SPECIAL REPORT

# China's Economy After the Pandemic

GPF GEOPOLITICAL FUTURES

# China's Economy After the Pandemic

by Geopolitical Futures

The past few years have been the ultimate stress test for the Chinese economy. Even before the pandemic, China had, by its standards, relatively dim expectations for 2020. Its economy had entered into a long, structural slowdown as the growth model that propelled its extraordinary rise beginning in the 1990s proved less sustainable. Along with the mess it made responding to the 2008 global financial crisis, this forced China's leaders to adopt a series of painful deleveraging and financial "de-risking" measures at the expense of growth. Also weighing on the economy were that still-unresolved trade and tech war with the U.S., demographic change, financial uncertainty after the takeover of Hong Kong and countless other potential triggers for a real crisis.

When the COVID-19 outbreak finally got the full attention of China's leaders in January 2020, they shut down the bulk of the country's economy quickly and ruthlessly. And as the epidemic turned into a pandemic, China's hopes of a swift recovery seemed to disappear as Western customers stopped importing its goods. For a moment, it appeared as though Beijing might finally face the economic reckoning it had feared for so long.

The moment never came. By the summer, the Chinese economy had regained its footing. By the third quarter, it had become the first major economy to grow again. By the end of the year, it was in the green. The prospect of an economic crash leading to mass unrest in the streets – the Communist Party of China's foremost fear and thus its chief motivator of policy choices – never materialized.

As a result, Chinese leaders appear more confident than ever in their ability to steer the country safely through existential challenges – and have grown even louder in their advocacy of the muscular state capitalism implemented by President Xi Jinping. Much of the West is left wondering if China has indeed stumbled upon a foolproof economic model that makes its growth in power and influence unstoppable. In truth, China is merely back to where it was before the pandemic: ascendant, defiant and incapable of shaking the fear that an economic reckoning is just around the corner.

## China's Many Economic Problems

China's incomparable growth over the past 40 years has been fueled by three things: cheap exports, investment, and the one-time gains of land and resource privatization and urbanization. This is the standard blueprint for developing economies, which take advantage of low wages to piggyback off growth in wealthier countries by undercutting their industries and profiting off their voracious appetites for consumption.

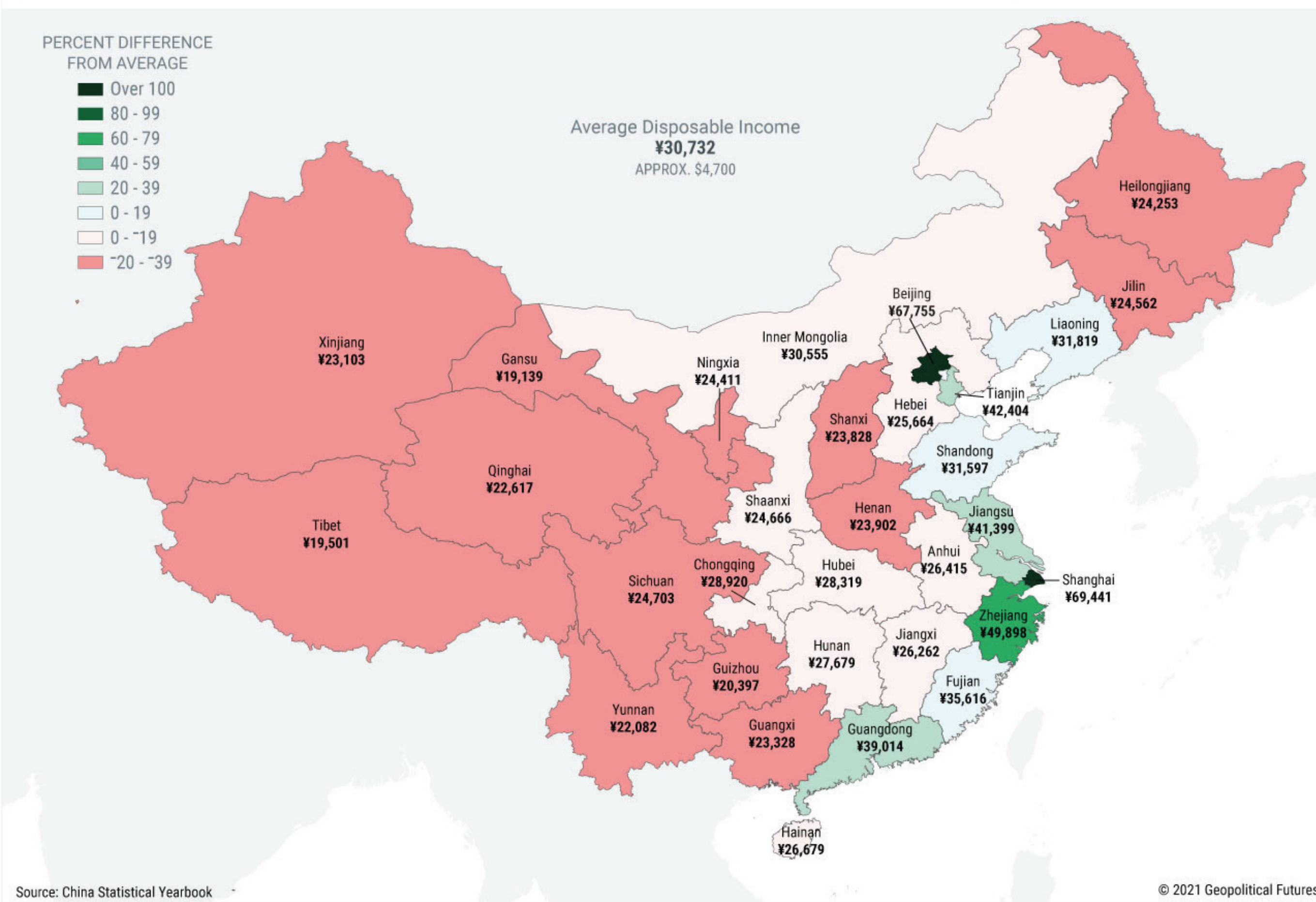
Exports have been particularly important for China, especially since joining the World Trade Organization in 2001, reaching as high as 64 percent of GDP in the mid-2000s. China was able to basically copy the industrialization model pioneered by powerhouse neighbors like Japan, South Korea and Taiwan and then turbocharge it, thanks largely to its having the world's largest labor pool. But there are two overriding problems with a dependence on cheap exports.

First, China's ability to sustain its economy depended too much on economic conditions outside the country. China is beholden to its customers, most of them located in distant markets, none of them immune to their own periodic downturns in consumption or protectionist social pressures. If the U.S. or European economies crashed, China's might well be next. Following the crash of the U.S. economy in 2008, for example, Chinese exports fell off a cliff – including by a record 26 percent year over year in February 2009. That January, the Chinese government estimated that 20 million migrant workers had lost their jobs in 2008 because of the global slowdown.

Second, the wealthier China becomes, the more difficult it becomes to sustain this export-heavy model. Rising standards of living push wages up, making Chinese exports less competitive and giving foreign firms in the country cause to look to lower-cost alternatives. China wants to accommodate these changes by moving into high-tech, higher-value exports, but here it faces competition from countries that climbed the value ladder decades ago – and, more recently, targeted measures by these countries meant to curb China's rise as a technological powerhouse. This is known as the middle-income trap – something China is desperate to avoid. The challenge for China has only intensified as its neighbors in South and Southeast Asia have modernized their own manufacturing and export infrastructure.

China has been laboring to rebalance its economy to depend more on domestic consumption for growth. And it's made great strides in this regard. Consumption as a percent of GDP has crept up over time, albeit in fits and starts. Per capita GDP has risen more than 1,000 percent since 2000, after all. China is expected to have the largest consumer market anywhere in the world by the mid-2030s. Standards of living in China's wealthiest regions, especially the tech and export powerhouses along the southeastern coast, are for tens of millions of residents little different than what one would find in Tokyo or Seoul. But much of interior China is still very poor, which limits the purchasing power of the domestic market as a whole. Hence why China's per capita GDP still ranks just 79th in the world, behind countries such as Iraq and Cameroon. China's unusually high household savings rates and the sky-high costs of homeownership in most Chinese cities further dampen domestic consumption. There's evidence that younger generations of Chinese are starting to reject the parsimony of their parents, as measured by rising household and credit card debt levels. (These same generations – most of them coming from one-child families – are going to be responsible for caring for China's elderly more than in countries with higher birth rates, so it's hard to see Chinese household spending reaching Western levels anytime soon.)

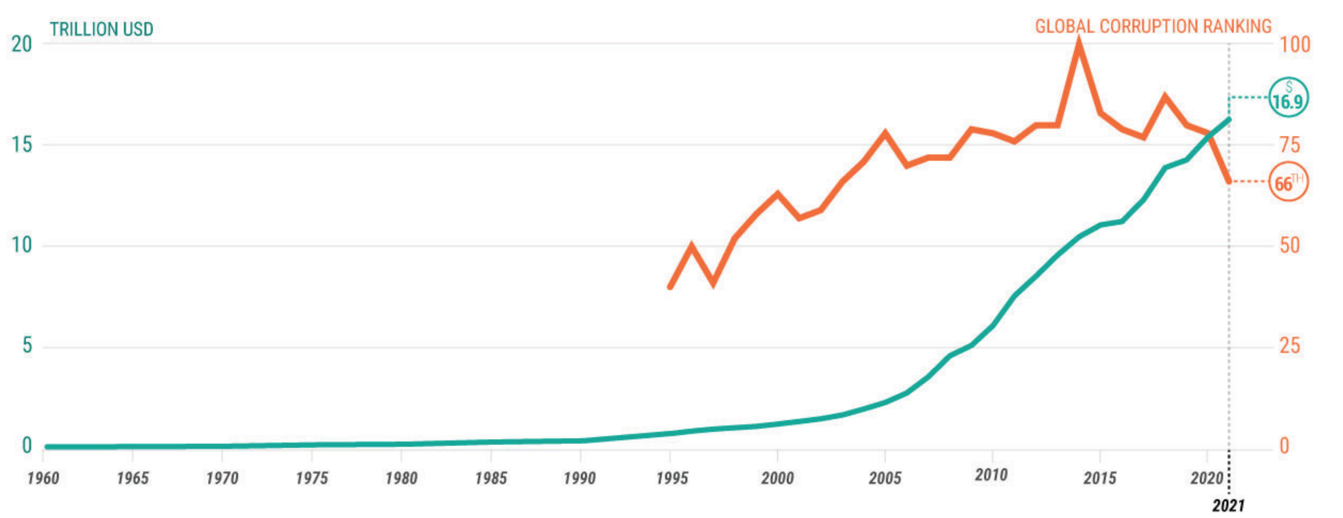
Per Capita Disposable Income by Administrative Division - *2019*



To sustain its breakneck growth, particularly during periods when demand for Chinese exports has cratered, China has become excessively dependent on investment, most of which comes from state banks and local governments. This has enabled Beijing to keep the economy humming amid global downturns in consumption and keep employment generally steady. The firehose of fiscal stimulus and credit Beijing opened up in late 2009 enabled China to bounce back from the crisis much quicker than most of the West and keep growth relatively stable ever since. The extraordinary amount of money it has pumped into public goods like infrastructure and things like research into next-generation technologies has also helped make China irreplaceable as a manufacturing powerhouse in many industries, with no other country capable of coming even close to matching its efficiency and bottomless, increasingly well-trained labor pool.

China GDP Growth Rate and Corruption Perceptions Index



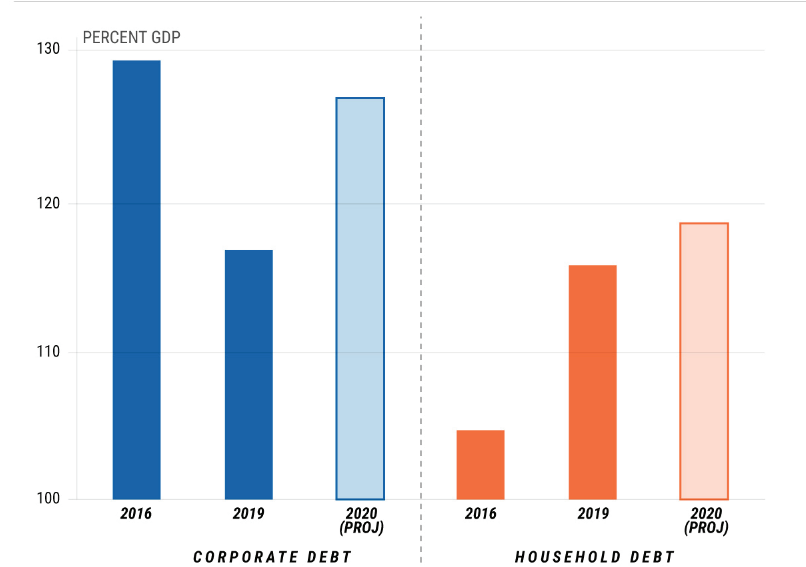

Sources: Transparency International, World Bank



But keeping the Chinese economic system perpetually swimming in cash has created other dangerous problems. It has resulted in a system that's awash in cheap credit and without enough productive places to put it. An enormous amount of this investment inevitably gets wasted, and it has become more and more difficult for China to get the same bang for its buck over time. Between 2008 and 2016, for example, the amount of credit required to increase China's GDP by 1 percent more than tripled, according to the International Monetary Fund. Chinese authoritarianism has hurt productivity, too, as state banks and local governments typically prioritize funding projects they think will conform with the Chinese Communist Party's wishes (and thus those that are most likely to be guaranteed by the state, should the investments go bust), rather than based on more standard risk/return calculations.

This has led to industrial inefficiency, widespread unprofitability and any number of distorted incentives up and down the Chinese system. It has also generated any number of other major headaches such as wildly inflated real estate and land bubbles, and has saddled firms, banks and local governments with unsustainable debt loads and ever-more burdensome debt repayment obligations. Put simply, the Chinese economy is littered with ticking time bombs. No country in history has amassed so much debt so quickly as China has without succumbing to a financial meltdown, according to the World Bank. So long as China's economy was galloping ahead at double-digit growth, with enough cash to paper over inefficiencies and the country's immature system for pricing risk, the chances of an uncontrollable financial crisis were low. But with China now facing a long, gradual structural slowdown, it's reasonable to believe the country cannot outrun its debt problems forever.

China: High and Rapidly Rising Private-Sector Debt Levels




Note: Corporate debt includes external debt but excludes debt of Local Government Financing Vehicles (LGFVs).
Sources: IMF, Haver Analytics



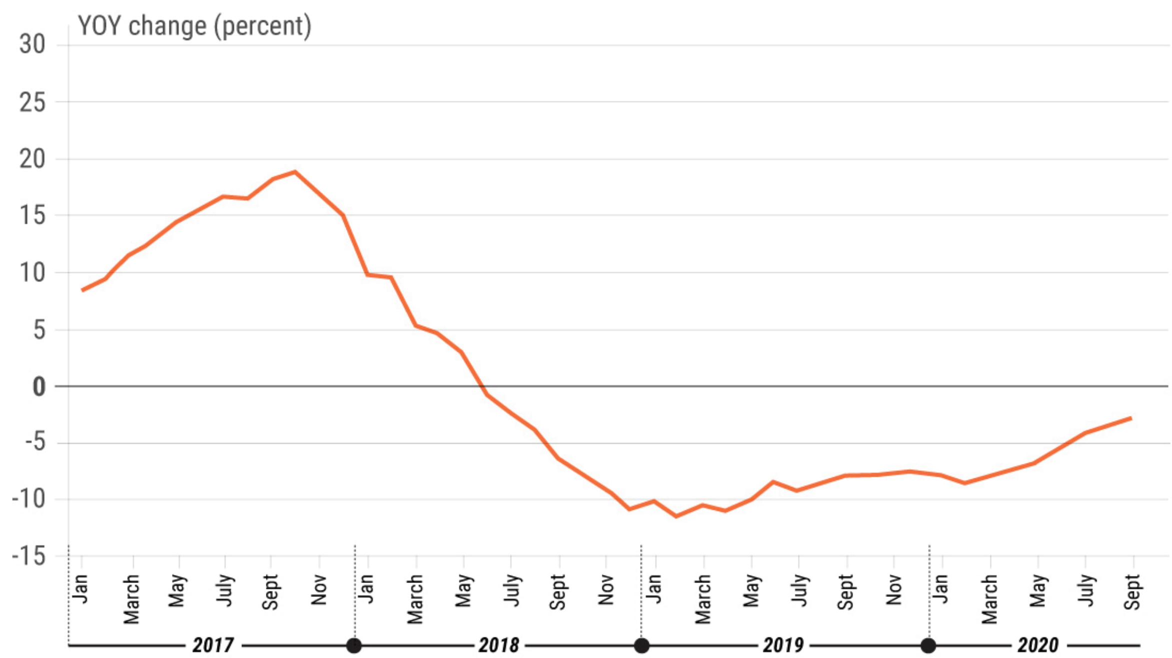
# Slowdown or Shock

What Beijing cares about most is stability. It cannot avoid a structural slowdown. Its investment-led growth model will inevitably require ever-higher levels of credit to achieve returns, but with some pluck and some luck, it may be able to guide the economy to a soft landing – at least that's what Beijing hopes. And so long as the slowdown happens gradually, it thinks it has the tools to handle the political risks of stagnation. In other words, it can intervene selectively to rescue firms or banks that are "too big to fail," use state-owned enterprises and pressure on factory owners to soak up excess labor, use state banks to metabolize toxic assets and shift debt around, and intervene selectively to stabilize property markets. And where it deems it prudent to let economic forces run their course, it can crack down on any social unrest that may result from layoffs, declining property values and so forth. What Beijing fears most is a shock – whether triggered by an external bubble or by a rupturing of any one of its interconnected internal socioeconomic fault lines – that sows panic, overwhelms its ability to respond, and exposes the inherent rigidity and clumsiness of its tightly centralized system.

There have been several close calls, particularly since 2008. There was an interbank lending crisis in 2013, a stock market crash and surge of capital flight in 2015, a peer-to-peer lending bust in 2018, a liquidity crisis and, by China's standards, an alarming string of bank failures in 2018-19. As a result, Chinese leaders have been acting with a sense of urgency to address financial risk that, in most countries, is typically seen only after a blindsiding financial meltdown has begun.

In 2017, President Xi Jinping elevated financial stability to the level of national security in terms of the Chinese Communist Party's priorities. His administration has attempted to implement a suite of ambitious de-risking reforms, many of them painful, coming at the expense of short-term growth to the point where China was facing a substantial slowdown in 2021 even if the pandemic hadn't struck. These have included overhauling the regulatory apparatus, sending anti-graft authorities after wayward officials and tycoons, and hammering local and provincial governments and banks to clean up their books and to curb "shadow lending" practices. It also gave the central bank free rein to tinker with the system in search of an elusive balance between liquidity and control.

Shadow Bank Financing




Source: People's Bank of China

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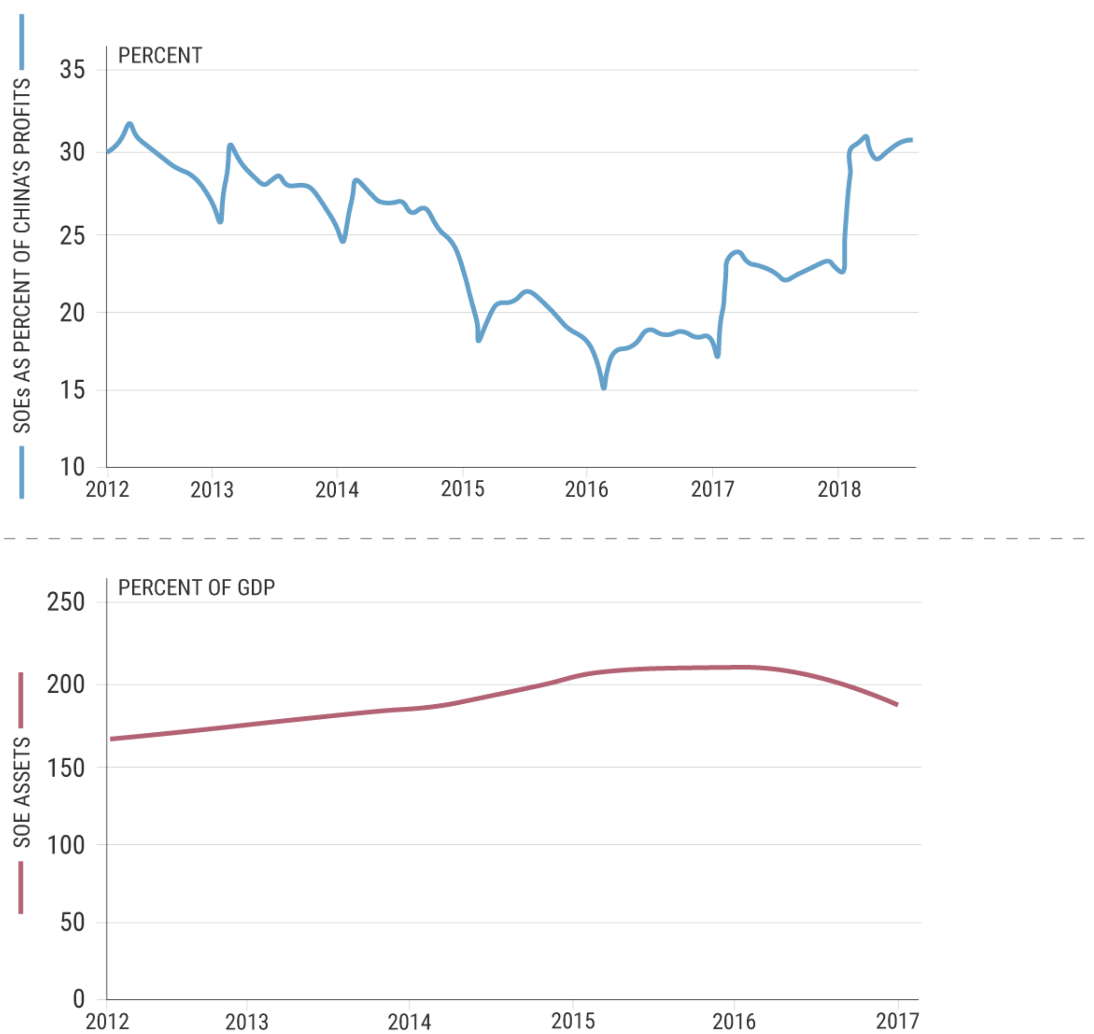
But this effort has been bedeviled by two chronic problems, both a result of Beijing's insistence on maintaining a state-centric system. One is a distorted banking system that's heavily incentivized to focus on the needs of China's more than 150,000 state-owned enterprises (the bulk of which are owned by provincial and local governments) and projects that banks suspect will be prioritized by the party at the expense of everything else. Consequently, the system is not particularly good at pricing risk or distributing credit to areas of the economy that don't have implicit state backing. It's particularly bad at meeting the needs of households and small and medium-size enterprises, which tend to have scant credit histories or assets available for collateral but which now make up the overwhelming share of employment in China. This forces businesses and cash-strapped local governments to seek funding via shadow lending vehicles (the opacity of which makes Beijing nervous) and households to rely on things like peer-to-peer lending platforms (the volatility of which makes Beijing very nervous as a potential source of social upheaval).

State-Owned Enterprises in China




Sources: Bloomberg, CEIC, SASAC

All this forces regulators to tread carefully when implementing new de-risking measures. Move too far, too fast, and the private sector may face a credit crunch, as it did in 2018 and 2019, and China's cherished growth may grind to a halt. Move too slow, and household savings – the great stabilizer and safety net of the Chinese economy – may fall away, speculative real estate bubbles may pop, and any number of interlocking fault lines may rupture at once.

The other core problem is moral hazard. Given Beijing's existential fear of unemployment and social unrest, lenders and investors understandably assume that the state will more often than not come to the rescue if things go sideways and pose systemic risk. Beijing also realizes that if people think that the state is guaranteeing their deposits or investments, and the state doesn't live up to its promise, people are likely to direct their ire not at poorly run banks or companies but at the state itself. Naturally, this encourages all sorts of risky lending and investment activity. This is particularly the case with state-owned enterprises and state banks. Beijing sees such entities as invaluable tools for soaking up surplus employment and funding or carrying out projects prioritized for social development or diplomatic goals, as well as for brokering factional peace and deepening dependence on the party's goodwill. It is willing to tolerate unprofitability and inefficiency in the state sector to secure these ulterior goals. Local governments, meanwhile, rely on the state firms they control to get around regulatory constraints and meet employment and growth targets set from above.

Regulators may grouse about the state sector's profligate ways, but they've generally been unwilling to expose it fully to market forces and leave state banks on the hook for losses. The handful of times they've tried, things have gone badly. The closest China has come to having its own Lehman Brothers moment was in June 2013, when Beijing briefly declined to intervene following a technical default between two small banks. This sent interbank lending rates soaring, grinding lending to a halt and sparking a liquidity crisis that began to spread into the rest of the economy. Beijing quickly backed down, and the merry circus continued.

Thus, heading into the pandemic, China was in a race against the clock to put its economy on sounder long-term footing – before Western economies crashed again, and before its internal debt loads and asset bubbles triggered a crisis it simply wouldn't be able to contain – to move the economy away from low-cost exports and investment and toward domestic consumption, high-value manufacturing and services. And in late January 2020, when the scale and gravity of the coronavirus outbreak in Wuhan finally dawned on China's leadership, the clock appeared to hit zero.

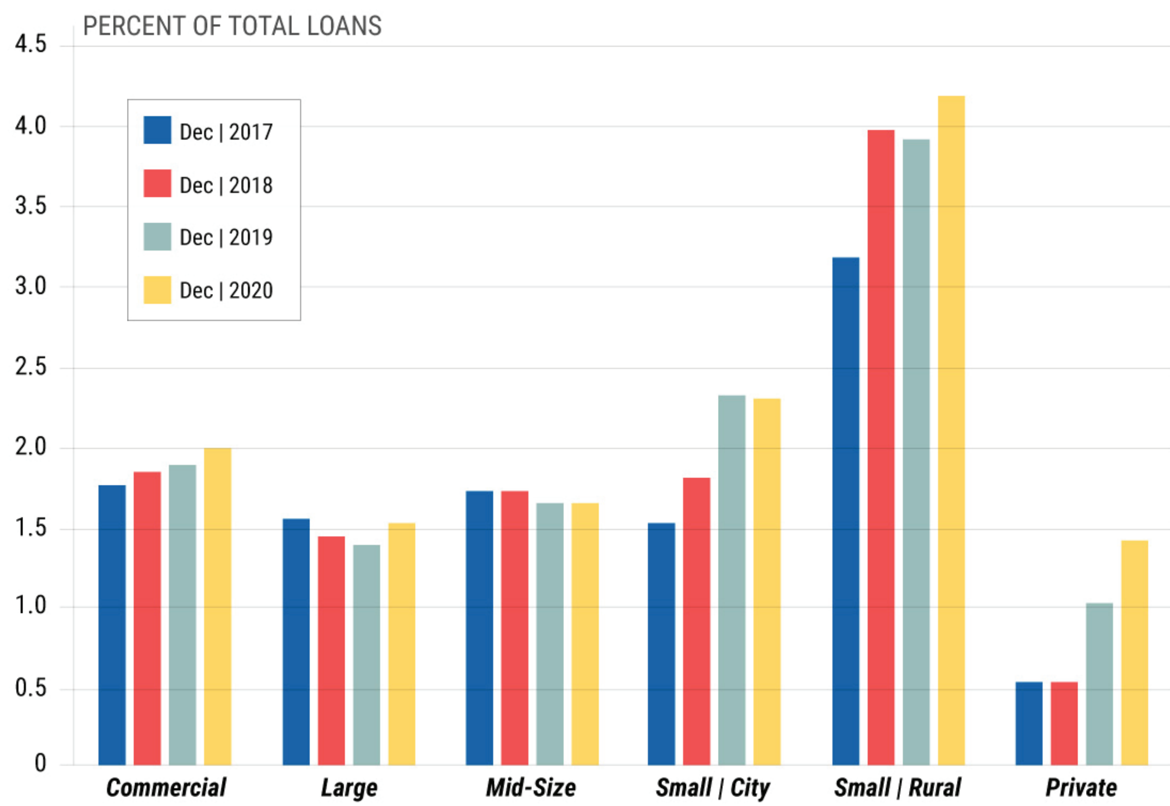
## COVID Crash, COVID Revival

The systemic shock from the pandemic could have exposed China's economy as a house of cards. China shut down the bulk of its domestic economy almost overnight. Countless small businesses – which were already weighed down by tariffs and the credit crunch before the pandemic – faltered, searching for rescue from an immature banking system that had already proved ill-suited for meeting the needs of China's burgeoning private sector. China's convoluted financial system, already lousy with shadow lending and toxic loans, seemed to be on the brink of collapse.

GDP contracted by 6.8 percent in the first quarter year on year, forcing Beijing to scrap its cherished annual growth target for the year. Industrial production contracted 13 percent. There was barely a dent in China's official unemployment rate, but this rate is among the more useless official figures published

China: Rising Bank Nonperforming Loan Ratios, Especially for Small Lenders




Sources: IMF, CEIC



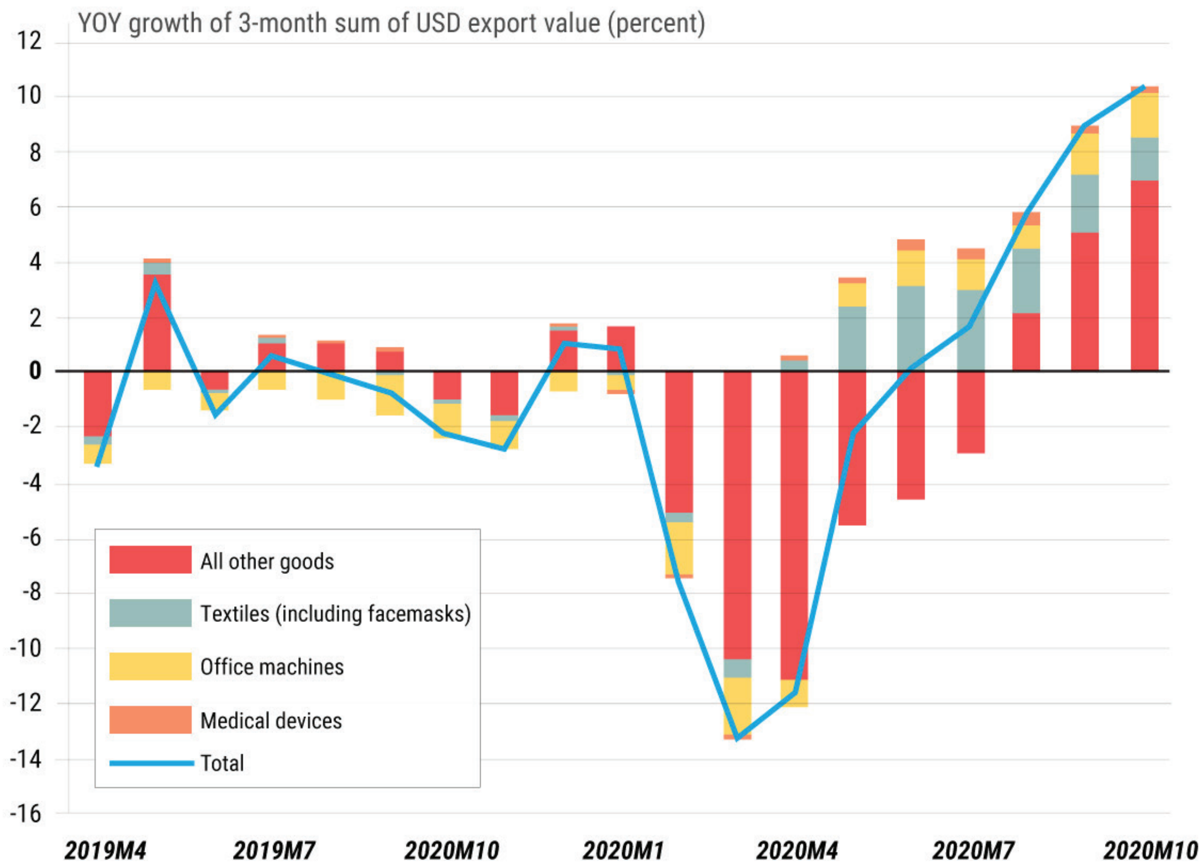
by the National Bureau of Statistics. Based on informal metrics such as surveys and the number of postings on job boards, the true unemployment rate in the spring months likely reached as high as 20 percent. Close to half a million businesses closed their doors at least temporarily in the spring, including one in six self-employed ones. Even when Beijing was able to reopen most of the economy, moreover, it faced a secondary crisis in the form of the prospect of collapsing demand for Chinese exports as the rest of the world's economies shut down.

So how did China bounce back to growth so quickly and avoid a systemic meltdown? Three factors, in particular, explain much of it. One is the fact that, after its initial missteps, China was relatively successful in containing the coronavirus and preventing it from becoming the sort of never-ending drag on economic activity that Western countries have experienced. The vast majority of the economy was fully back online by June, even in the epicenter of the crisis in Hubei province.

Second, China's main buyers in the West themselves proved far, far more resilient to the pandemic than just about anyone could have anticipated in the spring. To be sure, the pandemic has wrought enormous economic damage to countries across the globe, rich and poor, and the true extent of the damage won't be understood for years to come. But as societies adapted and learned how to navigate the crisis, it quickly became clear that the economic damage was extremely uneven within countries. While service sectors like travel and hospitality were slammed, most white-collar sectors weren't; by the summer, for example, employment in high-earning U.S. sectors had almost fully recovered. What they weren't spending on travel or eating out, they were spending on work-from-home gear. China makes a lot of that stuff. It also made a whole lot of masks and other medical equipment that suddenly everyone was stockpiling. There have been countless anecdotes over the past year of Chinese furniture or shoe or paper factory owners retooling their operations on the fly to start pumping out masks by the shipload. The data backs this up. From April through July, textiles, office machines and medical devices accounted for nearly all the growth in Chinese exports, and they remained strong through the end of the year. In the fourth quarter, total Chinese exports of goods reached a healthy $281 billion, compared to just $80.4 billion in the first three months of the year.

Third, China quickly pushed out a slew of stimulus measures to get liquidity to small and medium-sized enterprises (SMEs) without resorting to the lending free-for-all it did after 2008. For example, it reduced interest rates and redoubled its efforts to encourage banks to lend to private SMEs, which make up roughly 60 percent of the Chinese economy, plus around 80 percent of Chinese jobs. Beijing also cut taxes and pension

China: Export Rebound Driven by Pandemic-Related Goods




Sources: IMF, CEIC

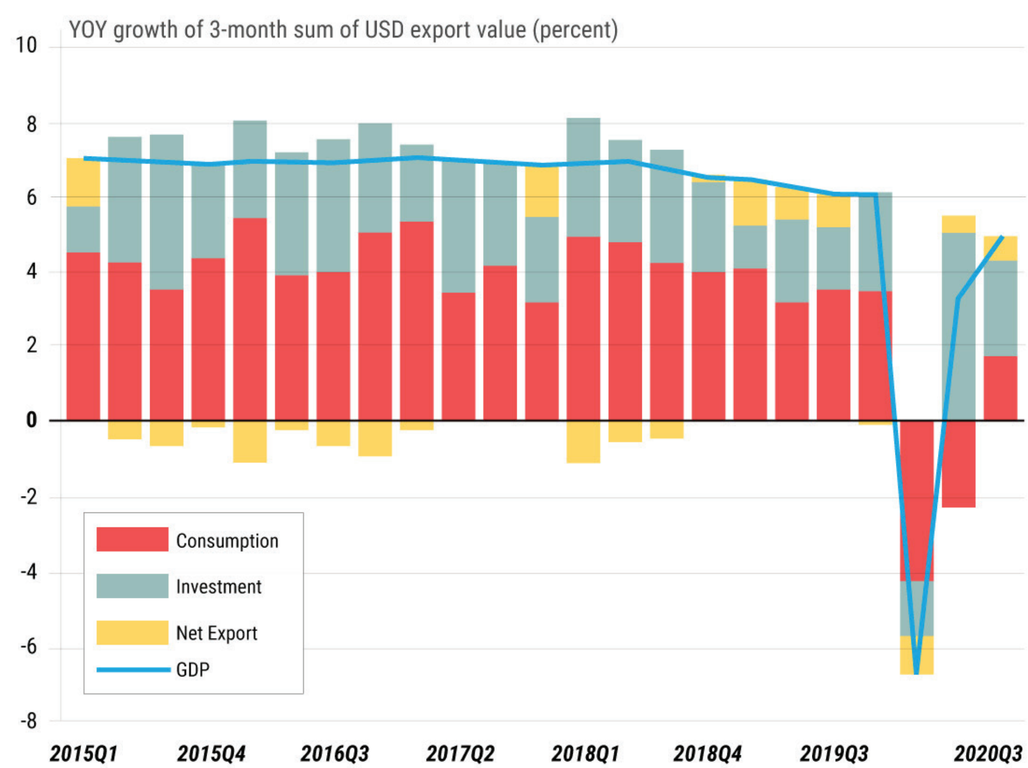


contribution requirements. In a survey conducted in the spring of 2020, nearly a third of respondents said they couldn't last more than a month on their current savings, and by the fall an estimated 18 percent of SMEs closed for good. Notably, though, just around 15 percent of SMEs reported seeing any of the 1.5 trillion yuan ($230 billion) in financial support Beijing had earmarked for them. This suggests that, compared to state-owned firms and private sector giants, SMEs remain ill-suited to survive the cash crunch that results from a crisis. Nonetheless, the work resumption rate topped 90 percent in nearly every major sector by May 2020, and there's little evidence that major job losses persisted into the summer and fall. (It probably helped that the epidemic overlapped quite a bit with the Lunar New Year holiday season, when many businesses shut down or operate at reduced capacity anyway until workers return from their typically weekslong holidays.)

## Victory in the War on Financial Risk?

Ultimately, there was a huge shock followed by a huge rebound in two of the three major drivers of Chinese growth. (Consumption continued to lag exports and investments through 2021.) And so the most important question remains: Given the depth of the initial shock, why didn't it trigger a meltdown? Did the fact that China survived the shock suggest the financial system is more resilient than expected? Or was the shock just too brief and the rebound too strong to draw any firm conclusions about the success of China's war on financial risk?

China: V-Shaped Recovery Driven by Investment While Consumption Recovers More Slowly




Sources: IMF, CEIC

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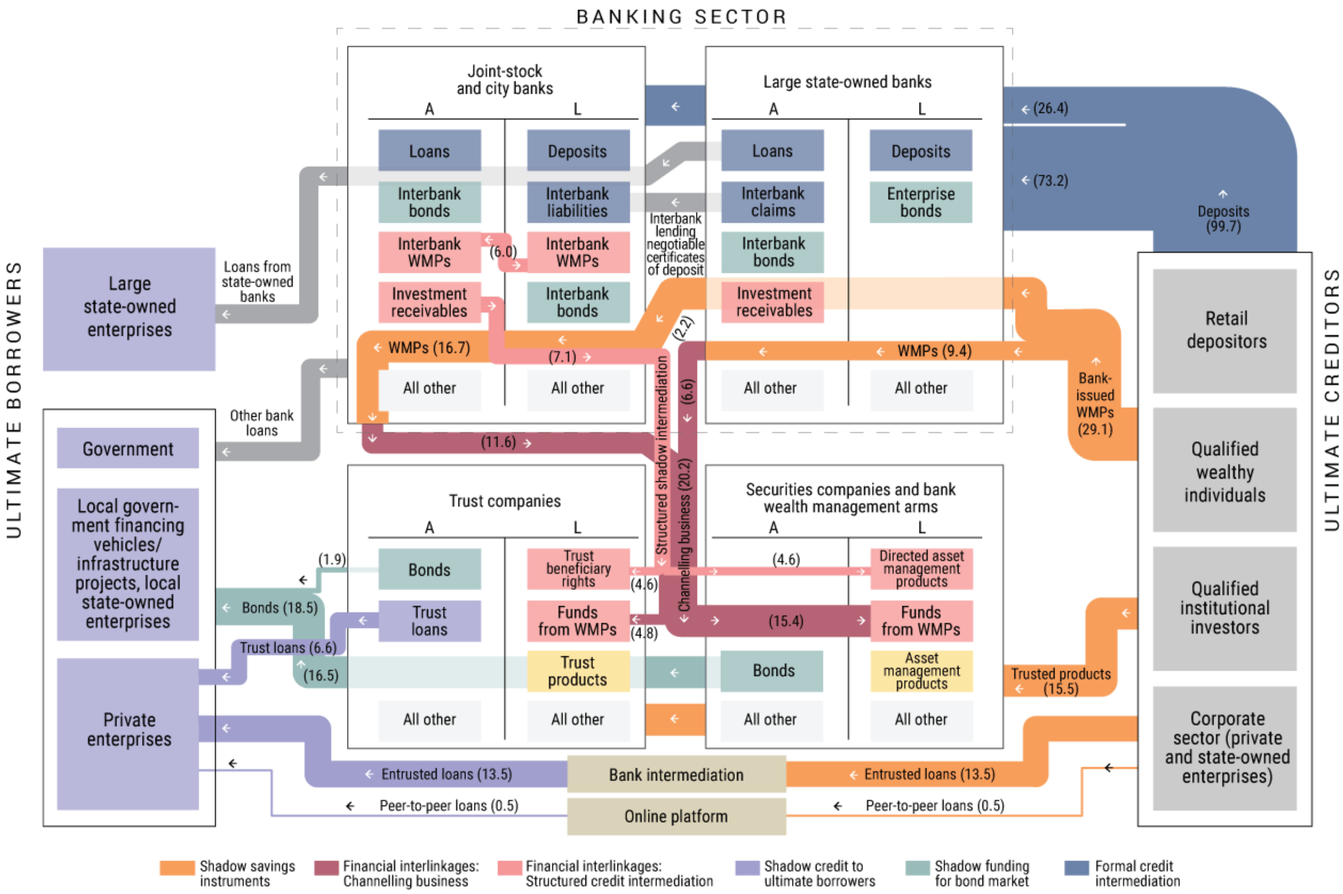
It's become increasingly clear that for all its inefficiencies the Chinese model has quite a bit of advantages, some of them unique to authoritarian and/or state-dominated systems. There is, of course, Beijing's ability to act relatively swiftly and decisively in a crisis. It can go nuts on stimulus or relax regulations or halt stock trading or stem capital outflows without having to have a drawn out fight in a legislative body. Its authoritarian model also gives it the means to control media narratives about a crisis to some degree, which can come in handy in taking the air out of a panic. Critically, its ability to tightly control the country's capital account – combined with the high savings rate and comparably limited availability of alternative investment mechanisms – ensures a relatively stable deposit base for banks.

It's also safe to say that Xi's approach to reform is paying off, at least a little. His power is typically overstated, but his administration has been uniquely capable of putting the fear of Xi into unscrupulous regulators, entrenched interests and sclerotic agencies opposed to some of the painful reforms introduced in recent years. It would have been much more difficult for his predecessors to attempt his overhaul of the state bureaucracy in 2018 – which included most of the country's financial regulatory apparatus – let alone succeed.

Finally, credit where it's due: China's leaders were proactive, creative and steadfast in pushing through painful de-risking reforms ahead of the crisis. Its leaders were able to learn much from Japan's collapse in the 1990s and South Korea's woes in the 1997 Asian financial crisis and the 2008 crisis and tweak their system accordingly. Some reforms, for example, like Beijing's moves to cut down on rampant shadow lending and risky investment products, brought a much-needed degree of transparency to the financial system and the country's debt loads. Informed by Washington's experience in 2008, Beijing has learned that high debt loads can be managed, but that not knowing how much debt there is, and where it's located, can be cataclysmic.

## Mapping China's Shadow Banking

*Structure of Claims, 2016*




Source: Bank for International Settlements

Graphic design by Geopolitical Futures

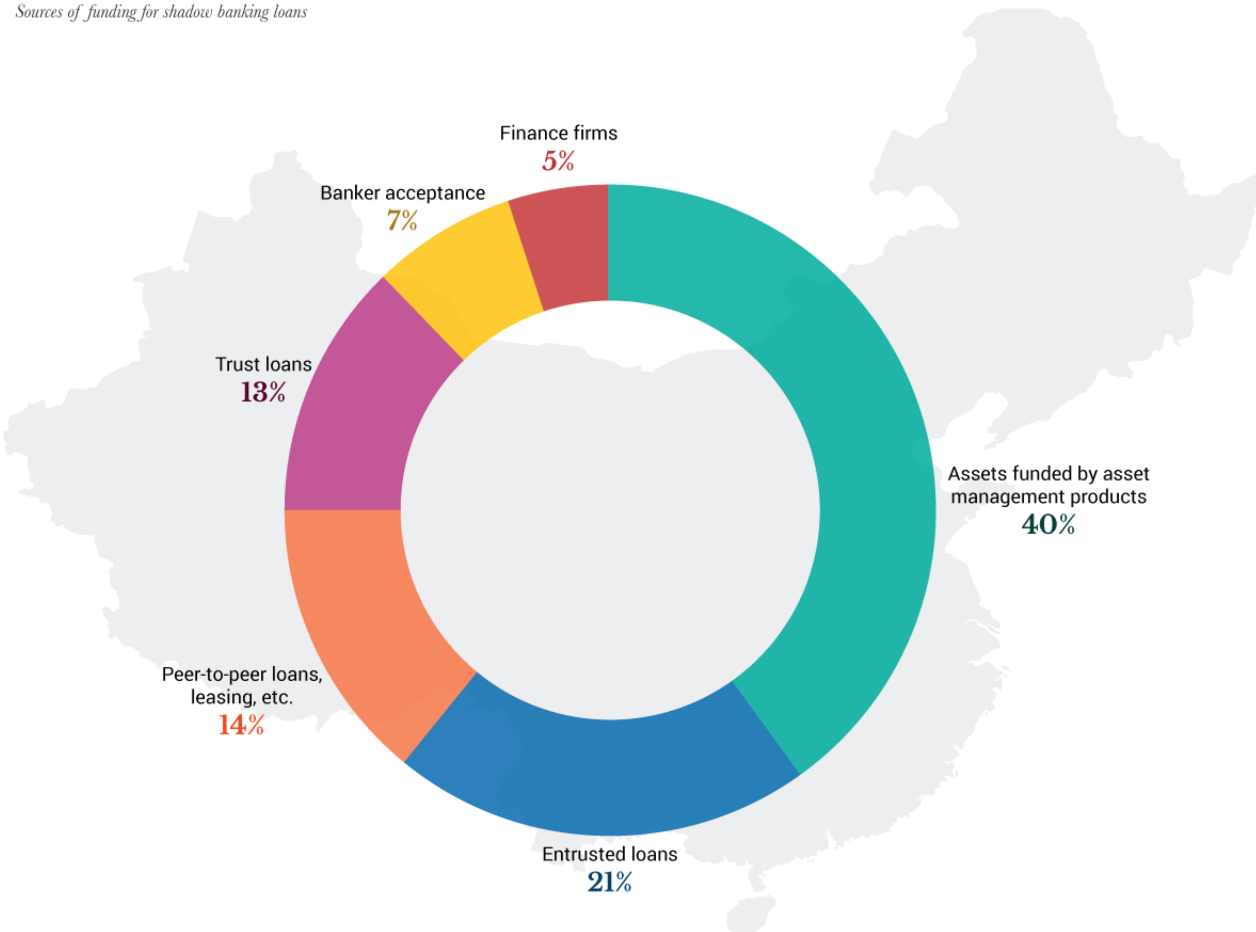
Reform under Xi has been neither pretty nor efficient, and China continues to operate in flagrant defiance of conventional economic wisdom. Conventional economic wisdom, however, has been coming under intense scrutiny over the past decade across the world, particularly in regard to the ability of governments, under the right conditions, to carry staggering debt loads without paying much of a price. Modern monetary theory has gone mainstream with astonishing speed.

China is by no means out of the woods. Its leaders are still behaving as if the next crisis is perpetually just around the corner.

China's $10 Trillion Shadow Maze

*Sources of funding for shadow banking loans*



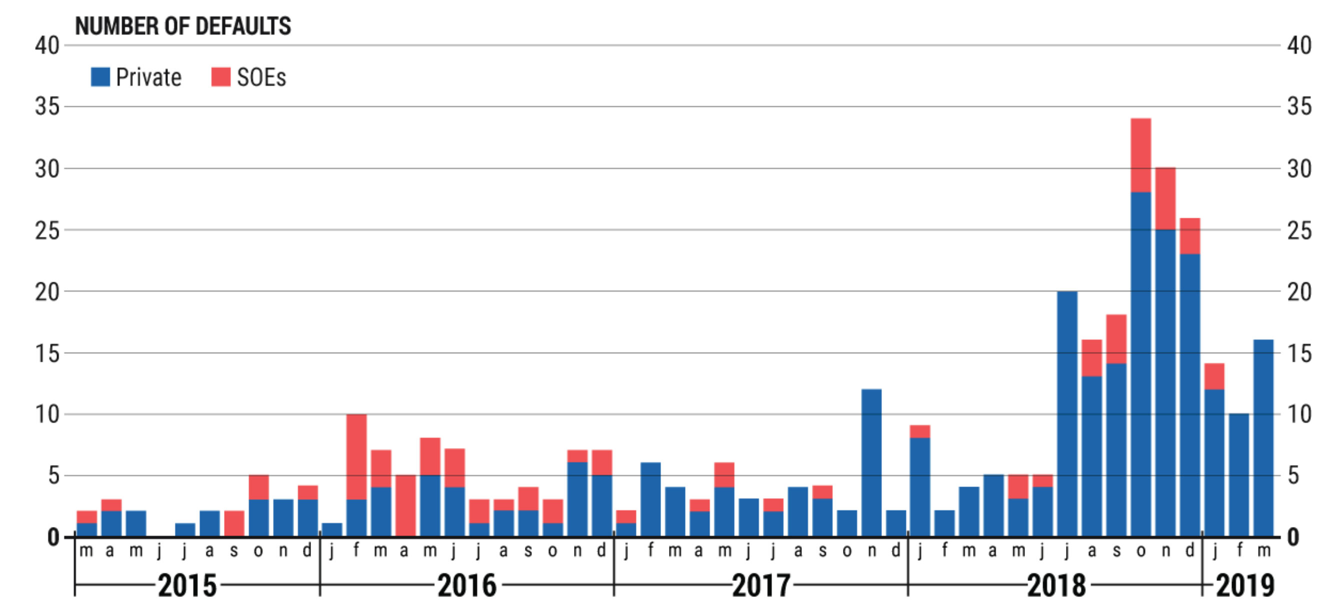

Sources: Bloomberg, Moody's Investors Service



The government was hellbent on avoiding 2008-style stimulus for this reason, and it began talking about pushing forward with stalled de-risking plans as early as last summer. Even so, financial system leverage reached 273 percent of GDP at the end of 2021.

It's facing headwinds from just about every direction. For example, there's China's deeply unfavorable demographic picture, in which the legacy of its one-child policies, combined with the declining birth rates that tend to coincide with rising household incomes, is already compelling Chinese households to save rather than spend and will be a drain on productivity and dynamism for decades to come. There's also the rapidly intensifying rivalry with the U.S. and its allies, which heralds continued, if halting, efforts by Western countries to "decouple" from the Chinese economy. Beijing is especially worried about its dependence on the U.S.-dominated financial system. There's major risks tied to its steady erosion of Hong Kong's autonomy, which has already triggered a slow exodus of foreign banks from the mainland's most critical financial gateway. And it's not as if China is completely past the pandemic. It's unclear how much long-term, structural damage the Chinese economy sustained from its spring shutdowns and the subsequent global turbulence. The wave of bond defaults China experienced last fall – including at state-owned firms, to the shock of investors who had assumed the state would never, ever let such firms collapse in view of the public – makes this clear.

## Bond Defaults by Chinese Corporates




Sources: Wind, China bond, IMF staff calculations

Graphic redesign by Geopolitical Futures

Perhaps most important, the core contradictions embedded in China's model remain. It's unlikely to ever embrace a cleansing but potentially destabilizing recession. It's not about to reduce the role of state banks and enterprises. It'll remain enormously difficult to weed out moral hazard altogether, and to persuade financial institutions to act against their own self-interest, so long as it sees a state-centric economy essential for party survival. There's an inevitable trade-off between dynamism and control. Its ability to simply grow its way out of risks will continue to diminish with time. Staving off a reckoning will remain an ever-present challenge, however good at tinkering Beijing gets, if for no other reason than that China is an enormous, endlessly complicated, geographically fractured country highly resistant to micromanagement.

Nonetheless, Beijing thinks the pandemic, like the 2008 global financial crisis, has in many ways illustrated the superiority of the Chinese approach to financial stability – or at least what Beijing hopes the system will become, with some additional technocratic tweaking, some purging of corrupt elements and regular injections of party ideology to get everyone marching in the same direction. And to be sure, Beijing deserves credit for empowering its regulators to take on painful reforms before the crisis hit and for implementing a countercyclical regulatory system designed to adjust on the fly, tightening and relaxing control as changing conditions demand. It can count real successes in curbing shadow lending and shutting down "zombie enterprises" in a relatively controlled manner. What the system lacks in market incentives to act prudently, Beijing has been able to offset, to an extent, by introducing fear of Xi. It may or may not work if the next exogenous shock isn't followed by such a robust exogenous rebound in demand. True financial meltdowns happen only when most assume they won't, so the biggest risk to China may ultimately prove to be its newfound confidence in its ability to manage risk. But don't expect Beijing to shed its crisis mentality anytime soon; the weight of Chinese history can't be shrugged off so blithely.

# MISSON STATEMENT

Geopolitical Futures understands the world through the rigorous application of geopolitics: the political, economic, military and geographic dimensions that are the foundation of nations. The imperatives and constraints contained in these define the nation. We study the past to understand the future. At its core geopolitics assumes, as does economics, that events are governed by these impersonal forces and not by individual whim or ideology.

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Above all, Geopolitical Futures is an intellectual undertaking, an ongoing experiment in finding order in the apparent chaos of the world. We are a business that lives the life of the mind.