China Watch

A China Business Report prepared by David Mahon
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One clear and calm thought turns the fiery pit into a clear pond,
and one bit of alertness enables the boat to reach shore.
Can we afford not to be vigilant?

Hong Zicheng, Daoist philosopher, 1600 CE

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Economic fatalism

The Chinese Government has been reluctant to stimulate the economy to boost consumption and confidence as the United States and the European Union did during and after COVID. The US spent USD 5 trillion on stimulus packages, a significant portion of which was in direct cash payments to individuals and employers. China made fewer payments to individuals and companies, and household payments were in the form of digital coupons for specific products and less inflationary. In 2023 the Ministry of Finance initially acted prudently to avoid creating the ballooning debts and nonperforming bank loans that resulted from over-stimulus during the Great Recession, but after 21 months of relative austerity, the Chinese economy is losing momentum and it is time for the government to intervene.

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Some commentators are saying that China does not have the money to prime the economy, pointing to examples such as government officials and school teachers having their salaries cut, the recent announcement of incremental raising of the retirement age, and local governments' issuing of bonds to replenish their beleaguered finances. Beijing continues to tax regions heavily while inhibiting local governments from generating cash by converting agricultural land into real estate projects, leaving some unable to recover from the economic ravages of the pandemic. It is indeed hard for the Ministry of Finance to support each region according to their needs, but it is right to demand greater transparency to avoid the off-balance-sheet liabilities of previous decades.

The People's Bank of China (PBOC) does have the money to assist municipalities selectively without destabilising the economy or resorting to substantial quantitative easing. Beijing has instead chosen to let market forces resolve entrenched problems, with the idea that it is better for its people to suffer short-term pain in order to grapple with long-term financial imbalances. But the government is now relying too much on its citizens' capacity for endurance and tenacity.

China's unprecedented economic rise over the last four decades has obscured the fact that it has not managed to provide its people, particularly the working-class, with the full social and economic benefits of growth. China rebuilt industry and created new physical and digital infrastructure, which unquestionably contributed to sustained growth and future prosperity. But while ordinary people's lives have improved and the middle class continues to grow, China spends less than 10% of GDP on social services, as opposed to the OECD average of 20%. Until this changes, households will consume cautiously, saving to be able to access services a state would normally supply. This deepens China's demographic imbalances because citizens will avoid having children they fear they will not be able to support. It is an ironic situation given China's recent communist history, but China has shown time and time again that it can adapt and put pragmatism before ideology.

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China's conundrum

A debate over what the state should provide and what the market should supply has raged since before the industrial revolution. But when unforeseen events or misconceived policies rock the foundations of economies, governments should be led by sound economic practices that aim to benefit the greatest number of people, not ideologies and minority interests. The Chinese Government knows householders will not spend direct cash handouts to boost consumption but instead save them, adding to average household savings rates of roughly 40%, among the highest in the world. Middle-class wealth in particular sits in stagnant pools rather than irrigating the economy. The government has many means to bolster confidence and consumption, however. It could consider issuing digital coupons for specific goods and appliances as it did during COVID, while it resets fiscal and broader economic policies. It could also promulgate regulations to restore confidence in the stock market, offering households investment alternatives to real estate.

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The Chinese Government is grappling with a conundrum, for while it attempts to guide the economy by a degree of centralised planning and relies heavily on state-owned enterprises and entities to implement polices, it knows that private companies remain the fundamental drivers of the economy. The private sector accounts for 60% of China's GDP, 70% of its innovative capacity, 80% of urban employment, and 90% of new jobs. Even in crises, such as rising bankruptcies in the property sector, the state is often inefficient in applying critical solutions. This year the Ministry of Finance committed USD 41 billion for local governments to buy excess real estate and convert it into affordable housing, in principle a practical strategy. Yet local banks have used less than 5% of this money as they must contribute 40% funding from their own coffers to any transaction, at a time when rent yields are unlikely to match these costs. The PBOC seldom rewards bankers for applying central policies obediently, more often punishing them for accumulating bad or weak assets.

In successful developing countries, governments – especially at local levels – play a greater role than they do in developed countries. In China, local administrations have for decades partnered with the private sector, especially as firms sought to grow their maturity, balance and scale. These partnerships have been a foundational success factor in China’s rise.

The way forward

The Chinese Government should not pour more money into the many stalled and insolvent real estate projects that present a drag on the economy, but invest in education, health and retirement resources to alleviate pressure on lower-income Chinese households. This would do more to restore a measure of confidence and free up household savings for investment and consumption. It should also explore offering new tax breaks to stable, private SMEs in key technology, food and beverage, tourism, and service sectors which have capacity for further growth and creating employment. The Chinese economy risks slowing further over the next six to 18 months unless the government makes some fundamental changes. Although Beijing hopes to achieve a GDP growth rate of 5% this year, the economy will unlikely exceed 4.7%. Although still a good rate, the risk is that it may fall further in 2025, and that contraction will gather momentum as household and investor confidence plummet with it.

If Beijing can act boldly and invest in its people and private businesses, it will make a palpable difference in the next year, recovering not just domestic consumer but also international investor confidence. The foundation already exists, delivered in large part by the market over the last decade. China's service sector accounted for 54.6% of the economy in 2023, agriculture for 7.1%, and industry 38.3%. Swifter growth in these sectors will allow them to eventually replace real estate, which has historically contributed between 25% to 30% of GDP. President Xi is tough enough to let significant parts of the real-estate sector fail to allow demand in stronger parts of the economy to recover. In the first years of his presidency, he cut the loss-making, polluting heavy industrial sector by more than half, and although recent data is hard to find, it now probably constitutes less than 10% of GDP. He has also confronted monopoly interests in the technology and property sectors in a manner few of his Western counterparts have been able to do.

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Global trendsetter

Despite short-term imbalances elsewhere in the economy, the technology sector has the potential to force a paradigm shift and allow China to become a global trendsetter rather than a passive responder to manufacturing demands from the US and Europe. China is dominant in global sales of EVs and internal combustion engines, replacing Japan as the world's largest vehicle exporter, and it makes five times more solar and wind power systems than the US, and twice as much as the EU and US combined.

Domestic overcapacity is an issue in these sectors, and rationalisation will be brutal, but the more innovative, well-funded consolidators will emerge even stronger and more globally competitive. US and EU claims against China for selling products below the initial cost of their production are questionable, for any country will export goods it does not consume. Germany, for example, exports 70% of its motor vehicles.

Many local governments in China are struggling with balance sheet recessions. Beijing is resolving distortions and recovering a degree of equilibrium in key regions with changes in the allocation of state-owned bank lending to the private manufacturing sector, accelerated by allowing non-state finance and banking institutions to take a greater market share.

A counterproductive strategy

The West is taking advantage of China's temporary economic weaknesses. The United States and the European Union are imposing new tariffs on Chinese goods in a blind hunt for any means to slow its economic growth and curtail its regional influence. In doing so they are damaging the sources of their own long-term prosperity and hindering the growth of economies throughout the world. This is, in part, depressing China's near-term economic recovery, but it is also accelerating China's medium-term technological, AI and manufacturing independence and resilience. Chinese exports will still constitute over 30% of global trade this year.

If the West were to increase its economic engagement in China selectively rather than trying to decouple, it would slow China's technological evolution. Beijing would continue to buy a greater share of high-tech inputs from the West without the need to make them at home. Great powers have much to gain by communicating with adversaries rather than threatening them or backing them into a corner. By avoiding targeted negotiations on trade and creating investor uncertainty, the West is also driving down the value of the renminbi, which is increasing China's export competitiveness and the already swollen trade balances China has with most of its partners.

Washington and its allies may cite human rights, unfair business practices and military spending as reasons for its actions against China, but their real motives are raw geopolitical competition and the maintenance of the United States' role as regional and global hegemon. In the quest to contain what they see as an existential Chinese threat, it is the American, European and allied economies – and the wellbeing of their citizens – that will bear the heaviest costs. ☯