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ANALYSIS

# Maybe China's Economy Isn't So Doomed

As Beijing struggles with a downturn, some experts make a brighter case.

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*By* ***Bob Davis***

It's lonely these days for optimists on the Chinese economy. There's widespread agreement among American China watchers—and there are so many of them now—that China has hit hard times that are bound to get a lot worse soon.

U.S. President Joe Biden has called Beijing's economy a "ticking time bomb." The *New York Times*'s Paul Krugman said the next few years "may be quite ugly" for China. "Dark clouds are hanging over China's economy," CNN's Fareed Zakaria said. Former PIMCO CEO Mohamed El-Erian said he's no longer certain China's economy will eventually eclipse the United States', even though it's nearly three-quarters as large now and growing more rapidly than America's.

But not everyone sees such a doom-laden future for Beijing. There's an argument that needs to be aired, one that argues China will once again defy expectations and continue to grow healthily, if not at the astonishing rate it once did. A uniformity of views on a system as complicated and shrouded in mystery as the Chinese economy is always dangerous. Analysts' assumptions about China's leadership are bound to affect how they interpret Chinese economic data and could lead to false conclusions.

For many years, for instance, China analysts assumed Beijing's superfast growth would continue uninterruptedly. That cheerleading is over, but analysts may now make the opposite mistake and overestimate China's slowdown.

"China's leadership is so good at withholding information about how it thinks and operates that it's become some combination of a black box and Rorschach test," said Tom Orlik, the chief economist for Bloomberg Economics. "When we read about China's leadership, we read a lot more about the underlying view of the analysts than what China's leadership is up to."

Count Orlik firmly in the glass-half-full camp. His 2020 book was called *China: The Bubble* *that Never Pops*, and he said he doesn't hear any popping sounds now, either. (Full disclosure: Orlik and I worked together for several years in the *Wall Street Journal*'s Beijing bureau.)

The White House generally takes a bearish view on the Chinese economy—as reflected in Biden's August quote about the time bomb. But it's searching for fresh information, too. Before the G-20 summit in New Delhi in September, the heads of the National Security Council and National Economic Council called in a handful of private economists to get their views.

The optimists' case relies on a close examination of Chinese economic data but also reflects the view that while President Xi Jinping and the rest of the Chinese leadership are hard-liners politically, they are economic pragmatists who want to follow in the tradition of Deng Xiaoping, who led China's opening to the West. Yes, Xi cracked down on wealthy business leaders in tech and real estate; and, yes, he forced the closure of the private tutoring sector; and, sure, he has further centralized the state sector, but he is capable of correcting course, the optimists argue.

"In July 2023 regulators gave the all clear sign" to the private sector that the crackdown on internet companies, at least, was over, wrote Peterson Institute for International Economics economist Nicholas Lardy. He estimated that private investment still accounts for more than half of all investment, reflecting Beijing's recognition that it needs to encourage entrepreneurship. Lardy, widely viewed as the dean of China economists, hasn't always been in the optimist camp. In the late 1990s, he was one of the first economists to detail the deep problems in the Chinese banking system before Beijing was forced to come clean about them.

Even among the optimists, there is broad agreement that the era of Chinese double-digit, or even high single digit, growth is over. And purges certainly continue. Evergrande Group, China's massively indebted real estate developer, said its chairman and founder, Hui Ka Yan, has been subject to "mandatory measures"—a kind of house arrest—while he is being investigated for possible criminal activity.

Former World Bank chief economist Justin Yifu Lin, who is now a dean at Peking University, maintains that China can still grow at 8 percent annually, but he is an outlier even at home. Former Chinese Premier Li Keqiang set a growth target of "around 5 percent" for 2023, which is less healthy than it seems because the base year, 2022, was so lousy. "The slowdown will be masked by a statistical artifact," Orlik said.

The question is whether China's growth will decelerate gradually over the years, as the optimists contend, to the 2 percent or 3 percent that rich countries like the United States manage, or will decline so abruptly or deeply that it sparks a crisis.

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The pessimists—increasingly the consensus—make a powerful case that the China model has run out of gas because of a confluence of structural problems. They include an aging population; shrinking workforce; rising debt; collapsing real estate market; frigid relations with China's biggest trade customers, the U.S. and Europe; and consumers' unwillingness to spend because they are spooked by how the leadership handled the COVID crisis and other issues.

After locking down the population on and off for nearly three years, Beijing suddenly lifted restrictions in December 2022 without vaccinating the most vulnerable population. Nearly 2 million people may have died in the first two months after lockdown, estimate researchers at the Fred Hutchinson Cancer Research Center. The Peterson Institute's president, Adam Posen, who is in the pessimist camp, said China suffers from "a case of 'economic long COVID,'" as reflected in sluggish consumer spending and business investment.

The usual levers China pulls when it's in trouble no longer work very well. Infrastructure investments pay smaller and smaller dividends after decades of building high-speed rail, bridges, subways, and the like. Ramping up lending would deepen chances of a financial crisis. "The argument that they will figure something out is nonsensical," said Michael Pettis, a senior fellow at the Carnegie Endowment for International Peace, who also teaches finance at Peking University.

Essentially, the pessimists say that China has run out of tricks. As Herb Stein, a prominent economist with a droll sense of humor once observed: "If something cannot go on forever, it will stop."

Perhaps. But Pettis said he has been making his argument about China's coming growth slowdown since at least 2012, while China has kept plowing ahead. During that time, China grew at a 6.4 percent annual clip, compared to the United States' 2.1 percent, according to the Interantional Monetary Fund.

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Given the drumbeat of stories about China's economic problems, it's easy to forget how remarkable China's economic rise has been. In 1980, when China was first experimenting with market reforms, its economy was 11 percent the size of the United States'. Now it's 71 percent as large, the IMF estimates, despite facing an Asian financial crisis in 1997 and 1998 and a global one in 2008 and 2009. Hundreds of millions of Chinese are no longer poor, and the country has become a technology leader.

“Despite their current problems, we shouldn’t forget that what China accomplished is the greatest economic miracle humanity has ever seen,” said Arvind Subramanian, a former chief economic advisor to the Indian government. In 2011, he published a book forecasting that China’s economy would eclipse America’s around 2030. He said he is sticking with that prediction despite China’s problems because he still expects China to grow faster than the U.S. for the rest of the decade.

Andy Rothman, a China specialist at the investment firm Matthews Asia, said it’s important to keep China’s track record in mind. He started living in China in 1980, when the country was poor, and has watched it surmount its problems and thrive. The obits for the Chinese economy are premature, he argues.

“One of the elements keeping China weak is that the Chinese people have only come out from COVID in January,” he said. “No one in China got a check [during lockdowns]. We have to be a bit patient.”

He and other optimists think the economic data is less dire than generally interpreted. As an example, the pessimists point to huge problems in the real estate sector, which accounts for 20 percent or more of Chinese economic activity. Apartment and land sales are sinking; some major developers are flirting with bankruptcy.

According to Lardy, home sales peaked in 2021, at 1.8 billion square meters, and fell to 1.4 billion last year. He figures they will decline further to 1.2 billion for 2023. Surprisingly, apartment prices haven’t fallen as much as expected, though that may be because local governments have a hand in setting prices for new apartments. Bloomberg reported that the official price data may not capture the depth of the decline because China collects its data, in part, from housing surveys rather than market transactions.

Problems in real estate cascade through the economy, affecting construction, sales of furniture, appliances, tiles, and the commodities they are made from, as well as people’s willingness to spend on other goods and services. Local governments, already heavily indebted, also count on property sales for revenue to fund their activities.

But real estate crashes are most dangerous when borrowers default on their mortgages, as happened in the U.S. during 2008 and 2009. That undermines banks and other financial institutions and freezes lending throughout the economy. In China, though, mortgage borrowers rarely default because they must put down 20 percent or 30 percent deposits. That makes the financial hit much greater of walking away from a loan than it was in the U.S.

during the financial crisis, when borrowers put down next to nothing for a deposit on a mortgage.

Lardy noted that while China's largest bank, Industrial and Commercial Bank of China, reported overall nonperforming loans of 1.38 percent at the end of 2022, residential mortgage defaults were just 0.39 percent.

Orlik, the Bloomberg economist, calculated that China was building 30 percent too many homes as the bubble inflated and people bought real estate as a speculative investment. Now the excess supply has been whittled down to 18 percent, he calculated based on depreciation and migration figures, meaning China is halfway toward getting its supply problem in order.

But demand has also sunk to below what he called a "sustainable level"—meaning the number of apartments needed to replace dilapidated buildings and house new families and migrants who move to the cities. Although that could mean supply and demand will continue to get further out of whack, deepening the downturn, Orlik argued it gives Chinese leaders room to encourage real estate purchases once again, but this time without reigniting a bubble.

Indeed, since August, China's Central Bank and other regulators have looked to spur the market by cutting interest rates and down payment requirements and easing the enforcement of anti-speculation regulations.

Similarly, the optimists have a different interpretation of the rise in household savings to 36 percent from 32 percent before COVID, according to Bloomberg. The increase has been broadly interpreted as a vote of no confidence in the Chinese economy, reflecting consumer worries about real estate prices, debt, and the government's ham-fisted COVID policies. Why spend today if you are worried you will need the money to survive tomorrow?

But Lardy offered a simpler explanation for the savings rise. Chinese households were locked up for nearly three years and had no way to spend money, so their savings increased. That produced a reservoir of cash that will soon be tapped, he said. Household disposable income in Chinese cities rose rapidly in the first half of 2023, he said, while the growth in consumption spending was about 10 times as fast as it was the year before.

"People couldn't get out of their houses," he said. The savings rate "isn't a good indicator of uncertainty or a fear of expropriation."

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Underlying the differences in data interpretation is a difference in views about China's leaders. Pettis, from Carnegie, said that the leadership remains stuck in the mindset that

China can only grow through investment—even if boosting investment no longer pays off as it once did. Xi and his lieutenants are too rigid and unwilling to pay the political price to shift the economy toward one that relies more on consumer spending, he said, which is the direction he and many economists think China must head.

"It requires a huge shift in domestic institutions" for the economic system not to favor exporters, manufacturers, and state-owned firms over consumers, he said. "It's not a question of communism. Brazil went through the same problem in the '60s and '70s with a military dictatorship. Japan went through it, too."

Matt Turpin, the Trump National Security Council's China director, summed up the pessimist view of Xi and his allies succinctly: "Seventy-year-olds in their third terms rarely make drastic changes in direction."

The optimists, though, said they see some signals that leadership is willing to make some changes—at least by encouraging private business to expand and foreigners to invest. Beijing often works by sending signals via speeches, campaigns, and regulations about the direction the leadership wants the economy to take. It's then up to localities to figure out ways to carry out those wishes.

Local leaders, whose promotions depend on carrying out the party's priorities, compete to start projects, even if that leads to overproduction and inefficiencies. It's no wonder the Chinese economy is awash in products ranging from steel to electric vehicles to solar panels, driving down prices until many of the producers operate at a loss.

"They make a lot of mistakes," Rothman said. "But we have seen signs since July that they are acknowledging mistakes and we're seeing pragmatism."

Those signs, he said, include speeches by Xi and Premier Li Qiang extolling the role of the private sector. A July Politburo meeting chaired by Xi "called for policies and measures to promote private investment and provide private enterprises with an enabling environment," the *Global Times*, a party-owned publication, reported, dubbing the new policies "Xiconomics." A month later, eight Chinese ministries issued 28 measures to back the private sector, the *Global Times* added.

Rothman interpreted a proposed easing in cybersecurity rules that foreign companies have complained about as another sign of pragmatism. But there are plenty of contrary signs that China will keep going in the same direction it has for years. Just one recent print edition of the *Wall Street Journal*, on Sept. 30, had stories about authorities looking to block Apple from offering Western social media apps on its iPhones in China and barring a Kroll risk advisory firm employee from leaving the country. That followed a raid on the offices of due-diligence company Mintz Group, among other harsh moves.

Christopher Johnson, a former CIA China analyst, also noted that the leadership has been late to set a date for two important economic conferences that are usually held every five years. One is called the Third Plenum; the other is the National Financial Work Conference.

The leadership can use those conferences to make important economic announcements. The 2013 Third Plenum declared that markets would play a "decisive role" in the economy, though that didn't occur. After a stock market meltdown in 2015 and 2016, Xi moved much more decisively to bolster the state-owned sector. "They are trying to create a new pitch," said Johnson, who now heads the political-risk consultancy China Strategies Group.

Cornell University economist Eswar Prasad finds a disconnect between the messages coming from Beijing and the financial center in Shanghai. During a July trip to China, he said, government leaders in Beijing assured him they were taking important steps to bolster confidence in the economy and support private enterprise.

But in Shanghai, the traditional home of Chinese entrepreneurs, he heard a very different story. "The view there was that something fundamental had shifted in Beijing's view of private enterprise," he said. "They viewed Beijing as somewhat hostile and that they needed to be very cautious."

Prasad said he thinks China will manage to pull out of its funk and grow healthily, but he said it's a close call. "Every time the Chinese economy stumbles, there is a tendency to say that finally the end is near," he said. "The optimists' view might be too optimistic, but it provides some grounding, so we don't get too carried away every time the Chinese economy stumbles."

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