Opinion **China Economic Slowdown**

Beijing holds China's economic future in its hands

To stop a problem becoming a crisis, the government needs to start spending

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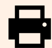
Robin Harding 2 HOURS AGO 

China's economy defies analogies. Just as its growth over the past four decades was unprecedented, its current difficulties — and it certainly has a problem, if not quite a crisis — are unique. It is not Japan in 1990, Korea in 1997 or the US in 2008. China does not face a financial crisis or a balance sheet recession; indeed, with growth still roughly on course to reach 5 per cent this year, it does not face a recession at all. Nonetheless, the situation is serious. In the past, the Beijing authorities have shown great flexibility and ingenuity to keep growth on track. Now they must do so again.

The current situation is characterised by a chronic lack of demand, even as the economy grows. Two statistics illustrate this. One is the consumer price index, which is on the brink of deflation: prices in June were flat year on year and down 0.2 per cent compared with a month earlier. The other is youth unemployment, which reached 21.3 per cent in June. This is clearly an economy where spending is not sufficient to occupy all of the productive resources available. One might call it "recessionary growth".

The danger from here is a deflationary spiral downwards, and the danger is real because no sector in China is well placed to spend more.

Consumers are still reeling from last year's zero-Covid policies, which saw lockdowns in China's wealthiest cities. Unlike in the US, Japan or Europe, there were no large transfer payments from the government, so the finances of exposed households took a battering. The scarring effect is quiet but profound. Consumers who had only experienced relentless growth have now tasted job insecurity, and found it bitter. With all China's structural barriers to consumption, such as a weak social security system that prompts saving to self-insure, spending will be slow to recover.

Private corporations, by and large, could invest if they wanted to. In a few, favoured sectors — most notably electric vehicles and the green energy supply chain — they are doing so on a massive scale. Elsewhere, things are gloomy. The technology industry is still reeling from the recent crackdown by regulators in the name of "common prosperity", US export controls and the effective closure of foreign capital markets. Between regulatory uncertainty and subdued consumption, service industries have little motivation to ramp up output. With the authorities reluctant to slash interest rates for fear of capital outflows, animal spirits will stay soggy.

Housing and infrastructure investment, the first place Beijing would normally turn for stimulus, are at the centre of concerns about a so-called balance sheet recession, in which a plunge in asset prices leaves households and companies insolvent and determined to pay down debt. China's overleveraged property developers, symbolised by Evergrande, do fit this story but a broader balance sheet crisis is not how things are unfolding.

Property prices have not fallen that far and the system is working hard to stabilise them. With property making up a large share of household wealth, as well as a crucial source of local government revenues, a crash would threaten financial and social stability. It would also create intense pressure for capital outflows. Municipalities in China have extensive tools available, including setting floors on the prices at which developers can sell, so instead of prices falling, transactions have dried up. That creates a serious problem of activity, but not one of default.

The other big borrowers are local government financing vehicles, which borrow to invest in local infrastructure. A number of these are struggling to pay their debts and need restructuring, but they are state-owned vehicles, which owe money to state-owned banks, which are financed by the vast savings of Chinese households, which are trapped in the country by capital controls. This will only become an acute crisis if the authorities are careless, and to the extent the problem requires shuffling assets and debts around the system, China should be able to manage.

Rather than existing debts, the big issue is the scope for new activity. Ageing and outmigration mean housing demand is essentially sated across large parts of the country. Allowing more building in mega cities such as Beijing, Shanghai and Shenzhen would give new vigour to the sector but bring its own set of uncomfortable and politically destabilising trade-offs. Incremental spending on infrastructure is always an option but it comes with diminishing returns and racks up more debt for the future.

That leaves two sources of demand: trade and government spending. China's current account surplus is already at 2 per cent of gross domestic product, itself an indicator of weak demand at home, and the rest of the world should be on alert for a renewed flow of ultra-competitive Chinese exports — now including high-end products such as electric vehicles. China exporting deflation in this way might help western countries overcome their current issue with inflation, but at a substantial long-term economic cost.

Everybody, inside China and out, should instead prefer the final option. China's central government is one of the least indebted in the world. It has ample scope to transfer cash to households, boost consumption and get the economy moving. Alarmingly, a recent politburo meeting provided a long list of policies but little sign of hard cash. If China is to sustain its long run of economic success, it is down to Beijing to act.

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