Oxford Analytica

Has China hit a wall?

Today we are considering the prospects for China and its economy. China's GDP growth rate has slowed, the housing market has slumped, youth unemployment is high and US sanctions threaten the Chinese tech sector. The country is no longer the world's most populous, and adverse demographics are starting to bite. A sense of pessimism is spreading across society. Are these fixable problems, or signs of a country that cannot escape the middle-income trap and fulfil the aspirations of its leaders and people? Answers to these questions matter greatly to the Chinese people, to those doing business in China and for the stability and peace of East and South-east Asia.

Political dimensions and implications

Our assumption should be that China has hit a wall. This is not something we should be surprised about, as substantial evidence suggests this has long been a potential prospect for China.

Firstly, due to the financial fragility of economies like China's. According to a 2016 IMF Working Paper, "out of 43 economies where credit-to-GDP ratio increased by more than 30 percentage points within five years, 38 economies subsequently experienced severe disruptions, manifested in financial crises, growth slowdowns, or both."

Secondly, due to the middle-income trap of emerging economies. The World Bank and State Council of China's 2030 report, issued at the start of President Xi Jinping's first term in 2013 highlighted that "of 101 middle-income economies in 1960, only 13 became high-income by 2008".

Thirdly, because of China's low education level. Countries which successfully escaped the middle-income trap had an average education level of 72%, countries which remained trapped had an average of 36%. At 30%, China looks weaker than the latter.

Fourthly, the propensity for international conflict. In his book 'Destined for War', Graham Allison points out that "in 12 of the 16 past cases in which a rising power has confronted a ruling power, the result has been bloodshed." While we are yet to observe physical aggression between China and its rivals, there has been some very serious economic aggression on the part of the United States, which appears to have done severe damage to China's efforts to become a developed economy.

Despite the high probability that China would encounter an economic downturn, many in the past emphasised the unique features of China and used to argue that China would not suffer the same fate as other developing economies.

In terms of the implications of China's economic slowdown, this has been written about thus far in very ominous and vague terms. There is a need to start anticipating in more detail what a less economically successful China might look like.

Four plausible possibilities of what China's future might look like are illustrated here. It is not an exhaustive list, and the directions are all deliberately extreme to be clearly distinguishable. They are based on two critical variables: the degree of political control the Communist Party can exert, and China's level of international engagement.

1) 'Big North Korea': a scenario in which the China's Communist Party retains political control by ratcheting up its repression and control of information. The military is spared from fiscal austerity, and this is justified by increasing xenophobia. In this instance, the weakening economy does not necessarily weaken China militarily. Like North Korea, this China is not expansionist; the government's main policy focus is insular, focusing on self-sufficiency and import substitution. However, this would be done at a much higher level of technological competence than North Korea and in such a way that might allow some economic recovery in the long term.

2) ‘Xi as Putin’: a scenario where political control remains tight and xenophobia is promoted. The military receives priority access to resources and Xi remains firmly in charge, but he starts to worry that his legacy will be as the leader who led China to decline. Therefore, he starts to try more aggressively to destabilise the West politically and to make gambits to restore China’s historic borders, with acts of calculated aggression against China’s neighbours. This is not necessarily about deploying nationalism to divert the public from discontent -- this is about Xi Jinping’s own personal ambitions.

3) ‘Communist Mexico’: a future in which China has persistently high unemployment, and as a result develops a large informal economy, high levels of organised crime and high levels of corruption. It is a China whose government in inward-looking, but whose society has international spillovers, with large numbers of emigrants and cross-border criminal networks.

4) ‘China’s Falklands’: a classic diversionary war scenario, in which external aggression is used in a calculated way to divert the public’s attention and rally nationalistic sentiment. Such a scenario could play out very badly for China and might very well undermine rather than strengthen the government’s position. It does not seem very likely that under Xi Jinping Beijing would take this kind of approach as Xi is not hot-headed. However, it is something which might become more likely in the event of Xi’s untimely retirement. The power vacuum left by him might be filled by a succession of much weaker leaders.

China’s economic situation

From the 1980s until the 2000s, China recorded an average GDP growth of roughly 10% per year. In the 2010s, GDP growth averaged just under 8% per year. Against these measures, China’s 2023 GDP growth of 5.2% is certainly a slowdown, in common with all countries as they get richer, but not exactly a wall. Fears of such a wall are not new, and an eventual deceleration of China’s economic growth had long been predicted. With economic growth still reasonably robust and the wall narrative far from new, what accounts for this fresh pessimism?

An annual GDP growth of 5% in China is still perceived as the minimum needed to maintain social stability and keep youth unemployment from rising markedly. Forecasts of growth slowing to 4-4.5% keep being delayed by a year or two, which delays the rebalancing. So, we must look beyond headline growth.

While from 2014 to 2019 private and state investment grew roughly at the same rate, in 2023 private investment fell by 0.4% and state investment grew by more than 6%. The Chinese state cannot do all the work on its own. In addition, retail sales grew by just 7.4% last year, the slowest ever excluding the pandemic years. Against this domestic backdrop, exports will offer little relief as world trade is historically weak. China is trading less with its larger partners, such as the United States, Europe and Japan, and more with its traditionally smaller partners, such as Russia, while prolonged shipping disruption risks are high. Furthermore, stimulus today is moderate compared with earlier periods. Although more monetary stimulus may come, it raises fears of currency weakness and outflows. Indeed, Shanghai’s stock market has lost over 6% of its value in the past year.

There are concerns that long-term economic factors are starting to bite earlier than hoped: demographics, debt and diversification.

Today, the Chinese workforce is 900 million strong, and the number of over-60s totals 200 million. By 2050, China will have 700 million workers, and 600 million over-60s. The shrinking tax base and increasing number of elderly people will strain healthcare and welfare provision hugely, and graduate numbers are rising far faster than the economy is creating skilled jobs.

China’s debts rose to over 300% of GDP last year. Corporate debt is a particular concern, at 166% of GDP. Many of the recent stimuluses have just helped local governments pay off debts, rather than enabling them to make new investments. Most of China’s debt is domestic; external debt is very low compared to other economies. However, this domestic drag could limit scope for productive public spending on things like social security.

The drop in China’s GDP growth is also partly because the economy is now more services driven. Services made up 55% of the average growth of the last decade, while manufacturing was 40%. In the decades prior to the 2008-9 crisis, this was the other way around. Government policy on economic diversification will be key. The longer that 5% growth is targeted, the longer rebalancing could take.

There are three major global implications for China's economic trajectory.

As China's capital account remains relatively closed, the world will experience China's economic slowdown more through trade rather than finance. However, China is gradually opening the capital account to facilitate the currency having a greater global role. As it does this, portfolio investment between the United States and China should rise, even as trade and FDI ties with the West weaken.

China is more economically exposed to Europe than the United States, as exports to China account for far more of Europe's total than US exports to China account for its total. Europe is also a bigger net importer of food and fuel, exposing it more to the impact of Chinese demand on commodity markets. Europe's trade is also much more exposed to the Red Sea disruption.

More favourable dynamics could see US growth outpacing China's within a couple of decades. In addition, India's working population will be nearly twice as big as China's later this century.

US engagement with China and response to China's economic downturn

Early in the Biden administration, Secretary of State Anthony Blinken described the United States' China policy as "competitive where it should be, collaborative when it can be and adversarial when it must be." Observers quickly recognised that Biden's approach was not dissimilar to that of the Trump administration. This is no surprise, as both Trump and Biden campaigned in 2020 on a determination to be tough on China, with the message that a China under Xi Jinping intends to usurp the US position of leadership in the world. The implication here is that the United States needs protecting from China.

For much of the first year of his administration, Biden continued the Obama administration's 'pivot to Asia' approach, with the AUKUS pact in September 2021. Later, in a diplomatic effort to respond to Chinese influence in the Pacific islands, Kurt Campbell was elevated to a new position as Indo-Pacific Policy Coordinator, a role that prioritised efforts to contain Chinese expansionism.

By the start of 2023, both Democrats and Republicans had developed relatively clear angles on China. With control in the House, the majority Republican government established a new Select Committee on Strategic Competition between the United States and the Communist Party, tasking it with showcasing the party's strong line on China. For the Biden administration, its policy had become to invest in the US economy via infrastructure spending, align policy with Washington's allies in the Indo-Pacific regarding China and compete with China in offering a vision of the future: democracy rather than authoritarianism.

Both parties' strategies involve limiting Beijing's ability to compete at the highest levels of technology, by limiting export to China of the most advanced hardware available. At the same time, Taiwan became the renewed focus of attention as a potential flashpoint, requiring a policy of deterrence, particularly after the visit of Nancy Pelosi to Taipei in the late summer of 2022.

Biden's policy was broken almost exactly a year ago with news of Chinese surveillance balloons flying across the United States. It took most of 2023 to restore the bilateral communications, severed in the aftermath of the row that followed. Biden's meeting with Xi in San Francisco in November was required to restore the relationship to what it was at the beginning of 2023. Visits to Beijing by Treasury Secretary Janet Yellen and Commerce Secretary Gina Raimondo were also particularly significant in bringing the relationship back from the brink, underlining the sense that at heart this is an economic relationship, more than a security-based one.

For now, managing the US-China relationship to produce cooperation where possible, and understanding where not, will continue. Against this backdrop, the Chinese economic slowdown is provoking surprisingly little response in Washington's policy circles. There seems to be three reasons for this. Firstly, as pointed out by National Security Advisor Jake Sullivan, economic peaks and troughs are not useful as a basis for making long-term policy, because they tend to be so variable.

Secondly, both the Republicans and Democrats have invested so much in portraying China as the United States' biggest rival, so there is little to be gained in domestic political terms by portraying China's might as in any way diminished. Thirdly, there is no appetite for using the Chinese economic downturn to try and destabilise the Communist Party, not least because so many US companies still see China as a lucrative marketplace.

The crises in Ukraine and southern Gaza have demanded more congressional attention and debates on China have gone somewhat quiet. However, the China issue will likely reemerge as a significant campaign issue in the run-up to the US election in November. The focus will be on how threatening China is, not about how economically challenged it may be. US-China ties remain a symbiotic relationship. Both sides need each other for political purposes, and the Biden administration will likely treat relations with China as something needing a floor put under it, but at the acceptance of a ceiling above it.

Q&A

How are internal factors influencing China's policy towards the United States? Might redlines in the South China Sea be shifted?

China is encouraging caution in its policy towards the United States. China has been on the defensive via-à-vis the United States at least since the start of the trade war with the Trump administration, matching US actions, rather than escalating tensions, every time. Observers tend to focus on the so-called unfair practices that provoke the United States, as well as China's actions in the South China Sea and Taiwan Strait, overlooking the fact that in the economic realm, it is usually the West, and the United States in particular, which is making the first move. China is merely responding to these moves.

In the South China Sea, China has always been deliberately unclear about what it claims and how. It draws the line wherever it thinks it can get away with it, but when it has met serious pushback, it has tended to fall back a little. There is a definite red line where Taiwan is concerned -- the One China policy -- but there is not an explicit one in the South China Sea. If something like the 2001 EP-3 collision incident were to happen again, the Chinese would need to respond very strongly to that, especially if their people were injured or killed.

How can or will China use its reserves to start reversing the massive imbalance in US-China balance sheets, and what would be the consequences of that?

There does not seem to be a huge prospect of a massive reversal in the US-China imbalance. If you look at trade since 2017 and when the tariffs were imposed, China's moves have not been enormous historically. China does not seem to want to run down its reserves, or to have a way of using its reserves to make a marked difference to the US-China imbalance. To improve its global standing, China is more likely to focus on lending to countries across the world to strengthen international ties and will keep pushing the renminbi as a global currency, although that is starting from a very low base and happening very slowly.

What implications would a change in China's economic model do in terms of politics and trade and investment flows with Southeast Asia?

China is still conducting multi-billion-dollar investment projects overseas as part of its Belt and Road Initiative (BRI), not in South-east Asia recently but certainly in Africa. However, it is proceeding at a slower pace and more cautiously than it did in the heyday of the BRI. The BRI is an export market, and China needs that. Its basic strategy of 'going out', i.e. going global, has not really changed. While indigenisation is certainly happening with more emphasis than before, China's 'dual circulation' strategy partially involves making the world as dependent as possible on China, and, as such, its external ambitions have not been reined in.

When looking at trade data from the past few years, both South-east Asia and Japan have been doing less trade with China, but the trends are industry specific. Across the world, in certain areas such as commodities, there has been more intraregional trade, which suggests that there are two trade dynamics at work. In terms of commodities, food and consumer trade, China, Japan and South-east Asia are likely to do a lot with each other, while also being in competition in other areas.

What do you think Trump has learned from the first term? What would be in store if Trump were to be elected for a second term?

For China, the mercurial nature of Donald Trump is undesirable. Something worth watching is what might happen to China's 'most favoured nation (MFN)' status, the trade designation which is given by the United States to pretty much every country in the world except for four, one of which is Russia.

Several times in the past few years, the Republican right has introduced legislation into Congress which would remove China's MFN status. This would see its tariffs increase up to nine times on goods which are not currently subject to the current Section 301 tariffs. This has become somewhat of a rallying point for the right.

However, at the end of 2023, a report from the House Select Committee on the Communist Party's competition with the United States left out the recommendation that the MFN designation be removed from China. The reasoning for this was due to the US agricultural lobby.

Much of US agricultural produce comes from Republican-held states, and although the sector did decently well out of the Trump tariffs during the first term, it got compensation worth about USD20bn from Congress, due to the impact that the tariffs had when Chinese purchases of corn and soybeans fell. The agricultural sector does not want to weather that kind of impact again. Straightforward lobbying from the agricultural sector and companies wanting to market goods in China led to the toning down of the report.

We will likely get bluster, bombast and a sense that President Trump is protecting the country from China. However, the actual impact of a Trump second term would probably be less than advertised. Just as we saw a surprising amount of continuity from Trump to Biden in China policy, we might see something similar from Biden to Trump. The US relationship with China can be presented to domestic audiences in different ways, without a fundamental shift in what is going on.

Nothing the very high level of public debt, particularly at the level of provincial governments, to what extent do you think this is a break or worse on Chinese growth?

The more the Chinese spend on their interest payments, the less can be spent on new productive investments. In November last year, the Chinese introduced a stimulus to allow local governments to issue new bonds to raise more money. The programme was mainly designed to cover the size of the debts that they already owed, rather than to pay for new projects. The bigger China's public debt, the more it will hold the country back on spending elsewhere, and the more it will reduce confidence in the Chinese economy.

Do you see changes in the way in which the Chinese public views the United States? Do you see China emancipating itself from its fascination with the United States?

The United States is still the favoured destination for Chinese who want to emigrate, and many of them still want to, despite the information control machinery promoting the idea that US society is racist. There is also clearly a lot of admiration for, and interest in, US culture and brands. At the same time, there is a sort of triumphalism in China and a sense that China is just as good. The 2021 insurrection in the United States has been presented as problematic, while China has been presented as stable and successful. As the economic situation gets worse, that image will be harder to sustain. Perspectives depend on how the Chinese economy is performing and whether individuals are doing well out of the system or not.

Compared to Japan's, how does China's property market slump look at the moment?

In terms of will China's property market slump be as long -- yes, almost certainly. Will it be as deep -- also yes, as it almost is already. However, there are some crucial differences between the two cases. China has a much lower average income than Japan did when Japan had its slump. There is a strong distinction in the housing market structure as well. Typically in the West, two-thirds of housing transactions are for existing houses that have already been bought and sold. In China, about two-thirds of transactions are newly built houses, where developers use the deposits people are making to fund the development. China's housing market also includes a lot of regional differences, so all these aspects will make China's property market slump quite different from Japan's.

How have the Communist Party and the People's Liberation Army responded to Japan's remilitarisation? Are China analysts worried about the longer-term implications?

Both the Party and the military are very worried and have always been much more concerned by Japan than one might expect them to be. Japan has aircraft carriers, missile defence systems, satellites, as well as F-35s, and over the years has undergone a gradual dismantling of the legal restraints on its use of force. Japan also has a direct territorial dispute with China, which has been a flashpoint in the past, as well as significant US military support. US aircraft frequently come within 13 nautical miles off the Chinese coast, and

Japan has the biggest deployment of US troops outside of the United States itself in Okinawa. This hinders China's access to the Pacific. The Japanese government is also increasingly interested in Taiwan and its continued autonomy.