The Chinese economy: Troubled times ahead

By George Magnus

There was a time when most people were in thrall to the resilience and dynamism of the economy of the People's Republic of China (PRC), but times have changed and there is trouble ahead. Even though the PRC's zero Covid-19 policies have undoubtedly accentuated economic stress and will probably be abandoned eventually, the PRC faces strong structural economic headwinds, many of which are systemic features, not easily fixable bugs. These include those arising from an overhang of excessive debt, a bust in the property market which has put almost 30% of annual Gross Domestic Product (GDP) at risk of stagnation for many years, and productivity and governance failings.[1]

It is fashionable to talk about 'course correction' in the PRC, that is the tendency in the past for the Chinese Communist Party (CCP) to change direction when things have gone wrong. Yet, it is a moot point whether the PRC can resolve these problems satisfactorily, partly because the CCP itself is one of the main architects of the economy's current ailments, and partly because of the systemic nature of the problems. Changing the system is simply not an option.

[1] Kenneth S. Rogoff and Yuanchen Yang, 'Peak China Housing', National Bureau of Economic Research, 13/08/2020, https://bit.ly/3fzr61n (checked: 04/11/2022).

As Kevin Rudd, a former Australian prime minister, has argued recently, the PRC's Leninist lurch leftwards in politics, Marxist lurch leftwards on the economy, and nationalist lurch rightwards in foreign policy has resulted in real policy changes.[2] Neither the 20th Party Congress in October nor the National People's Congress next spring are likely to result in a material shift in these policies. Indeed, anyone looking for these events to present an opportunity for a re-set and shift back to more liberal reforms will be disappointed. Instead, the CCP's agenda is about consolidation and continuity.

While these issues are of the utmost importance within the PRC, they also have great relevance for the rest of the world, and for the PRC's place within it. The CCP's ability to project power beyond Chinese borders militarily, and in other ways, depends to a significant degree on its economic heft and the credibility of the Chinese economic 'model' relative to what it insists is a failed system – democratic capitalism, particularly of the kind found in the United States (US).

The PRC's US$17 trillion (£15 trillion) economy, growing at 2%-3% annually, can still add a lot of GDP, but if that GDP is unstable and unproductive and does not add the quality, high paying jobs the Chinese economy desperately needs, the PRC's economic status will be adversely affected. This in turn might easily have a bearing on how it is perceived and how it behaves, as well as on the longevity of its leader.

The PRC's big distributional challenges

At the current time, the PRC is struggling with important distributional challenges, which run through the mix of current economic difficulties.[3] Specifically, it is trying to resolve the allocation of costs for the crisis in the real estate market among and between homeowners, banks, property developers and various levels of government after over a decade of misallocation of capital and rapid growth in indebtedness. More generally, persistently high levels of income inequality require attention to the allocation or distribution of income and wealth

[2] Kevin Rudd, 'Xi Jinping's Reach Exceeds His Grasp', *Wall Street Journal*, 12/08/2022, https://on.wsj.com/3BWc6SM (checked: 04/11/2022).

[3] A lot of economic challenges and crises come down to this 'simple' problem, namely how to determine the distribution of incomes, wealth, and often costs between the owners of land, labour and capital. In other words, the allocation between households, firms and entrepreneurs, and the public sector with a view to realising greater or lesser equality. This is often not just a question of fairness and social equity, but also of significance to economic growth and development, and increasingly relevant to climate change, regulation and the provision of public goods and services. See: Binyamin Applebaum, 'Distribution Matters', International Monetary Fund, 12/2020, https://bit.ly/3US7YMs (checked: 04/11/2022).

between better and less well-off groups of citizens, but more importantly, between the private and public sectors.

Property and prosperity

The PRC's US$55 trillion (£48 trillion) real estate market has been called the most important sector in the world because of its size, growth and voracious appetite for iron ore, copper, cement, and other goods and services.[4] It is also a bedrock of confidence and economic trust for the Chinese middle class, for which property represents about three quarters of its assets.[5] It has had its ups and downs over the years but it has never faced a tipping point in which the typical incentives and measures used to spur activity have failed to find traction. It may now face years of stagnation.

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About a year ago, the PRC's largest private property developer, Evergrande, finally had to confront its illiquidity and insolvency, paving the way for several other firms to also fall over like skittles struck by a ball. Since then the property market has deteriorated sharply, with large double digit declines in construction volumes and sales.[6] New home prices nationally have dropped significantly, especially in so-called Tier 3 and Tier 4 cities – lesser administrative classifications, and typically smaller but accounting for the majority of

[4] 'Measuring the universe's most important sector', *The Economist*, 26/11/2021, https://econ.st/3E3QQ0b (checked: 04/11/2022).
[5] Congmin Peng, Po-Wen She and Ming-Kun Lin, 'Financial Literacy and Portfolio Diversity in China', *Journal of Family and Economic Issues*, 43:452-465 (2022).
[6] Martin Farrer, 'A Ponzi scheme by any other name: the bursting of China's property bubble', *The Guardian*, 25/09/2022, https://bit.ly/3SH0Il7 (checked: 04/11/2022).

population, GDP and construction – and a number of banks with high levels of property lending have come under pressure to lower their exposure.[7]

With job losses starting to pile up, fretting about job security has become common for those in work. With even dynamic sectors like technology announcing thousands of layoffs it is clear that the real estate sector is in poor shape.[8] However, it is not just a cyclical problem, bad as that might be. The sector is also facing poor medium-term prospects. Prices have started to decline but the levels are high, as are vacancy rates. The balance sheets of many developers and local governments are laden with significant liabilities and with assets, whose values are now falling. Further, in the years ahead, demographics point to lower rates of household formation, and a decline in the cohort of 25-34 year old first-time purchasers.[9]

Moreover, the model for home sales is now under threat. The presale model, in which developers sell uncompleted housing units to households who take out mortgages up front, accounted for 90% of sales in 2021. With new cash flows to developers and borrowing opportunities sharply reduced or shut, this model has the attributes of a Ponzi scheme. With over 800,000 housing units unfinished,[10] and many mortgagees facing huge losses and or no homes, a mortgage boycott movement has flourished, alongside declining confidence in the market,[11] and a surge in the numbers of homeowners selling financial assets in order to repay their mortgages early.[12]

Losses in the real estate sector can only be distributed in a limited number of ways. Much depends on how the CCP behaves. If the CCP does not do enough, the functioning of the presale model and mortgage market can be seriously impaired. If it goes too far in bailing out homeowners and developers, it will simply encourage more mortgagees and developers to claim assistance and exacerbate the accumulation of debt. This seems to be happening in the PRC as already heavily indebted local government agencies, called local government financing vehicles (LGFVs), have been given approval to borrow money to buy

[7] Daisuke Wakabayashi and Joy Dong, 'China's Once-Sizzling Property Market Has Started to Cool', *The New York Times*, 20/06/2022, https://nyti.ms/3Sy3j0w (checked: 04/11/2022).
[8] Ryan McMorrow and Nian Liu, '"Let it rot": China's tech workers struggle to find jobs', *Financial Times*, 16/06/2022, https://on.ft.com/3e2A0UC (checked: 04/11/2022).
[9] 'Population Division', United Nations Department of Economic and Social Affairs, undated, https://bit.ly/3USmQtV (checked: 04/11/2022).
[10] Alicia Garcia Herrero, Jianwei Xu, Kohei Iwahara and Gary Ng, 'What to expect from the bursting of China's real estate bubble? Lessons from Japan', Natixis, 01/09/2022, https://bit.ly/3CvPJ0L (checked: 04/11/2022).
[11] 'Why Some Homebuyers in China Are Boycotting Their Mortgage Payments', Goldman Sachs, 15/08/2022, https://bit.ly/3rlqpvm (checked: 04/11/2022).
[12] 'Chinese Rush to Repay Mortgages Gains Momentum in Abrupt U-Turn', *Bloomberg*, 14/09/2022, https://bloom.bg/3C0keBG (checked: 04/11/2022).

land so as to bail out cash-constrained cities and provinces.[13] This is a risky move unless property prices rise: if they do not, and this is far more likely, the new burden of debt will leave local governments in even worse shape and simply extend the property market's denouement for years to come.

Homeowners, comprising the PRC's fabled middle class, are probably one group the CCP would like to keep in cotton wool for fear of triggering disquiet, if not unrest. Households generally have mortgage debt and total liabilities equivalent to about 40% and 60%, respectively, of GDP, which is not outlandish by international standards, but the latter amounts to nearly 120% of disposable income, which is.[14]

Banks might have to take some of the costs in write-offs and bad loan provisions, but the mortgages affected by the boycott might not be more than 1%-2% of outstanding mortgage debt, and probably no more than 6%-7% in the worst case. The bigger issues, bankrupt developers aside, are the consequences for households and banks of the fall in housing asset values and collateral, and of more restrained household repayment capacity for the sector as a whole. The CCP will certainly be minded to head off a situation in which banks, especially larger ones, risk deposit flight and funding difficulties because of a loss of confidence. In a state-owned and controlled financial system, this should be possible.

Ultimately, it is hard to avoid the conclusion that it will be local governments that take the bulk of the cost. Yet this also presents a serious distribution problem beyond the immediate tussle, with important political implications that could reach all the way up to Xi Jinping, General Secretary of the CCP.

Local governments are typically the agents that deliver economic growth and ensure that growth targets are met. They spend on infrastructure, housing and other projects to meet any shortfall, but generally without regard for commercial viability and need. They also account for the lion's share of industrial, social welfare and housing expenditure, as well as, more recently, funding expensive mass testing programmes related to the PRC's zero Covid-19 policies. Yet, they also account for a relatively small share of revenues, meaning that they are reliant on land sales. These account for about a third of their combined income from revenues, borrowing, and transfers from Beijing. Land sale revenues are now under pressure from the downturn in property and in real estate prices.[15] Local governments and their LGFVs have now run up debt that

[13] *Ibid*.
[14] Hunter Clark and Jeff Dawson, 'Is China Running Out of Policy Space to Navigate Future Economic Challenges?', *Liberty Street Economics*, 26/09/2022, https://nyfed.org/3M38cw7 (checked: 04/11/2022).
[15] Guo Yingzhe, 'China's Plunging Land Sales Threaten Local Government Coffers', *Caixin Global*, 05/07/2022, https://bit.ly/3C5HE8H (checked: 04/11/2022).

accounts for about 50% of GDP, and many are experiencing severe cash flow and, in many cases, debt servicing difficulties.[16]

The political problem is that Beijing and local governments are in a dysfunctional relationship, not for the first time, but at a highly sensitive and important time. Central government wants to keep local governments on a short leash for control purposes, which it can leverage via the transfers it makes to local governments and on which they depend. It wants to keep its own balance sheet limited and its debt restrained, not least because its status would deteriorate if it ever had to be explicit about its contingent liabilities, which include borrowing by government-backed special construction and guidance funds, policy development banks, state enterprises, and of course local governments and LGFVs.[17] These liabilities amount in total to about 120% of GDP or six times the central government's reported debt ratio alone.

Yet, local governments cannot really function properly any more without incurring even more dangerous levels of debt. At the same time, the more they do, the greater is the risk of both rising financial instability and of Beijing having to recognise those costs on its own balance sheet. This would undermine its credit standing, which would impair its own spending programmes. Sooner or later, a political resolution will be called for, in which local governments are better able to fund and finance their spending responsibilities. However, this will entail Beijing having to take more debt onto its own balance sheet, which in turn will make a review of the PRC's highly regressive tax system more urgent. This would help sustain the provision of public goods and services.

Income inequality is holding the PRC back

Income inequality is a global phenomenon, and, aside from economic and social justice concerns, is widely recognised as a constraint over economic growth and development. In the PRC, income inequality is not only especially high, but has remained persistently high over time.[18] Moreover, resolving it is not just a question of changing the distribution of income between richer and poorer people, but of changing the economic structure of the PRC. There remain large imbalances focused on the roughly 40% share of consumption in GDP[19], compared to 60% or more in most peer groups and developed market economies,

[16] 'Policy Brief: China's Growing Local Government Debt Levels', Massachusetts Institute of Technology Centre for Finance and Policy, 14/01/2016, https://bit.ly/3fEuxnH (checked: 04/11/2022).
[17] 'The Balance Sheet Constraints on China's Economic Stimulus', Seafarer, 08/2022, https://bit.ly/3C9NOoG (checked: 04/11/2022).
[18] 'Inequality in China: Trends, Drivers and Policy Remedies', International Monetary Fund, 06/2018, https://bit.ly/3M1sKFj (checked: 04/11/2022).
[19] Peter Brennan, 'Weak Chinese consumption holds back global economic recovery', S&P Global Market Intelligence, 16/03/2021, https://bit.ly/3M1GShT (checked: 04/11/2022).

and the 40% of GDP accounted for by the public sector [20] in which state enterprises and institutions receive significant industrial, financial and commercial privileges.

Income inequality is important with potentially ground-breaking political and social consequences. The distributional issue, as seen through a western lens, certainly involves tax reform – to make the system less regressive and perhaps raise far more from income tax than from value-added tax.[21] Yet, much more than this, it also would be based around state financial transfers or asset sales, including state enterprises, from local and provincial governments to the private sector.

These are precisely the kinds of initiatives to which the CCP is viscerally opposed, and which would threaten its control and, as it sees it, its *raison d'être*. Instead, under Xi's leadership, it launched a campaign in 2021 called 'common prosperity', according to which all citizens will enjoy increases in material and spiritual prosperity if they follow the teachings of 'Xi Jinping Thought'.[22]

'Common prosperity' is, so far at least, very light on identifiable policy proposals and more about programme goals. For example, there has been a significant regulatory crackdown on technology, data, finance and private education platforms that the CCP has, at least for now, stopped. There has been a strong coercive message to firms to pay donations to further CCP goals and causes. The CCP has also emphasised the need for rural revitalisation, health and healthcare habits and programmes, and carbon neutrality objectives.

However, as of now, 'common prosperity' is a slogan about inequality, not a solution to it. It is about the organising and central role of the CCP and its leader, not about measurable policies against which we will be able to judge inequality, and which, more to the point, Chinese workers and the middle class will be able to judge whether their employment and educational opportunities, and living standards, are getting better.

The PRC's Gini coefficient – a measure of income inequality where 0 equates to perfect equality and 1 to total inequality – has been elevated for many years. According to the World Bank it was 0.38 in 2019.[23] This is comparable to the US but significantly higher than in the United Kingdom (UK), continental Europe

[20] The private sector is widely acknowledged to contribute 60% of GDP, see: Dexter Tiff Roberts, 'The risky logic behind China's economic strategy: "Politics in command"', Atlantic Council, 07/05/2021, https://bit.ly/3V19jAj (checked: 04/11/2022).
[21] 'Revenue Statistics in Asia and the Pacific 2022 – China', Organisation for Economic Cooperation and Development, 12/07/2022, https://bit.ly/3ya71oO (checked: 04/11/2022).
[22] Ryan Hass, 'Assessing China's "common prosperity" campaign', Brookings, 09/09/2021, https://brook.gs/3dVno1T (checked: 04/11/2022).
[23] 'Income inequality: Gini coefficient, 2000 to 2019', Our World in Data, undated, https://bit.ly/3SMtqkc (checked: 04/11/2022).

and Japan.[24] There are, however, other, more broadly based measures including those from the China Family Panel Survey which estimate the Gini at around 0.54-0.55.[25] High income inequality is also corroborated by looking at the income distribution between various income groups. The top 20% of income earners, for example, get about 46% of income, virtually unchanged over the last decade or so, while the bottom 40% get a bit over 13%.[26]

The CCP has had some meaningful success in eradicating poverty in the PRC using a generous bar for measurement, but this will not suffice to secure its future if it cannot solve the crisis in the property sector, or more broadly reduce income inequality, which increasingly resembles its Achilles' heel.

This does not mean that poorer households have not been getting better off over time, but it does mean that the distribution of the benefits of economic growth have been disproportionately going to richer households for a long time. Yet, it is different now that the economy faces growth of perhaps 2-3% over the next 10 years, compared with 6% or so in the 2010s, and over 10% in the 2000s.[27]

Put another way, income inequality is high and exacerbated in the PRC because middle and lower income cohorts in the PRC receive wages and salaries that are a low proportion of GDP, and significantly lower than in developed market economies. While in the latter, labour compensation as a share of GDP tends to be about 70-80%, in the PRC it is more like 55%.[28] Much of the

[24] 'Income inequality', Organisation for Economic Cooperation and Development, 2022, https://bit.ly/3V19POL (checked: 04/11/2022).
[25] Sho Komatsu and Aya Suzuki, 'The Impact of Different Levels of Income Inequality on Subjective Well-Being in China: A Panel Data Analysis', *The Chinese Economy*, (2022).
[26] Ilaria Mazzocco, 'How Inequality is Undermining China's Prosperity', Centre for Strategic and International Studies, 26/05/2022, https://bit.ly/3rqnSzT (checked: 04/11/2022).
[27] As argued in my book, *Red Flags: Why Xi's China is in Jeopardy* (Yale University Press, 2019).
[28] Michael Pettis, 'Will China's Common Prosperity Upgrade Dual Circulation?', Carnegie Endowment for International Peace, 15/11/2021, https://bit.ly/3CvzDf2 (checked: 04/11/2022).

difference is attributable to social transfers to households, which are about 8-9% of GDP in the PRC, but 15-20% in the US and European Union.[29]

A snapshot of income inequality, though, does not tell us much about what it might look like in 10 or 20 years' time and therefore how the thinking of households and citizens might be affected. This depends on a number of other factors that drive trends in income inequality, such as the pace of urbanisation, the ageing of society, the tax system, and importantly, educational attainment and skills, and the amount and type of employment one is engaged in.

The reason that the PRC's policy makers now face an uphill struggle in trying to lower income inequality is that all of these drivers are leaning against them.

The PRC's 64% urbanisation rate is now at the point where further increases may be accompanied by higher rather than lower inequality, Further, the 2020 Census data showed that 200 million migrant workers – or roughly 71% of the total – did not have an urban registration (or hukou), and therefore do not get free access to public education, housing or welfare.[30] The CCP has been experimenting with changes to the urban registration system but remains reluctant to allow full-scale change, and local and provincial governments certainly do not want to be saddled with the bill for allowing fuller access to benefits.

Rapid ageing in the PRC is well documented, and the product of low birth rates and rising longevity.[31] As the PRC's cohort of citizens aged over 60 rises from 250 million, or 18% of the population, to well over 400 million, or almost 35%, by 2045, additional upward pressure on levels of inequality should be expected, unless the CCP can compensate for this change, which would again be a responsibility of local governments.

The most important barriers to lowering inequality, however, relate to educational attainment and employment, issues made clearer through the work of Scott Rozelle and Natalie Hell in their recent book, *Invisible China*, as well as subsequent research.[32]

Whereas in the PRC's earlier developmental years it needed workers that were numerate, literate and disciplined, it now needs workers who are educated to much higher levels. It also needs workers with the requisite skills to compete and cope in an increasingly technological and digital work environment, and one that is also competing with automation and artificial intelligence (AI), and losing

[29] 'Social benefits to households', Organisation for Economic Co-operation and Development Data, 2021, https://bit.ly/3SW21MF (checked: 04/11/2022).
[30] Kam Wing Chan, 'What the 2020 Chinese Census Tells Us About Progress in Hukou Reform', *Jamestown Foundation*, https://bit.ly/3rs6dYA (checked: 04/11/2022).
[31] George Magnus, *Red Flags: Why Xi's China is in Jeopardy*, (Yale University Press, 2019), Chapter 6.
[32] Natalie Hell and Scott Rozelle, *Invisible China* (The University of Chicago Press, 2020).

jobs to supply chains outside the PRC from countries such as Vietnam and Cambodia, to Bangladesh and even Mexico.[33]

The PRC's central problem is its low level of educational attainment. About 30% of workers have high school educational qualifications or better, compared to 78% in the Organisation for Economic Cooperation and Development (OECD) nations, and only about 15% have tertiary sector qualifications, compared to 35% in wealthy countries.[34] Based on the 2020 Census, these numbers have improved a bit to almost 37% and about 17% respectively, thanks to younger Chinese getting better schooling than their parents, but this will take a generation to improve, assuming that the requisite improvements are made in schools, universities and in teaching staff and curriculums.[35]

The bottom line, regardless, is that the PRC has a deficient level of human capital – a phenomenon which resonates increasingly in the Chinese labour market where the number of skilled, higher paying manufacturing and construction jobs is declining, and where the number of informal, labour-intensive, lower skill and lower pay jobs has been rising.

Unequal access to education, good schooling and healthcare has had a profound impact on the working age population and in preparing workers for the capabilities needed to excel in the modern, digital economy. They have not only entered the labour force inadequately prepared but are also facing intense competition from the CCP's accelerated attempt to introduce robotics and artificial intelligence into the Chinese economy, which tend to hit lower skill occupants especially hard.[36] In 2020, for example, it is estimated that about 60% of Chinese workers in urban areas were employed in the informal sector where low skills and pay prevail.[37] This compares to 40% in 2015, and with informal sector job proportions of 35% in Chile and 40% in Brazil.[38]

[33] 'Nearly One in Four European Firms Consider Shifting Out of China', *Bloomberg*, 20/06/2022, https://bloom.bg/3Cp22mO (checked: 04/11/2022).
[34] Natalie Hell and Scott Rozelle, *Invisible China* (The University of Chicago Press, 2020).
[35] Ilaria Mazzocco, 'How Inequality is Undermining China's Prosperity', Centre for Strategic and International Studies, 26/05/2022, https://bit.ly/3rqnSzT (checked: 04/11/2022).
[36] Georgios Petropoulos and Sybrand Brekelmans, 'Artificial intelligence's great impact on low and middle-skilled jobs', Bruegal, 29/06/2020, https://bit.ly/3C33VUL (checked: 04/11/2022).
[37] Scott Rozelle and Matthew Boswell, 'Complicating China's Rise: Rural Underemployment', *The Washington Quarterly*, 44 (2021).
[38] Georgios Petropoulos and Sybrand Brekelmans, 'Artificial intelligence's great impact on low and middle-skilled jobs', Bruegal, 29/06/2020, https://bit.ly/3C33VUL (checked: 04/11/2022).

Conclusion

The CCP has had some meaningful success in eradicating poverty in the PRC using a generous bar for measurement, but this will not suffice to secure its future if it cannot solve the crisis in the property sector, or more broadly reduce income inequality, which increasingly resembles its Achilles' heel. Solving these two systemic problems is not a technocratic issue or something that can be addressed by a shift in policy emphasis. Rather it entails the adoption of tough and sensitive distributional reforms that lie at the heart of the economic and political power model that the CCP enjoys, but which may indeed threaten it. Failure to address them though would also have political implications that might not be favourable to the current leadership, or perhaps for the CCP itself.

The irony is that the PRC has prospered greatly from allowing the private sector to develop and from openness and engagement with the rest of the world. Yet these processes embed their own dynamics and contradictions. A vibrant private sector has bred a new class of entrepreneurs, who Xi now wishes to tame and align with CCP goals. It has also nurtured the PRC's fabled middle class, whose aspirations now appear to be uncertain if not checked, and whose behaviour is subject to greater state scrutiny. Engagement with the outside world has been the handmaiden of the PRC's rise, but the PRC's own wish for self-reliance and adversarial relationship with most of the world's GDP is now leading the CCP to double down on state-led economics and control.

Big reforms that put local governments, which provide public goods and services, on to a more viable footing and that redistribute income and wealth to the private sector and middle and working classes from the state sector would go far in rebooting the PRC's economic model and capacity. No one, though, is holding their breath that Xi's PRC is up for the task.

About the author

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