China's Bumpy Path

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GROWTH SLOWS, RISKS ABOUND, BUT ECONOMIC AND FINANCIAL COLLAPSE CAN BE AVOIDED

China's economic performance has been stellar over the past three decades, with remarkable and persistent high growth that lifted the economy from low-income to upper-middle-income status. Measured at market exchange rates, China's GDP was $18.3 trillion in 2022, 73 percent of the GDP of the United States and 10 times more than the 7 percent of US GDP it registered in 1990. China's per capita income is now roughly $13,000, approximately 17 percent of US per capita income—compared with less than 2 percent in 1990. Over the past decade and a half, China has been the main driver of the world's economic growth, accounting for 35 percent of global nominal GDP growth, while the United States accounted for 27 percent.

China accomplished this without many attributes that economists have identified as being crucial for growth—such as a well-functioning financial system, a strong institutional framework, a market-oriented economy, and a democratic and open system of government. Until the COVID-19 pandemic rocked it back on its heels, the Chinese economy powered through periods of domestic and global turmoil seemingly unscathed.

But detractors have long argued that China's economic collapse was imminent, pointing to numerous fragilities. The country's growth has been powered by investment in physical capital, especially real estate, that has been financed by an inefficient banking system. With domestic debt levels high and rising, the property market unraveling, and the labor force shrinking, some analysts say the day of reckoning has finally arrived.

They are likely wrong. Unbalanced reforms that have kept the institutional structure weak, a schizophrenic approach to the role of the market versus that of the state, and strains in

Illustration by Álvaro Bernis

financial and property markets could result in significant volatility in coming years. But none of this means a financial or economic collapse is inevitable.

Sources of growth

China's economic performance has relied largely on investment growth financed by an inefficient banking system. This pattern intensified after the global financial crisis that began in 2008. Increased investment accounted for about two-thirds of GDP growth during 2009–10. Because China is a labor-rich economy and has a capital-to-labor ratio much lower than that of advanced economies, more rather than less investment is probably desirable. However, much of the investment has been driven by the public (state) sector rather than the nongovernmental sector. This is not inherently a problem. Investment in private sector firms, especially smaller ones, can be much riskier than in large, state-owned enterprises. But in China, state-owned enterprises, which collectively receive a disproportionate share of bank credit, typically have not generated strong returns on those investments.

Recognizing that its growth model has been inefficient and financially risky, the Chinese government set itself the objective of rebalancing the economy. This means

- Reducing reliance on investment-heavy growth and getting household consumption to be the key contributor to GDP growth
- Generating more growth from the services sector than from low-skill, low-wage manufacturing
- Shifting away from physical-capital-intensive growth in a manner that improves employment growth

In recent years, household consumption has in fact become the main contributor to growth. The services sector now accounts for more than half of annual GDP and close to half of aggregate employment.

Thus, while the trajectory has been uneven, there has been significant progress toward the objective of growth rebalancing, with household consumption becoming the key driver of growth and the services sector displacing investment as more prominent than manufacturing.

Growth prospects

Prognostications about China's growth prospects are a fraught exercise, and at best forecasters can use the growth of various factors that go into the creation of output as indicators of what the future might hold.

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China's labor force, the population in the 15–64 age range, is shrinking. By 2030, it is expected to decline by about 1 percent a year. Higher investment growth could pick up some of the slack, but that carries many risks. The recent decline in nongovernmental investment growth—state investment accounted for much of the growth in overall fixed asset investment outside the property sector in 2022—is a sign that private businesses are wary of increasing investment when they see the economic and political environment as unfavorable.

That leaves productivity, or the amount of output per unit of input, as a growth engine. For all the inefficiencies that pervade its economy, over the past few decades China has averaged a decent 3 percent growth in total factor productivity—which is growth that cannot be attributed to increased inputs, such as labor and capital, and is a general indicator of efficiency. But productivity growth has slowed to about 1 percent a year over the past decade. China's growth will run aground without an improvement in productivity growth.

Recognizing the need to improve productivity and shift away from low-skill manufacturing, the government recently articulated a "dual circulation" growth policy, which augments continued engagement with global trade and finance with greater reliance on domestic demand, technological self-sufficiency, and homegrown innovation. But the approach has run into difficulties. China still needs foreign technology to upgrade its industry, and rising economic and geopolitical rifts with the United States and the West could limit China's access to foreign technology and hi-tech products, as well as to markets for its exports. Moreover, the government's recent crackdown on private firms in sectors such as technology, education, and health has had a chilling effect on entrepreneurship.

Potential pitfalls

There are concerns that China's economy is headed for a crash similar to those experienced by other high-flying Asian economies—such as Malaysia and Thailand. China's overall debt has been a significant concern for many years. Over time debt has risen relative to the size of the economy—although gross debt levels are not out of line with those of other major economies, such as the United States and Japan. Moreover, public borrowing as a percentage of nominal GDP is lower in China than in other major economies. China has a high level of corporate debt—about 131 percent of GDP. But most of it is denominated in China's own currency and owned by domestic banks and investors, which presents less of a threat than were the debt owed to foreign investors and denominated in foreign currencies, such as the US dollar.

There are, however, specific sectors in which the concentration of debt could be a problem—especially the real estate sector. Real estate investment has become a bulwark of the economy, helping to keep growth on an even keel when other sectors floundered. Local government officials are eager to sell land to developers, boosting public revenues and enabling a range of government expenditures. So a fall in real estate prices—or the emergence of other factors that restrain real estate activity—could have knock-on effects across other sectors, local government finances, and even household wealth.

Household exposure to the real estate sector has created additional vulnerabilities that could affect economic and social stability. Easier access to residential mortgages, which the government encouraged, boosted housing demand and contributed to a surge in household debt, from about 30 percent of GDP a decade ago to more than 60 percent. Property has also become a mainstay of Chinese household wealth. Households are exposed in multiple ways to house price fluctuations. Still, total household debt is less than total household deposits in the banking system.

Because debt accumulation in China has been financed mostly by domestic savings, overall financial risk is limited. The state owns many of the key creditors and debtors, which means a financial shock is unlikely to set off a financial crisis or a collapse in growth. The more pertinent issues are major inefficiencies and waste because of a broken system of allocating capital.

How debt and assets are distributed throughout the economy matters. Tumbling house prices have caused several major property developers, such as Country Garden and Evergrande Group, to run into financial trouble recently, and many others are similarly exposed—with high debt and vulnerable balance sheets. So are some of the financial institutions that lent to them. But a systemic meltdown is not in the cards. Most major Chinese banks are under state control and can provide infusions of cash to troubled corporations, even if that only pushes problems off into the future. Stumbles are inevitable as China tries to give market forces freer rein, but the government has enough control and resources to prevent broader financial crashes.

External risks

Many emerging market economies have run into distress from high levels of external debt, particularly foreign currency debt, which can cause balance sheet problems when a country's economy and exchange rate deteriorate simultaneously. But China's external debt is estimated to be a modest 16 percent of GDP, and less than half of it is denominated in foreign currencies.

Still, economic and political uncertainty have created concerns about capital flight, which could bring down the financial system and cause the currency's value to crash. But this is an unlikely scenario, because much of the banking system is state owned and the government would probably back all deposits in the event of financial panic. Moreover, because the government directly controls much of the banking system, it can choke off the conduits for large capital outflows.

Although there have been reforms in recent years, many of them were related to the financial sector and capital markets, with far fewer in other areas, such as state enterprises and the institutional framework. This lack of balance creates risks.

The government seems to have grasped the need for financial sector reforms and liberalization to promote better resource allocation. Fixing the financial system is not just about managing risks and avoiding disaster but also about allocating capital to the more productive, dynamic, and employment-generating parts of the economy. China's financial system is still dominated by banks, whose loan portfolios are concentrated in the state enterprise sector. Fixing the banking system requires recognizing and removing bad loans from banks' balance sheets, as well as reform of the state enterprises themselves, including weaning them off dependence on bank credit.

In recent years, as it dealt with episodes of housing market and stock market volatility, the government often found itself caught in a schizophrenic effort to balance maintaining confidence in the market with allowing the market to discipline itself—which had the perverse effect of heightening market turbulence. This on-off approach to intervention has sometimes injected a strong dose of uncertainty on top of already fragile investor sentiment and added to market volatility.

Moreover, market-oriented reforms can backfire, adding to volatility and generating more risks if they are not accompanied by broader reforms. China needs more transparency in its policymaking process, better corporate governance and accounting standards, and more operational independence for the central bank and regulatory authorities to supplement its financial and other market-oriented reforms.

The government has rightly encouraged the development of stock and corporate bond markets. But it has done little to improve corporate governance of Chinese companies or their accounting and auditing standards. The resulting opacity has contributed to large fluctuations in stock and bond markets, because investors have limited information about the companies they are investing in, leading them to follow and exacerbate market swings.

Reconciling the government's two contradictory impulses—more freedom for markets but with a heavy hand of government intervention to maintain "stability and order"—poses difficult challenges. Implementing even well-intentioned reforms in an economy with rampant inefficiencies involves transitional risks that might manifest in financial and economic volatility, especially if the government does not clearly communicate its policy intentions and leaves households and businesses guessing. So far, the government has had enough resources and policy space to cope with some of those transitional risks, but its actions and attempts to intervene directly in markets at difficult times might exacerbate problems, with long-lasting consequences.

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What the future holds

The Chinese government has shown an uncanny ability to manage the severe economic and financial stresses that have built up from the highly inefficient and risky growth model it had embraced. At various points, the government has maneuvered the economy around the seemingly inevitable prospects of a banking crisis, massive currency devaluation, housing market meltdown, and economic collapse.

Yet each of these near misses has exacted a toll: a huge buildup in domestic debt, loss of $1 trillion in foreign exchange reserves during 2015–16, and highly volatile prices of stocks, property, and other assets.

The government now faces a number of policy dilemmas: how to continue reducing debt while maintaining growth, how to reduce energy-intensive production while the economy continues to rely on heavy industry, how to get markets to exert financial discipline even as the government tries to strengthen state control, how to restrain wealth inequality while relying on the private sector to generate more wealth, how to encourage private sector innovation while cutting successful private enterprises down to size.

The government's attempts to resolve these inherently contradictory impulses in the guise of market-oriented socialism will inevitably lead to further stumbles and accidents. Its policy approach, although driven by the right objectives, could generate more uncertainty and volatility in the short run, which in turn could reduce public support for much needed reforms to bolster long-term productivity and growth.

The underpinnings of China's growth seem fragile from historical and analytical perspectives. Even if no crises materialize, unfavorable demographics, high debt levels, and an inefficient financial system will constrain China's growth. Yet, if the government plays its cards right, one could equally well envision a more benign future for the Chinese economy—with moderate growth that is more sustainable from an economic, social, and environmental perspective. F&D

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