China's Medium- and Long-Term Growth Outlook and Constraints*

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Summary

Since the Covid-19 crisis, the slowdown in the Chinese economy is becoming increasingly clear. This paper examines and assesses the following four factors as constraints to China's economic growth: demographics, government's economic management and innovation, real estate and financial risks, and the U.S.-China conflict and derisking.

On the demographic side, the decline in the main population of homebuyers will reduce housing demand, and the aging of the population may have an impact on consumer spending.

In terms of government economic management, the strengthening of government micromanagement is seen as a constant constraint on business activity and innovation.

The real estate recession remains less likely to pose a risk of a financial crisis.

The U.S.-China confrontation has transformed the trade structure, but it is far from decoupling. On the other hand, U.S. efforts to block China's rise in advanced technologies such as semiconductors will likely cause delays in China's technological catch-up, but its rise in mature technology fields will continue.

Based on the above, this paper revises downward the basic scenario for China's medium- to long-term growth set forth in Fukumoto (2022).

Keywords: convergence theory, peak China, medium- to long-term growth, demographics, household registration system, common prosperity, banking system, U.S.-China conflict, derisking

JEL Classification: F40, G01, J11, J13, O12, O30, O40, R21, R31

I. Introduction

China's rapid economic development after reform and opening up in 1978 was unprecedented in its scale and speed in world history. China's economy expanded to 41 times its 1980 real GDP in 2023, and its per capita GDP was 28 times higher than in 1980.[1] Because the world's largest and most populous country has developed at such a rapid pace, its increased presence in the world economy has been quite significant. China's share of the world economy (nominal GDP in US dollars) was only 2.7% in 1980 but rose to 16.9% in

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[1] Data in this section are author's calculations based on the April 2024 edition of the IMF World Economic Outlook Database; Figures for 2023 are estimates.

2023. It is the second largest economy in the world, approaching 65% of the U.S., the number one economy.

China's economy grew at an average rate of about 10% from reform and opening up until around 2010, but the growth rate slowed to the high single digits in the 2010s, and by 2019 the growth rate was 6%. Nevertheless, many experts believed that it was only a matter of time before the size of China's economy overtakes that of the U.S. due to the difference in their respective speeds of economic growth.

However, the slowdown in China's economic growth has been accelerating since the Covid-19 crisis; the real estate recession that began in mid-2021 has been prolonged, and combined with local government debt problems, there are flickering concerns of a financial crisis. The total population peaked in 2021 and began to decline, and as the government tightens its control over the behavior of private enterprises, there are concerns about the negative impacts on their activities. The escalation of the U.S.-China confrontation is obvious to all, and as restrictions on the export of high-tech products have been introduced, there are concerns about the impact of supply chain reformation from the perspective of economic security. Against this backdrop, the so-called the idea of "Peak China" has been pronounced, particularly in Europe and the U.S..

How will China's economy develop over the medium- to long-term? In "China's Slowdown: Risks and Opportunities in the Era of 'Common Prosperity'"[2], published in June 2022, I listed and examined the key factors that will impact China's medium- to long-term growth and then presented three scenarios for the growth path of China through 2035. The basic scenario at that time assumed that China would not overtake the U.S. economy in terms of size, but that it would come close to it. However, I feel that the scenarios need to be updated in light of subsequent changes in the situation.

After reviewing the thinking behind China's medium- to long-term growth prospects and the recent debate over Peak China, this paper will examine separately the key factors that could impede China's medium- to long-term growth: the impact of demographics, the impact of government economic management on innovation, the impact of the real estate recession and financial risk, and the impact of the U.S.-China conflict and the impact of derisking. As a conclusion, I will update our medium- and long-term growth outlook.

II. Approach to China's Medium- and Long-Term Growth Outlook

II-1. Chinese Government's Idea

The 19th Party Congress of the Chinese Communist Party (CPC) in 2017 stated that socialist modernization will be basically realized by 2035. In response, the 14th Five-Year Plan for National Economic and Social Development and Long-Term Goals for 2035, adopted by the National People's Congress in March 2021, set the goal of "reaching the in-

[2] Fukumoto (2022)

come level of a middle-level developed country by 2035." Although no specific target was set for the rate of economic growth during the period, prior to this, Chairman Xi Jinping issued a commentary on the long-term goal[3] in November 2020, stating that "it is entirely possible to double the size of the economy by 2035." He then stated that, in consideration of uncertainties and the importance all sides place on the quality and efficiency of the economy, he limited himself to "quantitative targets with some implications."

From Chairman Xi Jinping's commentary, it is clear that the Chinese government's envisioned goal for economic growth is to double GDP in the 15 years through 2035. Achieving this would require an average annual growth of 4.7% during the period. According to Fukumoto (2022), if China can double its GDP by 2035, it will overtake the U.S. economy in size in the early 2030s under constant prices and exchange rates. In other words, the Chinese government is on track to overtake the U.S. in economic size.

II-2. Catch-up Theory

The key to economic growth in emerging economies is the increase in value added per worker, or labor productivity, and a major driving force behind this growth is the catch-up of labor productivity in emerging economies with respect to advanced economies. In medium- to long-term growth forecasts for emerging economies, we often consider the pace at which they are catching up against advanced economies, especially the frontier country, the U.S., whose labor productivity is the highest among major economies.

This is called convergence theory.[4] It could also be called catch-up theory. It is based on the empirical fact that low-income countries generally have a latecomer's advantage, and their growth rates tend to be higher than those of high-income countries. East Asian countries and regions such as Japan, South Korea, and Taiwan have achieved high growth mainly through catch-up. Medium- to long-term forecasts for the Chinese economy are also often based on the catch-up theory.

Many of the medium- to long-term forecasts for China from 2019 to 2021 also used catch-up theory to forecast growth in China over the next 10 to 15 years that did not deviate significantly from the Chinese government's assumptions. The Chinese government's assumed goal of doubling GDP in 15 years did not appear to be an extremely ambitious goal as of 2021.

II-3. Three Growth Scenarios

Fukumoto (2022) conducted a scenario analysis of China's future economic growth potential based on the Chinese government's approach to economic growth and previous studies. Based on this analysis, three scenarios for China's economic growth through 2035 were

[3] Xi Jinping (2020)
[4] Kerr et al. (1960)

established: a good scenario, a basic scenario, and a risk scenario. Under the three scenarios, economic growth between 2020 and 2035 was projected to average 4.7%, 4.2%, and 3.6% per year, respectively, in each case. In the good scenario, the economy exits the size of the U.S. economy, but in the basic and risk scenarios, it does not exit the size of the U.S. economy. Table 1 summarizes this.

Table 1. Three Scenarios for China's Economic Growth

	(1) Demographics	(2) Reform and opening up	(3) Digitization	(4) Decarbonization	(5) Financial System and Real Estate	(6) U.S.-China conflict	GDP in 2035 (vs. 2020)	As of 2035 US-China Economic Scale	probability
Favorable Scenario	Certain halts to the declining birthrate and doubling of the middle-	Reform and opening up accelerate, private economy develops	Digital China transforms corporate management	The shift to a decarbonized economy is well underway	Financial system maintains stability, soft landing of real estate	Limited decoupling, some success in developing advanced technologies	2.0 times (4.7% average annual growth rate)	Surpassing US in the early 2030s	20%
Risk Scenario	Fertility declining further; conversion of peasant workers to urban households unsuccessful	Reform and opening-up stalled, progress made in national development	Pace slows as private tech firms lose vitality, DX becomes formalistic	Distortions in the rapid shift to a decarbonized economy are having a negative impact on the economy	Real estate market undergoes major adjustment, financial system becomes more fragile	Increased scope for decoupling, weighing on China's technological rise.	1.7 times (3.6% average annual growth rate)l	China will not catch up to US (the gap will rather widen after 2035)	20%
Basic Scenario	Declining birthrate trend stops, but there is no marked improvement	Certain degree of progress in reform and opening up and continued development	Digital China transforms corporate management	The shift to a decarbonized economy is well underway	Financial system maintains stability, soft landing of real estate	Decoupling is partial	1.85 times (4.2% average annual growth rate)	Not catching up to US, but closing in on it	60%

(Source) Prepared based on Fukumoto (2022)

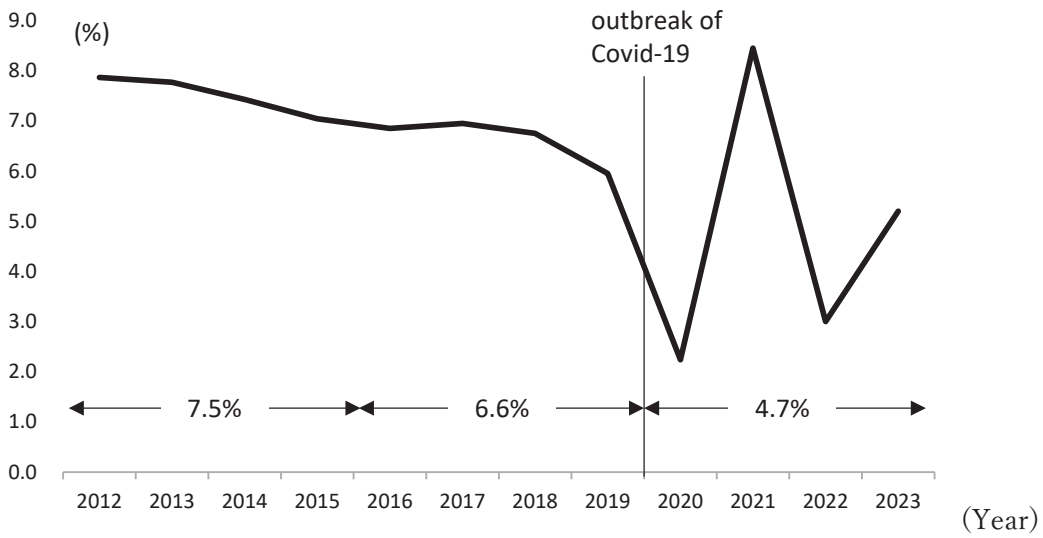
III. Acceleration of Economic Slowdown after the Covid-19 Disaster and the Peak China Theory

III-1. Acceleration of Economic Deceleration Following the Covid-19 Disaster

The Chinese government's view of economic growth and previous studies on China's medium- to long-term growth presented in Section II were mainly based on assumptions about China's economic situation prior to the Covid-19 crisis. However, since then, the pace of slowdown in the Chinese economy has been accelerating. The average annual economic growth rate declined to 4.7% from 2020 to 2023 after the onset of the Covid-19 crisis, compared to 7.5% from 2012 to 2015 and 6.6% from 2016 to 2019 (Figure 1).

In response, various agencies have revised their Chinese economic growth forecasts downward. The International Monetary Fund (IMF) has revised China's growth rate for 2027 downward by 1.1 percentage points, from 4.8% as of April 2022 to 3.7% as of April

Figure 1. China's Economic Growth Rate Trends



(Source) Prepared based on CEIC and National Bureau of Statistics of China

2024.[5] The Japan Center for Economic Research (2021, 2023) revised its 2030 growth rate downward from 3.7% as of December 2021 to 2.7% as of December 2023 and its 2035 growth rate downward from 2.9% as of December 2021 to 1.9% as of December 2023.[6] Both agencies revised China's medium- to long-term growth rate downward by approximately 1 percentage point.

III-2. Discussion on "Peak China"[7]

III-2-1. The idea of "Peak China"

The "Peak China" thesis, which claims that China's economy has already "peaked" after 2023 when the slowdown of the Chinese economy accelerates, is being presented over and over by foreign pundits. While there are a variety of opinions among pundits, they can be broadly categorized into two views. The first is that China's economy is likely to "Japanize," i.e., follow a path similar to that of Japan, whose economic growth stalled after the 1990s. The second view is that China's economic vitality will be eroded by more fundamental problems with its political system.

III-2-2. China's "Japanification"

The first view focuses on the similarities between the current Chinese economy and the Japanese economy of the 1990s. It states that the current Chinese economy is similar to that

[5] IMF (2022, 2024b)
[6] Japan Center for Economic Research (2021, 2023)
[7] This section is based on Fukumoto (2024a) with additions and corrections.

of Japan in the 1990s in terms of its excessive debt and investment-dependent economic structure, the bursting of the real estate bubble, the weakening of the financial system, and demographic changes such as an aging and declining working-age population.

Zongyuan Liu (Liu Zongyuan), International Political Economy Fellow at the Council on Foreign Relations,[8] notes that "the Chinese economy faces an increased risk of a Japan-style slowdown: soaring debt, sluggish demand, and demographic changes." Richard Koo, Chief Economist at Nomura Research Institute, also notes that "The key similarity is that both experienced the collapse of a debt-financed bubble. When asset prices plunge relative to liabilities, households and businesses are saddled with excessive debt and forced to deleverage...When few are left to borrow and spend the deleveraged funds even at zero interest rates, the economy invariably plunges into a balance sheet recession."

III-2-3. Argument that the problem is inherent in the political system of the Xi Jinping administration

The second view, on the other hand, holds that problems inherent in China's political system are eroding the vitality of the economy. In particular, since the transition to the Xi Jinping administration, the Communist Party and government have been increasingly intervening in the market economy, and this is undermining the vitality of the private economy.

Gene H. Chang, Professor Emeritus of Economics at the University of Toledo, says, "the problems China currently faces are more fundamental, which are also associated with its system. In the past decade, China has terminated the de facto privatization process begun under Deng Xiaoping, replacing it with orthodox Marxism under the slogan of 'Do not forget the original intention' of the Communist Party. The central and local governments exert and expand their control over the economy and society at large. They adopt discriminatory measures against private business, including charging higher interest rates on loans, setting up Communist Party cells in private firms to influence and lead the management, and even forcing firms to relinquish their shares to the government without compensation. These policies damage entrepreneurs' incentives, and therefore economic efficiency."

Adam Posen, Director of the Peterson Institute,[9] citing the tightening of controls over private enterprises and the sudden change in arbitrary Covid-19 policies after the Xi Jinping transition, said, "When an entrenched autocratic regime violated the 'no politics, no problem' deal, the economic ramifications are pervasive. Faced with uncertainty beyond their control, people try to self-insure...Their heightened risk aversion and greater precautionary savings act as a drag on growth, rather like what happens in the aftermath of a financial crisis. Meanwhile, the government's ability to steer the economy and protect it from macroeconomic shocks diminishes. Since people know that a given policy could be enforced arbitrarily, that it might be expanded one day and reversed the next, they become less responsive to stimulus plans and the like."

[8] Adapted from International Economy (2023). Similar remarks by Richard Koo and Jenné H. Chang.
[9] Adam Posen (2023)

Stanford University's Xu Chenggang[10] writes, "Following the CPC's recent Congress, it now seems clear that totalitarian control over every corner of society will be strengthened. The number of moderate technocrats and their weight in party-state agencies will be reduced. Economic policy will be politically determined. State-owned enterprises and party-state bureaucracies will steadily crowd out private enterprises and markets."

III-2-4. Refutation of "Peak China"

There are some strong arguments against Peak China. For example, Martin Wolf, Chief Economics Commentator for the Financial Times, said, "We shouldn't call 'peak China' just yet. Yes, there are deep structural problems in the economy, but this is also a country with significant strengths...According to the IMF, China's gross domestic product per head (measured at purchasing power) was 28 per cent of US levels in 2022. This is almost exactly half of Poland's relative GDP per head...Size matters. China will surely remain a very populous country for a long time...So, yes, it is indeed possible that we are watching the end of China's rise. But it is not inevitable. Above all, what happens will depend more on Chinese choices than on western wishes."

UC Berkeley Professor Barry Eichengreen also commented, "I also think that China's leaders have enough control of the levers of policy, and enough political autonomy, that they can recapitalize the banks, restructure the financial system, and apply countercyclical monetary and fiscal policies so as to avoid succumbing to a Japan-like slump."

III-2-5. Author's views on "Peak China"

Like Mr. Wolf, I believe that it is too early to say Peak China, although both views of Peak China do in part describe the problems facing the Chinese economy.

In order to understand the "growth potential" of China's economy, I make a comparison with the Japanese economy in the past. Based on World Bank data, China's GDP per capita in 2022 was USD127,000, about one-sixth that of the U.S.. Japan's per capita GDP was one-sixth that of the U.S. in 1960, a period of rapid economic growth. Urbanization also played a significant role in Japan's rapid growth. China's urban permanent population ratio at the end of 2023 was 66%, equivalent to that of Japan in 1963.

In other words, there are still many "young" elements in China's development stage in general. In terms of GDP per capita and room for urbanization, China should be considered to still have room for growth.

However, it is also true that various growth-constraining factors have already begun to come into play. In this paper, I examine the future course of four factors that I believe are particularly important for China's medium- to long-term growth: demographics, government economic management and innovation, real estate and financial risks, and the U.S.-China conflict and delinking, and how much they may become growth constraining factors.

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[10] Chenggang, Xu et al. (2023)

IV. Demographics: Impact of Low Fertility, Aging and Declining Population

IV-1. Rapidly declining birthrate, aging society and declining population

As the first constraint of growth, I examine the impact of demographic change on economic growth. China's working-age population (aged 15-64) peaked in 2014 and began to decline. The ratio of the elderly population aged 65 and over already exceeded 7% in 2001, which is considered to be the entry into an aging society, and will exceed 14% in 2021, which indicates that China will become an aging society. China is already facing the problem of "getting old before getting rich" in the sense that it will enter an aging society before it joins the member of developed countries. These facts have been anticipated.

However, the pace of China's declining birth rate is progressing faster than most expected: the 2020 Population Census shows that the total fertility rate in 2020 has dropped to 1.3 from the previous 1.7. The reasons behind this are a decline in the number of marriages due to a decrease in the population of marriageable age and other factors, as well as the rising cost of child rearing. In Japan, too, increasing urbanization has contributed to the declining birthrate, coupled with the rising cost of raising children in urban areas.

With the declining birthrate, the total population began to decline in 2022. The 2019 edition of the United Nations World Population Projections (medium projection, same below) had estimated that the total population would begin to decline in 2032, which means that the total population began to decline 10 years earlier than the previous UN projections.

The United Nations has substantially revised downward its population projections for China in its 2024 World Population Projections. First, the total fertility rate assumption of 1.7-1.8 in the 2019 edition was revised downward to 1.1-1.3 in the 2024 edition (Figure 2). Accordingly, the total population was revised downward significantly from 1.46 billion to 1.37 billion in 2035, from 1.40 billion to 1.26 billion in 2050, and from 1.07 billion to 0.63 billion in 2100 (Figure 3). In addition, the ratio of the elderly population aged 65 and over was revised upward (Figure 4).

Figure 2. Total Fertility Rate

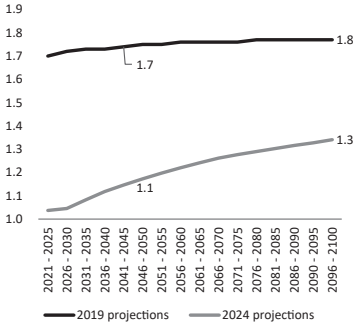


Figure 3. Total Population

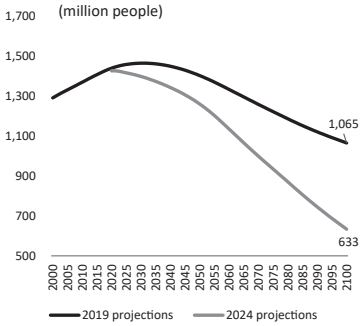
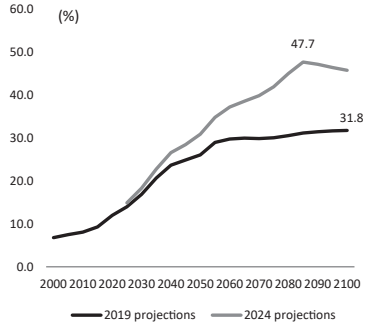


Figure 4. Ratio of Elderly Population (age 65~)



(Source) United Nations World Population Projections 2019 and 2024

The "Decision of the CPC Central Committee on Further Deepening Reforms and Promoting Chinese-Style Modernization" ("Decision") of the Third Plenary Session of the 20th CPC Central Committee in July 2024 pledges to "effectively reduce the costs of childbirth, childcare and education, develop a maternity leave system and establish a maternity subsidy system" and "strengthen the construction of an inclusive childcare service system and support the development of various models such as childcare by employment entities." The report also states that the government will "support the development of various models, such as childcare by employers, community-embedded childcare, and home childcare points."

However, many East Asian countries and regions have not succeeded in raising their fertility rates. The total fertility rates are all low: Japan 1.3 (2022), Singapore 1.1 (2021), Hong Kong 0.8 (2021), Taiwan 0.9 (2022), and South Korea 0.7 (2023), and none of these countries or regions has been able to implement any fundamental improvement measures. Given the precedents set by East Asian countries and regions, it is uncertain whether this level of support will be enough to increase China's fertility rate in the future.

The private Chinese think tank Yuwa Population Research (2023) estimates China's total fertility rate was 1.07 in 2022, and then sets three scenarios for future trends, with a recovery to 1.4 at the high-level estimate, a flat rate at 1.1 at the medium-level estimate, and a decline to 0.8 at the low-level estimate. It forecasts total population in 2050 to be 1.29 billion at highest, 1.23 billion at medium, and 1.17 billion at lowest. It forecasts total population in 2100 to be 0.8 billion at highest, 0.63 billion at medium, and 0.48 billion at lowest.

IV-2. Demographic Impact on the Economy

IV-2-1. Impact of Demographic Changes on Supply and Demand Side

How will the decline in total population and the aging of society with fewer children affect the economy? Fukumoto (2022) summarizes the effects of the decline in total population and the aging of society with fewer children in terms of both supply-side effects and demand-side effects. On the supply side, the decline in the working-age population will reduce labor input, while on the demand side, the decline in the mature population and the aging of the population will affect consumer spending and housing purchase demand. Fukumoto (2022) noted that on the supply side, the shortage of workers will likely be covered by labor-saving investments and the use of AI and digital technology, while on the demand side, the key to the impact will be the ability to achieve true urbanization, the "civilization" of peasant workers.

IV-2-2. Impact of Demographic Changes on Supply Side

Three years have passed since the writing of the book, so I would like to reevaluate the impact of demographics on the Chinese economy. First, the impact on the supply side has been generally in line with original assumptions. Although the pace of decline in the total population has been faster than expected due to the declining birthrate, the pace of decline in the working-age population (15-64 years old) has been as expected. In a sense, this is not surprising, since the decline in the birthrate at present will not affect the working-age popu-

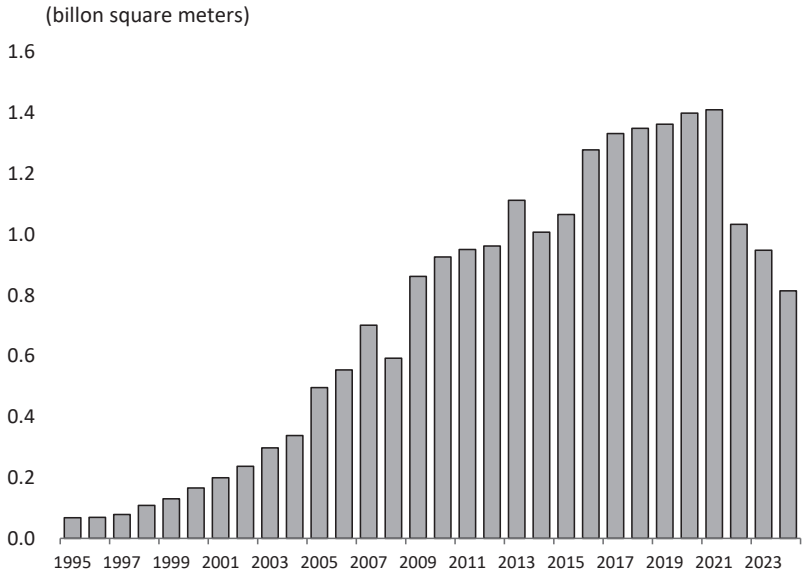
lation until 15 years from now. It will not affect economic growth until 2035, which is the period assumed by this paper. In response to the decline in the working-age population, labor-saving investments and the use of AI and DX are progressing well and do not seem to be putting downward pressure on growth from the supply side.

IV-2-3. Impact of Demographic Changes on Demand Side

(1) Impact on housing demand

On the other hand, regarding the demand side, the decline in housing demand has already become apparent: the housing recession in China that began in late 2021 has already lasted four years. The housing floor space sold has decreased by 42% from 1.41 billion square meters in 2021 to 0.81 billion square meters in 2024 (Figure 5). The lack of a boost in housing demand is largely due to the concern over solvency of real estate developers, as will be discussed later in this paper. In addition to this, however, there appears to be a significant impact from the apparent decline in actual housing demand in the first place.

Figure 5. Housing floor space sold

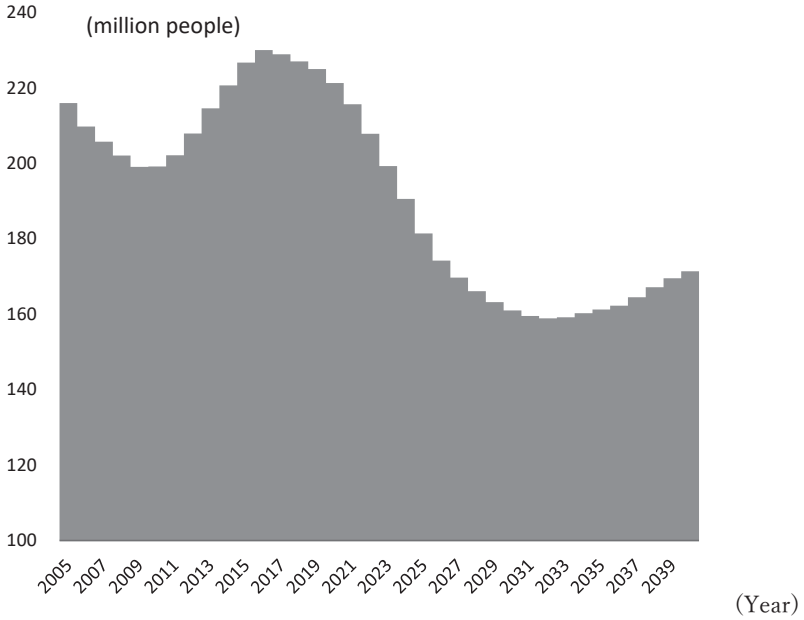


(Source) Prepared based on CEIC and National Bureau of Statistics of China

The main population for the first home purchase in China is the population aged 25-34, which is suitable for marriage. According to the United Nations World Population Projections 2024, the population aged 25-34 peaked in 2016 and is expected to decline by approximately 70 million by 2030 (Figure 6). Demographic changes have already reduced the actual demand for housing.

Nevertheless, housing demand remained strong until 2020. According to Southwest University of Finance and Economics (2018), in households' home purchase purposes, the percentage of starting dwelling fell from 70% in 2010 to 32% in the first quarter of 2018.

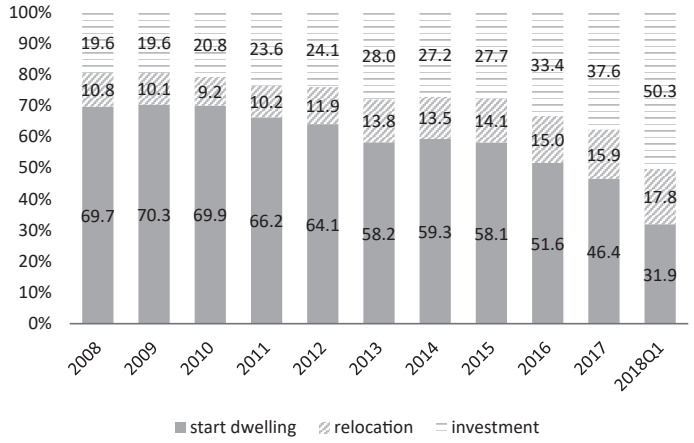
Figure 6. China's Population aged 25-34 (UN World Population Projections 2024)



(Source) Prepared based on the United Nations World Population Projections 2024

Meanwhile, the percentage of investment rose from 21% to 50% during the same period (Figure 7). The decline in housing demand may have been delayed by an increase in the share of investment in anticipation of housing price hike. In the housing recession since late 2021, in addition to the decline in actual housing demand, the drop in home prices led to a significant decrease in investment demand. It is natural to assume that this has led to a significant decline in housing sales.

Figure 7. Percentage of Households' Purpose of Home Purchase



(Source) Southwest University of Finance and Economics (2018)

Once the concern over solvency of real estate developers is resolved, the real estate market is expected to be stabilized from the current severe recessionary phase. Nevertheless, actual housing demand is expected to decline structurally. This is the view held by various institutions. According to Everbright Securities, housing demand will decline from 1.1 billion square meters in 2021-2030 to 850 million square meters in 2031-2040, and to 480 million square meters in 2041-2050 (Everbright Securities 2022). Tianfeng Securities Research Institute also forecasts actual demand for new housing to be 1.10 billion square meters in 2021-2025, to be 960 million square meters in 2026-2030, and to be 870 million square meters in 2031-2035 (Tianfeng Securities Research Institute 2022). Everbright Securities (2022) expects housing demand will shrink by more than 20% over 20 years.

The IMF's Article IV Consulting Report (IMF 2024), released in February 2024, takes a grimmer view and sees housing demand declining 33-55% (medium projection 44%) over the next decade.

Harvard University professor Kenneth Rogoff et al.[11] estimate that a 20% decline in real estate activity could result in a 5-10% decline in GDP. Combined with estimates by Guanda Securities (2022) and Tianfeng Securities Institute (2022), this would depress economic growth by 0.25-0.5 percentage points per year; based on IMF (2024), it could depress economic growth by more than 1% per year. At the time of writing my book (Fukumoto 2022), I had not fully incorporated these developments into his medium- to long-term growth forecast for the Chinese economy. It is necessary to take this into account anew in our medium- to long-term forecasts for China.

(2) Impact on personal consumption

In terms of demographic changes on the demand side, the impact of the aging of society on personal consumption may also have begun to emerge. The elderly tend to have relatively lower per capita consumption expenditures than the middle-aged. Based on the impact of aging on consumer spending, Cai Feng, a researcher at the Chinese Academy of Social Sciences, has predicted that China's economy will suffer a serious demand-side shock when the total population hits its peak.[12]

Weakness in China's personal consumption after 2022 is largely due to the Covid-19 crisis and the adverse wealth effect associated with the decline in the value of housing assets held. However, there is also the possibility that the effects of population aging on consumption are slowly beginning to take effect.

IV-3. Can China achieve the last bonus, "true urbanization"?

As discussed above, the accelerating aging of the population and the early arrival of a declining population could put downward pressure on China's economic growth, primarily in the

[11] Rogoff et al. (2020)
[12] Cai Feng (2021)

form of lower demand, especially for housing. On the other hand, there is one "final demographic bonus" for China that could offset the negative impact of demographic trends on demand. This is "true urbanization" in the form of the transformation of peasant workers into citizens. China's urban population ratio has risen from 21% in 1982 to 67% in 2024. Even so, this still corresponds to the 1964 level in Japan, and there is still much room for urbanization. Furthermore, China has a special household registration system that strictly separates urban households from rural households (the "hukou system"). In fact, the proportion of urban hukou population was only 48% in 2023, 18% difference from the 66% of the population living in urban areas in the same year. 18% of the population, equivalent to 250 million people, are mostly peasant workers and their families, who are migrant workers from rural areas to urban areas.

However, peasant workers and their families are severely limited in their access to public education, medical care, pensions, etc., due to their lack of urban hukou. According to the National Bureau of Statistics' survey of peasant workers (National Bureau of Statistics 2014), as of 2014, only 18% of peasant workers had access to public insurance and other forms of insurance: 18% for medical insurance, 17% for endowment insurance, which is equivalent to a pension, and 11% for unemployment insurance. This is the reason why peasant workers are called "semi-citizens." This limited access to public services suppresses peasant workers' demand for consumption and housing purchases.

The government work report for 2024 emphasizes a new type of "people-oriented" urbanization. However, true urbanization, in the sense of acquiring urban hukou for peasant workers, is no easy task either. In order to make public services in urban areas accessible to peasant workers, it is necessary to expand public infrastructure such as medical care and education. In addition, peasant workers tend to seek urban hukou in large cities where the working conditions are better, but large cities are overcrowded and reluctant to accept peasant workers. On the other hand, though small and medium-sized cities are willing to accept peasant workers, peasant workers tend to shy away from these cities because of the lack of job opportunities and the lack of good medical and educational infrastructure.

In this regard, the "Decision" of the 20th Third Plenary Session of the CPC Central Committee stated that "the system of providing basic public services through the family register of the place of residence should be promoted, and social insurance, housing security, and compulsory education for children of the relocated population should be promoted so that the relocated population enjoy the same rights as the urban hukou population, thereby accelerating the transformation of the migrant population into citizens." This is noteworthy because it indicates the direction that public services can be obtained on par with those of urban hukou holders without necessarily obtaining an urban hukou.

V. Government Economic Management and Innovation

V-1. Reform and Opening-Up and China's Economic Development

The most important factors in bringing about China's high growth since the 1980s were

a push for reform and an opening up. Economic reforms introduced market mechanisms and improved the efficiency of resource allocation. The private economy has also developed significantly. In addition, the promotion of openness to the outside world has led to the transfer of technology through trade with foreign companies and the acceptance of direct investment. Perkins and Rawski (2008) analyze that the average annual growth rate of China's total factor productivity turned positive from -0.5% in 1957-1978 before reform and opening up to +3.8% in 1978-2005 after reform and opening up, which induced capital input and realized high growth.

V-2. Economic Management in the First Term of the Xi Jinping Administration

One year after the start of the Xi Jinping administration, the Third Plenary Session of the 18th Central Committee of the Communist Party adopted the "Decision of the CPC Central Committee on Some Major Issues in the Overall Deepening of Reform" ("Decision"). The "Decision" stated that "the market should play a decisive role in resource allocation." This is a step forward from the previous central party policy of "letting the market play a basic role in resource allocation," and advances the role of the market mechanism. Regarding the privately-owned economy, the decision stated that "property rights are the core of the ownership system," and then treated the state-owned economy and the privately-owned economy in the same light, stating that "property rights in a publicly owned economy are inviolable, and property rights in a privately-owned economy are likewise inviolable." The decision, in general, was expected to promote reform and opening up through the development of market mechanisms and the privately owned economy.

During the first term of the Xi Jinping administration, a privately owned platform economy emerged, cashless payments developed rapidly, and the economy began to provide not only e-commerce, but also ride-sharing, shared bicycles, food delivery, and all other services for the common people. This private enterprise-led development of the digital economy also contributed to China's economic growth: according to IMF's Zhang Longmei et al.[13], there is a statistically significant correlation between digitalization and China's total factor productivity growth between 2007 and 2017.

The Xi Jinping administration supported entrepreneurship and innovation in private enterprises under the banner of "mass entrepreneurship and universal innovation." Although many of the new businesses undertaken by private enterprises were in areas where regulations were not necessarily set, private enterprises boldly took on new businesses. The Chinese government also tacitly approved the activities of private enterprises, saying that it was fine as long as they contributed to economic development. Professor Kajitani of Kobe University described the "tacit complicity between the authoritative government and the vibrant private economy."[14]

[13] Zhang and Chen (2019)
[14] Kajiya (2018)

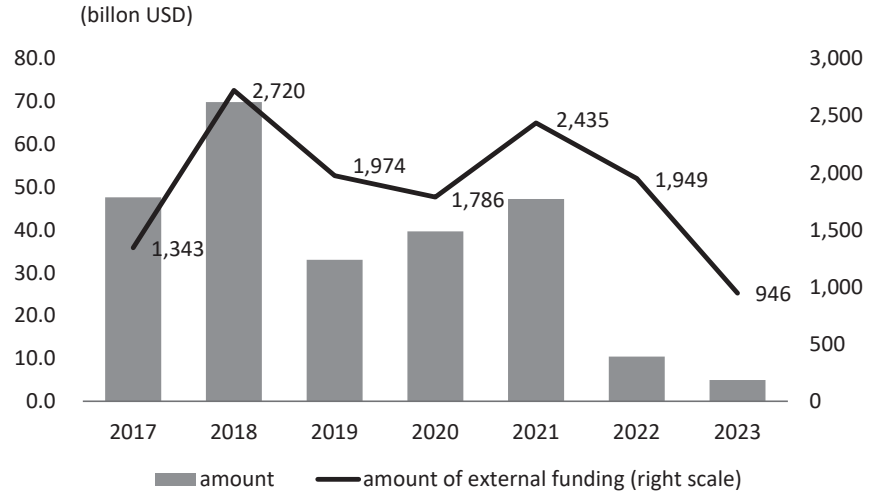
V-3. Tighter control over private enterprises since the second term of the Xi Jinping administration

Since the second term of the Xi Jinping administration, there has been a noticeable tightening of control over private enterprises. In November 2020, the listing of Ant Group, a financial subsidiary of Alibaba Group, which was considered the largest in the world's history, was canceled shortly before the planned timing. Subsequently, Alibaba Group, Tencent, the food delivery company Meituan, and the car-delivery service Didi were successively fined or investigated for violations of antitrust laws and national security laws.

The so-called "three red lines," regulations on corporate leverage, were also introduced for real estate developers. In the education industry, private cram and prep schools were suddenly banned at the compulsory education level. In the gaming industry, online gaming restrictions were introduced for minors. Since most of these regulations targeted private enterprises, it was perceived as a tightening of control over private enterprises.

The amount and number of external funding for internet-related industries, mainly platformers, declined significantly in 2022 and 2023 (Figure 8).

Figure 8. Amount and Number of External Funding for Internet-related Industries



(Source) Prepared based on the China Academy of Information and Communications Technology

Of the aforementioned Peak China advocates, Gene H. Chang, who states that "China has terminated the de facto privatization process begun under Deng Xiaoping, replacing it with orthodox Marxism," and Chengggang Xu, who states that "since Xi came to power in 2012, China has shifted back toward totalitarianism, with the CPC leadership reasserting control, particularly over the burgeoning private sector," both see these government regulatory tightening as problematic and an element that will continue to undermine the Chinese economy.

V-4. Strengthening of leadership by the Communist Party and its impact on business activities

With what intention did the Chinese government tighten regulations on private enterprises? Chairman Xi Jinping seems to believe that it is necessary to strengthen the Party's leadership in all aspects in order to maintain the one-party rule of the Communist Party, which is symbolized by his declaration after becoming Party General Secretary in November 2012. He said, "Party politics, military, civilian studies, east, west, south, south, and center, all are to be led by the Party." In the report to the 20th Party Congress in the fall of 2022, it was also stated that "the overall leadership of the Party will be firmly maintained and strengthened, and the authority and centralized leadership of the Party Central Committee will be strengthened."

The strengthening of micromanagement by the Party has also extended to private enterprises, with the establishment of Party committees in IT firms increasing rapidly since 2011.[15] Of course, it cannot be said that the mere establishment of Party committees alone has led to the strengthening of control by the Party. However, it is undeniable that the Party's policy of strengthening its leadership since the Xi Jinping administration has led to tighter control of private enterprises. The Xi Jinping administration cited "preventing the uncontrolled expansion of capital"[16] as the reason for tightening regulations on platformers and real estate developers. This may be in part because they believe that deterring platformers and real estate developers that have grown too large is necessary to maintain the Communist Party's one-party rule.

The "common prosperity" promoted by the Xi Jinping administration may also be seen as a reason for the strengthening of micromanagement by the Party and the government. In order to realize common prosperity, it is important for the general public to be able to afford housing and to have equal access to education. From this perspective, real estate regulations were suddenly introduced to curb soaring housing prices, and private cram schools and preparatory schools, where only the wealthy can provide education to their children, were suddenly abolished. The giant platforms, in conformity with the authorities' wishes, established a huge common prosperity fund in the form of donations. While the purpose of the common prosperity fund, which was to enrich all the people, was correct, the result was a discretionary clampdown by the government on private enterprises.

Although the tightening of regulations on platformers and real estate developers has since subsided, the uncertainty of how party and government micromanagement will be implemented in any industry in the future has made privately owned companies concerned.

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[15] Nobuhiko Tanaka (2020)

[16] The same wording is used for platformers in the 2020 Central Economic Work Conference and for real estate developers in the 2023 Government Activities Report.

V-5. Impact on the activities of private enterprises

Let us review the data on the activity of private enterprises since the second term of the Xi Jinping administration. The year-on-year ratio of fixed asset investment by private enterprises had been growing at a double-digit rate since the statistics began in 2011 until 2015, after which it gradually slowed down and declined by 0.4% year-on-year in 2023, the first decline since the statistics began to be published in 2011 (Table 2).

Table 2. Private Fixed Asset Investment YoY (%)

	Private FAI	Of Which Manufacturing	Of Which Tertiary industry
2011	34.2	n.a.	n.a.
2012	24.8	27.2	22.2
2013	23.1	21.4	25.4
2014	18.1	16.8	18.6
2015	10.1	9.1	9.4
2016	3.2	3.6	2.0
2017	6.0	4.8	7.7
2018	8.7	10.3	8.5
2019	4.7	2.8	6.7
2020	1.0	▲4.6	3.2
2021	7.0	14.7	3.6
2022	0.9	15.6	▲6.2
2023	▲0.4	9.4	▲6.2
2024	▲0.1	10.8	▲8.3

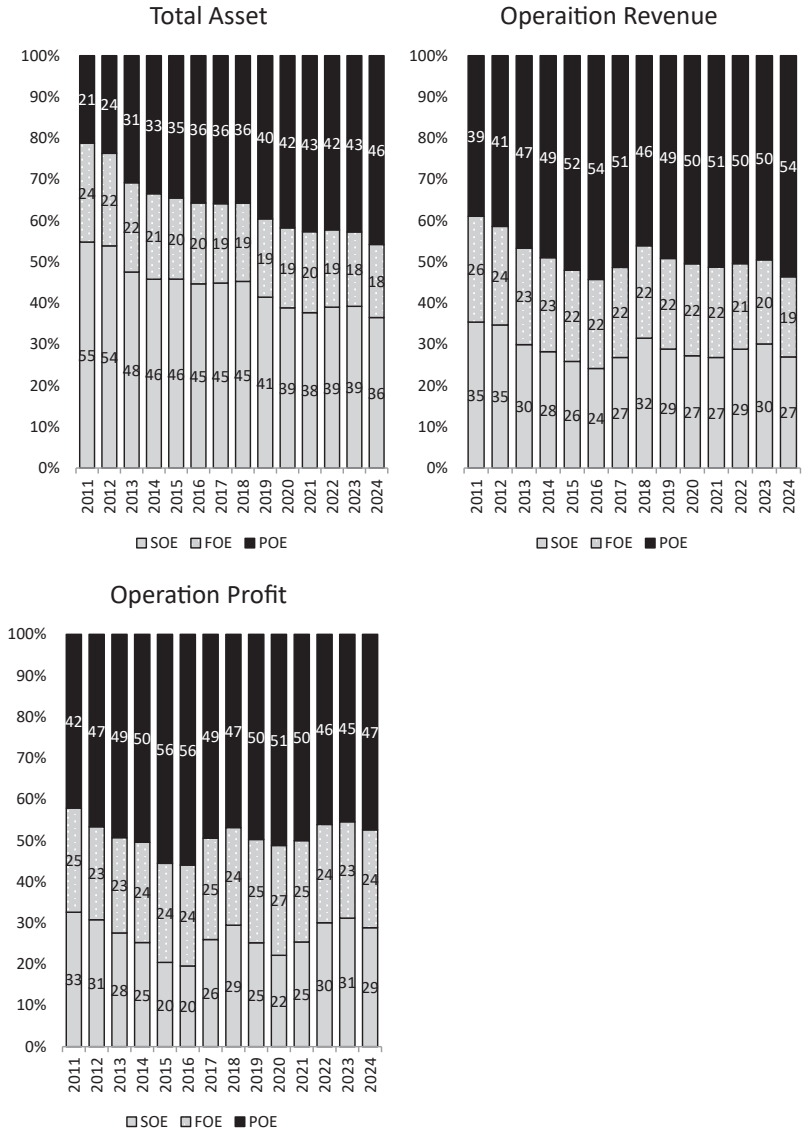
(Source) Prepared based on CEIC and National Bureau of Statistics

Looking at the weight of private enterprises, etc. in total assets, operating revenue, and total profits of industrial enterprises, all of which had been on an upward trend until the early 2010s, they have begun to somewhat level off from 2019 to 2024 (Figure 9). While this cannot be described in such a way as "the state sector advances and the private sector retreats," it certainly seems to lack the momentum it had until the early 2010s.

V-6. Resilient Private Enterprise Activities and Chinese Innovation

However, it would be an overstatement to say that China has lost the vitality of private enterprise since the end of reform and opening up. The report to the 20th Party Congress stated that "High quality development is the top priority in the overall construction of a modernized socialist country. Development is the first and most important task of the Party's

Figure 9. Weight of Industrial Enterprises by Type of Ownership



(Note) SOE is state-owned enterprises, FOE is foreign-owned enterprises, and POE is private-owned enterprises.
(Source) Prepared based on CEIC and the National Bureau of Statistics

administration and statehood." The report also states that "the Party will adhere to the reform and open-door policy," and it is safe to assume that the emphasis on economic development through reform and open-door policy has been maintained.

The "Decision" of the 20th Third Plenary Session followed the wording of the 18th CPC Third Plenary regarding the roles of the market and government, stating that "the decisive role of the market in resource allocation should be fully exercised and the role of govern-

ment should be better exercised. However, it also stated that "both '(market) activation through laissez-faire' and 'firm management (of markets)' will be realized to better maintain market order and compensate for market dysfunction," In sum, it emphasized the necessity of both market liberalization and regulation. In light of the rapid expansion of real estate and platform companies and their adverse effects, this may be a statement that laissez-faire alone will not work, and that management is also necessary.

On the other hand, with regard to the state-owned economy and the privately-owned economy, it expressed CPC's continued support for both "without wavering in the slightest." With regard to the privately-owned economy, it states, "We will enact a law to promote the private economy. The law will remove barriers to market entry, promote the fair and equitable opening up of the infrastructure competition field to management entities, and establish a long-term effective mechanism for private enterprises to participate in the construction of major national projects." Although there is some uncertainty about the effectiveness of the Law on the Promotion of the Private Economy and other measures, it is safe to assume that the Xi Jinping administration's strategy of "combining the best of state-owned and private enterprises" is continuing.

The Report of the 20th Party Congress also states that "we will adhere to placing emphasis on the real economy, promote new-type industrialization, and accelerate the construction of a manufacturing powerhouse, quality powerhouse, spaceflight powerhouse, transportation powerhouse, network powerhouse, and digital China." It also states, "We will accelerate the realization of high-level science and technology independence and self-reliance for the leading edge of science and technology in the world, for the main battlefield of the economy, for the critical needs of the nation, and for the life and health of the people."

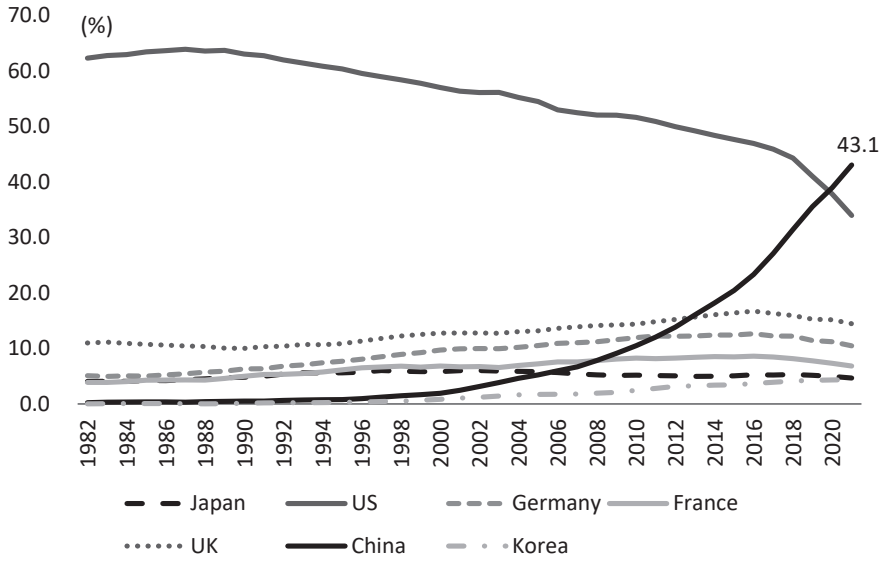
Further, the "Decision" of the 20th Third Plenary Session stated that for "high-quality development," the system and mechanism for developing "new quality production forces" will be soundly improved, and that "new industries, new models, and new driving forces will be created, and production forces characterized by high technology, high efficiency, and high quality will be developed." It also stressed the promotion of innovation through education, science and technology, and human resource development.

There is a clear focus on supply-side reforms, encouraging the development of the real economy, especially manufacturing and the digital economy, and encouraging the "self-reliance and self-reinforcement" of science and technology. In these areas, it is easy to obtain government support in terms of funding and other resources. Private investment in 2023 and 2024 was indeed down YoY, but this was due to a sizeable decline in investment in the tertiary sector, which includes real estate and platform companies, while investment in the manufacturing sector increased 9.4% and 10.8% (Table 2).

In terms of science and technology promotion, U.S. trade and investment restrictions to prevent technology transfer are constraints for cutting-edge fields such as semiconductors and AI (see below). However, China has the largest number of researchers in the world at 1.87 million (in 2018),[17] due in part to its large population of 1.4 billion people and high educational enthusiasm. In terms of quality, the development of scientific and technological

capabilities is also remarkable. According to the National Institute of Science and Technology Policy of the Ministry of Education, Culture, Sports, Science and Technology, as of 2021, China's share of the top 1% of science and technology-related papers in terms of number of citations was 43.1%, which surpassed that of the U.S. to rank first in the world (Figure 10). China's technological progress will continue to advance despite constraints.

Figure 10. Change in Share of Top 1% Corrected Papers in Major Countries



(Note) All fields, integer counts, 3-year moving average
(Source) National Institute of Science and Technology Policy, Ministry of Education, Culture, Sports, Science and Technology (2024)

VI. Real Estate Recession and Financial Risks

VI-1. Financial System Stability: A Dilemma Due to Government Control

One of the reasons China has been able to maintain high growth is that it has been able to avoid major financial crises through the control of the Chinese government. In the past, there have been several situations that raised concerns about financial risk, but the government's ability to control the situation did not lead to a financial crisis in the sense of causing a large-scale collapse of the financial system. In China, however, because of the government's ability to control the economy, there is a deep-seated expectation that the government will take care of things when the time comes, or in other words, an expectation of the government's "implicit guarantee," which has undeniably contributed to financial risks. The Chinese government has managed to protect the stability of its financial system while recog-

[17] National Institute of Science and Technology Policy, Ministry of Education, Culture, Sports, Science and Technology (2023)

nizing this dilemma.

VI-2. Risk of Real Estate Recession Leading to Financial Crisis

VI-2-1. Potential hard landing of real estate requiring separate consideration

China is currently facing a prolonged real estate recession. The risks of Chinese real estate are deeply intertwined with the risks of the banking system, shadow banking, and local debt, and the current real estate recession is the biggest test the Chinese financial system has ever faced.

The impact of the structural decline in housing demand on China's economic growth in the medium- to long-term was discussed earlier, but at that time, I did not envision a hard landing in the sense that a real estate recession would lead to a financial crisis. In Japan, the bursting of the real estate bubble in the 1990s led to a financial crisis and subsequent downward refraction of economic growth. Whether China can avoid a hard landing like Japan's needs to be examined separately.

VI-2-2. Status of China's Banking System

Let us review the state of China's banking system. As of the end of 2023, the NPL ratio of commercial banks was 1.6%, and 3.8% including the "watchful waiting" loans, which are considered the reserve for non-performing loans. In addition, the banks have accumulated loan loss reserves (RMB6.6 trillion), which is more than twice the amount of NPLs (RMB3.2 trillion), and their core Tier 1 capital amounted to RMB22.8 trillion. Furthermore, net income for 2023 is RMB2.3 trillion, a 5% increase over the previous year, and continues to increase. With the three bulwarks of loan-loss reserves, capital adequacy, and earnings, at least on the surface, China's banking system appears to be in good health.

VI-2-3. Banks' Real Estate Credit: Comparison with Before and After the Japanese Bubble

Next, I will review the situation of real estate-related credit, comparing it to the situation before and after the bubble in Japan. According to statistics from the People's Bank of China, the ratio of loans to real estate developers to RMB loans by financial institutions was 5.4% at the end of 2023. The ratio of loans to real estate developers by Japanese banks was 11.9% in 1990, during the bubble period, and 17% at the end of 2023.[18] The ratio in China is considerably lower.

The ratio of NPLs to real estate developers is not published by banks as a whole, but listed banks do publish it individually. According to my tabulation, the NPL ratio of loans to real estate developers of the five largest state-owned commercial banks[19] at the end of 2023 was as high as 5.4%. However, due to the low weighting of loans to real estate developers,

[18] Calculations based on Bank of Japan lending statistics by industry.
[19] Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China, and China Bank of Communications.

the overall NPL ratio for the five banks' total loans remained low at 1.3%.

On the other hand, commercial banks' weighting of residential mortgage loans in total RMB lending was 16% at the end of 2023. Japanese banks' weighting of mortgage loans was 10% at the end of 1990, during the bubble period, and 24% at the end of 2023. The ratio of NPLs to mortgage loans in China is low. For personal loans, of which housing loans are a large portion, the NPL ratio of the five largest state-owned commercial banks is low at 0.7% (Table 3).

Minimum down payment ratio regulations have been introduced for mortgages, which require that the down payment ratio be at least a certain percentage. Minimum down payment ratios vary from city to city, and the required down payment ratio levels are higher for second and subsequent homes than for first homes. According to a July 2023 survey by CRIC, a real estate research firm, the average minimum down payment ratio in the 20 largest cities in the country was 24% for the purchase of the first home and 42% for the second home.[20] The existence of minimum down payment ratio regulations has been a bulwark against mortgage non-performing loans.

Other real estate-related credit includes loans to companies secured by real estate, but Chinese commercial banks are generally conservative in their evaluation of real estate collateral. In the past, when I interviewed several Chinese commercial banks, they were generally conservative in their valuation of real estate collateral, ranging from 40% to 70%. In the case of Japanese banks, it is said that during the bubble period, real estate collateral was undervalued, and there were even cases where the collateral was multiplied by 100% or more. Compared to the Japanese banks of the time, they were conservative in their evaluation of

Table 3. Amount and Ratio of Non-Performing Loans of the Five Largest State-Owned Commercial Banks (End of 2023)

(Unit) billion RMB, %

	total loans		loans to the real estate industry		personal mortgage loans	
	NPL	NPL ratio	NPL	NPL ratio	NPL	NPL ratio
Industrial and Commercial Bank of China	354	1.4	41	5.4	61	0.7
China Construction bank	325	1.4	48	5.6	57	0.7
Bank of China	253	1.3	48	5.5	44	0.8
Agricultural Bank of China	301	1.3	47	5.4	59	0.7
Bank of Communications	106	1.3	24	5.0	20	0.8
5 banks total	1,338	1.3	208	5.4	241	0.7

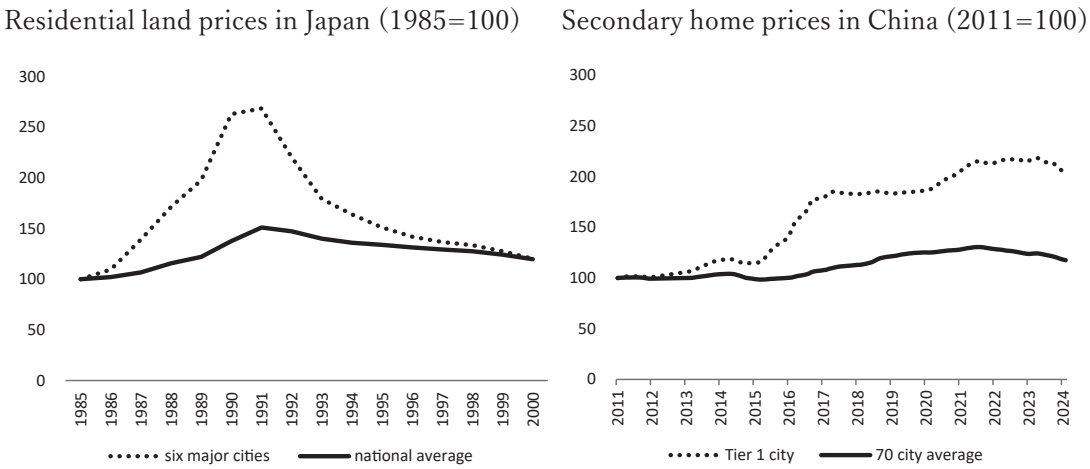
(Source) Prepared based on each bank's 2023 Annual Report

[20] Financial World (2023)

collateral.

The decline in housing prices in China is not as large as the decline in housing prices when the bubble burst in Japan (Figure 11). In the case of Japan, housing prices in major cities rose sharply from the late 1980s and fell sharply after the start of the 1990s. In contrast, housing prices in China have risen moderately and the declines have been small so far, partly due to government price controls. Residential land prices in Japan's six largest cities rose 2.7 times in the six years from 1985 to 1991 and fell 40% in the three years from 1991 to 1994. They continued to decline after that, falling 65% by 2011. In the case of China, the 70-city average secondary home price fell 10% in less than three years from its peak in June 2021, but the decline was larger in smaller and medium-sized cities, with a smaller decline of 6% in the first-tier cities of Beijing, Shanghai, Shenzhen, and Guangzhou.

Figure 11. Comparison of Housing Price Trends



(Source) Prepared based on Japan Real Estate Institute, Ministry of Internal Affairs and Communications, and National Bureau of Statistics of China

China's urban population ratio was 67% in 2023, the same as in 1964 in Japan, so demand for housing construction due to urbanization can still be expected.

Thus, there are many differences between the real estate situation in Japan in the 1990s and that in China today. This is the reason why it is not easy to immediately conclude that China is on the path of Japanification. That said, it is also impossible to immediately conclude that a financial crisis will not occur after the bursting of the real estate bubble in China. The low ratio of bank loans to real estate developers is due to the fact that most home sales in China take the form of pre-order sales, with advance payments received from homebuyers, as well as a large number of accounts payable from construction companies and other up-and-down suppliers. According to Zou Lan, Director of the Monetary Policy Department of the People's Bank of China,[21] bank borrowing and bond issuance accounted for a

[21] People's Bank of China (2023)

low 14% and 9%, respectively, of the debt of the 50 largest real estate developers, while home pre-order sales advances and accounts payable accounted for a high weight of 32% and 30%, respectively.

If the developer goes into legal liquidation and it is certain that the home will not be delivered, homebuyers may not be able to or refuse to pay their mortgages. In addition, bank loans to construction companies and other suppliers that have accounts receivable from developers may also be jeopardized. Furthermore, if many of the developers were to go into purely legal liquidation, this could increase market uncertainty and cause a further decline in real estate prices. As mentioned earlier, because of the conservative real estate collateral valuation, if real estate prices fall within a certain range, loan collections will not be immediately affected. However, if prices were to fall substantially, a deterioration in bank credit assets would be inevitable. In other words, if many real estate developers were to fail in an uncontrolled chain reaction, the possibility of a financial crisis cannot be ruled out.

However, I believe that the likelihood of the above scenario becoming a reality remains low. The Chinese government attaches great importance to the handover of uncompleted housing properties to buyers. If home buyers find out that they will not receive their homes, they are likely to become angry and start protesting, which will likely lead to social unrest. It is highly unlikely that a legal arrangement will be made in such a way that homebuyers will not be able to receive their homes from developers. The government will continue to guide developers and creditors to negotiate debt restructuring while construction and delivery of uncompleted properties proceed.

The Hong Kong High Court issued a liquidation order against Evergrande Group on January 29, 2024. The majority of Evergrande Group's assets are located in mainland China, and in order for the Hong Kong High Court to conduct a legal liquidation, permission from the mainland court is required. However, given the Chinese government's stance on the importance of housing extradition, it is unlikely that permission will be granted in the foreseeable future.

VI-3. Likelihood of financial risks remains low, but some points to keep in mind

As mentioned above, the Chinese government is adhering to the policy that the bottom line is to prevent systemic risk from materializing, and therefore, I believe that a significant downward refraction in economic growth due to a hard landing in the sense of a financial crisis should not be assumed in the basic scenario.

However, the following two points should be noted. First, there is a risk that the Chinese government will misjudge the bottom line of systemic risk occurrence. Simply postponing the debt restructuring of developers, as is currently the case, will not solve the fundamental problem. Eventually, the central government will have to take the brunt of the action, including temporary injections of public funds, to deliver uncompleted housing and promote an orderly shakeout and restructuring of the real estate developer industry. In March 2024, Ni Hong, Minister for Housing and Urban-Rural, stated that among insolvent real estate de-

velopers, "those that should be made bankrupt should be made bankrupt and those that should be restructured should be restructured." This statement reflects the authorities' concern that an easy bailout of debt-ridden companies and financial institutions may cause moral hazard.

However, there is a risk that the emphasis on avoiding moral hazard will increase market anxiety and misjudge the bottom line of systemic risk development. In such a case, how much would the impact be? The Japan Center for Economic Research (2023) predicts that in the event of a real estate bubble bursting and a financial crisis in China, the growth rate will be zero in 2027, and growth in the 1% range will be the norm from 2029 onward.

Second, it is important to note that financial fragility has large disparities by region. In the case of China, unlike when the bubble burst in Japan, real estate prices have fallen more sharply in small and medium-sized regional cities than in large cities. In many rural areas, local finances are severely strained due to the continuing economic stagnation and population outflow. This has already begun to affect the operations of small and medium-sized financial institutions in these regions, and the restructuring of small and medium-sized financial institutions is accelerating.[22] In other words, it is important to keep in mind that in some rural areas, the impact of the fragility of the financial system can have a greater impact on the economy.

VII. U.S.-China Conflict and Derisking

VII-1. The Prolonged U.S.-China Conflict and Its Impact on the Chinese Economy

Finally, I will examine the impact of the U.S.-China confrontation and the derisking trend on China's economic growth. One of the key factors that enabled China to maintain high growth after its reform and opening up was the smooth transfer of technology from developed countries by maintaining good relations with foreign countries. The U.S. has continued its policy of involvement in China, partly because it believes that if China transitions from a planned economy to a market economy system, its political system will eventually move in the direction of democratization.

However, with the rapid expansion of China's economic presence and the disappearance of expectations for China's democratization, the U.S. gradually shifted to a more guarded and hard-line stance toward China. Today, it is common knowledge among many intellectuals that the U.S.-China confrontation is long-term and structural. The question is how this long-term structure of the U.S.-China confrontation will affect China's economic growth.

Two years ago, I believed that "U.S.-China economic and trade relations may decouple in part but will never fully decouple. Trade and investment in many products and services other than high-tech products will continue to be closely related" (Fukumoto, 2022).

This paper points out the distinctive features of the recent stance of the U.S. and Western

[22] Fukumoto (2024b)

countries toward economic relations with China, and then analyzes how this is affecting the trade field in particular.

VII-2. U.S. Economic Stance on China: Derisking, "Small Yard, High Fence"

The current stance of the U.S. and Western countries on economic relations with China may be explained by the following two points.

First, in their economic relations with China, they aim for derisking, not decoupling. In May 2023, the communiqué of the G7 summit stated, "We are not decoupling or turning inwards. At the same time, we recognize that economic resilience requires de-risking and diversifying". Unlike relations with the Soviet Union during the Cold War, decoupling in the sense of complete economic fragmentation is unrealistic, as China is deeply integrated into the global economy and supply chains. While maintaining economic relations with China, including trade and investment, it can be said that the government has indicated a policy of reviewing its supply chain so as not to become overly dependent on China.

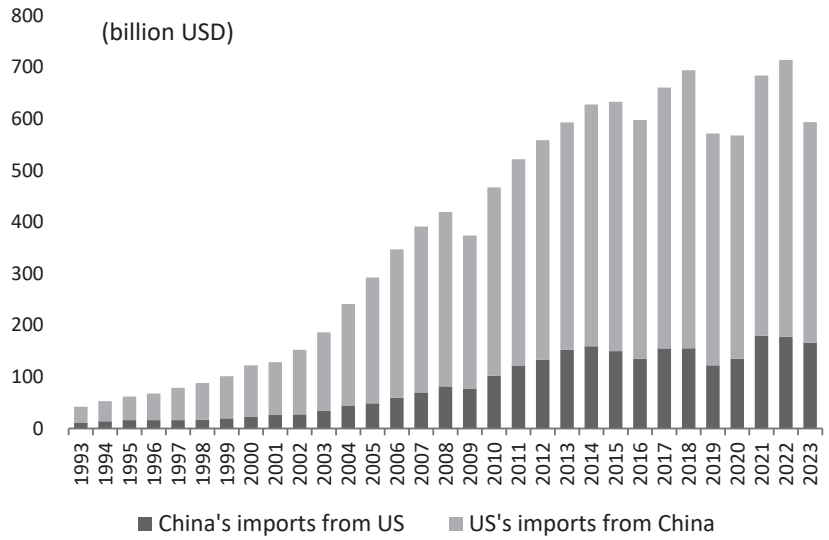
Second, the government intends to strengthen trade and investment restrictions to prevent the transfer of technology to China in the field of advanced technology. In April 2023, Biden Administration Assistant Secretary of State for Security Affairs Sullivan stated, "We are protecting our foundational technologies with a small yard and high fence...We've implemented carefully tailored restrictions on the most advanced semiconductor technology exports to China. Those restrictions are premised on straightforward national security concerns. Key allies and partners have followed suit, consistent with their own security concerns. We're also enhancing the screening of foreign investments in critical areas relevant to national security. And we're making progress in addressing outbound investments in sensitive technologies with a core national security nexus." While not completely decoupling trade and investment, the U.S. government has indicated a policy of tightening regulations to prevent the transfer of advanced and sensitive technologies to China.

In January 2025, the U.S. transitioned to the Trump administration. This has undoubtedly brought new uncertainty to US-China economic relations. However, I predict that the U.S. will neither seek nor be able to achieve complete decoupling from China.

VII-3. Impact of the U.S.-China Conflict on U.S.-China Trade

First, we review the changes in U.S.-China trade. As shown in Figure 12, U.S.-China trade followed an increasing trend until 2018, except for a temporary decline. In 2023, China relinquished its long-held position as the top U.S. import partner to Mexico. It is undeniable that the impact of the U.S.-China conflict is spreading with regard to general trade between the U.S. and China, and while the Covid-19 crisis appears to have had an impact in 2020, the declines in 2019 and 2023 are likely to be due to U.S.-China trade friction (2019), including the increased application of sanctions and tariffs, and supply chain changes due to derisking (2023).

Figure 12. U.S.-China trade volume (in USD)



(Source) Prepared based on CEIC, General Administration of Customs of China, and Census Breau of the U.S.

However, it would be premature to judge from this alone that the U.S.-China trade relationship is heading toward a fracture. Looking at recent trade developments, both China's exports to ASEAN and U.S. imports from ASEAN have increased notably: over the five-year period from 2018 to 2023, China's exports to ASEAN increased by 67%. U.S. imports from ASEAN over the same period also increased by 68%. These trends are particularly pronounced in Vietnam (VE), as well as in Thailand (TH) and Malaysia (MY) (Figure 13).

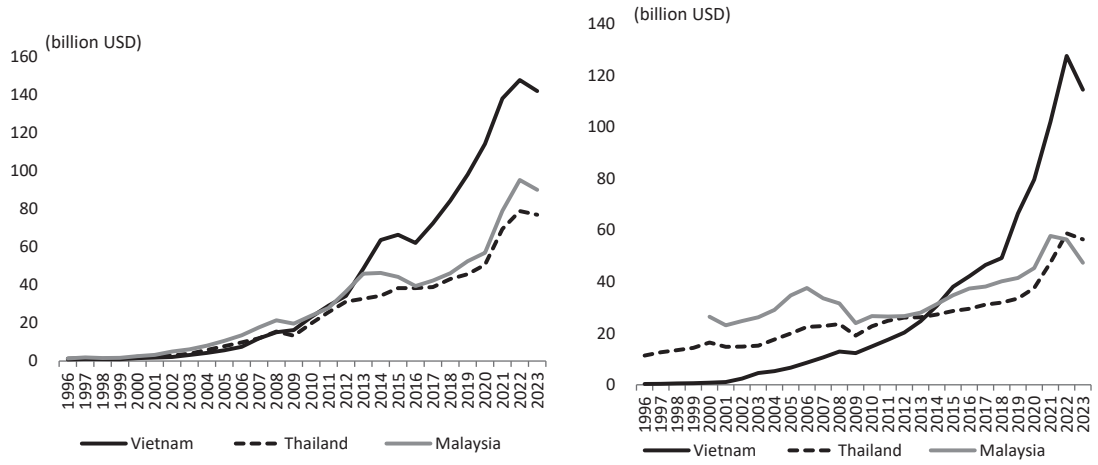
In recent years, it is often heard that manufacturers are transferring their factories to Vietnam and other ASEAN countries.[23] It is said that amid the intensifying trade friction between the U.S. and China, some manufacturers are transferring their factories to ASEAN countries in order to avoid U.S. sanctions against China or to perform labor-intensive processes in regions with relatively low labor costs. In many cases, it is believed that high value-added parts are still manufactured in China, assembled in ASEAN, and exported to the U.S. and other final consumption areas.

In other words, while U.S.-China trade itself appears to have reached a plateau or declined, the global supply chain, including U.S.-China trade, remains close when bypassing trade through ASEAN is included. While the U.S.-China confrontation and the trend toward de-linking have partially affected global supply chains, it has not been a unidirectional move toward decoupling.

According to my calculations based on UNCTAD statistics, China's share of world trade in exports will remain the world's largest by far in 2023 at 14.2%, up somewhat from 2018 (12.7%), five years ago.[24] While there is a certain impact on Chinese exports, I do not fore-

[23] Nihon Keizai Shimbun (2019)

Figure 13. Exports from China to Yue/Tai/ Ma and U.S. Imports from Yue/Tai/ Ma



(Source) Prepared based on CEIC, General Administration of Customs of China, and U.S. Census Bureau

see that this impact will significantly hamper China's export presence.

VII-4. Impact of the U.S.-China Conflict on Technology Transfer in Advanced Industries: The Case of Semiconductors

Next, I will examine the impact on China of the Biden administration's move to block technology transfers in advanced fields. The Biden administration does not aim to decouple general trade as a whole, but to build a "high fence" in the "small yard" of advanced technology areas that are related to the national security of the U.S.. The U.S. is particularly focused on preventing China's technological rise in semiconductors and the development of AI using these semiconductors.

In October 2022, the U.S. government embarked on a comprehensive tightening of semiconductor-related product export controls to China. Export of products for advanced semiconductor manufacturing facilities in China for logic semiconductors with line widths of 16 nm or 14 nm or less was banned. Furthermore, in October 2023, the government further tightened regulations on the export of semiconductor-related products.

Regarding the tighter regulations, U.S. Commerce Secretary Gina M. Raimondo said, " Today's updated rules will increase effectiveness of our controls and further shut off pathways to evade our restrictions." For example, since the introduction of the rule a year ago, NVIDIA, which designs logic semiconductors for AI, has been delivering products to China

[24] In 2020 and 2021, exports to the world from China, which was the first country to establish a production system under the Covid-19 crisis, increased, resulting in high market shares of 14.7% and 14.9%, respectively, for the same period. Since then, China's share has declined somewhat compared to the same period, as production systems have been established in other countries around the world.

with slightly lower specifications than those in violation of the regulation, but the revised rule will prevent those products from being exported to China as well.

The U.S. government is encouraging its allies, Japan and Europe, to follow suit. Export restrictions on semiconductor production equipment for the manufacture of advanced semiconductors were implemented in Japan and the Netherlands, which have major semiconductor equipment manufacturers, starting in July 2023 and September 2023, respectively.

A series of U.S. efforts to prevent the transfer of advanced semiconductor technology to China have been quite thorough and are seen by the industry as deterring China from playing technological catch-up in the advanced semiconductor field.

In addition, an advanced logic semiconductor with a line width of 7 nm was found to be used in the MatePro60 launched by the Chinese company Huawei in August 2023. Since Huawei is on the U.S. list of companies subject to export restrictions and cannot procure advanced semiconductors, the semiconductor was assuredly manufactured by a domestic foundry,[25] SMIC, and was noted as a successful example of advanced semiconductor manufacturing by a Chinese domestic manufacturer.

SMIC has also not been able to procure the state-of-the-art EUV (extreme ultraviolet) lithography equipment needed for semiconductor miniaturization due to regulations in the U.S. and allied countries. For this reason, the company is said to have used a technique known as "double patterning," in which two separate exposures are made using DUV (deep ultraviolet) exposure equipment, which is a previous generation technology. Without EUV lithography, further miniaturization is expected to be difficult.

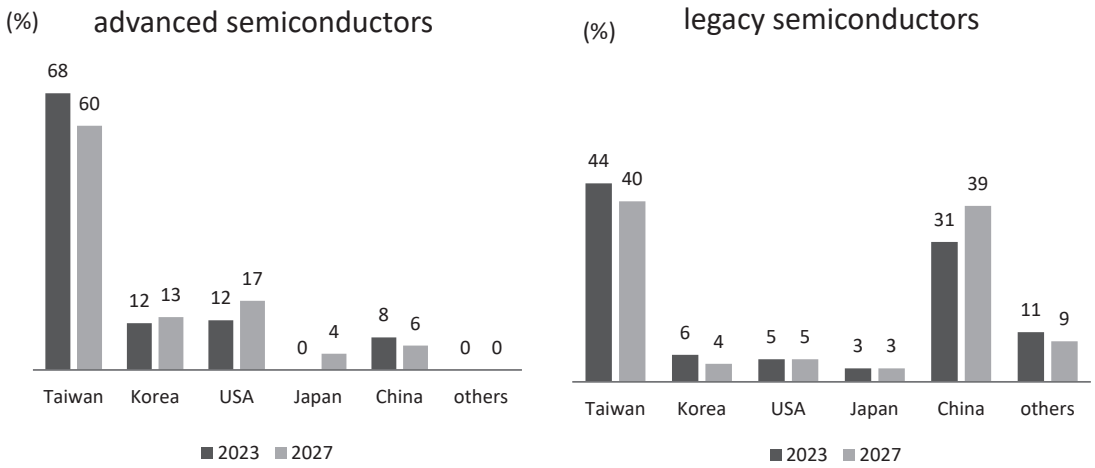
In light of the above, it appears that it will be difficult for China to catch up in advanced semiconductors, especially cutting-edge semiconductors, at least for the next few years. Trend Force, a private semiconductor market analysis firm, predicts that China's share of the global foundry advanced semiconductor manufacturing market will decline from 8% in 2023 to 6% in 2027 (Figure 14).

Meanwhile, China is now furiously increasing its manufacturing capacity for non-advanced semiconductors, known as legacy semiconductors. The Chinese government has set up a government fund called the National Investment Fund for the Integrated Circuit Industry to invest in semiconductor companies; the first phase, launched in 2014, provided about RMB140 billion in capital, and the second phase, launched in 2019, is worth RMB200 billion. Then, in 2024, the third phase began with a scale of RMB344 billion, exceeding the second phase.

Legacy semiconductors are used in a wide range of applications, including consumer electronics and automobiles, and according to Chung (2022), legacy semiconductors with line widths of 28 nm and above account for three-quarters of the world's manufacturing capacity by logic semiconductor node. Trend Force (2023) estimates that China's share of the legacy semiconductor market will expand, reaching 39% by 2027 (Figure 14).

[25] A foundry is a company that performs contract manufacturing of semiconductor front-end processes based on customers' semiconductor design data.

Figure 14. Global foundry capacity shares and forecasts for advanced and legacy semiconductors



(Note) Legacy semiconductors are processes with line widths of 28 nm and above, and advanced semiconductors are 16/14 nm and below.
(Source) Prepared based on TrendForce (2023)

In addition, China is the largest consumer of semiconductors, accounting for about 30% of the world's semiconductor demand. The SIA, the U.S. semiconductor industry association, in their report,[26] says that while security concerns are understandable, the loss of sales to China would significantly impact revenues and cash flow for U.S. semiconductor companies, and would put them at a disadvantage in global competition because they would not be able to generate funds for R&D investment. For legacy semiconductors, Western companies will likely continue to do business with China.

In summary, U.S. measures to block China's technological rise in cutting-edge areas such as semiconductors and AI will have a considerable impact on China's advanced semiconductor and AI development. However, with government support, Chinese companies' technology, especially in legacy semiconductors, will steadily improve, and China's domestically produced semiconductor industry is expected to expand in size.

VIII. Conclusion

In light of the accelerating trend of China's economic slowdown after the Covid-19 crisis, this paper summarizes the debate over Peak China and updates the situation through spring 2025 on four key points: (1) demographics, (2) economic reform and innovation, (3) real estate and financial risks, and (4) the US-China conflict and delisking. The paper then examines how each of these could act as a constraint on China's economic growth.

Taking all of these factors into consideration, I believe that the previously assumed baseline scenario for the growth trajectory of the Chinese economy (Fukumoto 2022) needs to

[26] Semiconductor Industry Association (2021)

be revised downward.[27] The main reasons are that (1) a structural decline in actual real estate demand due to demographic changes is expected to continue to depress growth in the medium- to long-term, and (2) the strengthening of micromanagement by the Chinese government and party is expected to continue, which will affect confidence, especially in private enterprises. Given these factors, I believe that the growth trajectory that I previously considered a risk scenario is now the new baseline scenario.

There are significant uncertainties in the outlook for future growth. Upside risks include; (1) "true urbanization," through the transformation of peasant workers into citizens, will proceed more successfully than expected, and (2) the Xi Jinping administration's "new quality of productive capacity" strategy will be successful, making China's manufacturing and digital-based industries more competitive than expected. On the other hand, downside risks include: (1) further strengthening of micromanagement of corporate activities and a decline in corporate confidence; (2) the authorities misjudging the bottom line of real estate risk management, leading to a financial crisis; and (3) the election of President Trump in the U.S. and a shift in economic stance toward China from "small garden and high fences" to a broader range of goods and services. Moreover, the election of President Trump in the U.S. may bring a shift in the U.S. economic stance toward China to a decoupling path that significantly raises import tariffs on a wide range of goods, rather than a "small garden and high fence" policy. Overall, downside risks are seen as greater than upside. Particular attention will be paid, for the time being, to how the government deals with the real estate recession.

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