Essay

Emerging Tensions in the Chinese Economy

Prerna Gandhi

"At present, the main social contradiction in our country has been transformed into a contradiction between the people's growing need for a better life and unbalanced and inadequate development."

Liu He, Vice Premier, PRC[1]

New headwinds threaten to derail China's growth model as it struggles to manage conflicting goals. Years of debt binge, growing geostrategic tensions, and deepening frictions with the United States on trade, technology, and security have led to new policy formulations such as dual circulation to expand domestic consumption and reshape engagement with the global economy. Though the pandemic has brought forth record exports, domestic consumption has slowed due to frequent lockdowns resulting from a zero Covid policy. Both growth and employment are facing serious challenges and undermining the Communist Party's self-proclaimed legitimacy to rule.

Seizing the interlude before the 20th Party Congress later this year, the Chinese Communist Party has initiated a spate of regulatory crackdowns on the giant private conglomerates in a bid to enhance controls, rein in rising corporate debt and sharpening inequality, and reinstate its state socialist credentials. Xi Jinping's push for 'common prosperity' has reignited the cake debate-- enlarging the cake or emphasis on growth and expanding the size of the economy vs. equally dividing the cake or emphasis on egalitarianism and distribution-- that had happened just prior to the beginning of the Xi Jinping era. But the bitter medicine of Xi's leftward turn has raised fears of a return of the 'Cultural Revolution' as rectification campaigns in the economy, finance, culture,

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and politics have gathered pace. Further, with an all-time low perception of China abroad, the Chinese leadership has fueled more suspicion of its ambitions by its belligerent provocations and antagonistic diplomacy.

Negative Perceptions Grow

With China shedding its power hesitations under President Xi, most countries are coming to realize that China is not just a benign marketplace or a big factory. Using its huge forex reserves as a strategic tool, China has begun to play a more important role on the global commercial stage as an alternative source of investment and technology beyond the West. However, the initial vision of the Belt and Road Initiative (BRI) to expand China-led trade by building logistics has begun to unravel and now finds reduced mention in the Chinese official discourse. While BRI investments in politically unstable countries confer China more influence and coercive power, the inherent instability in these countries, compounds China's economic and security troubles. Bad BRI loans clog the already overburdened Chinese financial system. Also, unfulfilled commitments and renewed push by countries to renegotiate BRI contracts have diminished Beijing's sheen. Further, initiatives by many governments in raising export-import controls, government-led incentives to manufacturing, supply chain security reviews, screening of Chinese investments, enforcing entity lists, economic sanctions on Chinese individuals and organizations, mandating stricter regulatory compliance, curtailing scientific and research collaboration, website and app bans show win-win cooperation with China is no longer held as an ideal. Figure-1 indicates the steep decline in Chinese outward loan/investment flows since 2016.

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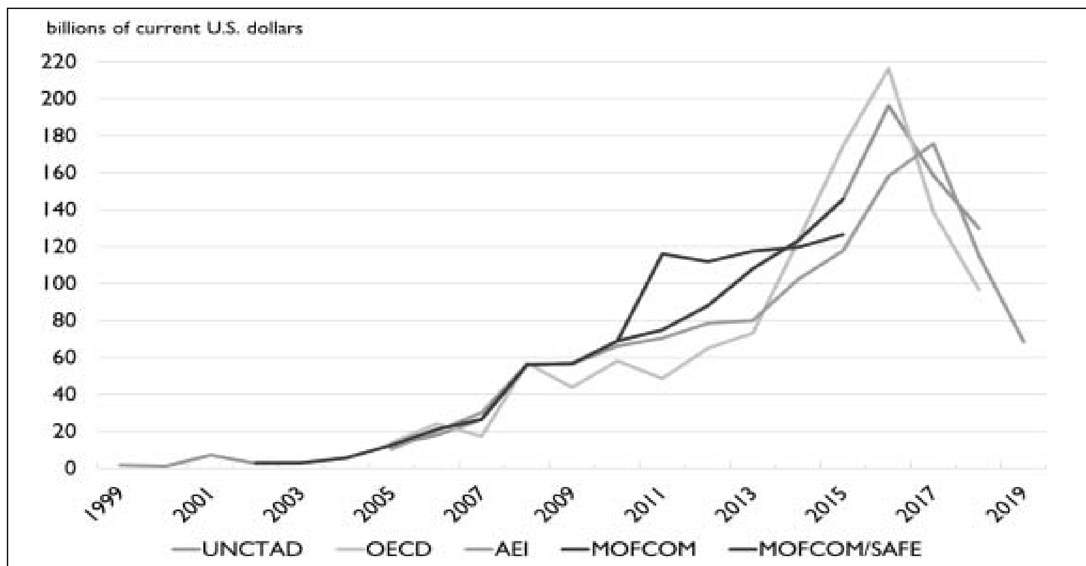
With US withdrawing from several multilateral trade agreements, China sought to lead the next phase of globalization. It has pursued approval or application of major regional trade agreements such as the Regional Comprehensive Economic Partnership (RCEP), EU-China Comprehensive Agreement on Investment (CAI), Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), Digital Economy Partnership Agreement (DEPA), etc.

It has also sought to weaponize its economic heft and dominate the global conversation about China through covert, coercive or corrupting mechanisms. After

Figure 1

China's Total Outward Direct Investment Flows[2]



Australia demanded an inquiry into the origins of coronavirus, China imposed huge tariffs on barley (80.5%) and wines (212%) to force Australia into submission. Even Lithuania, which decided to expand relations with Taiwan, is being made to bear the brunt of displeasing Beijing by being removed from China's customs registry. In June 2021, China's legislature expeditiously approved the 'Anti-Foreign Sanctions Law' to counter EU and US sanctions against China. All this has led a growing number of countries to be more wary of China as its unilateral aggression threatens to upend the existing rules-based order. As existing institutions and frameworks prove insufficient in dealing with China, there are several new geopolitical groupings such as the Quad, Australia-UK-US alliance (AUKUS), Inter-Parliamentary Alliance on China, EU-US Dialogue on China, etc., that are taking shape.

Regulatory Crackdown

Amidst a pandemic-induced slowdown, faltering consumer spending and higher commodity prices, the Chinese leadership gave the go ahead in September 2021 for an unprecedented regulatory crackdown on private tech companies involved in online payments, video games, ridesharing and education. Beijing's regulatory crackdown

erased $1.5 trillion from Chinese stocks amid a broader sell-off at its most extreme.[3] The private economy contributes more than 50 per cent of total tax revenue, more than 60 per cent of gross domestic product, more than 70 per cent of China's technological innovation, over 80 per cent of urban employment, and makes up more than 90 per cent of market entities in China.[4] Post the halting of the mega Ant IPO in November 2020, the Chinese Communist Party made countering large private capital a key agenda, in stark contrast to Jiang Zemin's Three Represents theory that called for expanding the private sector. A central-government investigation prior to the IPO had found that Ant's IPO prospectus obscured the complexity of the firm's ownership and ties to a coterie of powerful Chinese political families that represented a latent challenge to Xi's bid for a third term.[5] Regulations covering video games, education and entertainment were justified as cleaning up the toxic culture and reducing anxiety for the young generation.

Along with political motivation and enforcing antitrust regulation, access to the data accumulated by the private sector was an equal driving factor as the tech sector had earlier pushed back on some of Beijing's previous data-sharing requests. In late 2012, Xi Jinping visited Chinese tech giant Tencent and complemented its founder, Pony Ma, on the way the company was accumulating information and indicated that the data would be helpful to Beijing. "You have the most sufficient data, then you can make the most objective and accurate analysis," he told Ma, according to state media accounts. "The suggestions to the government in this regard are very valuable." However, eight years later, those passive suggestions are becoming aggressive demands.[6]

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There is a growing contradiction between CPC's desire to improve market efficiencies and bolster party control over the Chinese economy. The rapid development of new technologies that use big data now allows for a more dystopian Capitalism with Chinese Characteristics. Policy makers are also apprehensive companies could share data with foreign business partners, undermining national security. In fact, the spate of laws and regulations around digital data is being driven by the huge growth in data held by China's tech giants.

Search for Technology Independence

The "Made-in-China 2025" policy that was announced in 2015 triggered wide-ranging alarm and panic in the West. China aimed to secure 40 percent market share in its chosen high-tech markets by 2020 and 70 percent by 2025. The only way to accomplish that, according to western executives, was through massive subsidies and technology theft. So serious was the concern, that the 2018 report on the 'Findings of the Investigation into China's Acts, Policies and Practices Related to Technology Transfer, Intellectual Property and Innovation' under US Section 301 of the Trade Act' mentions Beijing's "Made in China 2025" policy 114 times. Though 'Made in China 2025' now finds no mention in official statements, all recent policy discourse by the Chinese government indicates the urgency to overhaul the tech system after persistent US sanctions limit China's access to advanced technology. The US government has sought to hinder the Chinese military from developing quantum computing and counter-stealth technology, including advanced radars and undersea sensors, via comprehensive sanctions. Thus, it is notable that the 14th Five Year Plan has dedicated a specific chapter to technology in a distinction from the earlier pattern. According to analysts, despite the very favorable domestic support environment, China is likely to face a harsh international reality that would make its path to becoming self-sufficient in advanced chips difficult.[7] Even then, China has the capabilities to boost the production of lower end chips used in automobiles and home appliances.

Power Shortage

Power cuts remain a recurrent feature every year in China, but their increasing frequency and consequent power rationing in nearly every major province – as was witnessed in the latter half of 2021-- marked a critical point. Beijing's ambitious carbon reduction targets without a significant shift to renewable energy and a severe coal shortage exacerbated by a trade war with Australia can be seen as the main causal factors. Beijing mandated cuts in energy consumption per unit of GDP by 13.5 per cent between 2021-25, while cutting carbon emissions by 18 per cent in the same period. These targets were seen as non-negotiable, resulting in the power companies to cut supplies.[8] Further, the stipulation by the National Development

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and Reform Commission (NDRC) that provinces could raise or lower electricity prices only by 15 per cent from a fixed point to prevent volatility in prices discouraged any efforts by power companies to enhance production. Despite increasing demand for electricity every year, the average price of electricity remained unaffected for both citizens and industry. But since the price of coal is not similarly regulated, it hit record highs in China. As a result, power companies found it less profitable to increase power supplies. A point to note is China depends on coal to meet 58 per cent of its power needs and burns as much coal as the rest of the world combined.

Environment Crisis

The dilemma of balancing environmental goals with economic targets is not unique to China. However, given growing public dissatisfaction with environmental pollution as the cost of rapid growth, the CPC has laid strong priority on cleaning up the environment to avoid political or social instability. After the US embassy in Beijing started releasing pollution data from its monitors in early 2010s, Beijing adopted a five-year programme in 2013 to target pollution and followed it up with a three-year air quality improvement action plan. In 2017, Xi Jinping listed pollution control as one of the three battles to achieve a moderately prosperous society. Air quality in China has improved significantly yet political concerns led the CPC to use cloud seeding ahead of its centenary celebrations even in 2021. The government laced clouds with chemicals to ensure rainfall over suburban Beijing and some neighboring areas hours before July 01.[9]

Water pollution is China's worst environmental issue. Half the Chinese population has water supply that is unfit for human consumption with elevated levels of arsenic, fluorine, and sulphates. The effects can be seen in China's high rates of stomach, liver, and esophageal cancer. Acidification, salinisation, and a decline in the fertility of arable land are other serious pollution concerns. Xi Jinping declared at the United Nations General Assembly in September 2021 that China's already high carbon emissions would peak by 2030 and the government aims to achieve carbon neutrality by 2060. But the realities of China's high coal dependence leave many unaddressed questions.

Debt Crisis

Growth financed by investment and debt, that have reached dangerous levels in China, marks the end of the upward phase of its long-term debt cycle in less than a

quarter of a century. Since 2008, it has needed ever more debt to deliver the same economic output, and debt as a percentage of gross domestic product grew more than 10 per cent a year on average. Using the 'Rule of 70' in economics, that means the debt literally doubled in 7 years from 2008 to 2015. In view of the Global Financial Crisis, the State Council of China had announced a RMB 4 trillion ($586 billion) stimulus package on November 9, 2008, that led to a frenzy of fruitless infrastructure spending and consequent domestic debt.[10]

The debt crisis has its origins in the earlier decade as Zhu Rongji's banking reforms post the Asian Financial Crisis stalled. In the late 1990s, People's Bank of China (PBOC) recapitalized the four big banks that would later list on the Hong Kong stock exchange. The PBOC also brought controlling equity interests in failed Chinese financial firms and restructured them to be later sold to foreign investors. However, with a nationalist outrage and an ensuing turf war between the PBOC, the Ministry of Finance and China Securities Regulatory Commission, and a change of leadership from Jiang Zemin to Hu Jintao, the reform process ended. In 2008, the stimulus program brought back old complacencies.

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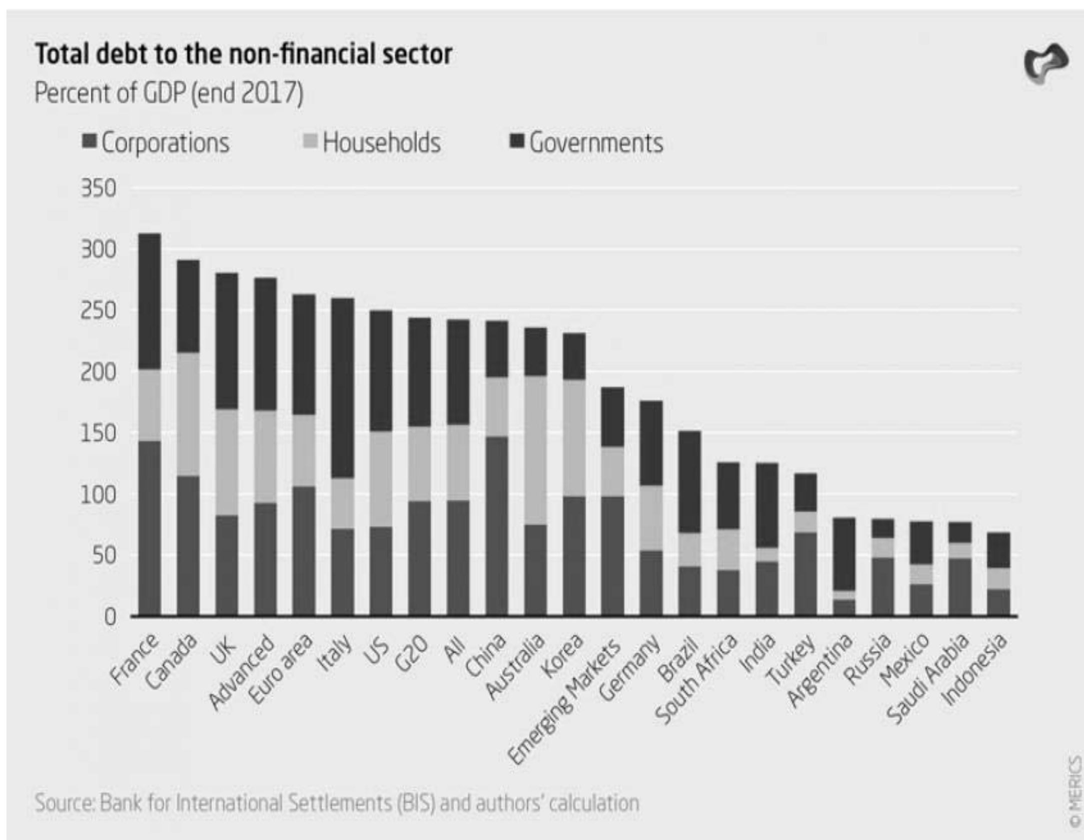
Defusing financial risk was the second battle listed by Xi Jinping in 2017 to achieve the goal of building a moderately prosperous society. In a bid to evade regulatory restrictions on deposit rate and loan quantity, banks in China developed strategies for moving assets out of their loan books in the form of trust loans, wealth management products, etc. The Shadow Banking sector's reach now accounts for nearly 60 per cent of China's GDP, posing large systemic risks. Also, China's large corporate debt to GDP ratio of more than 160 per cent poses greater challenges as compared to the US or Japan where government debt occupies the largest proportion in the total debt. The process of deleveraging hit significant roadblock in 2020 when pandemic prompted loosening of fiscal policy. China's debt to GDP ratio was 270.1 per cent at the end of 2020, up from 246.5 per cent at the end of 2019 (Figure-2). China's outstanding foreign debt, including US dollar debt, reached US$2.4 trillion in 2020.[11] But slowing economic growth has led to new downward pressures on small and medium enterprises. The levels of consumption in China remain low as 75 per cent of the middle class falls into the lower-middle income band.[12] China's outstanding debt claims on the rest of the world rose to more than US$5.6 trillion as of mid-2020,

making China one of the biggest creditors to low-income countries.[13] But domestic priorities may tighten China's deep pockets.

Figure 2

China's Corporate Debt to GDP ratio[14]



Yuan Levels

In a panel on 'Weal and Woe in Digital Economy' in Boao Forum for Asia in April 2021, Shen Jianguang, chief economist at JD.com Inc noted that "if you want to have a global reserve currency, you need to allow foreigners to hold it, to use it".[15] In 2016, Renminbi was included in the International Monetary Fund's SDR basket along with

the US dollar, euro, yen, and British pound. With the BRI, the 2018 launch of yuan-denominated oil futures contracts or the petro-yuan, and now large-scale trials of digital yuan, a Central Bank Digital Currency, the narrative of larger internationalization of the yuan has gained further traction. Yet realities on the ground indicate the contrary. In early December 2021, Chinese Commercial banks were ordered to increase the amount of their foreign currency deposits that are held as reserves— for the second time in the year. Last time such a policy intervention was announced was in 2007. The goal was to reduce the amount available for trading, thereby locking in nearly $20 billion of foreign reserves. The PBOC has widely stated its aims to make the yuan freely tradable but fears of losing competitiveness, inflation, domestic capital flight, and increasing cost of servicing China's external debt have held it back for now.

Real Estate and Property Tax

In 1998, major housing reform by Zhu Rongji completely abandoned the old system of linking housing distribution with employment units, replacing it with cash subsidies to new workers for purchasing apartments. This privatization of home ownership opened the floodgates of nearly two decades of real estate boom in China, which became a major contributor to China's wealth and prosperity. According to Goldman Sachs Group Inc, in 2019, the total value of Chinese homes and developers' inventory hit $52 trillion, twice the size of the US residential market and outstripping even the entire US bond market.[16] This led China's regulators to propose the most expansive rules to curtail the real estate sector--the introduction of the "three red lines" in August 2020. These required the highly leveraged developers to cap their liability-to-asset ratio, excluding advanced proceeds, at 70 per cent, their net debt-to-equity ratio at 100 per cent, and their cash to short-term debt ratio at one. Developers that failed to meet the three specific financial requirements by 2023 would be restricted or even completely prohibited from borrowing. Since the launch of the deleveraging campaign, the financial health of Evergrande, the world's most indebted developer, has raised fears of becoming China's Lehman moment.

An associated issue has been the delay in introduction of a nationwide property tax in China. It represents one of the most severe policy dilemmas in China's political economy. In theory, a property tax could provide a steady source of revenue, weaning local governments off reliance on volatile land sales, which account currently for around

a third of their revenue.[17] However, China's property market, which accounts for 27 per cent of GDP, has deteriorated since May 2021 as policymakers and monetary authorities have moved to cool the speculative fervor underpinning it.[18] Also, new home prices in China fell by the most in six years in October 2021, according to figures released by the National Bureau of Statistics in November, as analysts warned a deeper correction is yet to come. In such a scenario, a tax on the higher side will likely crash the market further. Shanghai and Chongqing rolled out a pilot property tax programme a decade ago. But the rate is low and there are many exemptions. The revenue from the tax was 1.2% of Shanghai's total taxation in 2020. Thus, even Xi Jinping, the most powerful Chinese leader in decades, may not have the clout to implement it—at least not soon. After pushback within the ruling Communist party, a proposal to test run the tax has been modified to around 10 cities, from an initial plan of about 30.

China's property market, which accounts for 27 per cent of GDP, has deteriorated since May 2021.

Inequality and Unemployment

In May 2020, Premier Li Keqiang's comment that 600 million Chinese citizens (43 per cent of the population) have a monthly income under $140 raised many red flags. This was preceded by Xi Jinping hailing China's success in eradicating extreme poverty just two months earlier, achieving a key battle in making China a 'moderately prosperous society'. In the February speech celebrating the achievement that year, Xi highlighted reaching "common prosperity" as the next stage of China's development. Economic inequality, however, is a major concern for the Chinese leadership. According to data from Credit Suisse, while living standards have risen dramatically in China, the country's Gini-coefficient widened to 70.4 in 2020 from 59.9 in 2000, making China one of the world's most unequal major economies.[19]

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Further, variable economic growth rates have led incomes in coastal provinces to triple whilst those in the inland provinces only doubled in the last decade. 'Go West', the precursor to Xi's Belt and Road Initiative (BRI), was intended to bridge the gap

between Eastern and Western China. The rural-urban gap in per capita incomes also poses a challenge. It is nearly three times in the coastal regions and 3.2 times in the inland provinces. Restrictions on rural-urban migration have limited the opportunities for the relatively poor rural population. This has led the Communist Party to pursue some liberalization of the hukou system, to allow rural hukou holders to apply for urban hukou based on a points system. Many restrictions continue to constrain migration to the cities.

With the pandemic-induced slowdown, job security is now back on top of the government's agenda. The National Bureau of Statistics in June 2021 noted that about 14 million people were expected to enter the urban workforce in 2021, of which 9.09 million were graduates.[20] However, the challenge of fresh graduates struggling to find jobs while companies struggle to recruit workers exists at the same time, indicating a structural mismatch between skills and opportunities. To find stable careers, there have been a record number of applicants for the national civil service examination that opens opportunities for roughly 30,000 government jobs in 75 central government agencies and 23 attached institutions. More than 2.12 million applicants registered in 2021 for the examinations, according to the state-owned China News Service. This is the first time the number has crossed 2 million. More than a million applicants have taken the exam every year since 2009.[21] Even job trendlines from the top Tsinghua University show nearly 70 per cent graduates choosing to join government agencies, publicly funded universities, or state-owned enterprises for job stability instead of pursuing entrepreneurship[22]. This is problematic considering the contribution of the private sector in fostering China's growth story and innovation.

Meanwhile, an anticipated labour shortage caused by low birth rates and an aging population has pushed employers to recruit more women to labour-intensive jobs in infrastructure construction at lower wages.

Conclusion

There are many such contradictions in the Chinese economy. Xi Jinping's emphasis on strengthening state enterprises dubbed 'guo jin min tui' -- "the state advances, the private sector retreats" -- has also raised some alarms. Despite tense relations with the US, China finally threw open its doors to Wall Street in 2020 in a bid to cultivate new

friends. Yet there are significant uncertainties emerging from both Chinese domestic policies and foreign policy that would have an impact on the economy. Systemic and entrenched corruption threaten to upend the political and economic stability of China. The myth of the strong central government and obedient party officials in provinces, cities and townships is purposefully maintained by grassroot officials themselves. Every jurisdiction is a company, and every company a jurisdiction. Land resources and real estate are a hotbed for state-led corruption due to the dual land use policy. Many generals caught in Xi's anti-corruption campaign were from the erstwhile general logistics department in charge of real estate projects. Further, the fiction that the Party is not involved in the private sector, carefully nurtured especially for the western audience, has been busted.

Many of the problems that the Chinese regulators are trying to address, such as deleveraging, curbing monopolistic behaviour, and reining in carbon emissions, face public criticism. The government appears to have the resources to bail out companies if financial risks rise too high, with ample room to ease monetary policy if needed. However, the social and political impact of the many emerging problems in the Chinese economy are only becoming more acute and intractable.

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