Testimony Before the US-China Economic and Security and Review Commission

Hearing on China's Financial and Economic Challenges

August 21, 2023

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Thank you to Commissioner Cleveland, Commissioner Glas, and all of the Commissioners and staff for your kind invitation to testify at this important hearing today. My written and spoken statements here reflect my personal views and not necessarily the views of Rhodium Group.

My testimony will focus on four topics related to China's structural economic slowdown and its implications for the United States. First and most importantly, I argue that the severity **of China's ongoing economic weakness is still widely underappreciated, and the United States no longer faces a *growth* challenge from China.** Beijing is no longer an economic pacing threat or likely to overtake the United States in any significant measure of economic power in the next two decades, assuming US growth continues at roughly current rates. **Beijing will never be able to make a credible claim to global economic primacy. The challenges that the United States faces in strategic competition with China are highly significant, but they will not be exacerbated by marginal changes in China's economic performance in the years ahead.**

Second, I discuss Beijing's effort to downplay public recognition of China's economic slowdown, both inside China and internationally, in order to maintain public messages that China's economic rise is inevitable. Third, I will discuss the importance of the growth of China's financial system in China's economic expansion over the past decade, and why that expansion will not be repeated. **China's past growth has been exceptional because the expansion of credit in China has been even more exceptional.** Fourth and finally, I will argue that the crises in China's property sector and local governments are interrelated, and closely linked to the end of China's unprecedented credit expansion. There is no easy solution for the local debt problem without changing China's entire growth model to make it less dependent upon investment.

China's Structural Economic Slowdown

This year should be a sobering one for both Chinese policymakers and for analysts of China's economy. At the beginning of 2023, the widespread expectation both in Beijing and among most economists was that China would have a strong recovery from the effects of COVID restrictions and lockdowns throughout 2022. Economic growth was expected to be around 5 to 6 percent, anchored by household consumption funded by a buildup of savings during the pandemic years. The property sector was expected to rebound from a dramatic correction over the previous eighteen months. And China was expected to contribute to global inflationary pressures in both goods and energy prices, with domestic demand straining supply chains. At the end of January of this year, the

International Monetary Fund raised its China growth forecasts to 5.2%, based on the probability of improving household consumption after the end of lockdowns and COVID restrictions.[1]

It is obvious at this stage that none of those expectations have been or will be met in 2023. Household consumption has been the only driver of growth in China's economy, and remains far below pre-pandemic rates. Official July retail sales growth in China was only 2.5% compared to the previous year, and full-year growth rates of retail sales are currently only 7.3%, even in comparison to the lockdown-impacted early months of 2022.[2] The property sector has continued declining, adding to broader pressure on the economy. And China is now grappling with deflation in both consumer and producer prices, rather than contributing to global inflation.

This dark view is reflected in official data; corrected for manipulation, the picture is worse. The economy has weakened far more significantly than expected over the past two years, both under the short-term pressures produced by COVID-related restrictions and a declining property market, as well as longer-term factors linked to the unsustainability of China's credit and investment-led growth model. Aggregate economic growth in 2023 is probably closer to 2 to 3 percent than the officially published 5.5 percent for the first half.

China's current economic slowdown is structural in nature. Simply put, most of the factors that contributed to China's rapid growth over the past two decades—an expanding labor force, unprecedented credit and investment growth, a booming property sector, a one-time buildup of infrastructure, and a constructive external environment—cannot be repeated in the next decade. Most analysts agree that growth in China will not recover to its previous rates. But there is still considerable disagreement about how severe the slowdown will become, and the implications of those changes for the United States.

Among those implications, the most important is that the United States no longer faces a *growth* challenge from China. Officially, China's economy as measured through GDP in 2022 was around two-thirds of the size of the US economy in dollar terms (65 percent at current exchange rates), even based on China's suspect official data.[3] Given China's long-term economic challenges, there is no realistic scenario in which China's economy becomes 150 or 200 percent of US GDP in the future, surpassing the United States by a wide margin. Narrower relative economic gains for Beijing are simply less relevant for the China-related policy problems the United States currently faces.

The United States will continue to be challenged by China's military buildup related to Taiwan and the South China Sea, powerful natural economies of scale and scope, China's outsized and politicized influence within specific next-generation industries and manufacturing supply chains, economic policies artificially boosting Chinese firms' competitiveness, and behavior to influence democratic political systems around the world. Those problems are exactly where US policy and legislative efforts should focus. **But none of these military, diplomatic, or ideological areas of strategic competition with China will be changed by marginal adjustments in China's economic heft from current levels to 90 percent or even 110 percent of the level of US GDP, even though the latter scenario is highly unlikely.** And China's slow pace of economic growth is more likely to weaken Beijing's capacity to confront the United States and its allies in these areas, rather than rapid economic growth boosting China's capabilities over time.

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[1] Paul Wiseman, "IMF upgrades outlook for the global economy in 2023," Associated Press, January 30, 2023, https://apnews.com/article/inflation-international-monetary-fund-china-economy-business-b38530a50416d0356fec60d30da97b61.

[2] Official data released on August 15, 2023, from China's National Bureau of Statistics, http://www.stats.gov.cn/sj/zxfb/202308/t20230815_1941958.html.

[3] Calculated using official GDP data from China's National Bureau of Statistics at 121.02 trillion yuan in GDP in 2022, and the exchange rate of 7.28 CNY per USD on August 15, 2023.

It will take time before the structural slowdown in China's economy becomes more widely accepted as a prevailing view, both in Washington and around the world. But if China's economic model continues to produce growth rates inadequate to achieve China's political objectives, this should change how we respond to threats from Beijing. On the assumption that China's system delivers more growth, some have counseled Western nations to follow suit. As China's economy falters, that is revealed as ill-advised. Beijing's model of economic development over the past decade has been not only ill-suited for other emerging economies, but for China itself. Changing US economic principles and market regulations with long track records of success to counter a fading Chinese economy is unadvisable.

The structural slowdown in China means that the United States can be more narrowly concerned about the national security implications of economic transactions, rather than whether or not a particular action will help or hurt the Chinese economy. There are significant national security concerns related to the transfer of advanced technologies with military or dual-use applications. But there is little at stake for the United States in US or allied investors buying stocks in Chinese consumer-focused companies or Chinese government bonds. Most trade and investment activity between the United States and China is mutually economically beneficial and poses no national security concerns. Global investors rightly want to maintain some degree of exposure to developments in the world's second-largest economy. US investment in China over the past 30 years has totaled at least $285 billion and has generated strong returns for American companies.[4] US commitments to free market principles are a valuable asset that facilitates greater alignment among our allies and partners, many of whom will be far more reluctant to impose trade and investment restrictions upon Beijing. Given the challenges that Chinese behavior and economic statecraft poses, de-risking from China's economy is widely supported and necessary. But in a decade in which China's economy will slow significantly independently of any action by the United States, we can more confidently keep the limits around US and allied economic engagement with China narrow.

The slowdown now underway is rooted in a number of factors that will keep China's economic growth through 2030 around half the pace of the previous decade.

Demographic shifts: China's demographic headwinds are well-known at this point, with the working age population declining since 2013 and the overall population declining starting in 2022.[5] There are very few examples of major economies in the world facing declining working-age populations—Japan's case is the most prominent and probably the most directly relevant for China's experience.[6] None of these countries managed to post economic growth averaging more than 3 percent five years after the working age population declined, and it is difficult to understand why China would be different.

The end of an unprecedented credit expansion. It is impossible to separate the growth of China's economy since the global financial crisis with the growth of China's financial system. From the end of 2008 to 2016, China's banks added $26.8 trillion in assets, equivalent to around one-third of global GDP. Since then, credit growth has basically been cut in half, falling from an average of 18% from 2007 to 2016 to just over 9% since 2017 (Figure 1).[7] Given the size of China's banking system, at $56 trillion in assets or over half of global GDP, and legacy costs of

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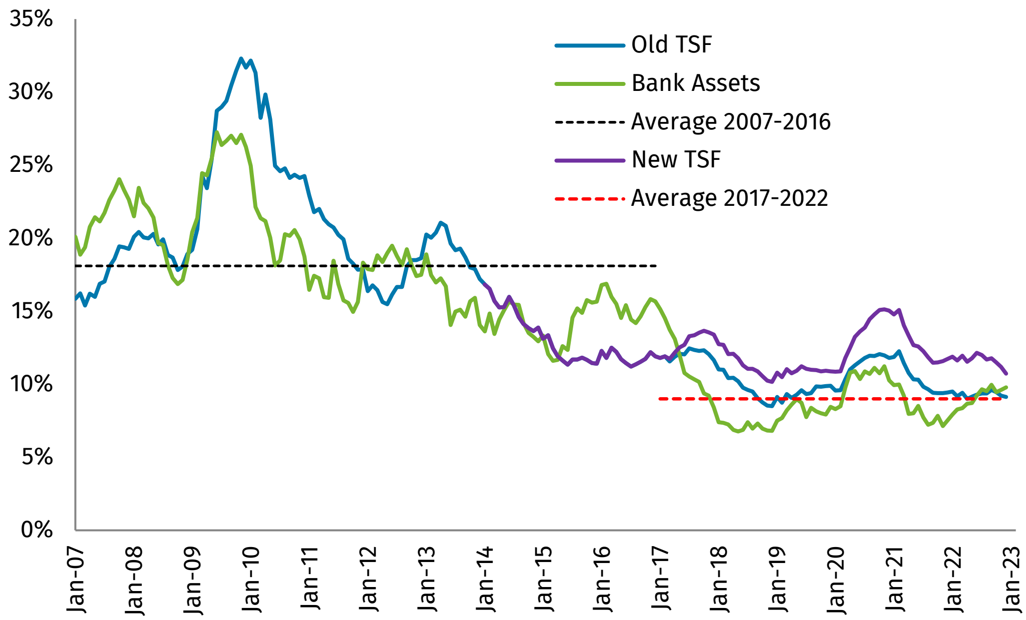
[4] Totals from Rhodium Group, "The US-China Investment Hub," covering data from 1990 to December 2020, www.us-china-investment.org.
[5] Albee Zhang and Farah Master, "China's first population drop in six decades sounds alarm on demographic crisis," Reuters, January 17, 2023, https://www.reuters.com/world/china/chinas-population-shrinks-first-time-since-1961-2023-01-17/.
[6] Other countries among the top 25 economies in the world experiencing declining working-age populations besides Japan include Germany for a limited timeframe before 2012, Poland, Russia, and Italy.
[7] Logan Wright, "The End of China's Magical Credit Machine," Rhodium Group, January 5, 2023, https://rhg.com/research/magical-credit-machine/. Credit aggregates here measured in terms of an average of total societal financing (TSF) from the People's Bank of China and bank assets as reported on the "Balance Sheet of Other Depository Corporations," with the 2023 version of the dataset here: http://www.pbc.gov.cn/diaochatongjisi/resource/cms/2023/07/2023071417041875025.htm.

the last expansion of unproductive investment, China will not be able to maintain the same rates of credit growth in the future.[8] The ceiling for credit growth between now and 2030 is probably in the range of 12-13%, and will frequently be lower (the current pace of credit growth in China is only 8.9% as of July 2023). That means that investment growth will remain under pressure as well, while China's financial system will no longer be as capable of insulating unproductive enterprises from defaults.

Figure 1

Measures of China's Credit Growth, 2007 – 2022

Percent yoy



Source: People's Bank of China, Rhodium Group calculations. "Old" and "new" TSF refer to measurements of China's total societal financing as provided by the PBOC, before and after significant revisions in how the series was calculated from 2017 to 2019.

The adjustment of China's property sector. China's property sector was the most important industry in China's economy throughout the past decade, representing around 20 to 25 percent of GDP.[9] Since major property developers started to default in 2021, new housing starts have fallen by over 56 percent from their peak levels. Land purchases by China's top 50 developers are currently at levels that are only around 10 percent of purchases from 2017 to 2020. Even when this market correction ends, China's property sector will never rebound to its past levels of construction and sales, and will probably settle around 40 to 50 percent of its previous peak. Home ownership levels in China are already very high, household debt levels have risen sharply in recent years, and new urban household formation rates will decline over time given China's demographic headwinds.

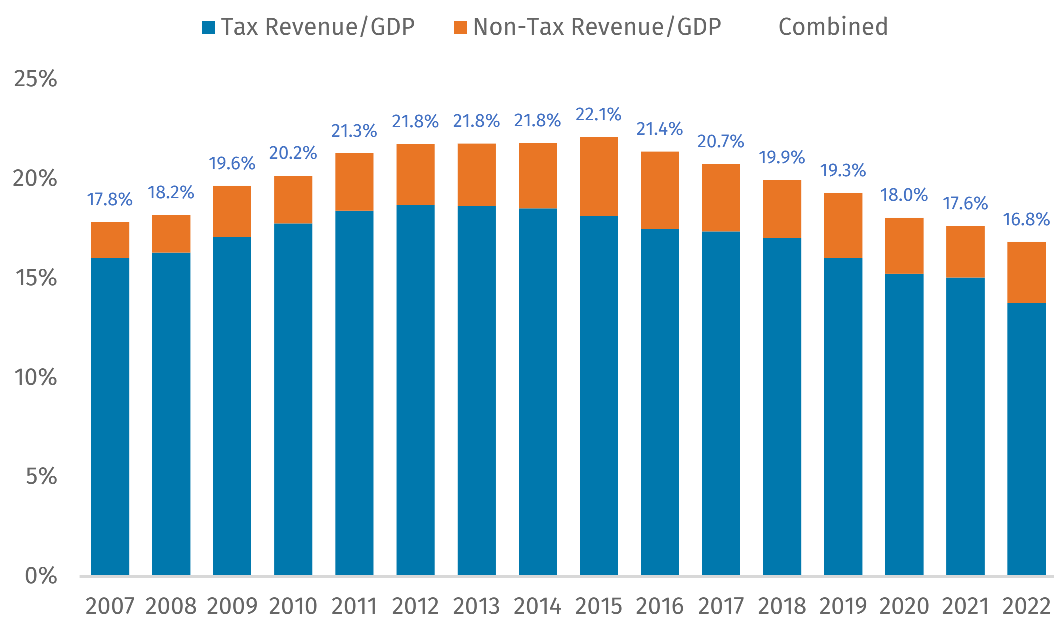
Limited fiscal capacity. China's local governments are struggling with significant debt burdens, which will limit China's capacity to use fiscal policy countercyclically to stabilize the economy. China's central government has a

[8] Calculation of the size of China's banking system based on June 2023 totals of 402.8 trillion yuan in banking system assets, from People's Bank of China, using current exchange rates of 7.2 CNY per USD. "Balance Sheet of Other Depository Corporations," http://www.pbc.gov.cn/diaochatongjisi/resource/cms/2023/07/2023071417041875025.htm.

[9] There are many different estimates within academic and financial markets literature available for the size of the property sector relative to China's GDP. The highest available estimate was 29 percent, based on 2016 data that was then revised lower, available via Kenneth Rogoff and Yuanchen Yang, "Peak China Housing," National Bureau of Economic Research, Working Paper No. 27697, August 2020, https://www.nber.org/system/files/working_papers/w27697/w27697.pdf.

relatively low level of debt, at only 21% of GDP, primarily because local governments have funded the majority of China's investment activity over the past decade, borrowing from banks through state-owned enterprises and financing vehicles.[10] Local governments are tasked with providing most social services in China, but depend upon fiscal transfers from the central government in order to meet these obligations. The debt servicing costs from past investments only add to those local fiscal pressures. Given high local debt burdens, channeling more resources to local governments is unlikely to produce a surge in investment or economic growth. Beijing also has a broader problem in maintaining tax revenues as investment and manufacturing output growth slows, given most tax comes from value-added taxes or enterprise income taxes, with aggregate tax revenues falling from 18.5% of GDP in 2014 to 13.8% in 2022 (Figure 2).[11]

Figure 2
Tax and Non-Tax Revenues in China Relative to GDP, 2007 - 2022
Percent



Source: Ministry of Finance, Bloomberg, Rhodium Group calculations.

China's external environment will be less accommodative. Over the past two decades since China's accession to the WTO, the barriers to China's external engagement with the rest of the world have been falling. The picture over the next decade will not be the same, with more countries imposing trade and investment restrictions on Beijing. Companies are actively discussing "de-risking" and diversification strategies to reduce reliance upon China as a sole supplier in several industries.

The reversal of structural reforms. One of the primary causes of both China's structural slowdown as well as the change in the external environment facing Beijing has been the slow pace or outright reversal of structural reforms to China's economy that were promised during the Third Plenum of the 18th Party Congress in 2013. China has attempted many such reforms, but has quickly reversed course when the costs of the changes became readily evident in the form of market corrections or suddenly emerging financial risks. The net result has been a

[10] Data on China's total government debt from Chinabond, "Monthly Statistics," April 2023, with 25.6 trillion yuan in central government bonds outstanding.
[11] Data concerning total tax revenues from China's Ministry of Finance, available via Bloomberg.

low pace of total factor productivity growth, which the International Monetary Fund has estimated at 0.7 percent over the past decade.[12] Any meaningful change in China's economic trajectory will require a significant reinvigoration of structural reform efforts to reduce the role of the state in the economy and credit allocation, which will be necessary to boost productivity growth. It is probable that Beijing will soon attempt to restart some of the reform agenda that has been set aside over the past decade, given the low-growth consequences of continuing on their present course. But the costs of structural reform have risen significantly over the years of inaction.

China will still see improving economic growth from time to time over the next decade. Next year, for example, actual economic momentum in China may pick up, in part because the downturn in the property market has been much more severe than anticipated in 2023, and state-owned property developers may restart construction. But this is typical of economic cycles. The structural downshift in China's economy is already underway, and represents a far more significant break with the past than currently understood.

Narrative Matters: China's Attempts to Control Economic Data

It will take time before the structural slowdown in China's economy is accepted as conventional wisdom. Beijing will also attempt to control the internal and external narrative about China's economy, which will introduce further confusion in the years ahead.

The most important propaganda message for China's leaders related to the economy is the argument that China's economic rise is inevitable, and that this will reinforce China's rise in great power status. As a result, the international press and coverage of China's economy often forces Beijing to react to reinforce their preferred economic narratives, either with new official messages or with policy responses to address specific problems. Chinese leaders believe they can influence the narratives about the economy through conventional domestic propaganda efforts, but also by restricting the availability of economic data and stories they dislike. China's headline economic data—meaning the data points likely to generate media coverage, such as GDP growth—should be understood as critical elements of China's internal and external narrative management concerning the economy.

The shift in Beijing's censorship concerning the economy has been significant over the past decade. When I lived in Beijing for most of 2001 to 2015, discussion about the economy was relatively unrestricted, and not considered politically sensitive. That has changed under Xi Jinping, but particularly since China's stock market crash and currency depreciation in 2015. This year, however, censorship and limitations on discussion of the economy have reached a new crescendo. Because few Chinese analysts are openly discussing the weak economic rebound, discussions of deflationary pressure in China have served as a proxy for the broader economy—no one can talk about growth, but you can talk about deflation. Now with China experiencing deflation in both headline consumer and producer prices, that discussion has been limited as well.[13] Some domestic analysts have been fired from their jobs or have seen their social media access restricted for negative comments concerning the economy.[14] Just last week, China's statistical bureau suspended the publication of monthly data concerning China's youth unemployment rate, as this had become a significant focal point for overseas discussion of China's economic

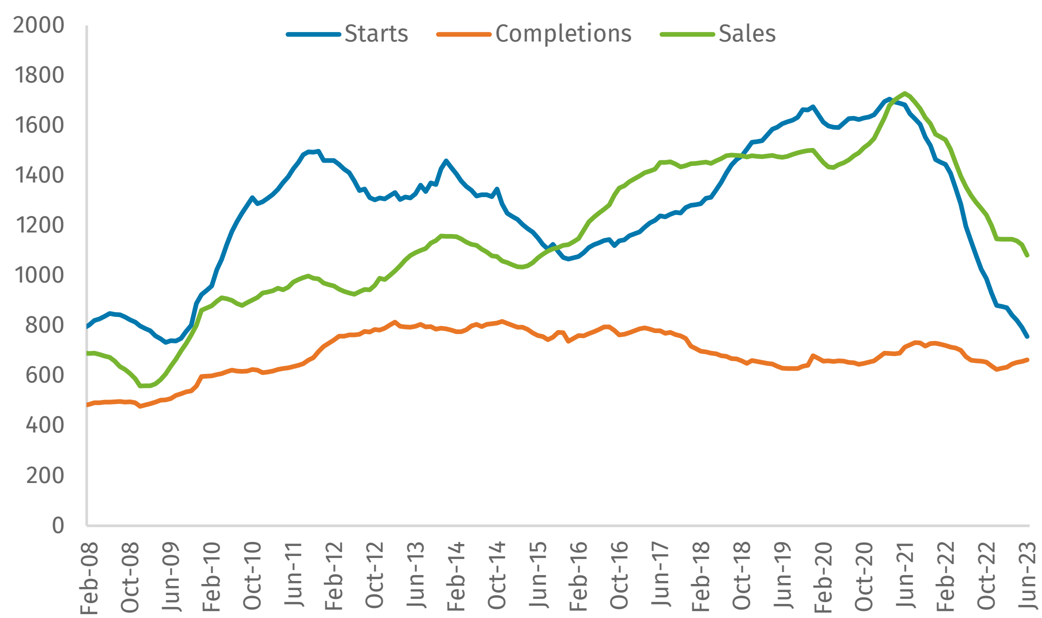
[12] Total factor productivity growth figure contained within International Monetary Fund, "Press Briefing 2021 China Article IV," January 28, 2022, https://www.imf.org/en/News/Articles/2022/01/29/tr012722-press-briefing-2021-china-article-iv.
[13] Sun Yu, "Chinese economists told not to be negative as rebound falters," Financial Times, August 5, 2023, https://www.ft.com/content/b2e0ad77-3521-4da9-8120-1f0c1fdd98f8.
[14] The case of Hong Hao leaving his prior position is discussed in Xie Yu, "China analyst leaves state-owned brokerage after bearish commentaries," Reuters, May 4, 2022, https://www.reuters.com/world/china/china-analyst-leaves-state-owned-brokerage-after-bearish-commentaries-2022-05-04/.

slowdown.[15] New controls on cross-border transmission of data raise further concerns that China is attempting to manage foreign access to data that could be used to support alternatives to official narratives concerning the economy. Ultimately, these restrictions hurt Beijing far more, as no foreign investor can have confidence in an investment in China if they are unable to perform adequate due diligence.

Moreover, there is considerable evidence that China's official economic growth has been overstated over the past decade, and particularly in 2022 and 2023. China's quarterly GDP data were the most stable we could find for any major economy from 2015 to 2019, varying only 1.3 percentage points in year-on-year terms over that five-year period. The reported stability in economic growth contrasted clearly with Beijing's own actions over that time, dramatically changing monetary and fiscal policy settings to manage regular economic cycles.

In 2022, it is highly probable that China's economy contracted, in contrast to reported growth of 3%, under the pressure from lockdowns and COVID restrictions in the second quarter and then in the fourth quarter last year. Headline retail sales growth was reported as falling last year, by 0.2 percent. The downturn in the property sector was extremely stark, with sales down 28%, new housing starts down 40%, overall investment levels down 10%, and land area purchased down 53%.[16] These are not minor disruptions—they reflect a bubble bursting. Aside from a modest pickup in China's trade surplus, it is difficult to understand what part of China's economy actually grew in 2022.

Figure 3
Major Property Sector Indicators in China, 2008 - 2023
Million sqm



Source: National Bureau of Statistics, Rhodium Group calculations.

This year, the story is simpler, as there has been a rebound in household consumption, but it is clearly occurring at rates too slow to support growth close to China's officially targeted level of 5%, as household consumption is only

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[15] Thomas Hale, "China stops reporting youth unemployment as economic pressures mount," Financial Times, August 15, 2023, https://www.ft.com/content/a14ef388-5fea-4696-9791-0379b37e68bf.

[16] Data are all official calculations from National Bureau of Statistics data series concerning China's residential property transactions in 2022, reported via CEIC.

38% of China's economy. The property sector continues declining, and overall construction activity has slowed further. Local government investment is impaired by high debt levels, and private sector investment has contracted in China. Exports are now starting to decline as well. Economic growth in China is trending closer to 2-3% than the officially reported levels of 5.5% for the first half of the year. It is probable that the size of China's economy should be around three quarters of a trillion dollars smaller in GDP terms based on the overstatements in growth in 2022 and 2023 alone.

Most of Beijing's efforts to prop up the economy in recent months have focused on rebuilding confidence, among private sector firms, among consumers, and among foreign investors. This follows from China's response to the global financial crisis in 2008. Following the crisis, all Beijing needed to do to stimulate the economy was provide cheap credit to state-owned enterprises and local governments, while encouraging other actors in the economy to pile in. But those same tools are no longer available. Credit growth is limited, and inefficient in driving investment. Local government fiscal capacity is constrained by high debt levels. Encouraging consumer and business confidence is one of the only tools Beijing has at its disposal, which is exactly why censorship and control over economic messaging have become tighter this year.

The narrative about China and its economy is important to the United States. The success or failure in Beijing's policymaking, and in a state-driven economic model, determines not just the relative performance of these two competitors, but the attraction—and hence the global soft power—of the Chinese system and its ability to displace commitment to traditional market economic norms. China's current economic leadership is completely untested in countering challenges of this magnitude, precisely because these problems are unprecedented—there is very little global experience from which Beijing can draw. Tighter controls over data and censorship of discussion of China's economy should be understood as reactive responses to real uncertainty among economic actors in China about Beijing's policymaking.

The Financial System and China's Economic Growth

One of the least understood aspects of China's economic record over the past decade has been the linkage between the rapid growth of China's financial system and economic performance. China's current economic slowdown is structural primarily because the unprecedented credit expansion that took place from 2008 to 2016 cannot be repeated in the next decade. **This was the largest single-country credit expansion relative to global GDP in over a century. Credit growth of this magnitude not only powered significant volumes of local government investment and property construction, but most importantly, it provided a shock absorber insulating China's economy from bankruptcies, defaults, and unemployment.** China's typical response to any economic slowdown over the past decade has been to unleash the same credit-funded local investment that was used to response to the global financial crisis. Innovation in counter-cyclical policymaking has been limited. One of the most accurate post-mortems of the US financial crisis was Steve Eisman's comment about US banks, claiming "they mistook leverage for genius."[17] Over the past decade, many analysts have mistaken China's credit expansion for the competence of policymakers.

No financial system can expand significantly faster than the real economy for several years without either significantly expanding the scope of financial services ("deepening" of the financial system) or adding credit risks by extending finance to less credit-worthy borrowers. In China's case, the financial system became far less stable between 2012 and 2016. Before 2012, the system was largely financed by deposits and made loans to state-owned enterprises and local governments, while there were steady inflows of liquidity from China's trade and capital

[17] Eisman has used the quote in several media interviews, but it is mentioned in Suzy Waite and Nishant Kumar, "Steve Eisman Says Wall Street Executives Mistook Leverage for Genius," Bloomberg News, February 22, 2018, https://www.bloomberg.com/news/articles/2018-02-22/steve-eisman-says-wall-street-execs-mistook-leverage-for-genius.

account surpluses. China's financial system may have been inefficient in generating growth, but it was generally stable.

By 2016, China's shadow banking system had grown significantly, encouraged by continued credit demand, financial speculation, and a lax and uncoordinated system of regulatory oversight. Marginal financing from the system no longer came from stable deposits but was instead sourced from commercial paper-like wealth management products (WMPs). Marginal lending growth was made by third-party asset managers or informal "shadow" lenders rather than banks. And banks were forced to confront rapid changes in capital inflows and outflows, leaving them more vulnerable to sudden shifts in liquidity conditions. Many compared the growth in China's informal lending channels to US conditions ahead of the global financial crisis.[18]

Beijing launched an aggressive deleveraging campaign to reduce risks within the financial system in the summer of 2016. The net result of that campaign has been a dramatic reduction in the footprint of shadow banks within the economy, but also a significant slowdown in overall credit growth. As credit growth has been cut almost in half, more and more borrowers are struggling to manage their past debts, and credit risks have emerged rapidly—first in peer-to-peer lenders, then in smaller banks, then in trust companies and property developers, and finally among local governments themselves. The key point is that while it was sensible for Beijing to address rising financial risks, the shadow banking system was far larger than Beijing could have known at the start of the deleveraging campaign. As a result, controlling shadow banks ended up producing a significant adjustment in China's overall economic growth and in the ability of several entities to access financing.[19]

The deleveraging campaign launched in 2016 ended China's unprecedented credit expansion. But even if Beijing now wanted to expand credit rapidly, there is no way to generate the same rates of credit growth as in the past. The banking system is not only already holding assets equivalent to over half of global GDP, but is already struggling with significant de facto non-performing loans, most of which are undeclared. With the likely slowdown in credit growth to single-digit rates in the next decade, China's investment growth—the key engine of the economy—will slow as well. It is impossible to consider the long-term growth of China's economy without considering the long-term growth of China's financial system.

The Property and Local Government Crises in China

The correction in China's property market has attracted considerable media coverage over the past two years, for good reason. Property was China's most important industry, representing around 20 to 25 percent of GDP. Starting in 2017, property developers responded to the loss of credit from shadow banking channels by borrowing directly from homebuyers, offering houses for sale before construction was finished. In China, developers can collect 100% of the purchase price in advance, and homebuyers will even start paying mortgages on unfinished apartments because they believe that prices will continue to rise. This introduced a Ponzi element to China's property construction in the late 2010s: new sales were necessary to finish construction on the houses that had already been promised, but remained incomplete. Between 2015 and 2021, annual revenues from pre-construction sales tripled, from 5.3 trillion yuan ($833 billion at end-2021 exchange rates) to a peak of 16.3 trillion yuan ($2.56

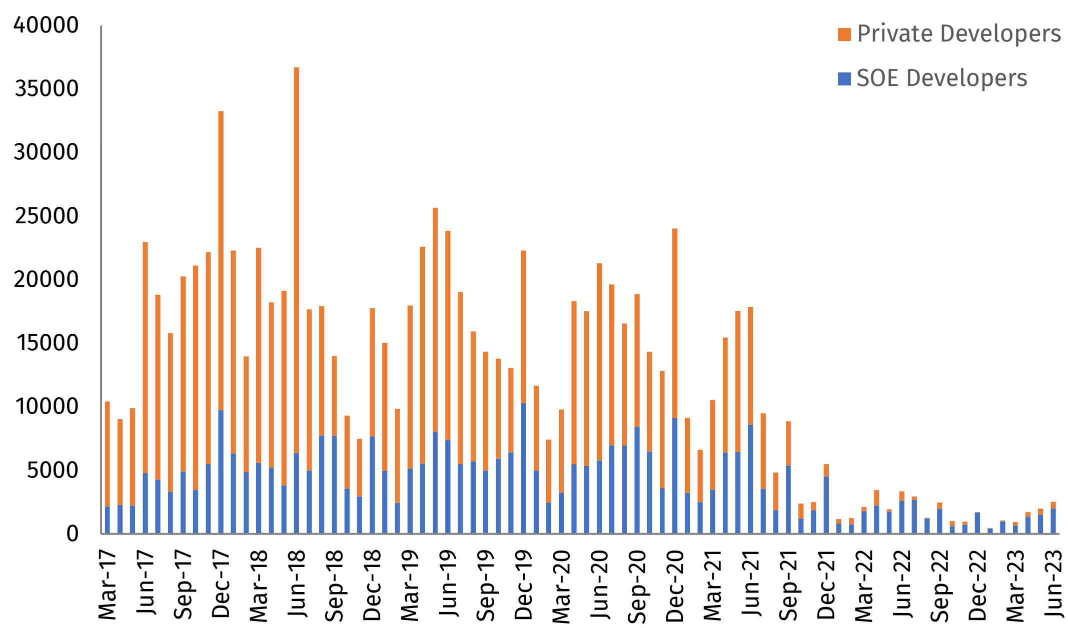
[18] For a more extensive discussion of the changes in China's financial system from 2012 to 2016, please see Chapter 2 of Logan Wright and Daniel Rosen, "Credit and Credibility: Risks to China's Economic Resilience," Center for Strategic and International Studies, October 2018, https://www.csis.org/analysis/credit-and-credibility-risks-chinas-economic-resilience.
[19] For a far more extensive discussion of China's deleveraging campaign and its impact on the real economy, please see Logan Wright, "Grasping Shadows: The Politics of China's Deleveraging Campaign," Center for Strategic and International Studies, April 2023, https://www.csis.org/analysis/grasping-shadows-politics-chinas-deleveraging-campaign.

trillion).[20] This was a huge extension of credit from homebuyers to developers, funded via mortgage loans. That credit drove China's new housing starts to a new peak in 2020 and 2021, driven by demand from speculators. This speculative demand produced a massive imbalance between housing construction and fundamental demand from owner-occupiers. When sales started to decline, and then COVID controls caused them to collapse, property developers could not finish construction activity, and started to default on homebuyers. This weakened sales further in a vicious cycle, and caused more property developers to default on their debt, slowing overall construction activity and the broader economy.

Similarly, there has been extensive focus on China's local government debt problem, with rising debt levels impacting social service provision at the local level and preventing Beijing from using fiscal policy to stabilize the economy. China's Politburo has recently pledged to unveil a comprehensive "basket of measures" to manage local government debt.[21] Local government investment has been a critical component of China's economic growth model. **There is no easy "fix" for the local debt problem without changing China's entire growth model.**

In many ways, these two crises are closely linked, and are tied to the end of China's unprecedented credit expansion. Property developers not only generated considerable employment and investment growth in China's economy, but boosted local fiscal coffers through land sales. The sudden correction of the industry has led to a sharp overall drop in land sales, particularly from the largest developers (Figure 4).

Figure 4
Land Purchases by China's Top 50 Developers, Mar 2017 – Jun 2023
Thousand sqm



Source: China Real Estate Information, via CEIC.

[20] Data on pre-construction residential housing from National Bureau of Statistics, as reported via CEIC, using annualized revenue totals.
[21] Kevin Yao and Samuel Shen, "China can no longer 'extend and pretend' on municipal debt," Reuters, August 7 2023, https://www.reuters.com/markets/asia/china-can-no-longer-extend-pretend-municipal-debt-2023-08-06/.

Fiscal revenues from land sales declined by 2 trillion yuan or 23% in 2022 alone, but land purchases are typically paid with a one-year lag.[22] China will see declining local government fiscal revenues until at least the end of 2024, even if the property sector stabilizes soon. The weakness in China's property sector has aggravated the immediate financial stress on China's local governments. These two forces worked in tandem to boost China's economy over the past decade, and now represent significant drags on economic growth.

The collapse of China's property bubble and the weakness in local government financing conditions have also aggravated Beijing's longer-term problems in maintaining fiscal capacity. China's tax collection system is far different from those in most developed economies. Beijing depends heavily upon value-added taxes, usually collected in manufacturing, and on enterprise income taxes, rather than individual income taxes or consumption taxes. China cannot grow out of its local government debt problem in ways that will make it more manageable over time, in part because weakening local government investment and industrial output will also correspond to weaker overall tax collection in China, and will widen fiscal deficits beyond the current levels of around 7% of GDP, including both central and local government balances. Tax revenues as a proportion of the economy have fallen significantly in recent years, and remain dependent upon investment-led growth.

Larger fiscal deficits alone are not necessarily a huge problem for Beijing, as they can be financed internally. But by necessity, Beijing's fiscal ambitions will also be constrained in the years ahead, because of the pressures created by the crisis in the property sector and local government finances. The scaling back of those ambitions has implications for China's military buildup, for investments in advanced technologies, and in external lending activity to other developed economies. Because Beijing will continue to prioritize these elements, none will experience a sudden drop in financing in the near future. But the economic foundation for China's broader policy ambitions will weaken. Maintaining fiscal capacity will become increasingly challenging, and will likely require significant reforms to the tax system.

Recommendations

US officials and lawmakers should speak candidly about China's current economic challenges and the problems of its economic data. All of the problems discussed above are occurring because of central features of Beijing's economic model. Negative economic spillovers from problems in China's economic model will impact American interests both directly and indirectly, and Washington has a legitimate and defensible interest in discussing the economic outlook in a systemically important country such as China. Many US officials are already discussing China's economic challenges. The United States should highlight those problems to external audiences but should not seek to aggravate them with specific policy measures. Beijing will blame the United States for doing that anyway. The audience for the US messages concerning China's economy should be countries that have deepened economic engagement with China over the past decade. Speaking more forthrightly about China's current economic challenges can help to counteract Beijing's own narratives that present its economic rise as inevitable.

Congress should prepare more active steps to extend alternative channels of financial support to emerging economies struggling to renegotiate debts with Beijing. No issue highlights the discrepancy between China's past economic strength and its current slowdown more than the change in Beijing's external lending practices to emerging economies. Beijing will not be in a strong fiscal or financial position to extend debt relief to multiple emerging economies, many of which are struggling with US dollar-denominated loans extended via commercial terms from China, in contrast to the concessionary terms offered from multilateral development banks. China has

[22] Data from Ministry of Finance and reported via CEIC. China recorded 8.68 trillion yuan in land sales revenues in 2021 and 6.71 trillion yuan in 2022.

been very slow to engage in negotiations over its external lending, as evidenced by the recent settlement involving Zambia. But without alternative financing options available, which will need to be led by the United States and its allies, Beijing will continue to remain central to economic diplomacy involving developing countries who are seeking alternative options to unlock additional channels of private sector financing. Even if these funding options are never used, a credible offer of alternatives will help to push Beijing back to the negotiating table for debt relief, out of fears of being bypassed (and facing immediate defaults) by official and private creditors.

Develop trade policy options that facilitate de-risking and supply chain diversification. In those areas which do require some degree of managed de-risking from economic engagement with China, it is crucial that Washington take stock of what next-generation trade and investment policies are needed. By design, the extant system enables China to use its natural scale and artificial policy advantages to grow its global position in many sectors. If alternative countries are to close the gap with China in critical industries, then new US economic diplomacy will be needed, both to facilitate that investment, and to reduce trade barriers to expand access to markets in the United States and among allies and partners.

Financial decoupling measures are high-risk and low-return. The main effect of US efforts to initiate financial decoupling from China will be to hand Beijing an easy explanation for falling capital inflows that will happen anyway, if economic and financial market reforms continue to be delayed, rather than bearing the blame themselves. Beijing will continue to struggle on its own to reduce perceived risks of investing in its onshore markets, given lower returns, weaker economic growth, and a volatile approach to market regulation. Market forces including responses to changing Chinese interest rates have already produced significant shifts in capital flows from China. Even “success” in driving divestment from Chinese markets may end up producing market distortions that make inbound investment more attractive to other types of global investors. There will be no shortage of capital outflows from China over the coming decade, primarily because of the diversification of China’s own household and corporate savings. But efforts to actively drive disinvestment from China offer little benefit to the United States, and may damage US pro-market credibility in other areas. Shifting global manufacturing and critical supply chains away from China will already be a costly project in terms of economic efficiency and the need for subsidized investments in some sectors, and decisions to incur those costs should be focused on areas with far greater national security concerns at stake.