, but particularly since 2022, a substantial discontinuity and level shift lower that will make it difficult not only to regain previous growth rates but a previous level of influence within the global economy."

He believes this decline in economic growth will not be easily reversed because China's boom was fueled by the world's "largest single country credit expansion in over a century." Today, China's banking assets are $60 trillion, which is over three times the size of its GDP and dwarfs the assets of U.S. banks, which are $23 trillion. "It's a very large, very unprofitable banking system, and the legacy costs of that expansion place significant constraints on them going forward."

He notes that China averaged annual credit growth of 18% from 2007 to 2017, falling to 9% from since 2017 and around 8% today. Last year, China's banks generated a return on assets of only 0.6%, about half that of U.S. banks, and he believes the system is riddled with assets that should be written down.

"China is an investment-led economy, but operating cash flow throughout the entire state-owned universe is very, very weak. If there's not a lot of operating cash flow throughout the system, it becomes more and more dependent on the financial system," he noted.

No Easy Fix For Credit Constraints

Logan supports China's recently announced stimulus actions but is skeptical that they will have a lasting impact on what he views as a structural problem.

"Cyclical momentum is further weakening credit growth, which is at or very close to an all-time low. Household consumption growth has been decelerating. So, the case for counter-cyclical stimulus is strong," he said.

However, he believes the Chinese government faces ideological and practical constraints to US-style stimulus focused on goosing consumption.

"Throughout the Chinese state apparatus, there's a lot of resistance to making transfer payments outside of your jurisdiction and hoping good things happen, which they see as welfare. Technically, China has a sizable non-banked population, and they don't have a history of making these types of transfer payments."

As a result, the government more frequently subsidizes trade-in programs, or "cash-for-clunkers," for large consumer items. These programs are easier to administer and generate sales tax for local governments. However, those rebates tend to "pull demand forward" and lack a sustained impact on consumer confidence.

He also doesn't believe that redirecting investment toward high-technology industries, or what is known as "new productive forces," will be the cure for lagging economic growth.

"The issue is just math. If you add up the three sectors they are talking about – auto, solar panels, batteries – it's hard to reach more than 10% of GDP. We think it's much closer to 5%," Logan said. "So, it's hard to see how these ever replace the growth in property and infrastructure, which historically accounted for 40% of GDP. And a lot of these new industries are not very labor intensive. They're capital-intensive and highly automated. It's not clear where employment growth comes from."

Predicting China's Sustainable Future Growth

Based on all these factors, Logan believes that China is in for a sustained period of much lower growth than economists' conventional wisdom suggests. Partly because he severely discounts the GDP numbers that China has been reporting over the past decade.

"There's a very strong statistical case against the accuracy of GDP rates as early as 2014, in my view," he said. "We looked at the top 20 economies in the world and their level of volatility in quarterly growth rates. From 2014 to 2020, the conclusion is that China's growth is too stable to be believable. And starting in 2022, it's far too high to be believable."

He points to a wide range of data points from 2022, such as new property starts being down by 39% and the consumption impact of rolling lockdowns, which point to far less robust economic activity than the government reported. If China had grown at 5.2% in 2023, you would not see producer and consumer price deflation and rising unemployment.

The requirement to clean up the financial system will likely make credit and investment a drag rather than a tailwind to GDP growth for at least the next decade.

Based on the track record of other economies that have crossed over to middle-income status, he believes that a sustainable consumption growth rate in China is in the range of 3-4%. However, given that consumption is about 39% of the Chinese economy, consumption can only contribute around 1.2 to 1.5 percentage points of annual GDP growth as the economy works through deleveraging.

This future will not look precisely like Japan's lost decades that started in 1990, "but it will rhyme in many of these comparisons. The demographic similarities are meaningful for the outlook for a declining savings rate, lower investment, and more structural deflationary pressure. Arguably, China's demographic situation is worse. Its working age population has already been declining since 2013."

BEIJING, CHINA - MAY 15: (CHINA OUT) Dollars and yuan notes are seen at a bank on May 15, 2006 in Beijing, China. China's official exchange rate rose today to 7.9982 yuan per U.S. dollar, its highest level since a revaluation in last July, the government said. (Photo by China Photos/Getty Images)

Tough Policy Options For China's Leaders

When asked what he would advise China's leadership if he could suggest policy directions, Logan confessed that there are no easy options.

"The conventional wisdom is that when you have distressed financial assets and a zombified financial system, the earlier you clean it up, the better. The longer you let it extend, the worse the pain becomes," he said.

But as China has attempted to rein in the excesses of its financial system, the central continues to run into the risk of clarifying where the line between private risk and state guarantees lies.

“Since the beginning of the deleveraging campaign, we’ve seen risks emerge in peer-to-peer lending in 2018, in small banks in 2019 and trust companies in 2020, property developers in 2021, individual mortgages in 2022, and real risks to local government financing vehicles starting in 2023. With each step, you’re getting closer and closer to the center of the financial system.”

The real risk is that by providing a clear statement about privatizing risk, the government could destabilize confidence in the entire system of assets that are implicitly believed to be backed by the state.

Restructuring the banking system is necessary but daunting. The last time China orchestrated a bank bailout, in 1999, only six banks needed to be rescued through the formation of “bad banks” to take their assets.

“It’s extremely expensive. Back then, it cost around 50% of GDP, and today, China’s banking system is 30 times larger,” he observed. “In my opinion, they don’t know where the bad exposures are. It’s not as simplistic to say, ‘You’re going to sell us these assets and retain the good assets.’”

Logan also believes that China needs to overhaul its fiscal system, away from a reliance on VAT tax and towards a more meaningful tax on individual incomes. He notes that this year, the government will collect just a bit over 16% of GDP in taxes, among the lowest levels in the OECD, which significantly constrains their ability to stimulate consumption.

Less Saber Rattling, More Jaw-Jaw

Regarding U.S. policymakers, Logan suggested they can afford to feel a bit more secure vis-à-vis China. However, they need to recognize that the greatest threat to

America's stature in the world is not the rising power in the East but Washington's own dysfunction.

"The strategic position of the United States has improved since the low point, which was arguably the events of January of 2021. I don't think it was on anyone's radar in 2021 that America's nominal GDP growth would outpace China for the next three years," he observed.

He gives significant credit to the current administration for investing in U.S. manufacturing capability and deployment of industrial policy. The most significant risk would be a cycle in which the U.S. continuously raises tariffs unilaterally, leading China to devalue its currency, leading to further increases in tariffs and, ultimately, mutual demand destruction.

"The most important recommendation I would give [to the next US president] is to use their credibility to mount a collective and affirmative trade policy because we are not in a stable equilibrium regarding China's overcapacity and the spillovers that China's domestic policy choices cause outside of China. I realize that trade policy is politically sensitive and not a welcome word around Washington, but I think that is where the conversation will wind up going," he predicted.

By lowering some of the anxiety around China's rise, it may be possible to manage the relationship between the two global powers to avoid a fateful confrontation. To quote Winston Churchill, who knew something of the consequences of failed diplomacy, "Meeting jaw to jaw is better than war."