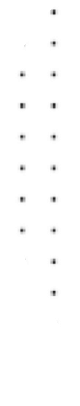


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Trends in the Chinese Economy: Structural Challenges and External Economic Engagement

by **Sanjay Pulipaka**

China's economic decline is eliciting considerable discussion among academics and policymakers. For instance, there was an interesting debate in *Foreign Affairs* magazine on the causes and consequences of China's economic decline. Adam Posen argued that China is experiencing "economic long COVID," which was "caused by CCP's arbitrary interference in everyday commercial life."¹ Posen noted that since the 1980s there was an unstated compact according to which "the CCP ultimately controlled property rights, but as long as people stayed out of politics, the party would stay out of their economic life."² With the advent of Xi Jinping, this compact had broken down with excessive government intervention in the market and consequently, "public's immune response to extreme intervention produced a less dynamic economy."³

On the contrary, for Zongyuan Zoe Liu the roots of the current economic crisis in China predate COVID-19 and are rooted in "an exhausted growth model, [and] stunted population growth thanks to the "one-child policy."⁴ Zongyuan Zoe Liu noted that China's "economic rise, was built on a system of financial repression that prioritised investment and exports over domestic household consumption, leading to harmful stagnation on the demand side of the economy."⁵ While Zongyuan Zoe Liu referred to failures of Xi's leadership, the emphasis is more on the structural problems. In a similar vein, Michael Pettis argued that "government intrusion is not China's biggest problem...its biggest problem is that it has not substantially adjusted its growth model."⁶ Pettis contended that "government intrusion is the consequence of weak private investment, not its driver...it must address the demand side of the economy by strengthening the share of its GDP that Chinese households retain."⁷

In his response, Posen contended that between 1980 and 2013, China's private firms did play a significant role. Further, Posen points out that "Chinese households are building up their liquid savings instead of consuming durable goods" and "small enterprises are remaining liquid and investing less."⁸ Posen argued that the "Chinese consumers have been notably sluggish" largely due "to a more autocratic approach to managing economy."⁹

While the debate rages on the causes of China's economic crisis, the consequences are becoming evident. The reports in the past few months have suggested that youth unemployment is growing rapidly. In June, it was estimated that some 21.3% of young adults (16-24 years old) could not find jobs.¹⁰ However, the unemployment data for subsequent months is not available, as China's National Bureau of Statistics has stopped publishing the data. There are concerns about the impact of the economic downturn on ordinary people, particularly the low-income groups in China. The State Council decided to "dynamically monitor the living conditions of the low-income groups" and initiate "more precise, prompt and effective assistance for the population in need."¹¹ The State Council also called on the local governments to shoulder greater responsibilities by taking region-specific policy measures such as "food assistance for the elderly and poor, and an increase in policy support for China's massive rural population."¹²

Real Estate: The Star Loses Its Shine

The star of the Chinese economy, the real estate sector's performance has been the cause of much dismay. Considerable oversupply was a significant cause of the crisis in the real estate sector. A senior official of the National Statistics Bureau reportedly stated that even "China's entire population

(1.4 billion) would not be sufficient to fill the empty apartments across the country.”¹³ The real estate sector in China reportedly accounts for 25%-30% of the economy and currently has ‘millions of empty flats which were sold but continue to remain unoccupied.’¹⁴ It is estimated that the real estate sector has experienced a decline of 34% year-on-year this August¹⁵. The stock value of one of China’s biggest real estate developers - Country Garden - took a major hit in the markets, and Evergrande filed for bankruptcy¹⁶. Leading property developer China Evergrande Group’s Chairperson Hui Ka-yun was arrested recently. His arrest sent shockwaves across the real estate sector, and there were concerns about whether Evergrande Group could restructure its financial commitments.¹⁷ Late last month, there was speculation that the Evergrande group “may be split up or liquidated.”¹⁸

The probability of the real estate segment experiencing a crash has become an important node of discussion. Some have argued that the real estate crash will result in a redistribution of wealth, which would be accompanied by “short-term disruptions to China’s real economy.”¹⁹ Since the Chinese government has numerous tools, “it can ensure that property price drop does not result in the same level of economic pain while still achieving income rebalancing.”²⁰ However, it needs to be noted that China’s property development “is cash flow insolvent, and its creditors will get less than 5% of their money back if it is forced into liquidation.”²¹ Therefore, letting a real estate property crash happen may inflict significant economic pain. Many small entrepreneurs and workers - such as builders, cement makers, painters and real estate agents - will struggle to sustain their business if the real estate sector collapses.²² The real estate collapse may inflict considerable pain on first-time buyers and middle/lower middle classes. Further, the real estate crash will undermine people’s faith that the government can repair the economy. Such loss of trust in the government may have severe consequences.

The property crisis is also testing the Chinese banking system as nearly “40 per cent of all bank loans are related to property.”²³ The banks had taken various measures, such as giving more time to borrowers, which many opine would result in a continuation of unhealthy property speculation.²⁴ Reportedly, various banks have significant non-performing loans from property developers, and it is estimated that banks would require around “three years to digest related losses.”²⁵ Simultaneously, Chinese authorities have reportedly instructed state-owned banks to roll over “existing local government debt with long-term loans at lower interest rates.”²⁶ According to the International Monetary Fund’s Chief Economist, “the challenge has been trying to give the sector enough support to cope with the transition without stimulating another property bubble or a rebound that makes these problems worse.”²⁷ The authorities have been experimenting with various other measures such as slowing the pace of land sales in cities, encouraging developers to lower housing prices to spur demand and loosening mortgage rules to help the property sector.²⁸ However, these measures are yet to yield positive outcomes.

Local Governments, Debt and Consumer Confidence

The slowdown of real estate has impacted the revenue generation of many local governments. Consequently, they are looking for new sources of revenue to service the debt. Reportedly, the IMF noted that the local government debt burden “as a percentage of gross domestic product will rise by nine percentage points in 2023 (in 2022, the rise was just 5 points, and in 2021 it was just 2 points).”²⁹ According to some reports, local governments have USD 9 trillion in hidden debt, and in an attempt to address such large debt, the local governments are issuing ‘refinancing bonds to service outstanding liabilities.’³⁰ It should be noted that the exact scale of hidden debts is challenging to quantify, with some estimates ranging from USD 12.58 trillion to USD 23 trillion.³¹

For decades, China’s economic rise was driven by the rapid growth of the real estate sector. The recent crisis has undermined consumer confidence and may contribute to declining interest in further investments in the real estate sector. While some major economies are battling high inflation rates, “China’s consumer prices remained flat during September”, raising concerns about deflation.³²

Given the scale of economic challenges, it was not surprising that the World Bank recently downgraded the Chinese economic growth rate from 4.8% to 4.4%.³³ In the coming weeks, consumer spending may witness a spike due to festive holidays.

Japanification and Reforms

China's economic slowdown has prompted cross-country comparisons. There is considerable speculation whether China's economic trajectory is similar to the growth slowdown that Japan experienced in the 1990s. A Goldman Sachs publication on October 05, 2023, stated, "China's situation looks even dire than Japan did some 30 years ago."³⁴ The Goldman Sachs report noted that "weakness in China's housing sector looks more pronounced" in terms of urban residential vacancy (20% in China; 9% in Japan 1990), and "residential investment represents about twice the share of China's GDP compared with Japan in 1990."³⁵ Despite these challenges, some economists in China opine that it is possible to avoid Japanification by reforming, opening up and "rectifying [policies] that run counter the principle of the market's decisive role in resource allocation and those that interfere with or restrict business operations and consumption."³⁶

Amid growing pessimism regarding the Chinese economy, the Ministry of Commerce spokesperson stated that there may be "further relaxing of foreign ownership restrictions to draw more global investors."³⁷ A few months ago, the Chinese Academy of Social Sciences (CASS), in its report, noted that State Owned Enterprises should deploy more resources to address "economic and technological choke points" and "to ensure key industrial and supply chains operate normally under extreme circumstances."³⁸ The 'extreme circumstances' probably referred to the US tech restrictions.³⁹

External Economic Engagement: Growing Restrictions

These domestic economic challenges have coincided with the growing external constraints. The external environment, especially access to developed economies, is slowly getting restricted for China. It appears that the US may be implementing, if not fully but partially, Posen's recommendations. Since households and SMEs are focused on 'self-insurance' and are holding onto liquidity, Posen called on the US to focus on the strategy of "suction of capital (financial, tech, and human) from the People's Republic of China."⁴⁰

With increased tensions in bilateral relations, the United States imposed controls on the export of sensitive technologies, including semiconductors, chip manufacturing and related equipment to China. As is well known, semiconductors play a significant role in developing cutting-edge artificial intelligence tools/products and have considerable use in military technologies.

Because of the US restrictions, there was a '14.6% decline in the semiconductor imports year-on-year in the first nine months of 2023.'⁴¹ It should be noted that the initial round of tech restrictions did not target Chinese subsidiary companies in various other countries, which ensured that semiconductor components were easily smuggled into China.⁴² Recently, the US has updated its policies to prevent such circumvention by placing restrictions on exports to Macao, countries under the US arms embargo, and there was an expansion of the list of manufacturing equipment that can be exported as well.⁴³ With new restrictions in place, it is likely that the tech war will persist and may impact other technologies.

The operationalisation of tech restrictions is encountering many significant challenges. The United States and China's chip war has impacted chipmakers in countries such as South Korea. The US policy adversely affected licenses given to South Korean firms such as "Samsung and SK Hynix, the leading South Korean chip makers that manufacture "memory chips used in smartphones and laptops in China."⁴⁴ However, on October 09, the South Korean manufacturers received waivers from the US government to continue their current production in China.⁴⁵ According to a South China Morning

Post report, the waivers will benefit the South Korean companies at the cost of Chinese rival chipmakers such as Yangtze Memory Technologies Corp (YMTC), which would have reaped the benefits of local demand.⁴⁶ All these developments indicate the complexities that need to be factored in for the US tech restrictions to be successful.

In addition to the US, Chinese economic engagement with Europe is coming under scanner. The European Union (EU) is reportedly planning to conduct “anti-subsidy investigations into steel makers producing in countries such as China.”⁴⁷ China responded by stating that the EU plans ‘will disrupt global supply chains, undermine international trade norms, increase production costs and undermine the interests of the consumer.’⁴⁸ Meanwhile, the EU top diplomat Josep Borrell is on a China visit and, while speaking to Pecking University students, stated that “it is in our interest to find common ground, to repress imbalances in economy and trade relations...otherwise de-risking may indeed accelerate far more than is good.”⁴⁹ During his visit, Borrell interacted with Chinese Foreign Minister Wang Yi.

The Chinese economic slowdown is impacting the economies in the region. For instance, the South Korea-China trade has been experiencing a significant slowdown. The International Monetary Fund has raised concerns that the Chinese slowdown will have a negative impact on Asian economies, particularly those that depend on commodity exports.⁵⁰ Similarly, the World Bank stated that economies in East Asia and the Pacific may slow down because of the growing economic challenges in China.⁵¹ Given the global and regional impact of the Chinese slowdown, the US and the EU must coordinate their strategies with other major economies to ensure a transparent and just international economic order.

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⁵⁰ Yan Carriere-Swallow, Krishna Srinivasan, “Asia Continues to Fuel Global Growth, but Economic Momentum is Slowing”, *IMF*, October 13, 2023, available at <https://www.imf.org/en/Blogs/Articles/2023/10/13/asia-continues-to-fuel-global-growth-but-economic-momentum-is-slowing>

⁵¹ World Bank cuts growth estimates for East Asia as China falters, *CNBC*, October 02, 2023, available at <https://www.cnbctv18.com/economy/world-bank-cuts-growth-estimates-for-east-asia-as-china-falters-17926251.htm>





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