
SPECIAL REPORT

CHINA'S ECONOMY AFTER THE PANDEMIC

2ND EDITION



China's Economy After the Pandemic

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by Geopolitical Futures

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

When the COVID-19 outbreak finally got Beijing's full attention in January 2020, authorities shut down the bulk of the country's economy quickly and ruthlessly. And as the epidemic turned into a pandemic, Beijing's hopes of a swift recovery seemed to disappear as Western customers stopped importing Chinese goods. Despite fears of an economic reckoning, by summer 2020, the Chinese economy had regained its footing. By the third quarter, it had become the first major economy to grow again. By the end of the year, it was in the black. Much of the West was left wondering if China had indeed stumbled upon a foolproof economic model that makes its growth in power and influence unstoppable.

However, following the success of beating the first wave, as the emergence of the second wave led to another series of lockdowns and other restrictive measures, what the Chinese leadership had been afraid of began to materialize. In August 2021, cracks appeared in China's property sector, and despite all efforts by the government, the issues persisted. After the problems in real estate became apparent, the banking sector began to grapple with growing financial distress caused primarily by the country's extensive shadow banking industry. These two problems were made worse by issues triggered by the COVID-19 lockdowns: decreased spending and factory production and falling foreign direct investment. By mid-2022, all these issues became impossible to ignore, creating a general dissatisfaction in Chinese society that resulted in a number of minor protests throughout the country.

By the end of 2022, most countries had lifted COVID-related restrictions, but China would not relent. As lockdown measures stayed in place, local governments were left almost entirely to their own devices, many of them without the financial resources to resolve their economic problems. Meanwhile, as President Xi Jinping secured his unprecedented third term in March 2023, the central government introduced new measures to resolve the real estate and banking problems. None were successful.

As China's internal problems became more apparent throughout 2023, several countries began to lose heart. More and more Belt and Road Initiative projects are left unfinished, and China is starting to lose its influence in the Indo-Pacific to a quickly emerging U.S.-led security alliance. Chinese society no longer has the blind faith it used to have in the government. And as 2023 comes to an end, the government is laser-focused on how to keep its house-of-cards economy upright and social unrest at bay.

Growth and Traps

China's incomparable growth over the past 40 years has been fueled by three things: cheap exports, investment, and the one-time gains of land and resource privatization and urbanization. This is the standard blueprint for developing economies, which take advantage of low wages to piggyback off growth in wealthier countries by undercutting their industries and profiting off their voracious appetites for consumption. Exports have been particularly important for China, especially since joining the World Trade Organization in 2001, reaching as high as 36 percent of GDP in 2006. China was able to basically copy the industrialization model pioneered by powerhouse neighbors like Japan, South Korea and Taiwan and then turbocharge it thanks largely to its practically limitless labor pool.

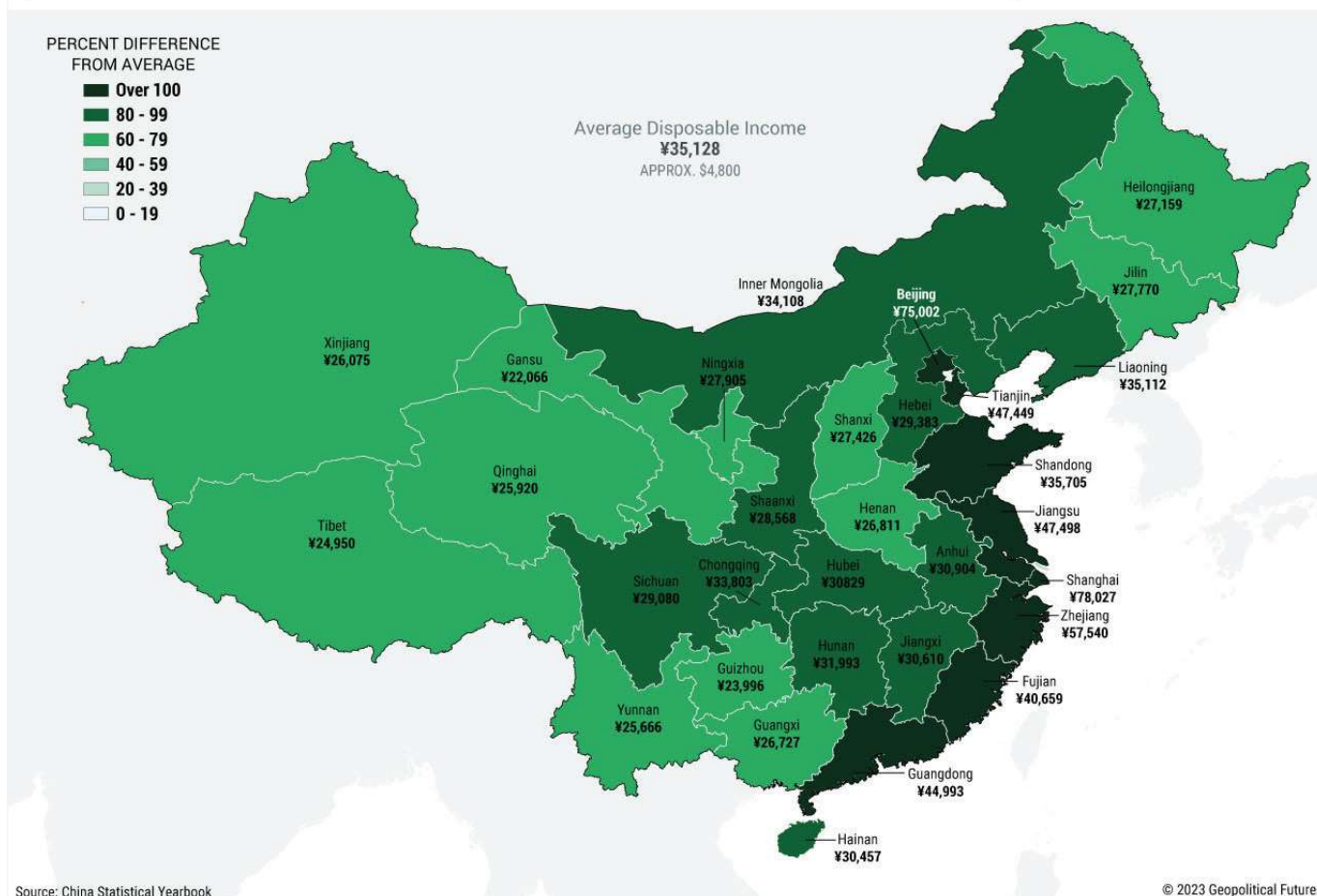
But there are two overriding problems with a dependence on cheap exports. First, China's ability to sustain its economy depended too much on economic conditions outside the country and thus outside of Beijing's control. China is beholden to its customers, most of them located in distant markets, none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

Second, the wealthier China becomes, the more difficult it is to sustain its export-heavy model. Rising standards of living push wages up, making Chinese exports less competitive and giving foreign firms reason to look for lower-cost alternatives. China wants to accommodate these changes by moving into

high-tech, higher-value exports, but here it faces competition from countries that climbed the value ladder decades ago – not to mention recent targeted measures enacted by these countries to curb China's rise as a technological powerhouse. This is known as the middle-income trap – something China is desperate to avoid.

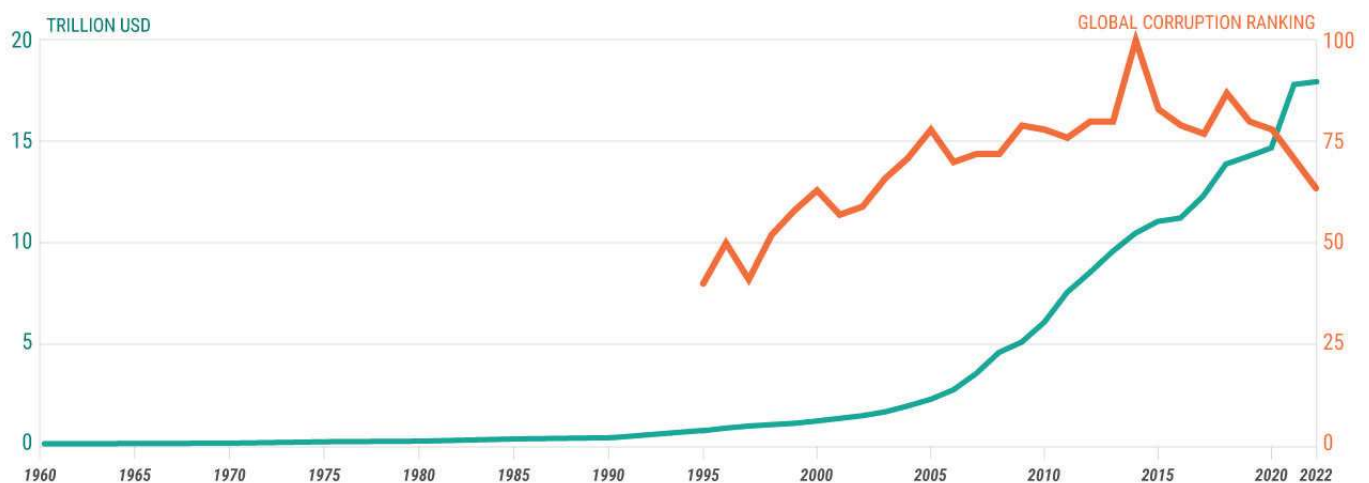
The challenge for China has only intensified as its neighbors in South and Southeast Asia modernize their own manufacturing and export infrastructure. China has tried to rebalance its economy to depend more on domestic consumption for growth. And it's made great strides in this regard. Consumption as a percent of GDP has crept up over time, albeit in fits and starts. Per capita GDP rose from \$951.16 in 2000 to \$12,540 in 2023. China is expected to have the largest consumer market

Per Capita Disposable Income by Administrative Division - 2021



in the world by the mid-2030s, though it is now rivaled by India, whose population has just surpassed China's. Standards of living in China's wealthiest regions, especially the tech and export powerhouses along the southeastern coast, are for tens of millions of residents little different from what one would find in Tokyo or Seoul. But much of interior China is still very poor, which limits the purchasing power of the domestic market as a whole. Hence why China's per capita GDP still ranks just 74th in the world, behind countries such as Kazakhstan and Turkmenistan. China's unusually high household savings rates and the sky-high costs of homeownership in most Chinese cities further dampen domestic consumption. There's evidence that younger generations of Chinese are starting to reject the parsimony of their parents, as measured by rising household and credit card debt levels. (These same generations – most of them coming from one-child families – are going to be responsible for caring for China's elderly more than in countries with higher birth rates, so it's hard to see Chinese household spending reaching Western levels anytime soon.)

China GDP Growth Rate and Corruption Perceptions Index



Sources: Transparency International, World Bank

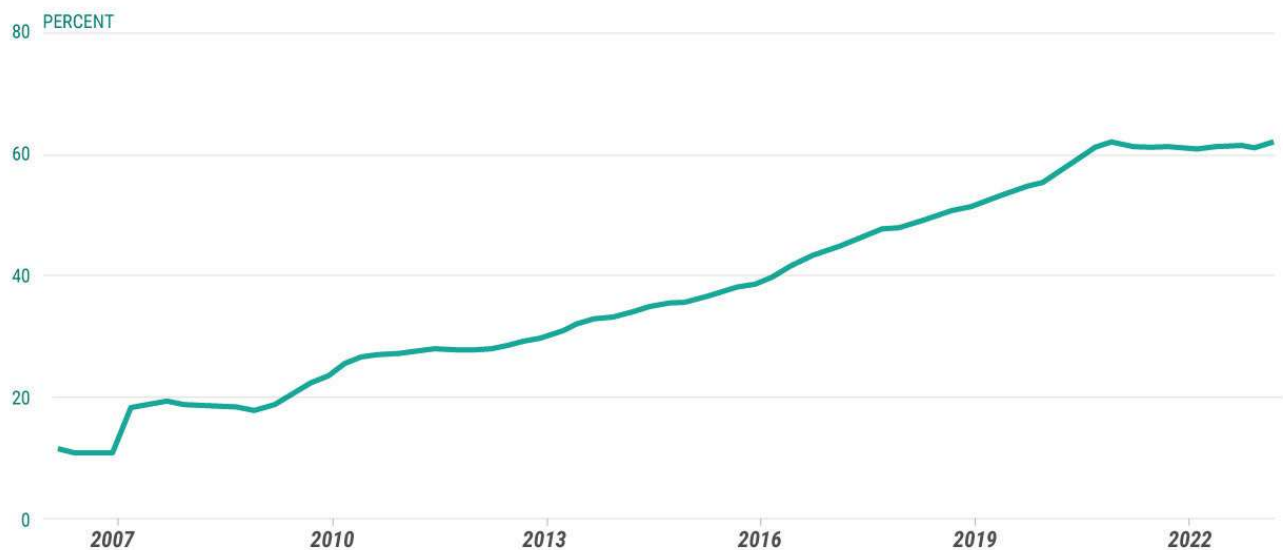
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To sustain its breakneck growth, particularly during periods

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

But keeping the Chinese economic system perpetually swimming in cash has created other dangerous problems that have become all the more acute since the 2021 downturn. An enormous amount of investment inevitably gets wasted, but it has been even more difficult for China to get the same bang for

Rising Household Debt in China



Source: Trading Economics

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its buck. Beijing's authoritarianism has hurt productivity over the years, too, as state banks and local governments typically prioritize funding projects they think will conform with the Chinese Communist Party's wishes (and thus those that are most likely to be guaranteed by the state, should the investments go bust), rather than based on standard risk/return calculations. This has led to industrial inefficiency, widespread unprofitability and a number of distorted incentives throughout the Chinese system. It has also generated a number of other major headaches such as wildly inflated real estate and land bubbles, and has saddled firms, banks and local governments with unsustainable debt loads and ever-more burdensome debt repayment obligations. Put simply, the Chinese economy is littered with ticking time bombs. No country in history has amassed so much debt so quickly as China has without succumbing to a financial meltdown, according to the World Bank. So long as China's economy was galloping ahead at double-digit growth, with enough cash to paper over inefficiencies and the country's immature system for pricing risk, the chances of an uncontrollable financial crisis were low. But with China now facing a long, structural slowdown, it should come as no surprise that the debt problem has finally caught up with the country's economy.

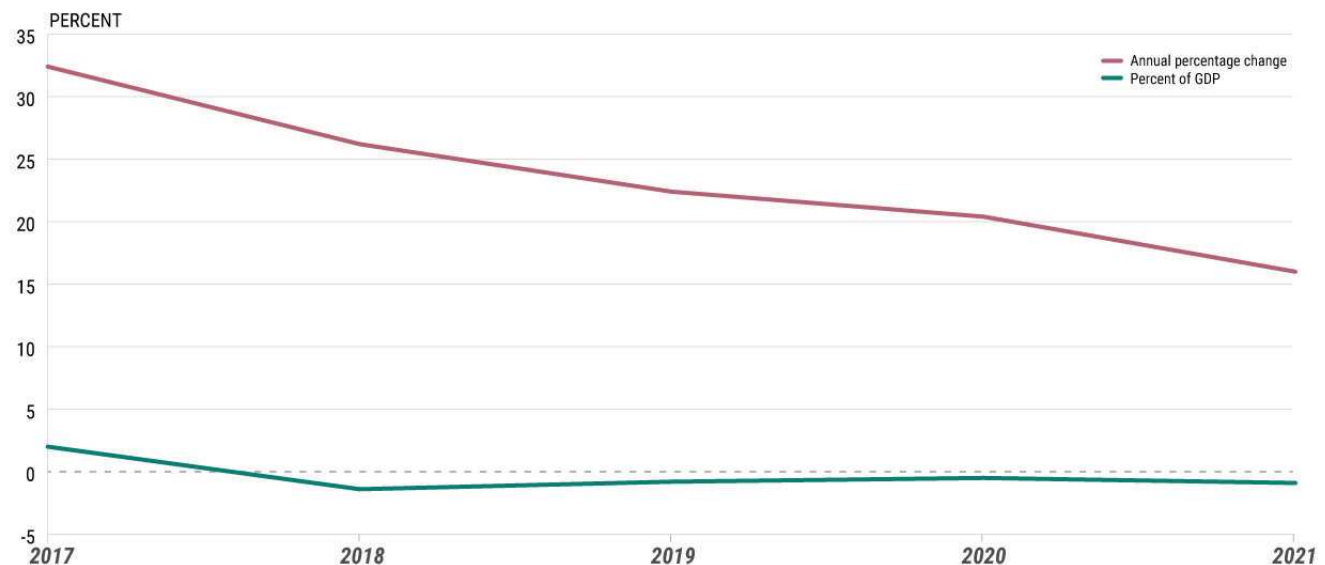
Hazards, Moral or Otherwise

In light of the rebound from the first wave of COVID-19, it seemed that the Chinese economic system was adequately resilient and that Beijing had the tools to maintain social stability in the event of a downturn. But China's current hardships are different. The real estate and banking crises, as well as the dwindling FDI inflows, are much more difficult to resolve. Moreover, social unrest has become frequent by Chinese standards, and though the government has managed to keep protesters largely in check, it has not been able to conceal the

protests from the outside world. What Beijing fears most is a shock – whether triggered by an external bubble or by a rupturing of any one of its interconnected internal socioeconomic fault lines – that sows panic, overwhelms its ability to respond, and exposes the inherent rigidity and clumsiness of its tightly centralized system.

There have been several close calls, particularly since 2008. There was an interbank lending crisis in 2013, a stock market crash and surge of capital flight in 2015, a peer-to-peer lending bust in 2018, a liquidity crisis, an uptick in pandemic-era shadow banking and, by China's standards, an alarming string of bank failures in 2018-19. As a result, Chinese leaders have been acting with a sense of urgency to address financial risk

China's Shadow Banking in Total Social Financing



Source: IMF

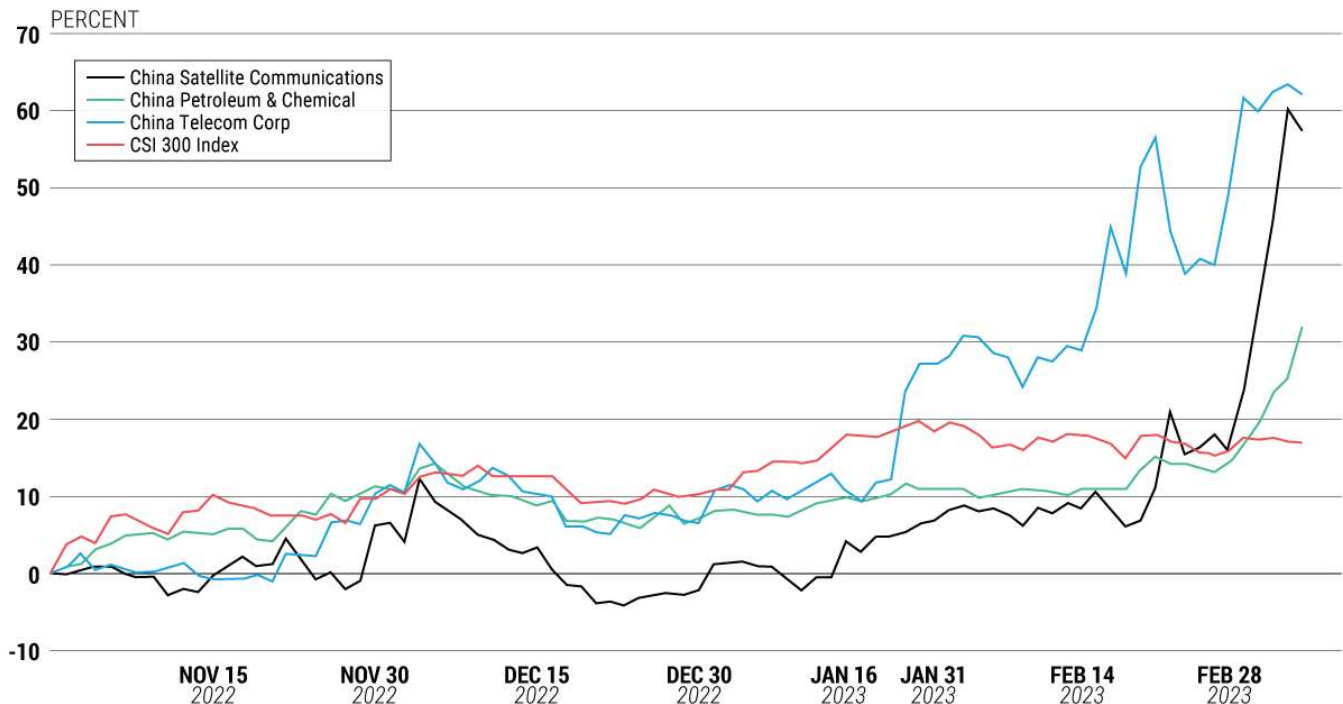
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that, in most countries, is typically seen only after a financial meltdown has begun. In 2017, Xi elevated financial stability as a matter of national security. To that end, his administration has attempted to implement a host of ambitious de-risking reforms, including an overhaul of China's regulatory apparatus,

sicking anti-corruption authorities on wayward officials and tycoons, and hammering local and provincial governments and banks to clean up their books and to curb shadow lending practices. It also gave the central bank free rein to tinker with the system in search of an elusive balance between liquidity and control.

But these efforts have been bedeviled by two chronic problems, both a result of Beijing's insistence on maintaining a state-centric system. One is a distorted banking system that's heavily incentivized to focus on the needs of China's more than 150,000 state-owned enterprises (the bulk of which are owned by provincial and local governments) and projects that banks suspect will be prioritized by the party at the expense of everything else. Consequently, the system is not particularly good at pricing risk or distributing credit to areas of the economy that don't have implicit state backing. It's particularly bad at meeting the needs of households and small and medium-size

State-Owned Enterprises in China



Source: Bloomberg

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enterprises, which tend to have scant credit histories or assets available for collateral but which now make up the overwhelming share of employment in China. This forces businesses and cash-strapped local governments to seek funding via shadow lending vehicles (the opacity of which makes Beijing nervous) and households to rely on things like peer-to-peer lending platforms (the volatility of which makes Beijing very nervous as a potential source of social upheaval).

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

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

get around regulatory constraints and meet employment and growth targets set from above.

Regulators may grouse about the state sector's profligate ways, but they've generally been unwilling to expose it fully to market forces and leave state banks on the hook for losses. The handful of times they've tried, things have gone badly. China came close to having its own Lehman Brothers moment in June 2013, when Beijing briefly declined to intervene following a technical default between two small banks. (More recently, with property giants Evergrande and Country Garden having defaulted, the crisis is at another level.) Interbank lending rates soared, grinding lending to a halt and sparking a liquidity crisis that spread into the rest of the economy. Beijing quickly backed down, and the merry circus continued. Thus, heading into the pandemic, China was in a race against the clock to put its economy on sounder long-term footing – before Western economies crashed again, and before its internal debt loads and asset bubbles triggered a crisis it simply wouldn't be able to contain – to move the economy away from low-cost exports and investment and toward domestic consumption, high-value manufacturing and services. And in late January 2020, when the scale and gravity of the coronavirus outbreak in Wuhan finally dawned on China's leadership, the clock appeared to hit zero.

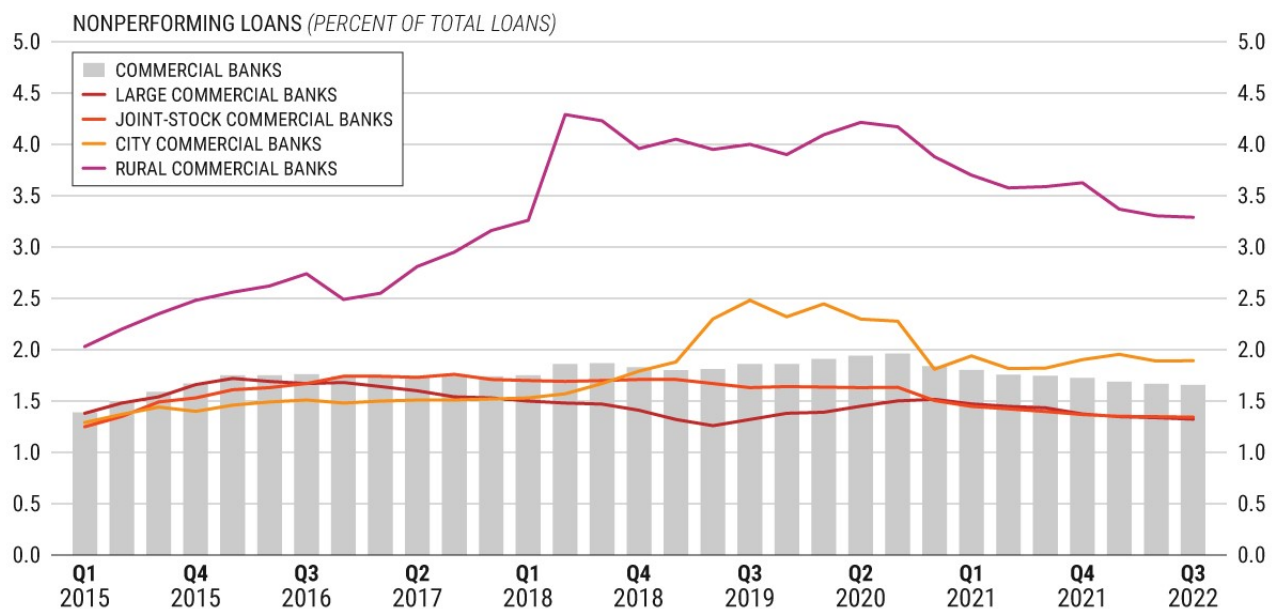
Recent Challenges

The systemic shock from the pandemic and the associated lockdowns could have exposed China's economy immediately. Countless small businesses faltered, looking for rescue in a banking system that already had begun to show its own problems. China's convoluted financial system, already lousy with shadow lending and toxic loans, seemed to be on the brink of collapse. In 2020, GDP contracted sharply, while unemploy-

ment reached a new high. Close to half a million businesses closed their doors at least temporarily in the spring, including one in six self-employed ones. Even when Beijing was able to reopen most of the economy, moreover, it faced a secondary crisis in the prospect of collapsing demand for Chinese exports as the rest of the world's economies shut down.

Despite all the initial issues, China in 2021 managed to bounce back to pre-pandemic growth levels thanks to three factors. One is the fact that, after initial missteps, China was relatively successful in containing the coronavirus and preventing it from becoming the sort of prolonged drag on economic activity that Western countries experienced. Second, China's main buyers in the West proved far more resilient to the pandemic than just about anyone could have anticipated. As societies learned how to navigate the crisis, it quickly became clear that the economic damage was extremely uneven within countries. What people weren't spending on travel or eating out, they were spending on work-from-home gear, of which China manufac-

China's Nonperforming Loans

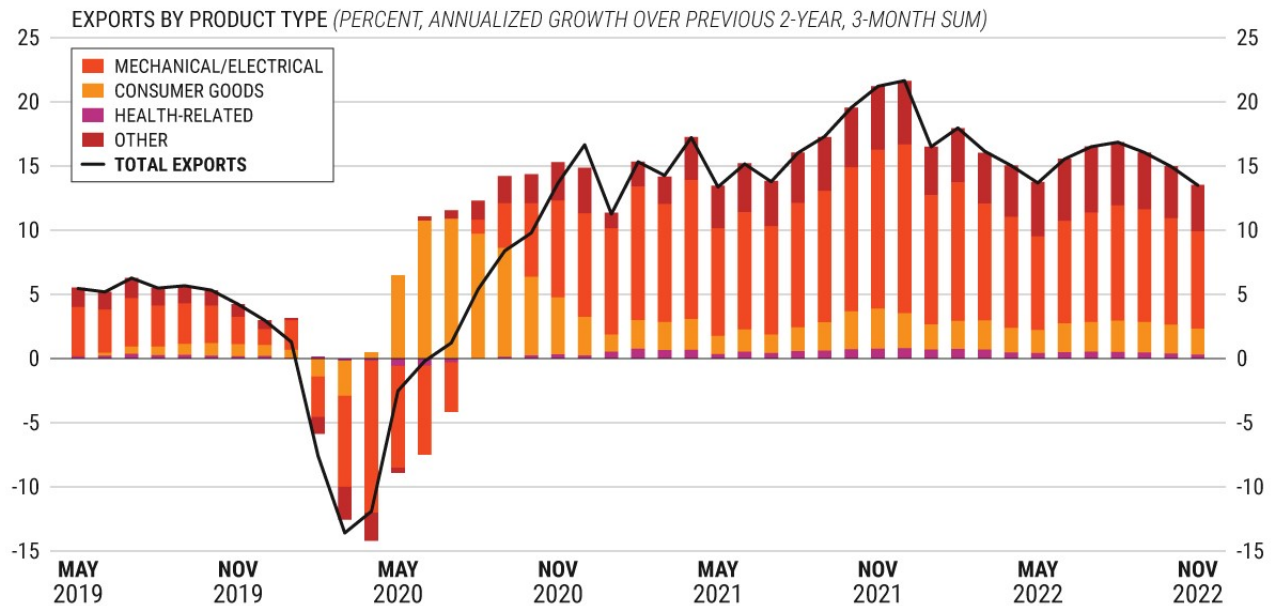


Sources: IMF

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tures a lot. It also made untold numbers of masks and other medical equipment that suddenly everyone was stockpiling. From April to July, textiles, office machines and medical devices accounted for nearly all the growth in Chinese exports, and they remained strong through the end of the year. Third, China

China's Export Rebound



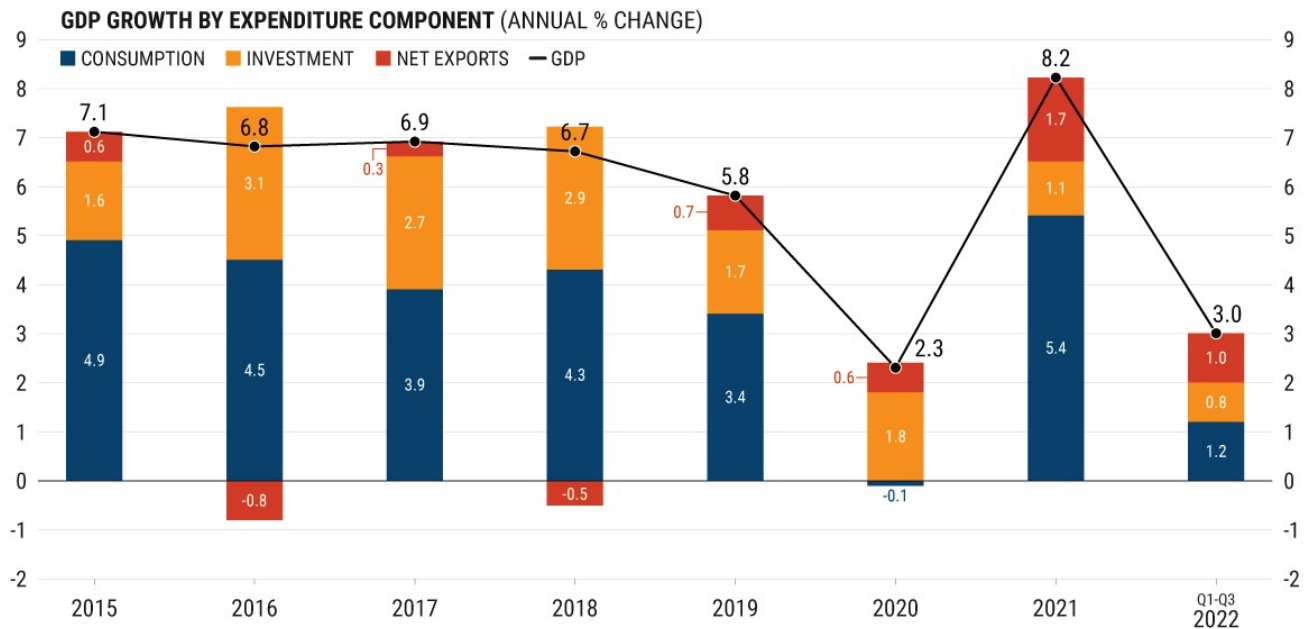
Sources: IMF

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quickly pushed out a slew of stimulus measures to get liquidity to small and medium-sized enterprises without resorting to the lending free-for-all it did after 2008. For example, it reduced interest rates and redoubled its efforts to encourage banks to lend to private SMEs, which make up roughly 60 percent of the Chinese economy, plus around 80 percent of Chinese jobs. Beijing also cut taxes and pension contribution requirements. In a survey conducted in spring 2020, nearly a third of respondents said they couldn't last more than a month on their current savings, and by the fall an estimated 18 percent of SMEs had closed for good. Notably, though, only around 15 percent of SMEs reported seeing any of the 1.5 trillion yuan (\$230 billion) in financial support Beijing had earmarked for them.

Throughout 2021, consumption continued to lag behind ex-

Chinese GDP Growth



Source: China's National Bureau of Statistics

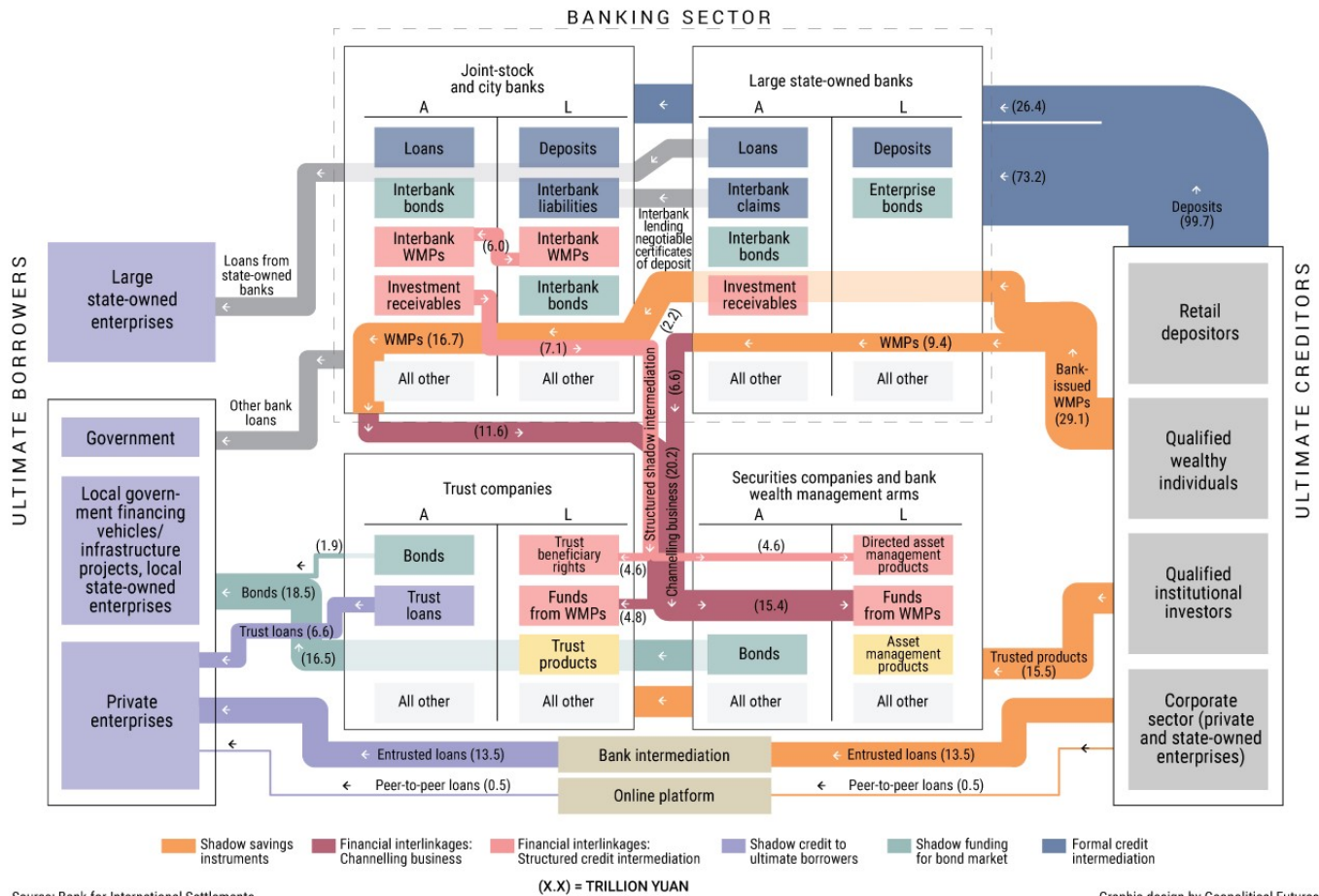
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ports and investments, but a meltdown did not start immediately. However, it became clear that China was facing headwinds from just about every direction. For example, there's China's deeply unfavorable demographic picture, in which the legacy of its one-child policies, combined with the declining birth rates that tend to coincide with rising household incomes, was already compelling Chinese households to save rather than spend. This will be a drain on productivity and dynamism for decades to come. There was also the intensifying rivalry with the U.S. and its allies, which heralded continued, if halting, efforts by Western countries to "decouple" from the Chinese economy. Beijing has been especially worried about its dependence on the U.S.-dominated financial system. Nor was China entirely past the pandemic.

In 2022, the consequences of sustained lockdowns came to fruition, dramatically disrupting economic activity in the second quarter and resulting in a real rate of growth of only 3 per-

Mapping China's Shadow Banking

Structure of Claims, 2016

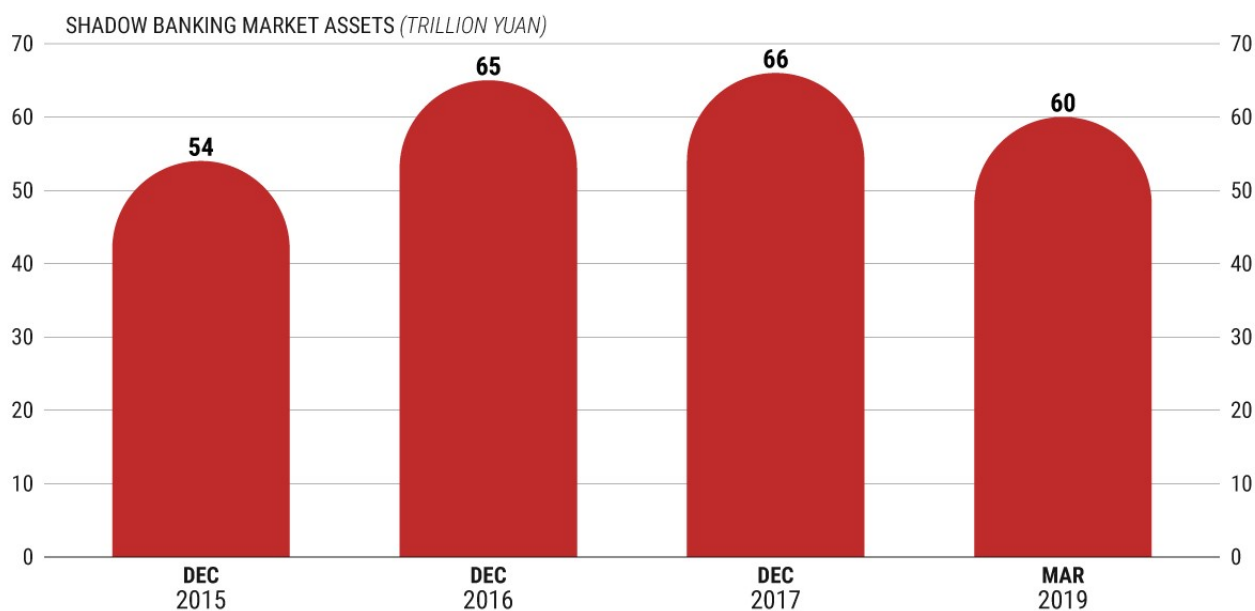


cent for the year. (This was the second lowest annual growth rate since economic reform and opening began in 1978, and only slightly more than half the original target rate of 5.5 percent.) Moreover, the crude birth rate, which had been declining already, fell to 6.77 per thousand (well below the crude death rate of 7.37 per thousand) for the first time since 1960. The total population declined by 850,000 to 1.411 billion. Thus, in 2023, India surpassed China as the most populous nation in the world.

2023 also marked the first year of a new term for the Chinese government. Officials placed a renewed focus on economic development – and had a lot of work to do in that regard. In

2022, China had a per capita GDP of \$12,270, roughly one-fifth that of the U.S. and ranking 80th in the world. Beijing sought to maintain the hardline zero-COVID policy when restrictions were lifted all over the world, but public frustration with the lockdown measures finally swayed the opinion of officials. Even so, the Chinese economy still faced uncertainties throughout

Chinese Shadow Banking Assets



Sources: Statista

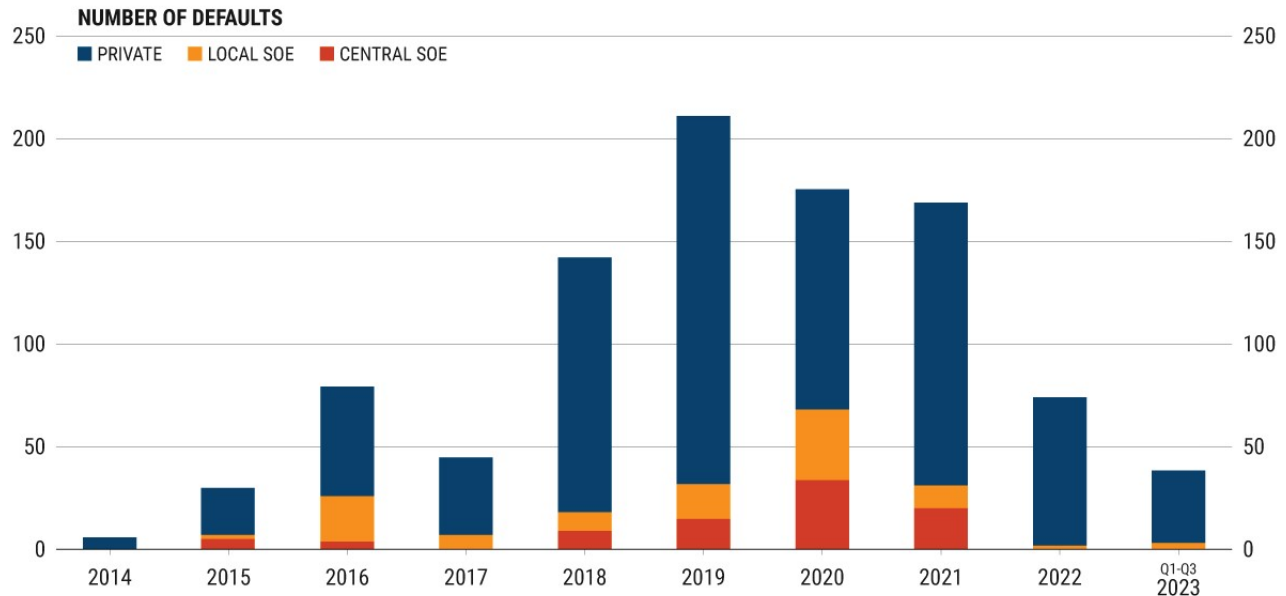
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the year, including the possibility of a global economic recession, the potential impact of U.S. decoupling measures and its bubbling demographic crisis.

After a strong and ambitious start to 2023, Chinese economic activity has fallen short of expectations. Exports have collapsed. Consumption, production and investment slowed considerably, while inflation levelled out as unemployment edged up. The yuan hit new lows in August and September 2023, driven mostly by worries about the domestic economy. Amid deteriorating balance sheets, an ailing property sector and limited macroeconomic policy responses, concerns began to

mount. The balance sheets of households, enterprises and local governments are now stretched thin.

Chinese Bond Defaults



Source: Amstad, Marlene and Zhiguo He, "Chinese Bond Market and Interbank Market"

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With the property sector stalling, Beijing is trying to find new engines of growth. Xi recently stressed the need to promote "a new type of industrialization" in which sectors like green technology could take the place of property. But that goal may be impossible in the near term; sectors now defined as "strategic emerging industries," including advanced materials and tools and green energy products like electric vehicles, generated a little over 13 percent of GDP in 2022. It's unlikely that new manufacturing sectors alone will reach the scale or generate the growth and jobs that property did. Because of this, Xi's new industrialization plan appears more like a tool to achieve tech self-sufficiency and compete with the West than a means to goose GDP growth.

Fiscal and monetary responses to China's problems have been fairly modest, despite China's risk of deflation. Since late

2020, real interest rates have been relatively flat, even increasing over several quarters when the consumer price index fell faster than the policy rate. Instead of putting their money into banks, Chinese citizens tend to buy apartments and houses. Amid deflation, the value of their property will decline as their debt holds steady. Deflation in China is still relatively mild, but it is setting expectations of what's to come.

The absence of a comprehensive set of responses reflects Beijing's current policy objectives. Authorities have tended to prefer supply-side reforms. Some of them were implemented to address national security concerns, while others were attempts to deal with existing regulatory problems such as consumer protection and fair competition. They reflect the increasing weight the government assigns to security issues and the costs it is willing to bear as a result.

Another major concern is local government debt, which has increased dramatically thanks to a sharp drop in land sale revenues, as well as the lingering impact of the cost of imposing pandemic lockdowns. Local government debt reached \$12.58 trillion in 2022 – roughly 75 percent of the country's economic output. Part of that is debt issued by local government financing vehicles, which cities use to raise money for infrastructure projects, often at the behest of the central government when it needs to boost economic growth. The fiscal stress seen at local levels not only poses great risks to Chinese banks but also blocks the government's ability to stimulate growth and expand public services. Debt-laden municipalities are a major risk that the central leadership finally seems to have realized. In October, the People's Bank of China ordered major state lenders to extend terms, adjust repayment plans and reduce interest rates on outstanding loans to local government financing vehicles. It is unclear exactly how much debt will be restructured, but large-scale loan extensions and interest rate reductions are likely to deal a heavy blow to banks' operations.

Long-term Challenges

This is to say nothing of China's long-term challenges, including strained relations with key trading partners such as the United States and Europe. Today, China is one of the largest export markets for U.S. goods and services, and the U.S. is among the top export markets for China. U.S. imports from China came to \$536.3 billion in 2022, up 6.3 percent from 2021 and up 26 percent from 2012. U.S. exports to China accounted for 7.5 percent of overall U.S. exports in 2022. Bilateral trade with China has helped Washington keep prices low for consumers and keep profits high for corporations, but it has also created less desirable outcomes. For example, millions of Americans lost their jobs due to import competition. The U.S. has long accused China of pressuring U.S. companies to hand over their technology. The optimism that accompanied China's entry into the World Trade Organization more than 20 years ago vanished as Beijing embraced state-led development, pouring subsidies into targeted industries to the detriment of U.S. and other foreign companies. The Biden administration's recent ban on certain chip exports to China has strained U.S.-China ties even more, and despite a continuing dialogue between the two nations, substantial, long-term improvement still seems far away.

Several European nations and multinational corporations adversely affected by supply chain disruptions, meanwhile, are now re-evaluating their approaches toward China. Though many businesses see China as a vital market, uncertainty remains about its recovery. Some European officials are increasingly aligning with the U.S. on China as they safeguard their economic interests. The Italian government has said it will pull out of China's Belt and Road Initiative. The European Commission has pushed for export controls on sensitive technologies.

Germany's latest China strategy calls for effective frameworks for future engagements with Beijing. And as Europe's trade deficit with China rises to unprecedented levels, more European companies have called for decoupling.

But this being the EU, not everyone is on the same page. Various member states have different approaches when it comes to dealing with China. At the EU level, China is seen as a competitor, but at the national level, each country possesses a unique set of business interests that shape its official policies. Striking a balance between accommodating these interests and upholding EU approaches is a difficult task for every country.

Then there is China's demographic crisis. Earlier this year, China released data that showed its population started shrinking last year for the first time in six decades. This presents significant challenges to its economic growth potential. The decline in labor supply and increased health care and social spending could lead to a wider fiscal deficit and higher debt burden. A smaller workforce could also erode domestic savings, resulting in higher interest rates and declining investment.

All this is to say China's economic miracle has most likely come to an end. Higher incomes and higher labor costs, deteriorating external conditions and an ageing population all present serious long-term impediments to growth. In October, the World Bank cut China's gross domestic product forecast for 2024 to 4.4 percent from 4.8 percent. Days earlier, the International Monetary Fund said it expected China's growth to slow to around 3.5 percent over the medium term.

For China's leadership, stability is paramount. It's easy enough for Beijing to keep people fat and happy when the economy is humming; it's much more difficult when the economy is sputtering. The fact that improvements will come much more

slowly than was anticipated after the pandemic is a major challenge for Beijing, which needs to restore faith in the government, keep the people in line and maintain its power and influence.

The fact is that China now has an ailing economy, grave demographic issues and a general hopelessness over the future, especially among the country's youth, who have always been regarded as a cornerstone of Chinese society. Unsurprisingly, a faction opposing Xi's agenda has formed within the Politburo. That he has removed some members of that faction demonstrates fear of unrest and challenges to his power. Even if Xi manages to come out on top, the country he will lead won't be like the country he promised would prosper.

MISSION STATEMENT

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

Geopolitical Futures is rigorously non-ideological. Our staff may have their personal beliefs, but they must check them at the door. Therefore, we strive to be objective and indifferent to the opinions swirling around the world. We believe that liberal democracy can survive only if there is a segment of society, which we call the learned public, who is not caught up in the passions of the moment, but is eager to look at the world as it is. It is this learned public that will influence the political system toward the prudence that flows from understanding, and whom we serve with the methods we have developed.

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