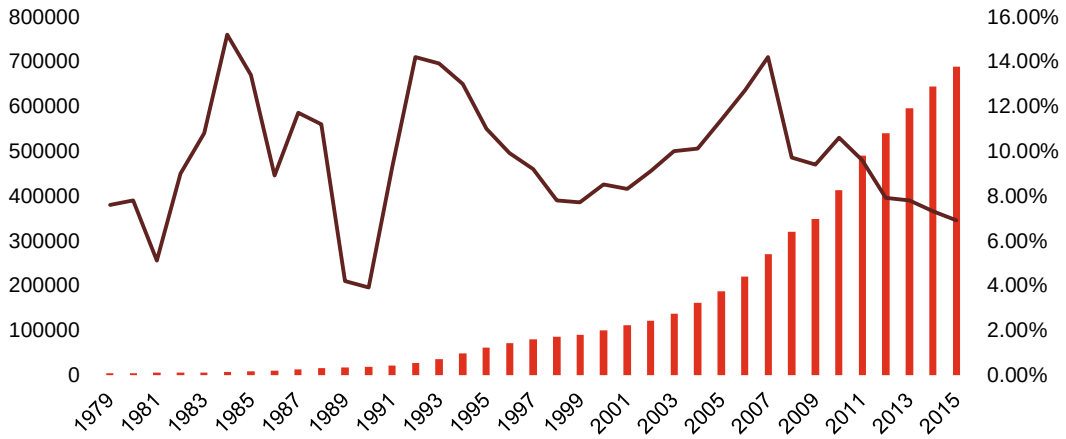
China's long-term economic growth prospects

Trend of China's GDP and its growth rates (RMB 100mln)



Source: China National Bureau of Statistics

China is currently undergoing a transition from an export- and investment-driven economy to one that is consumption and services oriented.

Nonetheless, fixed investment remains a key driver of China's economic growth for the moment. In 2016, fixed investment steadily rose to a new high of RMB 59.6 trillion (US$8.7 trillion), accounting for around 80% of total GDP, thanks to government's strong push for infrastructure investment. This trend is likely to continue in the coming years as urbanisation moves ahead and new government initiatives are rolled out, such as the Belt and Road, Beijing-Tianjin-Hebei city cluster, Yangtze River Economic Belt and International Industrial Capacity Cooperation initiatives. Investment is also a powerful tool to help maintain an average GDP growth rate of around 6.5% in order to achieve the goal of doubling GDP and GDP per capita by 2020 (relative to 2010) as set out in the 13th Five-Year Plan.

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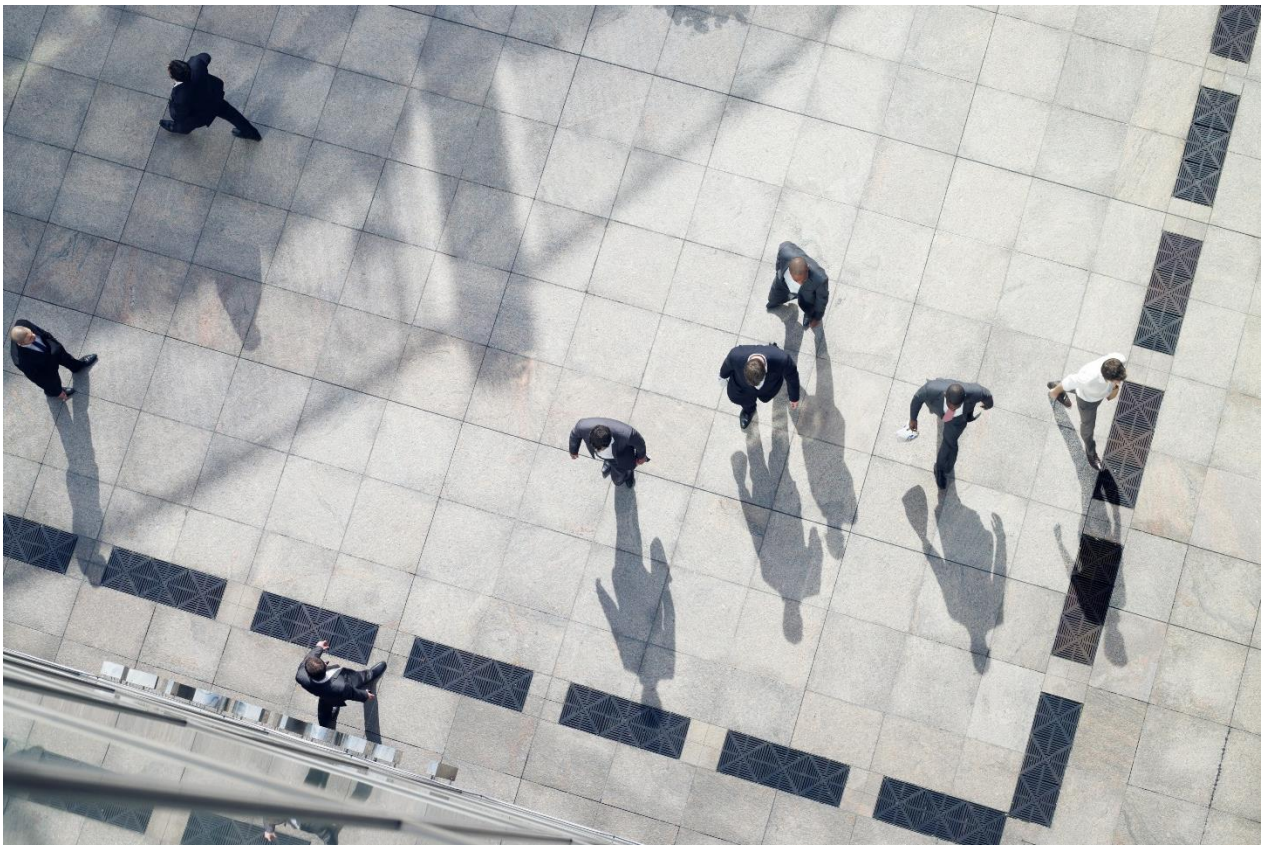
Going forward, the key challenges for investment are twofold: diminished marginal returns and low levels of private investment, which accounts for over 60% of total investment. In 2016, private investment grew by only 3.2%, as compared to 18.7% for the state sector, due to lack of business confidence. The government will need to make sure that future funds will flow into productive sectors and projects instead of the "zombie enterprises".

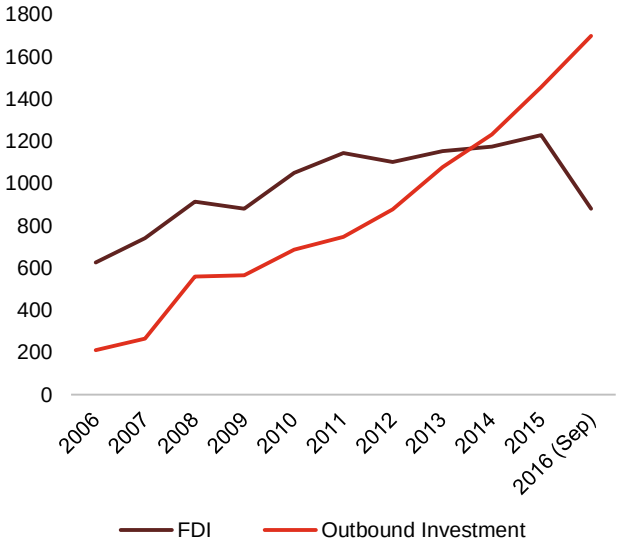
Meanwhile, exports have lost steam, declining by 2% year-on-year while imports rose slightly by 0.6% in 2016. Total exports are expected to contract further in the near future due to slower global economic growth, sluggish demand and the prospect of heightened trade friction with the US.

In contrast, the services sector has maintained its strong growth momentum, rising to 51.6% of GDP in 2016, while consumption remained robust, contributing 64.6% to GDP growth. By 2030, services are expected to rise further to around 70% of GDP and China's rising middle-class could generate a consumption market of US$6 trillion, the largest in the world.

Meanwhile, China remains one of the most attractive destinations for foreign direct investment, which rose from US$110bn in 2010 to US$136bn in 2015, providing valuable technologies and management skills to nurture China's modern industries. As China moves up the value chain, more and more Chinese companies choose to directly acquire foreign brands, technologies and market networks. China's outbound investment shot up from US$75bn in 2011 to US$150bn in 2015, making China a net global investor (see chart). These two-way investment flows will help improve China's productivity, which is currently only around 20% of OECD levels on average, thus providing further impetus to its future economic growth.



FDI vs Outbound Investment (Unit: $100mln)



Source: China National Bureau of Statistics

However, demographic changes pose a severe challenge for China's long-term growth. According to the National Bureau of Statistics, China's working-age population between the ages of 16 and 59 has declined for three straight years since 2012, with the over-60 population reaching 222 million in 2015, accounting for around 16% of the overall population. The total workforce is predicted to decline to about 700 million people by 2050, when one in three people in China will be aged over 65. The "two children" policy came too late to make much difference to this trend. The ageing society and shrinking working population will push up labour costs significantly and could undermine China's competitiveness and economic vitality unless offset by strong technology-driven productivity gains.

Rising bad debt levels represent another key risk factor. China's total debt is believed to be around 260% of GDP, with corporate debt rising quickly to 160% of GDP, the highest level among the major world economies. Non-performing loans of the banking sector, though officially standing at less than 2% in 2016, could be much bigger if judged by international accounting standards.

China's ongoing supply-side structural reform will play a critical role in nurturing the long-term growth potential and saving the country from falling into the middle-income trap. Streamlining regulation, lowering business costs, creating a pro-innovation environment and developing strategic industries and the services sector are important measures in unleashing the vitality of the private sector and boosting growth. Reducing inventories of residential properties will be vital in avoiding a Japan-style housing bubble. Yet reducing industrial overcapacity will have a knock-on effect on short-term GDP growth.

Looking ahead, China still has great potential for growth. Its urbanisation process is still at a relatively early stage, and its services sector has a lot of scope to catch up with the West in terms of quality, sophistication and business range, in particular producer services such as logistics, information, financing and commercial services. Reform of state-owned enterprises, if properly handled, could shatter monopolies and create new business opportunities worth trillions of dollars.

To a large extent, China's success will depend on how the government enforces the principle of "letting market forces play a decisive role in resource allocation" as adopted by the 18th Party Congress. So long as the reform agenda progresses further, China is likely to forge ahead to become the world's largest economy before 2030 as PwC projections suggest, though growing at a relatively slower rate in the long-run than in recent decades.

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