China’s Economic Woes: Sources, Challenges and Diminished Longer-run Potential

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China’s Economic Miracle Unravels

- China’s economic story has been extraordinary
- A sustained surge in growth lifted it from an impoverished nation to the world’s 2^{nd} largest and the driver of global growth and trade
- Its economy now faces major challenges and is faltering
- Primary themes stand out:
  - China’s earlier embrace of US-style capitalism worked economic miracles
  - President Xi’s imposition of China socialist ideals and clamping down on free enterprise and personal freedoms is a failing economic strategy
  - Misallocation of resources has led to current economic troubles
  - Longer-run potential depends critically on the economic regime chosen

Introduction and Summary

- Government-driven excesses in real estate (RE) and debt have driven China’s recent years’ sustained rapid growth are unraveling
- Falling RE values are undercutting household net worth and consumption
- Unraveling excesses in RE and debt undercut government finances and constrain fiscal stimulus, a key driver of economic growth
- It will likely take years to unwind the excesses
- China’s weakness is spreading globally, depressing growth and trade
- China remains the world’s 2nd largest economy, but fundamentals point toward diminished longer-run potential growth

Recent Publications

- WSJ Op/Ed, China Is About to Fall Into the Middle-income Trap, by Mickey D. Levy, October 26, 2022
- China: From engine of global growth to a source of weakness and risk, Berenberg Capital Markets, August 18, 2022
- WSJ Op/Ed - China Pays for Economic Mismanagement by Mickey D. Levy, August 24, 2023
- https://www.hoover.org/research/chinas-bill-comes-due, Hoover Institution Defining Ideas, September 19, 2023

China’s costly economic mismanagement

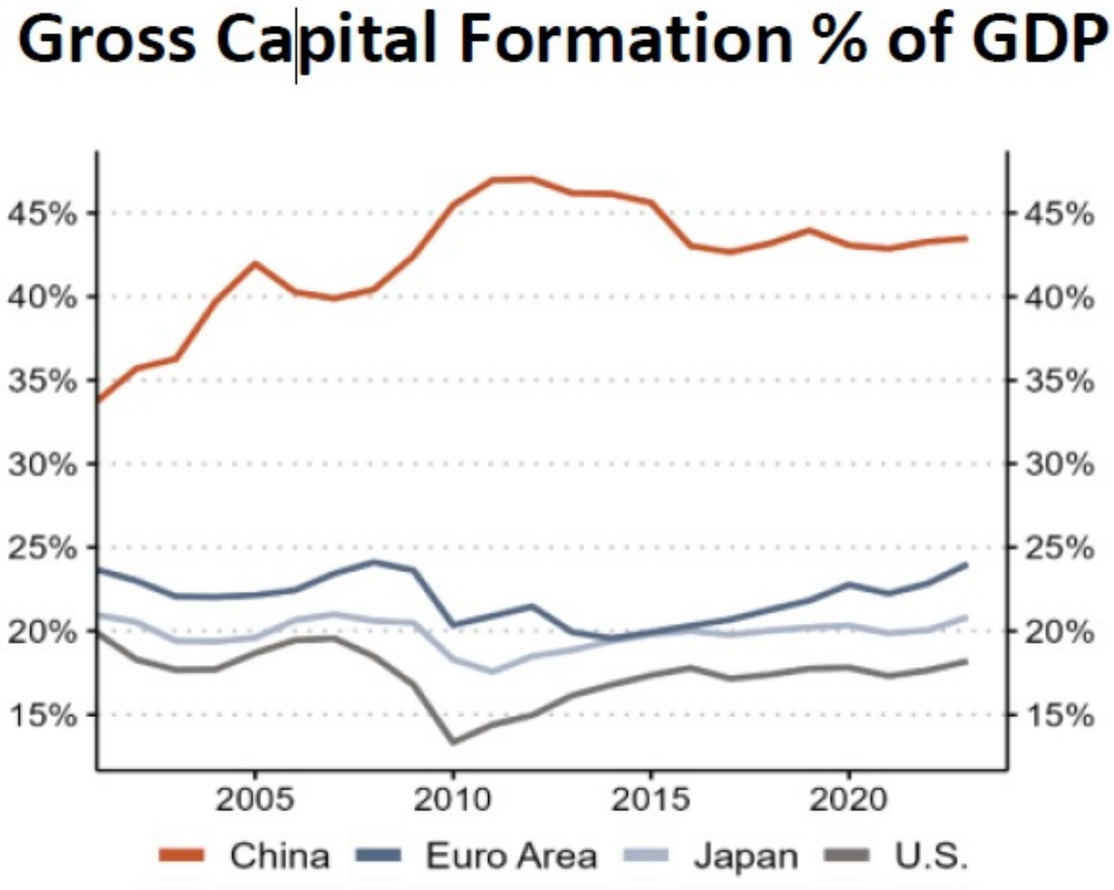
- Boom years’ regime: central control that allowed U.S.-style free enterprise that introduced and applied innovation and foreign technology to expansive labor supply, ramping up productivity
- China becomes powerhouse of global manufacturing, accounts for 30% of global growth between 2000-2014 and trade share rose from 4% to 14%, significant high tech developer
- President Xi gradually shifts back to central control to allocate national resources, and clamps down on free enterprise and innovators
- Potential growth gradually slows naturally as labor and capital use rise toward capacity, slowing productivity and raising production costs

Excess Government Investment in Infrastructure and Residential Real Estate

- Central planners continue to target rapid GDP growth despite failure of transition to consumption failed and potential slowed
- Achieving lofty GDP targets required aggressive government investment in infrastructure and RE
- Beijing set targets for local governments, distributed tax revenues to LGs but funding was insufficient to achieve output goals
- Construction and RE boom
- LGs relied heavily on land sales to developers and bond issuance to finance booming real estate activity

Excess Investment in Real Estate

- Gross capital formation, which combines government and business investment, exceeded 40%, a telltale sign of resource misallocation
- National Bureau of Statistic's measure of gross capital formation does not disaggregate data
- Common estimates of residential RE roughly 25% of GDP

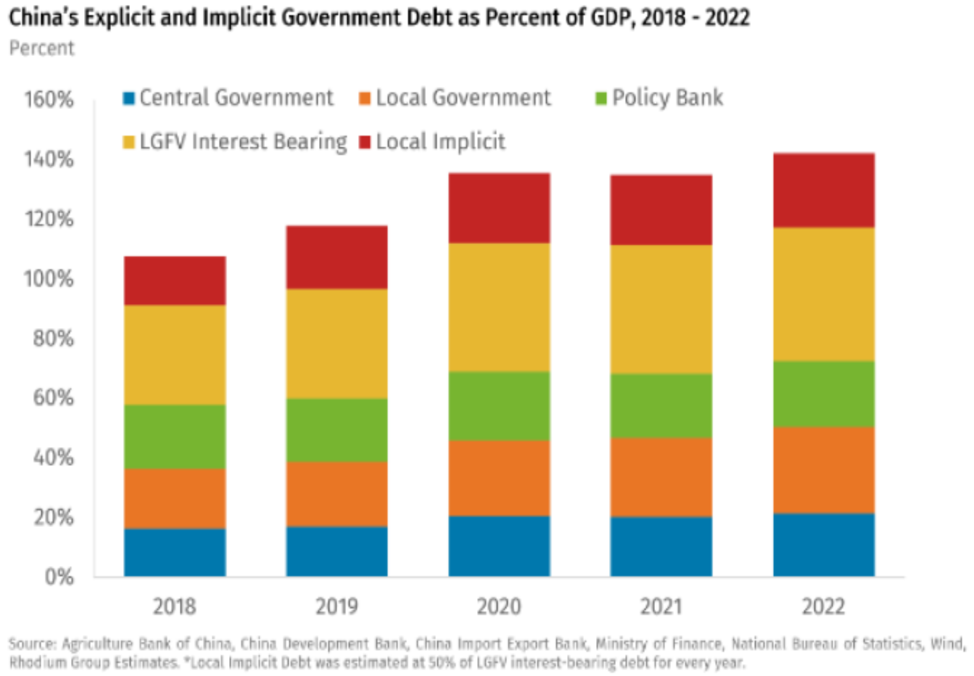


Note: Data for China and Euro Area include public investment
Source: Eurostat, China National Bureau of Statistics, Cabinet Office of Japan, Bureau of Economic Analysis, Haver Analytics

High Debt and Murky Finances

- Excessive reliance on land sales and debt, and a murky interconnected web of financial flows
- Local govt debt bought by Local Government Financing Vehicles (LGFVs), shadow banks, wealth managers
- It all worked until expectations shifted down
- Faltering of RE reveals fragile state of debt service and unanticipated credit risks
- Bankruptcies of Evergrande, other land developers are tip of iceberg
- Government financial structure stressed

China Government Debt



The Negative Economic Fallout in China

- **Residential RE activity** and home prices are falling, declines most severe in lower-tier cities—excess supply and cautious demand
- **Consumer spending** soft, reflecting dramatic fall in household net worth and confidence
- **Gross capital formation (private sector + govt)** outlook limited by government financial squeeze that limits flexibility to stimulate
- **Exports** declining, reflecting weak global economies and reduced exposures to China supply chains; hits manufacturing jobs and wages
- **Imports** declining, reflecting weak domestic demand and production

Observations on China’s Official Data

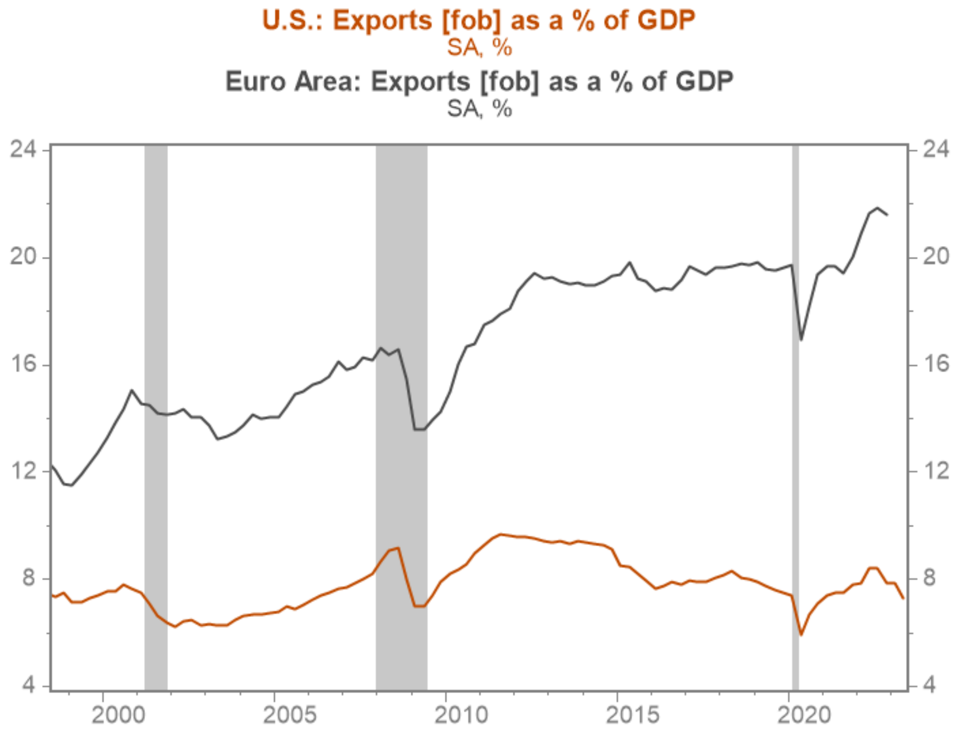
- China National Bureau of Statistics (NBS) data unreliable, distorted and incomplete
- The NBS blends data that make them difficult to analyze
- NBS stops publishing select unfavorable data
- ***Estimating official GDP is more a guess of what you think the NBS will print than a reflection of true economic conditions***
- Current speculation: NBS will continue to report high GDP growth, while actual private sector conditions are distinctly weaker

Global Implications

- China's weakness slows global growth, hits trade
- Exports of all large Asian nations are declining (Japan, South Korea, Taiwan, Hong Kong, Singapore, Australia, India)
- Many EM that rely heavily on exports to China are harmed
- Sizable hit to Germany (declining exports and industrial production)
- The renminbi has weakened but PBoC manages it
- China's financial conditions and international economic strategy are aggravated by major problems in its EM Belt and Road Initiative

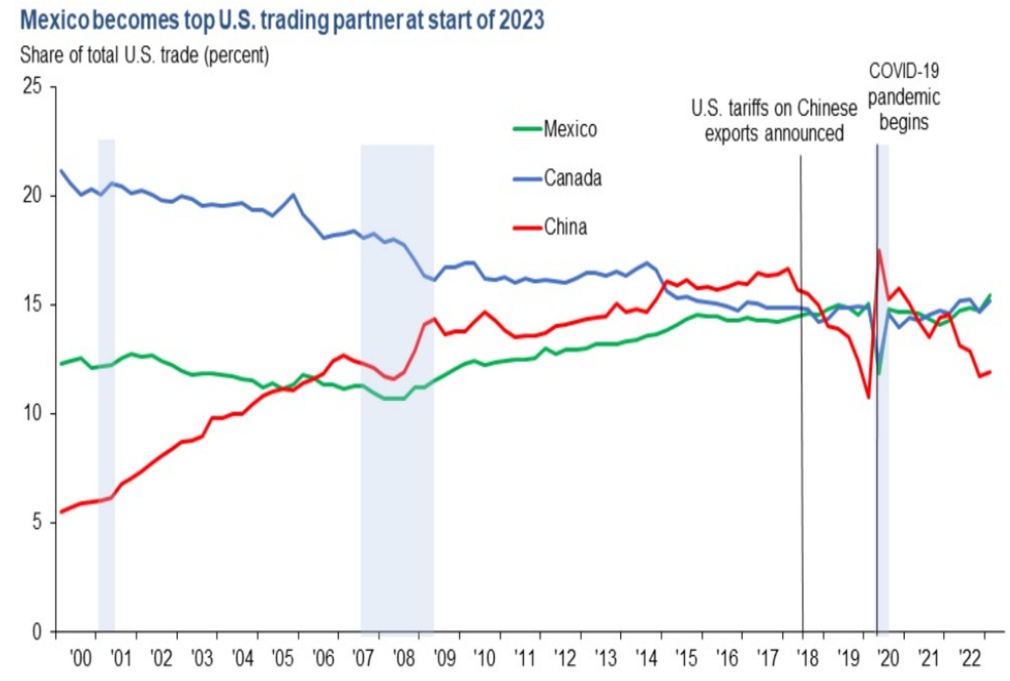
World Trade Volume Declining; U.S. Relatively Well Situated

Source: Netherlands Bureau for Economic Policy Analysis/Haver Analytics



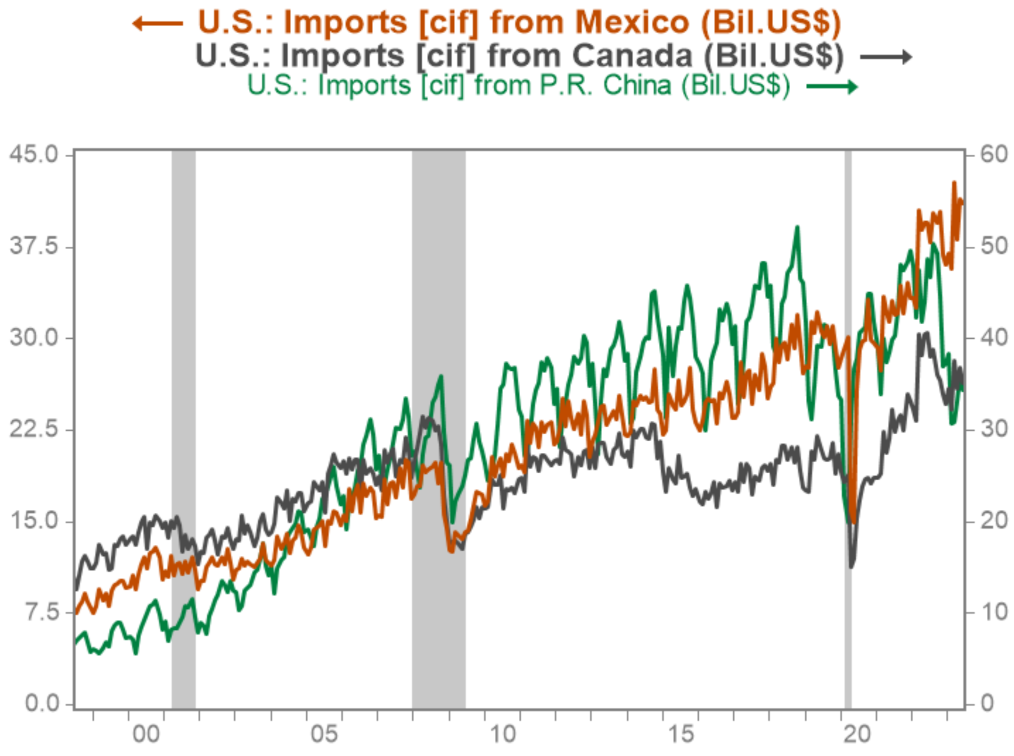
Source: OECD/Haver

U.S. Direct Trade Shifting Away from China and Toward Mexico and Canada



NOTES: Data are seasonally adjusted and quarterly. Figures also include April 2023. Shaded area denotes a recession. Total trade is the sum of exports and imports.
SOURCE: Census Bureau.

Federal Reserve Bank of Dallas



Source: The International Monetary Fund/Haver Analytics

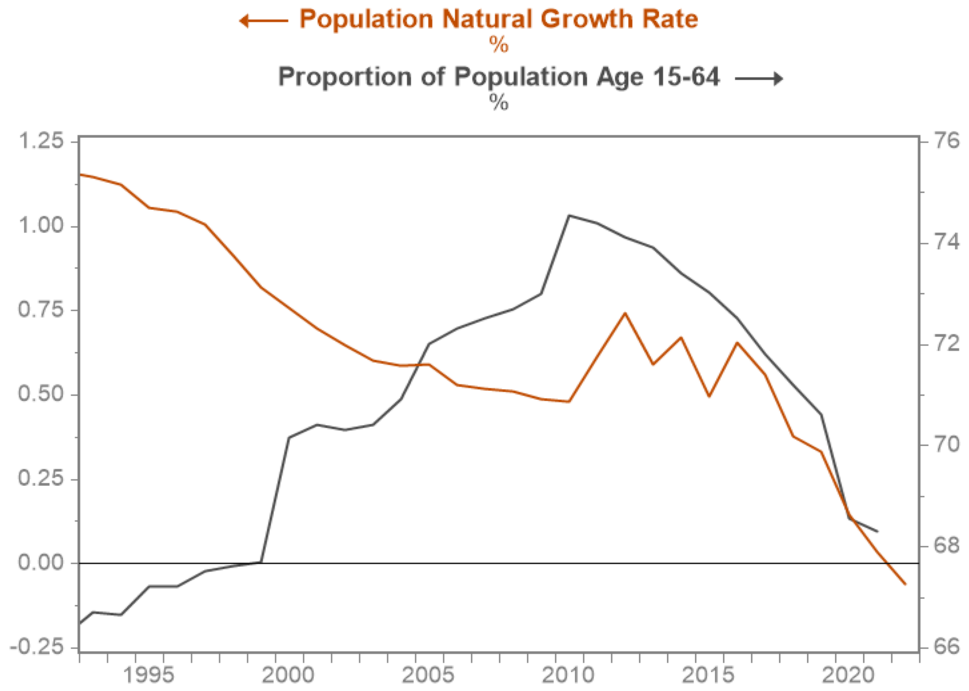
Unwinding China’s Excesses: How Long Will It Take?

- The history of unwinding excesses in Japan (1990s) and U.S. (following early 2000s) suggests a lengthy period of adjustment
- U.S.: debt-financed housing bubble in early 2000s (and complex derivatives facilitated by low rates) led to financial crisis and anemic recovery
- Japan’s asset price bubble of late-1980s fueled by low rates led to 70%+ collapse in Nikkei and RE, “lost decade” of on-and-off deflation and recession
- China’s unwind strategy: reductions in RE excesses, select debt bailouts and forgiveness; raise taxes; subsidize winners
- Challenges accentuated by China’s geopolitics and global isolation; declining FDI and imported technology, reduced supply chain exposures

Longer-Run Potential Growth Outlook Diminished

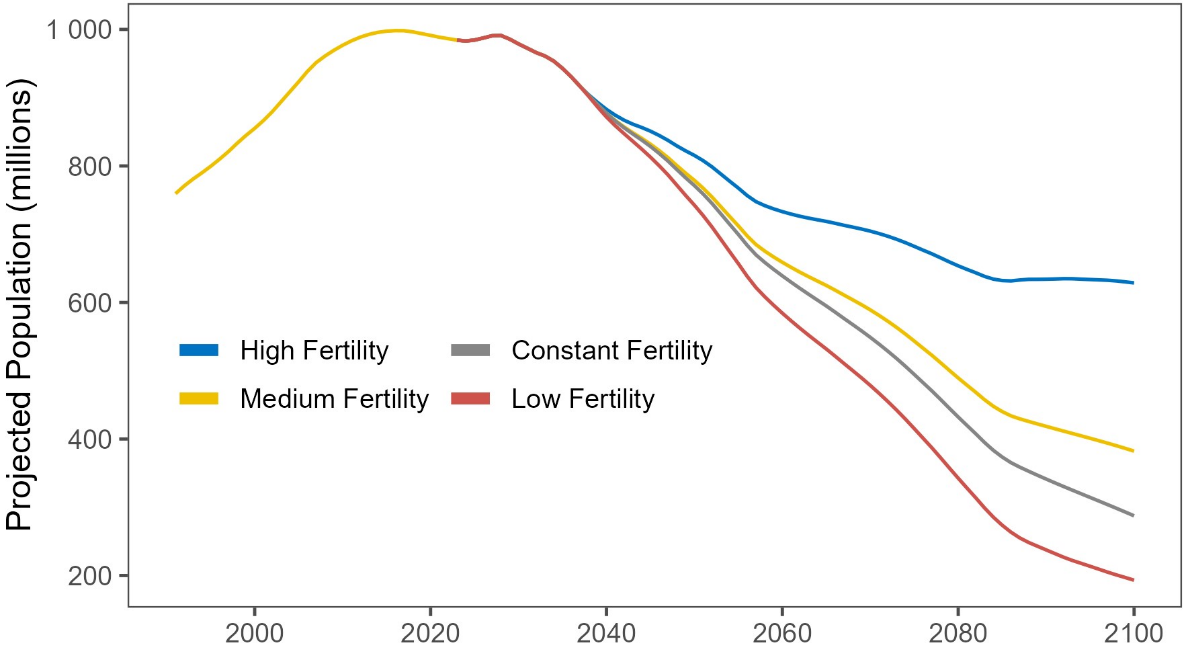
- **Fundamental factors: labor supply, capital and productivity (TFP)**
- **Labor force** and population are declining
- **Private investment weak:** slower growth trajectory; government investment misallocations
- **Productivity** gains suppressed by rising allocations to low productivity SOEs and government constraints on private innovators; declining FDI, joint ventures and inflows of technological knowhow
- Diminished potential growth and low probability that China will escape middle income trap
- China is *capable of* sustained high potential growth, but its socialist central control regime inhibits it

China’s Population and Labor Force Declining



Source: China National Bureau of Statistics/Haver Analytics

China Working Age Population Projections (15-64 Years Old)



Source: United Nations, Haver Analytics