Choose your own adventure: China's economic destiny

How China develops over the next decade will have huge global ramifications. What does it mean for the rest of the world if China becomes the world's preeminent economic superpower? Alternatively, what does it mean if China gets stuck in the middle-income trap?

It is the year 2029, and you are living in a world where China has:

(a) stumbled and become stuck in the middle-income trap

(b) overtaken the United States as the preeminent economic superpower

Choose carefully: either outcome has tremendous implications for the international order, and the pace and shape of economic growth globally.

What follows is not a forecast but an exploration of possible bull and bear China scenarios over the next 10 years; for illustrative purposes, in some cases we have presented quite extreme or colourful examples. Actual outcomes might well fall somewhere in between: China could become the next US (as superpower), the next Japan (ageing and indebted), some combination of the two – or it could simply muddle through. Overall, we see three areas where reforms (or the failure to reform) will have the biggest impact on the arc of China's development in the coming decade: the financial, industrial, and consumer sectors.

First, the case for stagnation.

Option A

January 2029 – The story so far

In retrospect, the progression of events that led China to stumble and become stuck in the middle-income trap were entirely avoidable. Ten years ago, in 2019, China at least appeared to be firmly on the path to financial liberalisation. The International Monetary Fund had recently included the renminbi in its basket of official reserve currencies. Chinese stocks and bonds gained entry to global indices like the MSCI emerging markets equity index in 2018 and the Bloomberg Barclays Global Aggregate Index in 2019. Beijing had pledged to allow foreign entities to take bigger stakes in banks, securities brokerages and asset management firms.

How did things go wrong? For starters, the renminbi failed to supplant other international reserve currencies like the US dollar, euro and yen after China baulked at loosening capital controls, retaining limits on the freedom of exchangeability for the currency. Offshore use of the renminbi was limited to import–export deals among regional trading partners. It did see a dramatic and notable boost after Hong Kong, a former British colony with its own monetary system, scrapped the local dollar's peg to the US dollar and tied it instead to the value of the offshore renminbi. Unlike onshore renminbi, the offshore renminbi, or CNH, had been freely exchangeable, but the People's Bank of China still held considerable sway over its value given the central bank's massive influence over foreign exchange markets.

Capital flight fright

China's capital controls had persisted in part because authorities were concerned that any inflows from foreign investors would have been more than offset by destabilising outflows, putting downward pressure on the Chinese currency. Those restrictions continued to rile foreign investors and stifle development of China's financial markets, and the country was labelled a currency manipulator by the US Treasury on 20 January 2029 – the day President Chelsea Clinton was sworn into office, honouring one of the key promises of her populist 2028 campaign.

Instead of broadening and deepening in the image of America's capital markets, China's financial markets generally muddled through the 2020s. For example, the onshore government bond markets ended up looking more like Japan's, with low yields and ownership concentrated among domestic institutions, mainly banks, while foreign participation remained extremely modest. Local government-linked debt remained too opaque and worrisome, thus uninvestable for overseas money managers.

Measures to increase foreign investment in brokerages and related businesses likewise struggled, as the established might of domestic rivals discouraged further foreign activity in these sectors. The state retained control of the banking and financial sectors through equity ownership and zealous

regulatory and administrative oversight. Indeed, perceptions of an uneven playing field for non-state companies remained common across many sectors.

Dealing with debt

Looking back, it is clear that so much of what came to pass in the 2020s was driven by China's struggle to manage its huge debt burden in the face of slowing economic growth. The economic hard landing or 'sudden shock' financial crisis that many had once expected never arrived. Outspoken China bears with huge short positions – investors like Kyle Bass, Jim Chanos and others – moved on to their next targets.

The comprehensive deleveraging campaign that the leadership pursued in the previous decade did deliver modest reductions in credit growth. But credit was still growing, even relative to nominal GDP – and it was already more than twice the size of the economy at the start of the decade.

Problematically, much of that was corporate debt, not government debt, with naturally higher repayment risk. A lot was concentrated in local government financing vehicles, or LGFVs, which turned out to have made many economically unproductive investments in infrastructure, real estate and other areas during the go-go decade of credit-fuelled expansion that followed the 2008 financial crisis. Those hefty infrastructure investments delivered GDP growth during construction but were later revealed to not deliver positive risk-adjusted returns to investors (i.e. the government) while their economic multiplier effects also came in less than expected.[1]

One of these white elephants is the world's largest sea crossing, a 55-kilometre bridge–tunnel spanning the Pearl River estuary and linking Hong Kong, Zhuhai and Macau. The project opened in 2018 after repeated delays and budget overruns, and eventually fell far short of projected usage levels once a newer, rival bridge–tunnel just 30 kilomtres to the north opened in 2026 to link the neighbouring Pearl River Delta cities of Shenzhen and Zhongshan. But more than high-profile white elephants, it was generally widespread overinvestment and the law of diminishing returns that better explained how China's addiction to infrastructure investment backfired, as poorly conceived projects overran on costs and fell short of revenue forecasts on a massive scale.

When Beijing's crackdown on shadow financing and the deleveraging campaign began to really bite in the early 2020s, LGFVs needed to be bailed out. The national government stepped in, but in the face of slowing GDP growth the fiscal deficit ballooned in relative terms. Official figures put the national budget deficit at a modest three per cent of GDP as of 2017, but by the IMF's calculations the underlying burden was much larger. Once off-budget investment spending was factored in, China's augmented general government debt (adjusted by the IMF to include off balance sheet local government obligations) had risen to 91.6 per cent of GDP by 2023,[2] and leverage across the economy continued to increase, to around 300 per cent of GDP – high not only for a developing nation but for any economy globally.

It wasn't just government-directed infrastructure spending that proved economically unviable. Policies to drive Chinese industry up the value chain into new technology seemed bold and long-sighted at first. Significant state support in the form of subsidies, tax breaks and policy bank lending flooded into semiconductors, electric vehicles and other fast-growing new economy sectors, with some commentators proclaiming that China's global dominance of these industries was inevitable. However, far too much debt-fuelled growth and perverse economic incentives led to poor investments and significant overcapacity, with even the few Chinese companies with globally-competitive technology struggling to turn a profit as a result. China's high-tech sector suffered the same fate as its coal mines and steelworks did little over a decade earlier.

A dragon's dream deferred

The net result by 2029 was a heavily indebted economy; a government with less capacity to correct its fiscal deficit given a shrinking workforce, ageing population and slowing growth rate; and a consuming class caught in the middle-income trap as per-capita GDP growth stagnated.

Of course, China's failure to open more fully to the world was partly a response to the West's increasingly cold shoulder. The European Union and Japan joined the US in putting up trade restrictions against China. The common criticism was that China didn't play by market-based rules and was increasingly competing unfairly, while several companies from China were seen as having uncomfortably close links to the military.

For investors, the implications were huge: China was still a massive economy but no longer ranked as the biggest driver of global economic expansion. The country was still an important part of a portfolio allocation to emerging markets, alongside nations like Brazil or South Africa. But China never quite became a standalone investment allocation like the US or Japan. And investors seeking growth started to look elsewhere – mainly to India, which overtook China as the world's most populous country in the late 2020s – and to other similarly young and fast-rising economies.

Still, China presented interesting options for thematic or bottom-up investors. For example, the rapidly growing elderly population was a boon to the healthcare sector. More prosaically, as in Japan a decade earlier, adult diapers had recently started to outsell those made for infants. The slowdown in real estate construction also had dramatic macroeconomic implications, from land sale revenues (which were an important source of income for local governments in China) to the production levels at Australian iron ore mines. But all this was a far cry from the superpower dominance that China looked on the verge of attaining back in 2019.

1 Does infrastructure investment lead to economic growth or economic fragility? Evidence from China. By Atif Ansar, Bent Flyvbjerg, Alexander Budzier and Daniel Lunn. Oxford Review of Economic Policy, Volume 32, Issue 3, 1 January 2016, Pages 360–390, https://doi.org/10.1093/oxrep/grw022

2 IMF Executive Board Concludes 2018 Article IV Consultation with the People's Republic of China. International Monetary Fund, Press Release No. 18/310, 25 July 2018, https://www.imf.org/en/News/Articles/2018/07/25/pr18310-china-imf-executive-board-concludes-2018-article-iv-consultation

Option B

In retrospect, the progression of events that led China to overtake the United States as the world's preeminent economic superpower were entirely predictable.

Ten years ago, in 2019, China appeared firmly on the path to financial liberalisation.

And despite delays – and pushback from some conservative corners of the Chinese leadership compound in Zhongnanhai – the government under Xi Jinping, now concluding his third term in office, eventually moved to relax capital controls and forge ahead with long-promised financial overhauls. China progressively freed up the exchangeability of the renminbi, opened the doors wider still to cross border equity and bond market flows, and ultimately allowed foreign banks, brokerages and asset managers to play a significant role in the domestic finance industry.

Importantly, the gradual and well-controlled nature of this opening-up meant that China never faced a significant market crisis of confidence. By 2029, the renminbi had supplanted the euro, yen and pound as one of the world's most widely-held reserve currencies, and it had the US dollar firmly in its sights. In tandem, China's government debt had become a recognised safe-haven investment, like US Treasuries, while China's relatively higher interest rates added to the allure of its bond markets – a reflection of the continued underlying robustness of the economy. That key first step – loosening the state's grip on finance and access to capital – paved the way for two even more transformative developments, with dramatic and far-reaching effects around the world:

- The wholesale reform of industrial policy, and
- The emergence of the Chinese consumer as the main driver of global growth.

Sunset for state capitalism

Even back in 2019, China's official policy was to make state-owned enterprises subject to market-led reforms. But the reality was that this initiative had stalled. Instead, efforts to diversify ownership of state companies meant in practice that companies would invite more and different government-controlled entities to acquire a stake. It was only later that privatisation became a key focus of China's economic policy.

What triggered the shift? A combination of factors. The leadership in Beijing realised it could kill two birds with one stone: by selling off state assets, China rapidly dispelled concerns over general government debt; paying it down created renewed fiscal space, while freer market forces boosted economic vitality. Consolidation was a huge driver – among the dozens of firms under the central government's direct control, but also among the thousands of state firms controlled by local governments. A stronger institutional regulatory framework created less need for the government to police industry through equity ownership. And greater competition from a local private sector – reinvigorated by fresh access to capital and financial markets – helped accelerate the changes.

Private firms to the fore

Indeed, the 2020s were the decade where private companies made their greatest gains in contributing to growth in China. A trend of bank disintermediation took hold, as firms that used to rely on borrowing from state-controlled banks switched to tapping China's deeper and more diversified equity and credit markets, which now included access to more foreign capital. This increased market discipline and helped to allocate capital more efficiently across the economy, which gave rise to some truly global champions within China's corporate sector. By the end of the decade, the world's biggest companies in insurance, retail, mobile communications, hotels, and restaurants were all privately-owned Chinese firms.

The rise of the private sector happened even despite greater competition from foreign firms, as China continued to make good on pledges it made on joining the World Trade Organisation in 2001 to increase market access in the services and manufacturing sectors. After the United States withdrew from the WTO during President Donald Trump's second term, China's sway over the ground rules to international commerce increased. This role was cemented in 2025, when China established the 163-member Global Trade Organisation (GTO), headquartered in Boao, Hainan province.

Global consumers

Underwriting the commercial boom at home and abroad was the Chinese consumer.

If the 2010s were the decade where China's rising middle class and newly rich caught the attention of multinational consumer goods manufacturers and luxury firms, the 2020s were the decade where a half-billion affluent Chinese city dwellers supplanted the American consumer as the single biggest driving force in the global economy.

How China became the first communist country to make the leap from middle income to rich country was similar in ways to capitalist America's path several generations earlier. Both started as large continental economies rich in natural resources, which provided vast homegrown markets for goods and services. Both regulated away economic monopolies (market-derived monopolies in the US, and government-established ones in China) to pave the way for vibrant private sector competition. Both established open financial markets and freely exchangeable currencies. And both reduced the barriers to the free trade of goods and services (that is, until the US began more recently to reintroduce them).

Specifically, in China's case, the collective spending power of consumers was unlocked by two key developments:

- Individuals were given more freedom over how they managed and invested their savings. The beginnings of a 'third pillar' private pension system were put in place. At the same time, the government introduced a strong social security system and nationwide healthcare network to help meet the needs of its ageing population. This meant people needed to rely less on their precautionary personal savings and, in effect, had greater disposable income.

- As China moved up the industrial scale, extraordinary real wage gains resulted across the country, compressing the wage differential between coastal and inland provinces. At the same time, increases to the education levels of millions of youths in more rural areas boosted productivity across the labour force, as this younger generation took on jobs in services and high-end manufacturing (as opposed to the agricultural jobs that their parents or grandparents performed). The resulting income growth boosted consumers' spending power across the economy.

For investors, these changes meant nothing less than a complete paradigm shift in global economic leadership. For the first time since the collapse of the Soviet Union, the United States by 2029 was facing a rival for the role of the world's preeminent economic superpower. And the US was losing.

Choose your own ending.

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