International Commentary — January 10, 2022

Can China Become The World's Largest Economy?

Summary

China is likely to be defined by a slower pace of growth going forward; however, despite multiple headwinds and structural imbalances, there is a high likelihood China could overtake the United States as the largest economy in the world. In this report, we use our short-term economic and currency forecasts as well as make longer-term assumptions around the evolution of the Chinese economy to determine when China could ascend to the world's largest economy.

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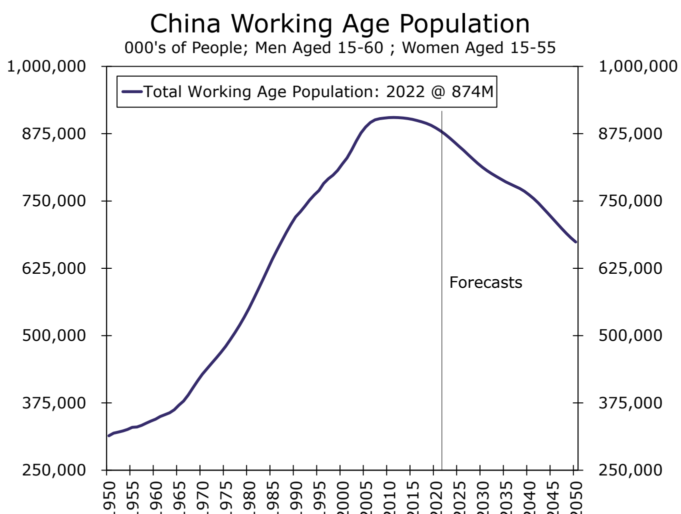
Short Answer, Yes...

...But, becoming the world's largest economy will be no easy task for China. As we've highlighted in the past, China's economy has been slowly decelerating for some time now. The double-digit growth rates experienced over the course of recent decades have disappeared, and in our view, are likely gone for good. Even the government's target growth rate of 6% per annum seems ambitious. Unless conditions locally (and globally) change significantly, we believe China's economy is unlikely to experience a post-COVID annual growth rate of 6% again. This year, we forecast China's economy to grow 5.5%, and in 2023, just 5.4%. Should our forecasts materialize, aside from the depths of COVID in 2020 where the economy grew a little over 2%, the next few years could mark the slowest pace of annual growth in China since the aftermath of the Tiananmen Square protests in 1990.

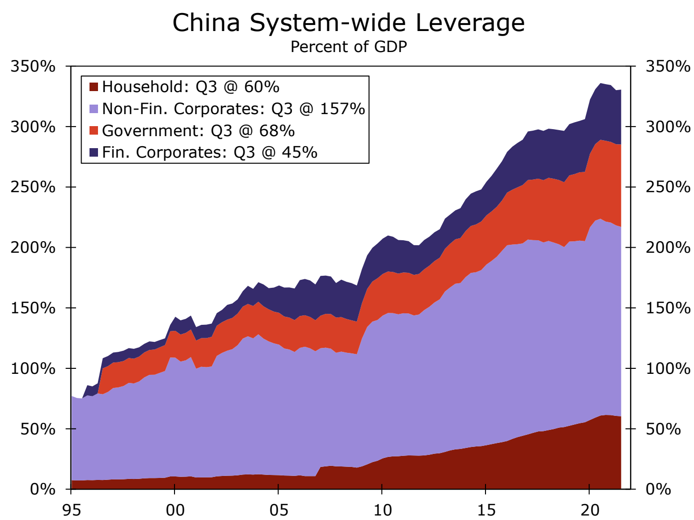
In order to overtake the U.S. economy, China will have to contend with multiple issues. COVID-related disruptions do not appear to be going away anytime soon, and Chinese authorities are likely to stay committed to the "Zero COVID" policy and keep mobility restrictions in place for the time being. "Common prosperity", designed to promote wealth equality, is likely to be a theme going forward as well. So far, the common prosperity campaign has led to a sharp decline in the local property sector and has introduced the possibility that China may become a less desirable investment destination due to heightened policy uncertainty. In addition, Trump-era tariffs remain in place and should continue to act as a drag on China's export sector, while other sources of tension between the U.S. and China seem likely to persist. President Biden seems committed to a coordinated approach to combat China's economic rise, and should trade or geopolitical tensions escalate, China could be further usurped as a supply chain hub and confidence toward China's local financial markets could wane should geopolitical frictions mount.

Figure 1



Source: United Nations and Wells Fargo Economics

Figure 2



Source: IIF and Wells Fargo Economics

Structural problems also exist within China's economy, and in our view, these imbalances are the biggest obstacles to China becoming the world's largest economy. First off, trends in local demographics have been working against China for over a decade. China's population is aging, and the working population has been in decline for years (Figure 1). To that point, the United Nations expects China's working age population to fall to 874M people this year, down from a peak of over 905M in 2011, and eventually drop to 673M by the year 2050. A shrinking working age population is a legacy result of China's one-child policy as well as elevated living costs. And even though the Chinese government has allowed for and encouraged more children by lifting child limitation policies, fertility rates remain low by historical standards. As our colleagues highlighted in a series of reports, an aging economy can reduce a country's growth prospects. A smaller workforce means fewer people operating the country's capital stock, leading to less productivity. Eventually, less productivity results in slower growth in overall economic output. China's other structural challenge stems from its over-leveraged economy. As of Q3-2021, system-wide leverage in China amounts to 330% of GDP (Figure 2). Leverage has been a key tool to fuel growth in China; however, authorities have come to the view that borrowing is not a sustainable long-term growth strategy. As a result, Chinese authorities have committed to deleveraging the economy over time. As deleveraging progresses, China's longer-term growth prospects are likely to diminish.

10 Years To Take The Reins

Despite these short and long-term challenges, we believe China can become the world's largest economy. In fact, **our base case scenario suggests China will become the largest economy in the world by 2032**. To reach this conclusion, we utilized our short-term economic and currency views to forecast nominal GDP through the end of 2023. We also made longer-term assumptions around the evolution of the Chinese economy in an effort to forecast nominal GDP through the year 2040. As far as the details of our base case scenario, as mentioned, we forecast the Chinese economy to experience a real GDP growth rate of 5.5% this year and 5.4% next year. On the inflation side, we forecast CPI to rise 2.1% in 2022 and 2.2% in 2023. Combining our real GDP growth and CPI forecasts gives us a nominal GDP growth rate of 7.6% for the next two years. Growing China's level of nominal GDP by a growth rate of 7.6% brings China's nominal GDP to 115T renminbi by the end of 2023. As far as the United States, our U.S. economics colleagues forecast the U.S. economy to expand at a nominal GDP growth rate of 8.7% this year and 5.2% in 2023. Using these forecasts, nominal GDP in the U.S. could rise to a little over $26T in two years. In order to accurately compare the size of each country's economy, China's nominal GDP needs to be converted into U.S. dollars. We expect the renminbi to modestly weaken against the dollar over the next few years, and accounting for renminbi depreciation, the level of Chinese nominal GDP in U.S. dollar terms could be around $19.6T at the end of 2023.

Embedded in our short-term economic and currency forecasts is a shift to more accommodative policy from the People's Bank of China (PBoC), as well as more accommodative economic policy from the Chinese government. This turn toward policy accommodation delays the deleveraging effort for at least the next two years; however, as China's economy moves past COVID-related disruptions and stabilizes, we expect debt reduction efforts to continue. As deleveraging becomes a priority, we expect the Chinese economy to continue its deceleration, albeit at a modest pace. In addition to deleveraging, we assume a diminishing workforce and aging demographics can also place downward pressure on the economy. In our outlook, we assume the fertility rate does not rise enough to alter demographic trends and the working age population shrinks in line with United Nations forecasts. **From 2024-2030, we believe China will experience an average annual real GDP growth rate of 4.5%**. From 2030-2040, we expect China's demographics to deteriorate further and for deleveraging to remain a priority. **Throughout the 2030s, we assume an average annual real GDP growth rate of 4%**. Long-term price pressures are also likely to remain contained. To that point, we assume average inflation rises at a trend-like pace of 2.25% until 2040. And despite a bearish outlook on the renminbi over the next few years, we believe the longer-term prospects for the Chinese currency are more optimistic. We believe Chinese authorities will continue to make local financial markets more accessible to foreign investors, and Chinese assets will be included in additional equity and bond indices. Also, many fair value models suggest the renminbi is undervalued, perhaps as a result of capital controls and other FX intervention efforts. In order for confidence in China's local financial markets to gather momentum and for the renminbi to play a larger role in currency markets, capital controls will have to be lifted and intervention will have to be limited. We expect these dynamics to materialize over the next few decades and for the USD/CNY exchange rate to move toward CNY5.50 by 2040.

Modeling these assumptions reveals **the level of dollar denominated nominal GDP in China will reach $37.9T by 2032**. Also included in our outlook is an assumption of nominal GDP growth for the U.S. economy. During the prior economic cycle (2010-2019) nominal GDP growth in the U.S. averaged 4% per year. Our U.S. economics team has reason to believe the American economy is likely to expand at a similar rate, on average, in a post-COVID world. Assuming a similar average growth rate going forward, **the U.S. economy's nominal GDP level may only hit $37.4T by 2032, about $500B smaller than China's nominal GDP** (Figure 3).

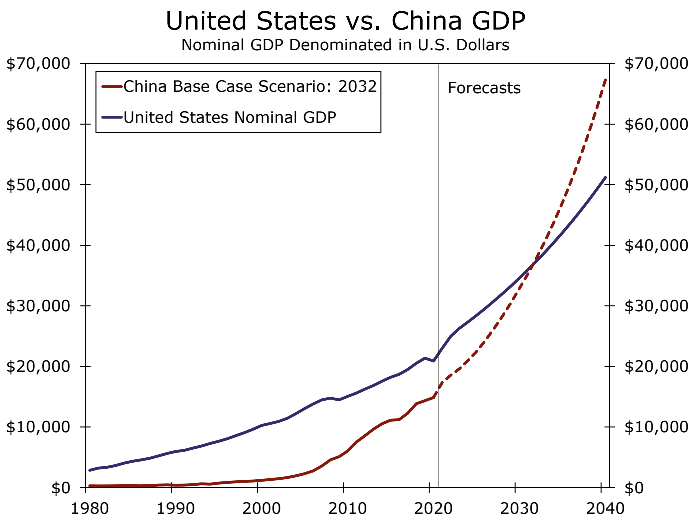
Policy Support and Aggressive Reform Agenda Could Mean 2030

While we are in uncertain times and the outlook is likely to be clouded by COVID for an undetermined period of time, we feel the risk is tilted toward China becoming the largest economy earlier than 2032. **In an upside scenario, we believe China could overtake the U.S. economy as early as 2030.** However, in order for China to takeover as the world's largest economy, the monetary and fiscal policy mix would have to remain accommodative and expansionary for longer than we expect. To that point, we expect Chinese authorities to provide fiscal stimulus to the Chinese economy over the next two years. Despite an augmented fiscal deficit (i.e. federal, local and other off-budget government spending) of over 16% of GDP, Chinese institutions still have space to provide fiscal support to the government. This support could come from new infrastructure spending as well as various of tax reductions. In addition, the government could choose to provide bail-out capital to struggling private sector corporations, a policy authorities have pushed back on in recent years.The PBoC, in our view, also has room to ease monetary policy at a more aggressive pace and for an extended period of time. We currently believe the Reserve Requirement Ratio (RRR) for major banks will be lowered to 11% in Q1-2022; however, an RRR of 11% is one of the higher bank capital requirement rates in the emerging markets. There is scope for the RRR to be lowered more in line with peer emerging market central banks. PBoC policymakers also have multiple lending rates that can be cut over time, while the official policy rate could also be lowered.

Authorities would also have to take more explicit steps to solve the structural demographic issue. Chinese authorities have already taken steps to address the declining workforce, but in our view, there is scope to speed up reform measures. Authorities lifted the one-child policy and allowed households to have two children in 2016, and just recently, authorities allowed families to have as many as three children. Also, in our view, the common prosperity campaign is partially designed to reduce the cost associated with having children. Should the policies aimed at reducing the cost of housing, education and healthcare trigger a rise in the fertility rate, the combination of lifting child limitation policies and the common prosperity agenda could act as a tail-wind to China's economy over the longer-term. In addition, pension reform aimed at extending the age where workers can start receiving benefits, could also result in a rising workforce and support longer-term growth prospects in China. And given the uncertainties associated with COVID, the deleveraging campaign could be delayed past 2023 and the credit impulse to the broader Chinese economy could rise for an extended period.

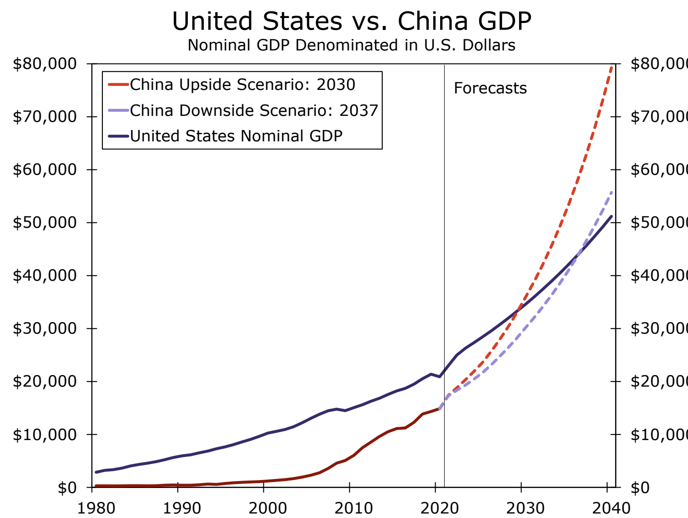
In this scenario, the Chinese economy could get a boost in the short-term and the longer-term. We believe that should policy turn more accommodative than we forecast in our base case scenario, the Chinese economy could experience a real GDP growth rate of 5.75% this year and 5.65% next year. Further out, as the structural issues improve, China could experience an average real growth rate of 4.75% from 2024-2030 and 4.25% from 2031-2040. Stronger growth momentum could also result in higher inflation through 2023 and above-trend inflation over the longer-term. In that context, CPI could rise 2.3% in 2022 and rise 2.4% in 2023. These growth and inflation dynamics would yield a nominal growth rate of slightly over 8% for the next two years. In our upside scenario, the renminbi could remain steady over the next two years; however, given the renewed strength of the economy, authorities could open local financial markets at a quicker pace and could allow for a more rapid pace of currency appreciation. In our model, we forecast the USD/CNY exchange rate to move toward CNY5.10 by 2040. Under these assumptions, **the level of dollar denominated nominal GDP in China could reach $35.9T by 2030**. We maintain our view that the U.S. economy could grow around 4%, and **by 2030, the size of the U.S. economy would only be $34.5T, $1.4T smaller than the size of China's economy** (Figure 4).

Figure 3



Source: IMF and Wells Fargo Economics

Figure 1 - Figure 4



Source: IMF and Wells Fargo Economics

China's Ascension Seems Inevitable

While we believe China will become the world's largest economy within the next 10 years, **growth prospects could falter to a pace where China's economy does not contend with the United States until 2037**. As of now, we assign a relatively low probability to this scenario (5%-10%), but is nevertheless a scenario worth outlining. **In order for China's economy to remain smaller than the U.S. economy until later in the 2030s, policymakers would need to make a dramatic turn on policy**. Fiscal and monetary policy would have to turn restrictive, which while unlikely, is not completely out of the question. Authorities have strongly expressed a desire to protect China's economy as well as the financial well-being of its citizens from asset bubbles and financial instability risks. Scaling back on fiscal stimulus, particularly infrastructure spending, could be reduced to protect against these financial stability risks, but would also result in slower growth. Tighter monetary policy could also defend against asset bubbles; however, it would also result in diminished growth prospects. In addition to slower growth, tighter policy could also weigh on inflation. In a scenario where Chinese policymakers do indeed shift away from expansionary and easier policy, we would expect price growth to also soften. This scenario could see real GDP growth slow to 5.25% in 2022 and slow to 5.15% in 2023. Inflation could also slow to below-trend rates, and we would expect CPI to soften to 1.8% this year and 1.9% in 2023.

Protecting against financial instability could also mean prioritizing the nation's leverage issue and embarking on a much stricter deleveraging campaign that continues this year and extends over the longer-term. As mentioned earlier, leverage is an important tool that facilitates growth in China. If credit restrictions tighten and the credit impulse turns negative, the effects could be felt immediately and drag down growth prospects. As far as the demographic challenges, China could delay urbanization efforts by regressing on progress to dismantle the hukou system that restricts migration from rural areas into cities. Other efforts to address the aging population, such as pension reform and incentives for households without children to start a family, would also have to be postponed. Should deleveraging efforts become the immediate priority and the reform agenda stall, we expect real GDP growth to average just 4.25% from 2024-2030. From 2031-2040, we believe the average real GDP growth rate could average only 3.75%. Slower growth and tighter policy should also lead to lower inflation over time. In our view, CPI would slow to just 2%, a rate of price growth below historical inflation rates in China. And despite tighter policy, we would expect this scenario to hurt sentiment and disrupt capital flows into China. Poor sentiment would likely result in a weaker renminbi over the next few years and also restrict the renminbi's long-term prospects. In this scenario, we assume a weaker renminbi through 2023 and very modest currency strength through 2040.

Softer growth and inflation prospects as well as a weaker through renminbi 2023 puts China at an early disadvantage in catching up to the United States. Diminished longer-term growth and inflation expectations, and only minimal currency strength, results in a much smaller nominal level of GDP than our base case scenario. Modeling our assumptions, **by the year 2037, China's economy will grow to $46.3T**. Still assuming a 4% nominal growth rate for the U.S. economy, **by 2037 the American economy would expand to $45.5T**. Even in a downside scenario where China's growth rate slows significantly and the renminbi prospects are less optimistic, China's rise to the top of the economic throne seems inevitable. On the margin, the timing around China's ascension may vary; however, over the coming decades we expect to see China become the largest economy in the world.

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