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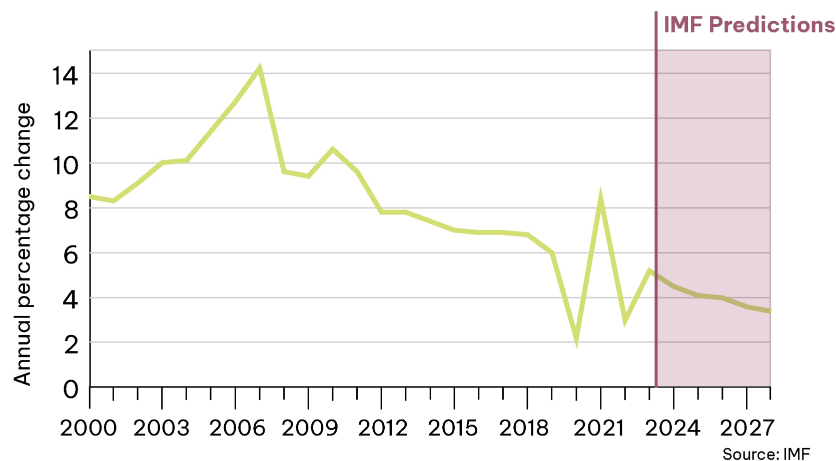
Summer Read: Four Scenarios for the Chinese Economy



Tough Economic Circumstances

China's economic numbers do not paint a pretty picture. The **International Monetary Fund**, **World Bank**, and **private sector** forecasters have lowered their 2023 and 2024 China growth projections to around five and 4.5 percent, respectively.

- The economy **grew** by just 0.8 percent in the second quarter of 2023 from the previous quarter, while inflation **fell** to 0.4 percent in June from 0.6 percent in May – prompting **deflation** concerns.
- Consumer confidence remains weak, with China's average household having **lost** 20 percent of its wealth in 2022 alone.
- The USD 65 trillion property sector is also heavily indebted. The amount of **outstanding** bonds held by developers has reached

USD 400 billion, and about one-third of those debts are **due** within the next eleven months. This is particularly noteworthy since property-related loans and credit **comprise** 41 percent of the assets in China's banking system. Meanwhile, China's overall private sector debt has **jumped** over 100 percent within the last decade.

- Looking to the future, the country continues to age, productivity improvements are slowing, and a distressingly high proportion of young **Chinese** citizens remain unemployed.

China's top policymakers have promised several **measures** to boost the economy, but these are almost surely insufficient.

Four Medium-term Scenarios

As a result, over the coming years, China's economic path is unclear. **The nation's economic fate may now be determined by a political process that has prioritized national security and state control over liberalization measures that would allow market forces to stimulate growth.**

Below, The Asia Group (TAG) examines four possible medium-term **scenarios** for China's decision-making and resulting economic growth path, ranging from most to least optimistic:

1. Meaningful **reforms** and rejuvenated growth.
2. Smaller reforms and some good luck in competitive sectors allowing China to **muddle through** with diminished but solid growth.
3. Insufficient reforms leading to **deflation** and consistent slow growth.
4. Outright **collapse** following a confluence of too many "grey rhinos" and "black swans" crowding together at one time.

The instinct of many prognosticators is to foresee the second, status quo scenario of muddling through. But based on our observation of Beijing's desultory economic policy decision-making trends, TAG assesses that **deflation is the most probable scenario** for China in the medium-term.

Naturally, the prospect of a prolonged Japan-style deflationary situation in China carries significant implications for both investors and geopolitical planners worldwide.

Scenario #1: Meaningful Reforms

Wrenching structural reforms would help improve the fundamentals of China's economy and enable it to emerge successfully from the "middle-income trap"– the dilemma described in economic theory where productivity growth starts to falter in an upper-middle income economy.

At such a stage in economic history, it becomes harder and harder for an emerging economy to diffuse rapid productivity gains throughout the economy, geographically and by sector – especially in a large and stratified economy like China's. It also becomes more and more difficult for the "middle-income trap" economy to capture the elusive aspects of systemic improvement that can fuel nationwide competitiveness gains vis-à-vis advanced economies.

Like Japan in the 1980s, China suffers from *too much* savings and investment, rather than not enough. Thus, reallocating state-owned enterprise (SOEs) assets to private firms, improving competition between SOEs and private firms, and unwinding the government's heavy-handed approach to technology and other sectors are all necessary to improve productivity.

Other critical reforms recommended by economists for China include rebalancing the allocative relationship between central government revenue and provincial government expenditure. Provincial governments bear more than eighty percent of obligatory expenditures, including medical and education spending. To meet central government economic stimulus mandates, local governments end up intervening in markets – including real estate – to capture rents and revenue. A permanent reallocation of broader revenue authority to provincial governments could address bottlenecks by encouraging local governments to depend less on real estate and divest from business ownership (which stifles innovation).

Additionally, China needs to substantially reform its property sector, primarily to reduce the investment-driven housing demand that has fueled the property bubble – in line with President Xi Jinping's oft-repeated **declaration** that "houses are for living in, not for speculation." **Offering** households alternative savings options beyond property, such as voluntary private-funded pensions, would reduce investment-driven demand. **Increasing** households' attractive savings options outside of property, and increasing the supply of affordable public housing and rental housing, could lower the relative attractiveness of private property. A recurrent property tax could also help curb speculative demand.

Finally, raising China's retirement age – which, at 60 years old for men and 55 for women office-workers, is among the world's lowest – would increase the country's labor supply and boost growth. Improving China's weak social safety net would also increase lower-income workers' willingness to spend, generating domestic consumption. Other reforms to spur consumption include raising China's minimum wage and relaxing policy restrictions on emerging sectors like fintech and the data-intensive internet-based services sector.

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China's decision-makers have shown little appetite for implementing bold reforms in the coming five-year period, suggesting that China’s best-case scenario – of extensive and meaningful reforms leading to sustained consumption-led growth – is **actually quite unlikely.**

Beijing is loathe to implement budgetary reforms that would lead to a diffusion of national government power. By retaining a high percentage of fiscal revenue, the central government keeps its debt

percentage-to-budget ratio low, which enhances its sovereign debt ratings. More important to Beijing, the retained revenue also provides resources for military spending and other strategic priorities.

In fact, China's top policymakers are moving in the opposite direction on SOE reform, seeking more control over the country's economy, particularly in critical sectors such as advanced technology.

Meanwhile, Beijing has not changed the retirement age since the 1950s – and any prospect of doing so remains unpopular in China. Policymakers and the public also oppose the kind of large-scale immigration needed to counteract demographic decline.

And while China's Politburo has **pledged** to improve the nation's social safety net, actually doing so will be difficult. To be effective, such reforms would require the participation of small firms and individual businesses across the country – not to mention several hundred million rural workers.

Scenario #2: Status Quo

In this scenario, China offers moderate fiscal and monetary stimulus that boosts consumer spending more than expected, and the country muddles through its current economic troubles and avoids a serious bout of deflation in the near-term, even without more meaningful economic reforms.

Bullish observers also point out that increased foreign purchases of items for which China dominates production – like electric vehicles (EVs) and solar panels – could drive a new expansion of manufacturing activity in the country. China-based firms produce cheaper high-quality EVs and EV batteries than their competitors. Even if these cars and batteries are not favored by top-tier Western economies, consumers in eastern Europe, Southeast Asia, the Middle East, and Latin America will find them attractive.

Under a status quo scenario, a resurgence of Chinese exports could boost capital inflows into China as multinationals scale up investment under the thesis that the "**next China is still China**." Meanwhile, Beijing could dabble in economic reforms that are minimally threatening to powerful stakeholders or Communist Party political imperatives, like steps to even out imbalances in the property sector. Any such steps would help create moderate sustained growth over the medium-term.

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This moderately optimistic scenario of muddling through, based largely on fiscal and monetary stimulus plus strong manufacturing performance, is **more likely than the first scenario of fundamental reforms.**

But China achieving above five percent growth consistently over the coming years would still depend on seeing some improvement in domestic consumption and related services sector investment. Absent

strong policies to support such improvement in private demand, however, the current trajectory of moderate fiscal stimulus is unlikely to overcome **sluggish** consumer confidence, which stems from deeper-seated concerns about the country's future.

Moreover, any scenario that relies on a resurgence in China's manufacturing also depends on a failure of Western efforts to diversify supply chains away from China. Governments across the West – which **hold** around 40 percent of the world's wealth – are rolling out industrial policies to produce EVs and solar panels at home or in friendlier countries, rather than rely on China. These efforts face some headwinds, but the national security framing of the issue suggests that the United States, European Union, and like-minded Indo-Pacific partners will eventually succeed to some degree in "de-risking" their supply chains by diversifying manufacturing beyond China.

Meanwhile, foreign investment in China looks likely to continue **tapering off**, given the confluence of investor-unfriendly policies in China such as the updated counter-espionage law, various investigations into foreign consultancies, and data security laws that prioritize national security over the economy. In addition to operational risks, geopolitical and reputational risks are also deterring foreign investors, even as China's government makes official statements and hosts events to court them.

Scenario #3: Deflation

China-focused macroeconomists increasingly believe that China's over-reliance on investment and savings presages a shift to a period of sustained deflation. This could be akin to the conditions that Japan experienced starting in the 1990s after its equity and property market bubbles burst, after which non-performing loans started bankrupting banks and securities companies.

Like Japan, China has sufficient wealth and political wherewithal to avoid a severely debilitating financial crisis or balance-of-payments crisis. But also like Japan, it could take many years for China to achieve sufficient structural reforms to pull out of a deflationary cycle once that cycle starts. With its political commitment to "socialism with Chinese characteristics," China seems quite likely to rely on mere Keynesian measures or monetary policy shifts to try to engineer growth, rather than questioning the weaknesses of its fundamental policy model.

In deflationary circumstances, consumers ratchet back on spending and begin paying back their debt. The resulting fall in prices prompts consumers to further postpone consumption despite low interest rates, further weakening the economy.

If China slips into deflationary conditions, productivity growth would falter even more than already anticipated, even as the country's working population keeps declining. The traditional drivers of growth in China – domestic and foreign investment in manufacturing – would also weaken.

As for which trigger could set off deflation, China's debt – currently around 280 **percent** of GDP, a higher proportion than that of either Japan or the United States – seems almost certain to eventually weigh down the economy with "**zombie**" firms and un-payable loans. A drop in housing prices therefore seems inevitable, even as many of the loans owned by SOEs and property developers default.

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Given the current state of China's economy and Beijing's opposition to meaningful structural reforms or even large-scale Keynesian stimulus due to concerns about the country's ballooning debt, **TAG assesses that a deflationary scenario is the most likely of the four outlined in this memo.**

In the near-term, China's top policymakers may provide enough stimulus to avoid a technical recession, but not enough stimulus to avoid a continued slowdown. The government's fear of expanding credit when it is already over-leveraged, coupled with the inability to boost domestic demand, will thus produce a period of prolonged deflation and still lower consumption and borrowing.

This would hurt foreign firms selling luxury goods or other non-essential products and services such as certain electronics and tourism. The impact on firms producing goods in China for foreign markets would probably be less severe. Foreign firms following a "**China for China**" production strategy would face consumption pressures.

Deflation also carries risks for the economic performance of countries that remain reliant on China-bound exports, including France, Italy, Japan, Germany, South Korea. The U.S. economy is more diverse and has stronger fundamentals, but a severe slowdown in China's consumption would also likely weigh negatively on U.S. economic growth.

Scenario #4: Collapse

Some analysts **argue** that China's economy is already in a much worse state than is being reported and will further weaken, largely driven by a declining property sector. In this scenario, China's accelerating and underestimated demographic decline would bring about a major property sector crisis – with fewer new sales, unused existing stock, and a huge collapse in value degrading the wealth of a significant proportion of the population, whose wealth is largely held in property.

The ensuing property crisis, combined with persistently high youth unemployment, would represent an unraveling of the bargain the Communist Party has made with its people: that the population could prosper economically if they stayed out of politics. In such an event, China's economy would become so bad that it sparks a rebellion of the nation's citizenry, resulting in a Soviet-style regime **collapse**, which would be followed by a sharp economic decline pending a reconstitution of stable governance.

TAG Take

TAG considers this scenario the least likely of all four in this memo. China's top leaders have **studied** the collapse of the Soviet Union and concluded that the way to avoid such a scenario is to improve the welfare of the country's average citizens – suggesting that if China's political stability began to rapidly deteriorate, Beijing would overcome its opposition to large-scale reforms and stimulus to offer some kind of support.

Examples would include monetary stimulus in the form of deep interest rate cuts to increase investment, a steep depreciation of the Chinese yuan to levels that could still drive export growth in the face of slowing global demand, and fiscal stimulus through consumer cash distributions that – while controversial – would drive consumption if applied aggressively in combination with other approaches.

Such measures all carry long-term downsides, such as increasing debt levels, fueling inflation, and prompting retaliatory actions by other trading nations. But China's top leaders would deem these risks acceptable in the face of social unrest.

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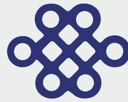
*This report was prepared by **Charles Dunst**, **Kurt Tong**, and **David Hathaway**.*



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