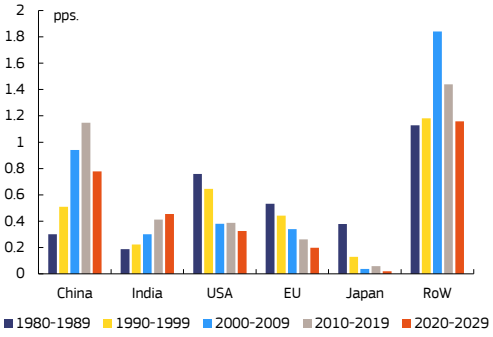
4.2. CHINA'S IMPRESSIVE RISE AND ITS STRUCTURAL SLOWDOWN AHEAD: IMPLICATIONS FOR THE GLOBAL ECONOMY AND THE EU

The impressive rise of China's economy has shaped the global economy over the past four decades. The EU's economy has benefited in many ways and its exposure to China has grown steadily over time. With the prospect of China embarking on a structurally slower path of economic expansion, this special chapter examines the evolution of China's economy over time, takes a look at recent policy actions in China and discusses the implications for the global economy and the EU.

The rise of China and its impact on the world

China's ascent into the global economic arena marked the start of an era of prosperity for the country. China's impressive evolution started in the late 1970s with the "reform and opening up" agenda launched by Deng Xiaoping. Starting from a low level of development, its impact on the global economy was initially minor (Graph I.4.4). Since joining the World Trade Organization (WTO) in 2001, China's economy has increased in size tenfold, with profound impacts, both domestically and globally. According to the World Bank classifications, China became a lower middle-income country in 2001 and transformed into an upper middle-income country within just ten years, in 2010. In 2022, China's GNI per capita stood less than 8% below the threshold for being considered a high-income country [60]. This impressive economic performance has been accompanied by a steep reduction in poverty, with more than 800 million people being lifted out of extreme poverty, [61] swelling China's middle class. Still, an estimated 17.2 % of China's population still lived below the World Bank's poverty line for upper middle-income countries (USD 6.85 per day) in 2023.

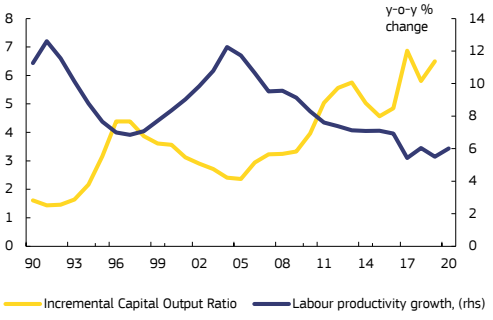
Graph I.4.4: **Contribution to global growth**



Source: IMF WEO, April 2024.

Two periods can be distinguished in China's economic development since 2001. Between 2001 and 2008, China's growth averaged around 11% annually, supported by both domestic and external demand. In this period, China rapidly integrated into global supply chains and became a global manufacturing powerhouse, benefiting from rapid urbanisation, abundance of cheap labour, and strong labour productivity growth. Its current account surplus peaked in 2007 at almost 10% of GDP. As external demand dropped in the aftermath of the Global Financial Crisis, China increasingly turned to infrastructure investment to drive growth. Authorities unleashed an unprecedented infrastructure building agenda and

Graph I.4.5: **Productivity indicators**



Source: National Bureau of Statistics, ECFIN calculations.

[60] For the 2024 fiscal year, the World Bank defines lower middle-income economies as those with a GNI per capita (calculated using the World Bank Atlas method) between USD 1,136 and USD 4,465; upper-middle-income economies are those with a GNI per capita between USD 4,466 and USD 13,845; high-income economies are those with a GNI per capita of USD 13,846 or more.

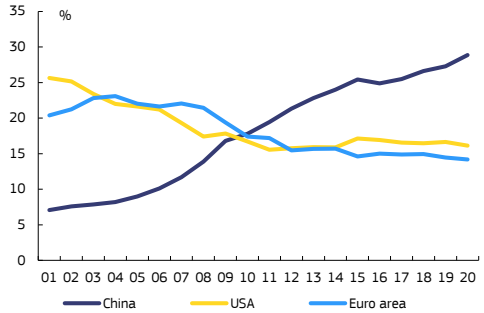
[61] World Bank (2022). "Four decades of poverty reduction in China: Drivers, insights for the world, and the way ahead." Washington DC: Development Research Center of the State Council, the People's Republic of China.

supported a rapid expansion of the real estate sector. The increasing reliance on capital formation has been accompanied by decreasing return on investment, accumulation of debt imbalances, and slowing productivity growth (see Graph I.4.5). Between 2009 and 2023, real GDP growth averaged 7%, with a clear, persistent downward trend.

Supported by foreign direct investment (FDI) and domestic industrial policy, China's manufacturing sector became progressively more sophisticated. According to the Economic Complexity Index, [62] China's economy went from ranking 52nd in the world in 2002 to 24th in 2022. In the early 2000s, two thirds of the value added in Chinese exports of finished goods came from imports, while today most of the value added is produced domestically. Furthermore, while the depiction of China as an assembly hub may have been warranted in the early 2000s, this no longer holds, as the share of exports of goods involving processing and assembling imported goods fell from 47.6% in 2009 to 20.7% in 2023. The reasons for these changes are grounded in China's gradual industrial upgrading as well as its deliberate policy of accelerating import substitution ('Made in China 2025' policy launched in 2015) and its massive industrial policy spending. China's spending on manufactured imports for domestic uses fell from 9% of GDP in 2004 to below 5% today. The increased self-sufficiency of Chinese export-oriented manufacturing proved beneficial during the pandemic, as it limited the disruptions from supply chain shocks, allowing the economy to adjust quickly to the rising demand for consumer goods from advanced economies.

China's rise has had a profound impact on global trade and production. In 2001, China accounted for just below 4% of global GDP but this share increased to 17% by 2023 [63]. Over the same period, China contributed on average 27% of total global growth. It also became the world's largest exporter, accounting for 17.6% of global goods exports in 2022. Manufacturing accounts for around 28% of gross value added in China, above the share in the Republic of Korea, at 26%, and significantly above that of Japan (19%) or Germany (15%). Furthermore, due to the size of China's economy, the global reach of its manufacturing sector is unique. According to the 2020 OECD Trade in Value Added (TiVA) data, China accounted for the highest shares by far in global gross manufacturing production and global manufacturing value added – at 35% and 29%, respectively. In fact, China produces more manufacturing output than the next 10 countries in the ranking combined. China's ascent as the global manufacturing powerhouse is even more impressive considering that in 2001, China accounted for only around 9% of global gross manufacturing, and 7% of manufacturing value added. In contrast, the US and the euro area accounted for 23.5% and 21% respectively of gross global manufacturing output in 2001, but their shares dropped to around 12% and 13% by 2020.

Graph I.4.6: **Share of global manufacturing value added**



Source: OECD TiVA 2023 Edition.

The rise of China has had a significant impact on the manufacturing sector in advanced economies. Over time, advanced economies came to exhibit significantly higher dependencies on China. By contrast, China started decreasing its reliance on foreign suppliers around the Global Financial Crisis. While already benefiting from the asymmetric tariff system negotiated during its WTO accession, China has also been using market access restrictions and subsidies to help its (often state owned) companies achieve scale with little foreign competition [64]. By operating in a vast protected domestic market supported by state subsidies, but at the same time being able to export to open markets, these companies quickly captured sizeable global market shares in some sectors (e.g.,

[62] The Economic Complexity Index was developed by Cesar A. Hidalgo, from the MIT Media Lab and Ricardo Hausmann, from Harvard University's Kennedy School of Government. It is a holistic measure of the productive capabilities of large economic systems, usually cities, regions, or countries.

[63] Shares are calculated from nominal USD GDP figures, IMF WEO data

[64] SWD(2024)91

solar panels). However, due to the scale of its domestic production, a cyclical weakening of domestic demand in China can create shifts in supply towards exports that have the potential to undermine trade and production patterns for specific sectors elsewhere. For example, estimates show that steel production capacity in China is around 1.1 billion metric tons per year (around 47% of global production) [65]. Most of this still goes towards domestic consumption, e.g. real estate and infrastructure construction. However, since the start of the real estate crisis in the second half of 2020, steel exports increased by more than two thirds, raising concerns also in emerging economies with a significant steel sector, e.g. in Brazil.

The EU's direct trade and investment exposure to China has grown over the past two decades. Since 2000, EU imports from China have been increasing almost three times faster than imports from the rest of the world. Their composition also changed, with electronics and pharmaceutical products replacing lower value-added consumer goods. Moreover, China is now the main source of the EU's strategic product dependencies, having been identified as the main origin of 64 out of 204 products in sensitive industrial ecosystems [66] and providing more than half of the total import value of these products. At the same time, the importance of China as an EU export market more than tripled in the past two decades (from 3% to 10% of extra-EU goods exports). China is an especially important destination for the EU's automotive (e.g. 18% of total revenue of Volkswagen comes from China) and integrated circuits manufacturing sectors (35% of total extra EU exports go to China). On the other hand, exposure to China through the investment channel remains- more limited. At the end of 2022, the cumulative stock of EU investment into China was estimated at around EUR 160 billion [67], comparable to the EU's annual direct investment in the US. Reflecting a deteriorating investment environment and high policy uncertainty, many EU companies established in China have lately been delaying new investment, while also considering alternative locations for future investments, in particular in ASEAN countries [68]. Chinese investment in the EU has also been on a multi-year decline. Still, there is a noticeable shift away from investment by state-owned enterprises (SOEs) and M&A transactions, towards more private and greenfield investment. Furthermore, Chinese FDI in the EU has recently been gearing towards investments in the mobility sector, supporting Chinese battery and electric vehicles (EV) makers' global expansion [69].

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[65] Latest Developments in Steelmaking Capacity 2024, OECD (2024)

[66] Arjona R., W. Connell, C. Herghelegiu. (2023). "An enhanced methodology to monitor the EU's strategic dependencies and vulnerabilities", Single Market Economy Papers

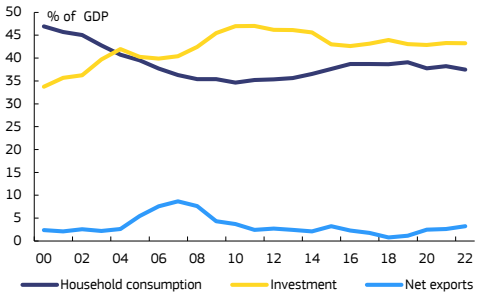
[67] Kratz A., N. Barkin, and L. Dudle. (2022).: "The Chosen Few: A Fresh Look at European FDI in China", Rhodium Group.

[68] European Union Chamber of Commerce in China (2023): Business Confidence Survey.

[69] Recently announced Chinese investments in the EU include large battery plants by Chinese leaders such as CATL or Svolt but also more upstream production facilities of battery components and materials such as cathodes, separator films etc.

What are the underlying drivers of China's structural economic slowdown?

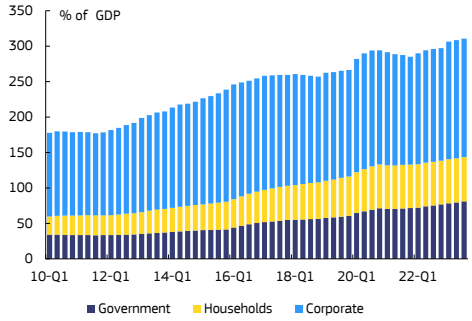
Graph I.4.7: **China - Consumption, investment and exports**



Source: National Bureau of Statistics.

China's current growth model is running out of steam. A growth model based on subsidised investment and export-oriented manufacturing, that indirectly depresses household consumption, largely resembles the approach taken by Japan and South Korea in their initial stages of development. However, the scale of China's reliance on investment is unprecedented, even among countries that pursued similar growth models and share geographical, demographic, and cultural similarities [(70)]. While China accounts for around 17% of global GDP, it represents only 13% of global consumption and 32% of global investment. The share of investment in the economy averaged 38% of GDP between 1990 and 2008 and rose to 44.5% on average thereafter (see Graph I.4.7). Slowing overall economic growth, low productivity growth and demographic pressures are increasing the urgency to rebalance the economy towards consumption.

Graph I.4.8: **China - Credit to non-financial sectors**



Source: The Bank for International Settlements.

The investment surge has been financed by one of the most rapid debt accumulations in history that is now weighing on business decisions by corporates and local governments. According to the Bank for International Settlements data, between 2001 and 2008 total debt in China stabilised at around 137% of GDP. It has since risen to 310% of GDP in 2023-Q3 (see Graph I.4.8). Within this aggregate, corporate indebtedness remains particularly high (167% of GDP in 2023-Q3). Such an accumulation of debt has created a significant debt overhang for both the public and corporate sectors, where the servicing of existing debt obligations consumes a substantial portion of cash flows, increasing financial stability risks.

Ample policy support directed at China's real estate sector since the Global Financial Crisis (GFC) enabled unsustainable growth in the sector. The real estate sector in China benefited from strong demand due to rapid urbanisation. Furthermore, due to financial repression in China, for most Chinese real estate is the only asset available for investment. Being important for delivering on ambitious growth targets, the sector enjoyed abundant access to debt financing by the state-owned banking sector. Furthermore, local governments came to increasingly support new real estate projects, as a significant share of their revenue came from land sales to developers. All this contributed to a ballooning of the sector and a significant misallocation of resources. Estimates show that, at its peak, the real estate sector accounted for between 25% and 30% of China's GDP At the same time, around 20% of the total real estate stock was estimated to remain vacant [(71)], suggesting problems of overbuilding in some areas. Furthermore, speculative investment fuelled a real estate bubble, further worsening housing affordability. The bubble finally burst in the second half of 2021, following the regulatory crack down on high leverage in the sector.

(70) For instance, Japan's investment rate peaked at 40.7% of GDP in 1973, when its GNI per capita stood at around USD 3600. Investment in South Korea peaked at 39% of GDP in 1991 and somewhat later on its developmental path, when its GNI per capita stood at around USD 7500. In both cases investment rates came down as the country became richer, eventually stabilising at around 25% and 30% in Japan and South Korea respectively. In 2022, investment accounted for around for 42% of China's GDP and its GNI stood at USD 12 850.

(71) Rogoff K., and Y. Yang. (2020)., "Peak China Housing.", NBER Working Paper Series.

In parallel, several factors continue to weaken household consumption and the prospects for domestic demand to support growth. Household consumption accounts for a relatively small share of GDP (37.5% in 2022), in a context of very high household precautionary saving, high income and wealth inequality and policies that directly or indirectly transfer income away from households and towards enterprises and the state. Scarring effects from the COVID-19 pandemic gave new impetus to this trend, with the household savings rate increasing further from 32.4% in 2019 to 34.6% at the end of 2023. Overall, domestic demand is being undermined as households and private firms exhibit poor confidence, opting instead to deleverage and (re)build savings buffers after enduring a prolonged pandemic shock.

Demographic headwinds have important implications for the medium-term growth outlook. In 2022, China recorded the first population decline since the Great Famine in 1961. The drop was repeated in 2023. According to the World Bank projections, by 2035, 30% of the population in China will be aged 60 or above, compared to approximately 20% in 2022. This rapid ageing reflects low and declining fertility rates, affected by the one-child policy (in place from 1979 to 2015), and increasingly longer life expectancies. Demographic ageing has two important implications: first, the working-age population peaked in 2011 in China at 900 million, decreased thereafter and is projected to fall to around 700 million by 2050. Second, the old-age dependency ratio is projected to increase significantly in the coming decades (to above 50% in 2050), placing strains on social welfare systems and healthcare services.

High inequality in China presents a profound socio-economic challenge. Growth in China has been accompanied by a surge in income and wealth disparities, threatening social cohesion and economic stability. While wealth and income inequality levels in China used to be lower than in Europe in the 1970s, they are now approaching US levels. The bottom 50% in China earns about 15% of total income, compared to 12% in the US and 22% in France. Furthermore, the wealth share of the top 10% in China stood at 67% in 2015, close to the 72% in the US, and much higher than the 50% in France [(72)]. Different Gini coefficient estimates show persistently high (and potentially) increasing inequality [(73)]. High overall growth rates over the past 20 years generated enough new jobs to help cushion the effects of the high-income inequality. However, a more pronounced structural growth slowdown may add to the fragility in the social system. Rising youth unemployment points to the already limited opportunities for the young. The official Chinese data series was discontinued in June 2023 upon reaching its highest ever level at 21.3%. Moreover, inequality of access to education and other services, exacerbated by a household registration system that constrains citizens' access to social services (limiting access to services to their place of origin, which may be far from their place of employment), weigh on overall economic growth and labour productivity.

Rising tensions with major trading partners over trade and technology raise doubts about the ability of the external sector to underpin growth. Since 2018, the US and China have been mired in a trade confrontation that led to several rounds of retaliatory tariffs. While the conflict found a truce when both sides signed the "*Phase One Deal*" in January 2020, tensions have continued, affecting trade, technology, and investment. In parallel, the EU has adopted a multi-faceted strategy towards China that aims to achieve a more balanced and reciprocal trade and investment relationship, but also to derisk its dependencies, especially in strategically important industries. More recently, as China is channelling its sectoral overcapacity via exports, some emerging economies (e.g., Brazil, Vietnam) are resorting to trade defence mechanisms. Overall, an international context increasingly characterised by trade fragmentation and the potential reconfiguration of supply chains compromises the ability of the external sector to systematically contribute to China's growth.

(72) Piketty T., L. Yang, and G. Zucman (2019). "Capital Accumulation, Private Property, and Rising Inequality in China, 1978–2015". American Economic Review.

(73) E.g. estimates by the National Bureau of Statistics and the Center for Strategic and International Studies

The government's policy response

The 2017 Communist Party Congress signalled a change in policy regime, tolerating lower growth targets in exchange for addressing broader political objectives. Overall, the shift in policy was grounded in two considerations. First, increasing concerns over financial contagion risks stemming from the high indebtedness of local government units and corporates, especially in real estate. Second, the awareness that China's upgrade to middle-income status required a change in growth drivers to avoid the middle-income trap and ensure a transition from capital broadening towards "*high quality*" growth, more grounded on innovation and higher value-added creation, greater inclusiveness, and environmental sustainability. The renewed importance of inclusive growth is also in line with the principle of "*common prosperity*". In practice this meant a need to curb an unrestrained housing market, which had created problems of housing affordability, aggravated income inequality and contributed to dampening birth rates.

During the summer of 2020, regulators enacted by far the most aggressive policies to restrict leverage in the economy and reshape the property sector. The main element was the so-called "*three red lines*" [(74)] policy, which severely limited the ability of developers to raise new debt. These rules proved problematic for many overindebted firms in the sector, as exemplified by the collapse in 2021 of Evergrande, the second-largest developer in China. Contagion from Evergrande´s financial woes spread quickly through the sector, with weaker firms facing a sharp rise in yields and worsening access to finance. In addition, mortgage boycotts emerged in the first half of 2022 as a direct consequence of households having deployed their savings for large down-payments on projects that developers with payment difficulties had not managed to complete. Overall, the context delivered a sharp deterioration of buyer confidence, triggering a collapse in housing transactions [(75)] and putting additional pressure on the already cash strapped developers.

However, the new policy approach also signalled a turn towards a more closed and more state-dominated economy in which private entrepreneurship could be further constrained. In 2021, Beijing took a series of regulatory actions that increased the state influence over the economy and shook the private sector confidence. Examples are the anti-monopoly guidelines for internet platform companies (February), the banning of crypto assets mining and trading (May, September), or the forced conversion of tutoring firms to non-profit entities (July). These also reflect a shift in policy emphasis towards security and domestic stability and less towards pursuing growth at all costs. This, along with the three years of COVID-19 economic disruptions, and the harsh and sometimes arbitrary pandemic containment policy, sent business confidence to historical lows. Capital flows reflected the change in investor perception of China as both net FDI and portfolio flows turned negative in 2021. Furthermore, in 2023-Q3 inflows of FDI turned negative for the first time ever, indicating that foreign firms operating in China are not only declining to reinvest their earnings but are also selling their existing investments in China and repatriating the funds.

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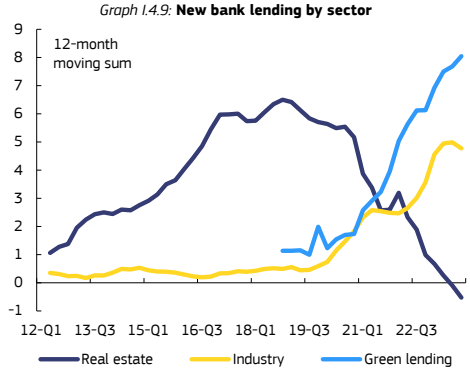
(74) Developers' financial soundness is evaluated against three criteria: (1) having a liability-to-asset ratio of less than 70%, (2) a net debt to equity ratio of less than 100%, (3) and a cash-to-short-term debt ratio of at least 1. If a firm fails them, regulators can place limits on the firm's allowed annual debt growth.

(75) The Chinese Academy of Social Science estimated the annual potential demand for real estate space at 1 billion square meters (m2). At its peak, the sector sold around 1.7 billion m2. Since the real estate bubble burst in the second half of 2021, sales have come down to around 1 billion m2 with little signs of stabilising. However, construction starts in the last 12 months have fallen below 0.7 billion m2, significantly below potential.

Graph I.4.9: **New bank lending by sector**



Source: People's Bank of China.

Timid attempts to rebalance the economy towards consumption have been unsuccessful. The current dominant thought among the authorities holds fundamental objections to "Western style" consumption-driven growth, seeing it at odds with the goal of making China a world-leading industrial and technological powerhouse. Consequently, while the Chinese authorities often refer to demand side support, in practice policy focuses on factor input subsidies, or tax breaks to companies. These measures have been yielding diminishing returns for years and are not addressing the current needs of the economy. Increasing the share of household consumption in GDP would require implementation of policies that support stronger wage growth, development of a stronger and more broad-based social security safety net, reforms of the labour market and the Hukou [(76)] household registration system and decreasing the role of the inefficient SOEs in the economy. However, recent government measures have reinforced some of the existing challenges, particularly as regards the presence of SOEs and government intervention in the economy.

Instead, the authorities are trying to offset the drop in real estate investment, by supporting investment in infrastructure and manufacturing capacities. Local governments have traditionally resorted to infrastructure building to boost demand and deliver on preset growth targets. In addition, authorities have been increasing support to the manufacturing sector through a wide range of supply side policies, including increased investment support. In particular, the China 2025 industrial strategy launched in 2015, and the Dual Circulation strategy adopted in 2020 set out a massive support programme to China's manufacturing sector, with the explicit objective of fostering exports, reducing import dependencies, and increasing self-sufficiency. High tech manufacturing and industries important for the green transition have been the prime beneficiaries of the new industrial policy (see Graph I.4.9). Overall, the current industrial support effort is already causing evident overcapacities and overproduction at sectoral levels.

What potential consequences might this slowdown have on the global economy and on the EU?

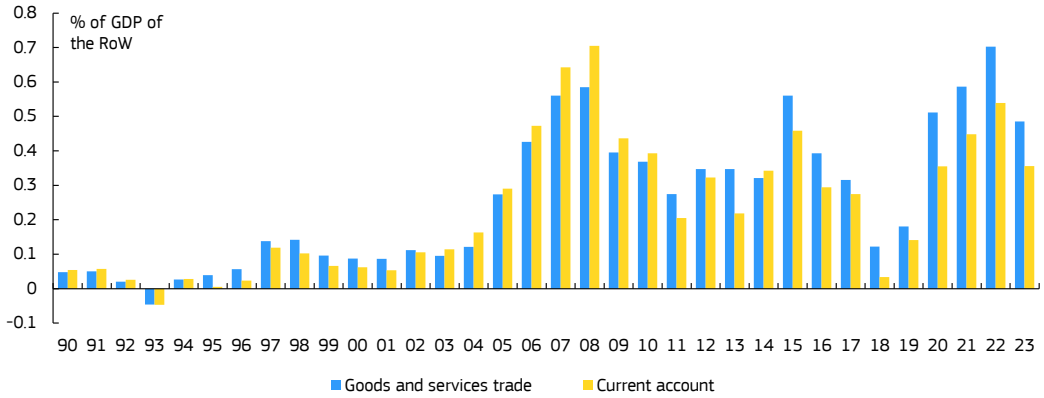
A structural slowdown in China will have implications for the global economy. Given the size of China's economy and having been the largest driver of global growth for decades, a continued growth slowdown in China would result in a structural downward shift in global growth. Commodity markets, global trade, supply chain patterns and financial markets could all be profoundly affected. China is the largest importer of raw materials and energy in the world and its demand remains an important predictor of global commodity prices. Developing countries relying on commodity exports to China could face lower export proceeds and greater economic uncertainty. Countries integrated in Chinese-led supply chains (e.g. ASEAN) could follow, especially if geopolitical tensions and decoupling/derisking pressures continue. The developed world would be mostly affected through the trade channel. Still, after years of self-reliance promoting industrial policy in China, the direct effects on global export demand for finished goods would be moderate.

With consumption systematically depressed, maintaining the current growth model in China could lead to more profound global trade and production disturbances. The Chinese current account and goods trade surplus may have peaked in 2007 at 9.9% and 8.5% of GDP, respectively, but compared to the rest of the global economy Chinese imbalances have been persistently high and have increased since the pandemic. As Graph I.4.10 illustrates, China's trade

(76) Hukou is a system of household registration used in China. It determines where residents can access credit, government jobs, education, subsidised housing, welfare, and other social services.

surplus stood at an all-time high of 0.7% of Rest of the World GDP in 2022 [77]. The current scale of the Chinese economy, therefore, leaves external demand increasingly unable to offset weakness in domestic demand. In addition, the recent policy boost to the manufacturing sector will likely increase the pressure to export an even larger share of new output.

Graph I.4.10: **China's external imbalances**



Source: National Bureau of Statistics of China, IMF.

Along with the export push, China is limiting investment and business opportunities for foreign firms operating in or exporting to China. A survey conducted by the European Chamber of Commerce in China identified the lack of meaningful SOE reform, increasing political risk for businesses operating in China, and uncertainty derived from shifting supply chain strategies, where China's central position is likely to be challenged as important factors limiting new investment in China [78]. Furthermore, the procurement market in China is becoming more closed. In some sensitive sectors, foreign owned companies are increasingly being excluded from tenders even when producing entirely within in China (e.g., medical equipment manufacturing). The new policy focus on domestic security is also undermining the position of foreign-owned companies operating in China. For example, the restrictiveness of new laws on data sharing has prevented normal business operations between international companies and their subsidiaries in China. Most large foreign-owned companies are already changing their business model by introducing separate supply chains: "China for China" and "Separate from China". However, the increasing burden of doing business in China is weighing more heavily on foreign SMEs that may not have the resources to establish separate operations.

The structural slowdown in China combined with the current growth model will likely continue to pose challenges for the EU economy. China is the EU's second largest goods trade partner and the largest supplier, but the relationship is becoming more unbalanced. The bilateral goods trade relationship has been traditionally characterised by a persistent EU deficit, but it has drastically increased in recent years [79]. The EU's reliance on China as a supplier increased markedly as the EU's total imports from China grew by almost 42% since 2019. The increase of imports from China moved beyond traditional sectors (electronics, consumption goods) to include those where the EU used to have a clear competitive edge (e.g. chemicals, automotive), as well as the strategically-important sectors related to the green and digital transition. At the same time, exports to China grew much more moderately, around 12%. Overall, the EU remains one of the most open economies in the world, but asymmetries in market access and trade

[77] In 2022, the current account surplus as a share of Rest of the World (RoW) GDP was 0.5%, the highest since 2008. The current account and trade surplus expressed as % of RoW GDP illustrate the size of China's trade imbalance in relation to the economic size of its trading partners.

[78] EU Chamber of Commerce in China (2023). Business Confidence Survey 2023.

[79] EU-China goods increased from EUR 150 billion on average in the five years before the pandemic, to almost EUR 400 billion in 2022. They stood at EUR 292 billion in 2023. The price effect can explain deficit reduction in 2023, as the trade in volumes remains equally one sided.

openness between the EU and China are becoming more evident. China's current growth model, its recent policy focus, and rising sectoral overcapacities could further exacerbate the already imbalanced trade relationship and increase EU's industrial dependencies on China.