Xi Jinping's Year of Instability

Mounting Challenges to China's Economy in 2022

And the Implications for Chinese Domestic Politics and Foreign Policy

An address to the Asia Society, New York

9 May 2022

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Introduction

Since the start of the year, observers around the world have been trying to make sense of where China's economy is headed as the country enters the most politically sensitive and important year of Chinese President Xi Jinping's decade-long tenure.

At the 20th Party Congress this November, Xi will seek a historic third term in office – thereby effectively crowning himself emperor for life. Central to Xi's bid for continued political rule is his success in maintaining Chinese economic prosperity. Xi, therefore, has an overriding interest in ensuring minimal disruptions to China's economic growth, financial stability, and social well-being for the year ahead. Unfortunately for Xi, however, 2022 has so far provided him with none of the stability he craves.

The purpose of this address is to assess where the Chinese economy is likely to land by year's end, as well as what this is likely to mean for Chinese politics, foreign policy, and U.S.-China relations.

So How Did We Get Here?

When I gave an update on China's economic and political outlook for 2022 in January, I argued that a rapid-fire series of economic policy decisions over 2021, and the simultaneous crackdown on a number of large Chinese private sector corporations, represented a reconsolidation of power into the hands of the party-state over the market.

Central to this effort was Xi's "common prosperity" campaign, which targeted rising inequality – placing China's private sector, tech giants, and the super-wealthy in general firmly within the party's sights.

Beyond common prosperity, I also argued there had been other shifts to the left in economic policy under Xi including:

- the reversal of a long-standing plan to reduce the size and role of state-owned enterprises;
- a re-birth of industrial policy on a grand scale; and
- an ever-expanding policy mandate for "self-reliance" across a range of "strategic industries."

Then, beginning in the summer of 2021, Beijing launched a significant crackdown on Chinese tech platforms based on their purported excessive market power that wiped out more than $1 trillion in stock value from their peak.

At the same time, Chinese financial authorities sought to orchestrate the managed – redistribution of the assets of China Evergrande Group, the troubled real estate developer with more than $300 billion in debt. Evergrande's plight was symbolic of China's heavily indebted property sector – a sector representing some 29% of Chinese GDP. Indeed, more than 10 Chinese property firms have defaulted on dollar-denominated debt since last year, including Kaisa Group – the sector's second-biggest offshore bond issuer after Evergrande and owner of $287 billion in total liabilities.

I argued in January that the shift to the left in China's overall economic policy settings, combined with the crackdown on the property and tech sectors, had created significant economic headwinds for China's growth numbers in 2022.

I also noted in that address that, beginning with the Central Economic Work Conference held in December 2021, China had already started to readjust Xi's left-leaning economic policy settings as the full economic impact of his 2021 measures began to be felt in the real world through declining economic growth. But as I warned back then, this would be easier said than done. In particular, I warned that restoring private sector trust and business confidence would be difficult because, for the Chinese private sector, it was now a case of "once bitten, twice shy." And in the six months since the December "reset," that has proven to be the case.

In this address, as part of a rolling quarterly series of analyses on China's evolving political economy and real-world economic performance, I intend to update my earlier analysis to take account of more recent domestic policy developments, China's zero-COVID challenge, as well as the geo-strategic and macroeconomic implications of Russia's invasion of Ukraine.

In it, I argue three core propositions:

First, that Chinese economic growth is slowing because of collapsing business investment confidence, poor consumer demand (exacerbated by the brutal implementation of a zero-COVID strategy across metropolitan China) and rising inflation – so much so that it is now shaping up as the most serious economic slowdown since the aftermath of Tiananmen Square in 1989.

Second, that this is in large part one of Xi Jinping's own making, and that it is still unclear whether he can effectively correct his current policy course – despite the need to do so if he wishes to restore growth.

And third, that a combination of slow growth at home, foreign policy overreach abroad on Russia and Ukraine, and the politics of pandemic management make it less clear that Xi will have a comprehensive political victory at the Chinese Communist Party (CCP)'s 20th Party Congress in November.

But, to begin, let's first review what the data is showing us about the health of China's economy.

China's Faltering Economic Growth

Recent data from the National Bureau of Statistics (NBS) shows that, officially, China's GDP expanded by a surprisingly strong 4.8% in the first quarter of 2022.

This data is not really believable. To begin with, it is inconsistent with the official monthly data collected during the course of the first quarter. Furthermore, looking at growth in quarter-on-quarter terms, China's GDP only grew 1.3% in Q1 of 2022 from Q4 of 2021. This represented a slowdown from a 1.6% increase in Q4 from Q3 of 2021. It also suggests that the 1.3% official increase in GDP recorded in the first quarter primarily reflected strong growth in the first two months of January and February, while seeming to downplay the extent of the COVID-induced economic downturn beginning in March.

Indeed, the NBS acknowledged these forces in its April bulletin when it stated that China "is facing recurring waves of the pandemic in many places and its impact on the economy is increasing." Six Chinese provincial-level jurisdictions – all of which suffered a rise in infections in the January to March period – lagged the national GDP growth rate in the first quarter.

The International Monetary Fund (IMF) has now cut its annual growth forecast for China to 4.4%, citing disruptions from COVID-19 lockdowns and the Russia-Ukraine war. This marks the IMF's second downgrade in three months. Many private banks are even more pessimistic. Nomura, for example, has warned that China's zero-COVID policy could drag down growth to 3.9% this year. Official manufacturing data also points to an even more negative picture ahead. Purchasing manager indexes showed significant contractions in factory and service-sector activity for a second straight month in April, falling to their lowest levels since the pandemic began in 2020.

So what are the causes of this slowdown in growth?

First, there is private fixed capital investment. Coming into 2022, private investor confidence was already on thin ice. The general crackdown on China's private sector, and efforts by the party to target what it described as the "reckless expansion of capital" in both the property and tech sectors, had already left investors in deep shock. In the span of a year, market-cap evaluations of the ten largest Chinese tech firms have fallen by around $2 trillion in market value.

In mid-March, JPMorgan Chase had downgraded 28 Chinese internet stocks, including Alibaba and Tencent Holdings, to underweight ratings, judging them "uninvestable" over the next 6 to 12 months. That announcement contributed to spiraling losses for Chinese tech stocks, for which there was only a temporary respite following a meeting with Chinese Vice Premier Liu He to try to address the matter on March 16.

In the first three months of 2022, private fixed asset investment growth slowed to 8.4% from 11.4% a year earlier. This may well be only the start of a broader investment strike as the outlook for investors worsens.

Second, there is the problem of private consumption. For the better part of two years, China's much-vaunted zero-COVID policy had seen most of the populace living largely COVID-free lives, with Xi claiming victory against the virus. However, in February, despite the victory proclaimed in the propaganda war, the virus defied Marxism-Leninism and jumped the fence from Hong Kong.

China's outbreaks are now becoming much more difficult to control as new, more contagious variants have arrived. In addition to Shanghai, at least 13 provinces have since imposed total or partial lockdowns. Guangzhou is also conducting mass testing and has grounded all domestic flights. Beijing has closed down some schools and public spaces as it races to complete mass testing for the city's 22 million residents and hovers on the edge of its own lockdown. According to Nomura, some 373 million people in 45 cities, or about a third of the total Chinese population, are under some kind of lockdown. This accounts for roughly 40% of China's total economic output or around $7.2 trillion in annual GDP.

In March, consumer prices also jumped 1.5% year-on-year, reflecting significant upward momentum on Chinese inflation. Specifically, that prices of daily essentials have soared, with fresh vegetables being 17% more expensive, fruit up 4.3%, and flour up 4.6% compared to the same time last year. Retail sales also fell in March, down 3.5% from a year earlier and paling in comparison to the 6.7% year-on-year increase recorded in the first two months of the year.

Third, there is the problem of rising unemployment. At a State Council meeting on April 27, Chinese Premier Li Keqiang admitted that "the new round of COVID flare-ups have hit employment quite hard," and pledged to keep employment stable. But this will be a difficult task.

Surveyed unemployment in China's 31 largest cities has surpassed the level hit when Wuhan and other cities were locked down in 2020. Overall, China's unemployment rate in March rose to a 22-month high of 5.8%, breaching the annual target of 5.5% in the process. The number of new formal jobs created also fell 18.1% year-over-year last month.

Particularly notable is the decline in jobs available for fresh university graduates: according to a study by Renmin University, the number of positions available per applicant fell by more than half since the second quarter of last year. The dimming employment outlook for college graduates is particularly worrying for the state, as a record 10.76 million graduates are set to enter the market this year. Youth unemployment is now 16% according to official data.

All this of course feeds into slowing growth in private consumption, as those fearing unemployment also begin to save rather than spend.

Fourth, there is the impact of the war in Ukraine on both global commodity prices and global capital flows to China. The outbreak of the Russia-Ukraine war and China's tacit backing of Russia have left global investors unnerved, inducing an unprecedented exodus of foreign capital from China. In March, foreign investors cut their holdings of Chinese bonds by $18 billion, marking a record monthly retreat from China's bond markets. This came just a month after global investors had withdrawn more than $7 billion from onshore trading stocks through a Hong Kong trading link in February.

A number of major onshore Chinese stock indexes have also endured their toughest quarter since 2015. The CSI Index, which contains the largest companies listed in Shanghai and Shenzhen, lost nearly 15% in the three months leading up to March 31. The Shenzhen Component Index dropped 18%. For both, the losses were the biggest quarterly decline in percentage terms since the third quarter of 2015. Separately, the Shanghai Composite Index recorded its worst decline since Q4 of 2018, falling 11%.

Beyond rattling investor confidence, the ongoing war against Ukraine has also resulted in an uptick in prices for key commodities, including energy and iron ore. As one of the world's largest economies – and the largest manufacturer – China is among those most exposed to the economic fallout of the conflict. Surging energy prices are particularly problematic for China, the world's largest oil and gas importer. With crude oil prices already over $100 a barrel, the impact of energy price inflation alone would – if the situation persists – shave an estimated 0.5 % off China's annual growth, according to analysis by the consultancy Capital Economics.

In addition, a significant spike in the price of iron ore and other metal contracts is also badly impacting China, the world's largest steel producer. Another real concern is rising grain prices – already impacted by the loss of much of the Ukraine wheat harvest. This has been compounded by torrential rains in China itself where the country was already facing a wheat harvest that its agriculture minister had described as "the worst in history." Such is the severity of the situation that Xi devoted an entire speech on March 6 to berating China's policymakers to "not slacken our efforts on food security."

China's economic headwinds are therefore manifold, complex, and strong – and in large part self-inflicted due to a number of especially poor policy choices by China's leadership.

An Attempted Economic Policy Course Correction

The most obvious sign of an economic policy course correction has been a quiet U-turn on Xi's common prosperity campaign. This signature program had underpinned Xi's efforts to address widening wealth inequalities, including his clampdown on the technology sector. Last year, the term was visible everywhere and on everyone's lips. But this year it has all but vanished.

There was only one mention of "common prosperity" in Premier Li Keqiang's annual government work report delivered in March 2022. By contrast, the term "stability" appeared a record 76 times in the same report. And, in Chinese economic parlance, "stability" means "don't rock the boat with unpredictable forms of policy innovation" – like common prosperity.

Furthermore, the Finance Ministry notably did not allocate resources from the central government to support Xi's common prosperity campaign. And Zhejiang province, home of Alibaba and earmarked last year to be the primary testing ground for Xi's common prosperity agenda, now barely mentioned common prosperity in its new economic plans for 2022. In addition, the government has shelved a plan to expand new property tax trials that would have funded new social welfare programs aimed at reducing inequality, citing "unripe" conditions for it.

Moreover, since January, Xi has deemed it necessary to reassure global investors that the common prosperity campaign is not aimed at absolute egalitarianism – and that China remains open to investment. As he put it then: "We will first make the pie bigger, and then divide it properly through reasonable institutional arrangements." Even Xi appears to have recognized that common prosperity has unnerved audiences abroad as much as it has at home.

Apart from the common prosperity agenda, in the property sector, there has also been a partial walk-back by Beijing from its deleveraging campaign. Since January, regulators have been encouraging property sector M&A as a way for struggling developers to receive much-needed cash.

As a result, of some relaxation of credit, Sunac China Holdings, Agile Group, and Shimao Group all sold assets to state-owned developers in January. In March, Hong Kong-listed Yuzhou Group Holdings and Logan Group also sold assets to state firms.

Also in March, the head of China's Banking and Insurance Regulatory Commission, Guo Shuqing, highlighted the change in the central government's stance, noting that the property sector's downturn has been "a good thing for the financial sector," but warning of unintended consequences if it goes too far. Specifically, Guo noted that Beijing sought to minimize the negative impact of the property sector's slowdown on the broader economy: "We don't want the impact on the economy to be too big. A lot of people borrow to buy properties for investment or speculation. If property prices drop [too much] or other problems emerge, it could turn into a huge financial crisis."

In addition to course corrections on common prosperity and the property sector, Beijing also has shown signs of support for the embattled tech sector – of which its 10 largest firms are currently valued at a 50% discount compared to their American peers after the massive stock market losses that have followed recent barrages of hostile government regulation.

Recently, reports emerged that some of China's biggest tech companies including Tencent and Didi are conducting large-scale layoffs. These reports sparked such public angst that the Cyberspace Administration of China had to come out to try to refute them.

Vice Premier Hu Chunhua, regarded as an economic liberal, entered the debate on April 7, calling on Chinese companies to "actively fulfill their social responsibilities while seeking their own growth and striving to stabilize and increase jobs."

Already in mid-March, Chinese Vice Premier Liu He had convened an urgent meeting of China's Central Financial Stability and Development Committee and released an extraordinary public statement aimed at calming a roiling Chinese stock market.

Liu's reassurances were followed in quick succession by a series of economic-themed meetings convened and chaired by Chinese Premier Li Keqiang on March 29, April 7, and April 11. In the meeting on April 11, Li instructed a handful of provincial governors to be vigilant against unexpected economic perils and emphasized that policymakers "prevent and correct policies that go against market expectations." Li's comments echoed his earlier remarks at a State Council meeting on March 29 on the need to refrain from measures "detrimental to stabilizing market expectations."

That Li felt the need to explicitly repeat warnings against policy experimentation and remind officials to not do anything that might impair growth *twice* in the span of several weeks is significant. These warnings were underlined further by Li convening a meeting of experts and business leaders on April 7, where the Premier acknowledged that "some unexpected factors have exceeded expectations" and brought about "greater uncertainty and challenges to the smooth operation of the economy."

This series of statements by Li during March and April are, therefore, a clear attempt on Beijing's part to execute a policy pivot to try to staunch the self-inflicted economic wounds of the previous year. But reading between the lines, they also signal that Beijing is anxious, uneasy, and uncertain about how exactly to now go about restoring stable growth. Furthermore, there are also conflicting political and policy lines remaining in the public discourse that continue to cause confusion among private sector actors and public officials – inducing businesses to, therefore, adopt a cautious approach, resulting in inertia. Moreover, uncertainty and anxiety among private investors and consumers are only likely to grow if it becomes clear that Beijing's reassurances have not worked and business and consumer confidence remain low.

Has the Change in Policy Course Had Any Effect?

Data collected by the International Institute of Finance shows that the heavy capital outflows that started in February at the onset of the Russia-Ukraine war have continued through at least the first half of April.

On April 11, U.S. and Chinese bond yields converged for the first time in more than a decade, with Chinese government bonds yielding less than their U.S. counterparts. The flip only lasted for a day, but reflects a trend that has been unfolding for some time. The advantage of Chinese government bonds, which have long yielded 2-3% more compared to U.S. dollar bonds, is quickly vanishing, reflecting a retreat in the confidence levels of foreign investors. While Chinese government bond yields are likely to recover and remain relatively stable, the long-term reputational effect is likely to linger and may caution some foreign investors from further large scale investing in China.

Meanwhile, in the property sector especially, the crisis has only deepened. Issuance of dollar-denominated debt by Chinese property developers has come to a near standstill. According to calculations by the *Financial Times*, high yield dollar bond issuance by Chinese developers during the first quarter of 2022 is down a record 97% compared to a year earlier.

In March, the top 100 largest property firms experienced a 53% decline in sales year-on-year, marking the ninth consecutive month of declines and the steepest drop for the industry since last summer. This comes after those firms saw a 47% and 40% drop in February and January respectively. In the first three months of this year, the volume of land sales in 300 Chinese cities dropped 60% from the same period in 2021.

More than two-dozen Chinese real-estate companies, Evergrande and Kaisa Group included, have failed to submit audited financial results for 2021 by a March 31 deadline. This follows reports of multiple international auditing firms such as PWC and Deloitte resigning from auditing for property developers, reflecting the degree of difficulty that have experienced in verifying their financial health.

A now-deleted editorial recently published by the state-owned *China Real Estate Newspaper* acknowledged that, “It is not an exaggeration to say it is the most difficult time since before the dawn of the industry,” and called for more government support for the embattled sector.

Nor is the ideological addiction to common prosperity-inspired attacks on the private sector yet broken. A *People’s Daily* op-ed published on February 8 called on China to “support and guide” the healthy development of capital and prevent the “barbaric growth” of capital, suggesting that “orderly development of capital” will remain a central goal this year.

As for the tech sector, on April 8 the Cyberspace Administration of China announced that it will continue conducting onsite inspections of various internet companies and ask them to submit their services for review, highlighting Beijing’s ongoing campaign to curtail the influence of China’s richest and largest companies. This will likely further unnerve investors. Meanwhile, one of those internet companies, Meituan, has reportedly axed 10-20% of its staff in the company’s core business units.

In summary, therefore, as of early May 2022, private sector business confidence is far from restored. There are many mixed signals from the center, suggesting there is a continuing internal debate on how to resolve, with finality, the central economic line. Investors, therefore, remain spooked. The property sector's downturn grinds on. And the tech industry continues to be buffeted by Beijing's continued onslaught.

The Ongoing Impact of China's Zero-Tolerance COVID Strategy

Efforts by Chinese financial authorities to restore momentum in the growth of domestic consumption continue to be affected by China's ongoing struggle to contain the spread of COVID-19.

Attempting to forecast the future trajectory of the pandemic is a fruitless task, replete with unpleasant surprises. The spread of the virus has slowed, with new cases outside of Shanghai falling, on average, over the course of April and into May. At the same time, however, any optimism must be tempered with the recognition that China's struggle with COVID-19 still has a long way to go. Though steadily on the decline from a recent peak on April 14 of more than 29,000 new infections nationally, daily cases still number in the thousands across roughly half of all provinces, with over 5,000 reported on May 5. Around 91% of those cases continued to be concentrated in Shanghai – for now.

Localized COVID-19 lockdowns nonetheless appear to be proliferating across the country. Earlier, I mentioned Nomura's estimate that 40% of China's GDP was affected by some kind of lockdown. A new tally by Gavekal Dragonomics focusing on full or severe lockdowns, estimates they cover more than 12% of Chinese GDP. These cities include northern industrial powerhouse Taiyuan as well as southern megacities of Guangzhou and Shenzhen. Across these cities, lockdowns have been enacted, lifted, and then re-imposed again with no clear end in sight.

As the lockdowns have dragged on, the sounds of public dissonance have intensified. In Shanghai, since-deleted video footage has captured scenes of frustrated residents clashing with police. Cell phone footage has recorded videos of frustrated Shanghai residents screaming out from the windows of high-rise residential apartments. These signs of frustration have been accentuated by the reports of residents having difficulty securing food and other needed supplies. The issue seems to be so widespread that even a public call for help to secure daily essentials by Chinese billionaire Kathy Xu Xin – known as "China's venture capital queen" – garnered considerable sympathy.

In Beijing, anxious residents have begun stockpiling supplies, emptying supermarket shelves – mindful of the painful lessons from Shanghai and distrustful of local government reassurances that food will be provided. With Chinese censors constantly removing any negative report on COVID management, the true economic and social cost of China's zero-COVID policy could be much higher than is officially acknowledged.

Another indicator of public disquiet is that inquiries from wealthy Chinese individuals looking to leave the country have surged since the lockdown of Shanghai. According to reports from more than a dozen consultancies, the COVID outbreaks and the harsh measures taken by authorities are encouraging wealthy clients to "vote with their feet" and explore avenues for travel and long-term relocation abroad.

Furthermore, native Chinese are not the only ones becoming frustrated. Confidence among foreign direct investors is also running thin. A recent survey of German investors saw half of the respondents report that their supply chains had been "completely disrupted or severely impacted" by China's lockdowns. The President of the European Chamber of Commerce, Jörg Wuttke, estimated that China has lost more than 50% of all European expats since the start of the pandemic. Earlier in April, Wuttke warned in a letter addressed to China's State Council and Vice Premier Hu Chunhua that the new Omicron variant was "posing new challenges that seemingly cannot be overcome by the old toolbox of mass testing and isolation," and called on Chinese authorities to move away from the zero-COVID approach. However, despite all this, policy change appears unlikely. The Party's *Global Times* newspaper dismissed the European Chamber's stance, noting that "biased smearing against China's lifesaving policy is counterproductive."

Visible signs of public discontent with the regime's handling of COVID have contrasted sharply with an increasingly tone-deaf response coming from the top. On April 13, Xi signaled that China would not change course and called on the Chinese people to not be slack or "defeatist" in their attitudes, declaring that "prevention and control work cannot be relaxed" and that "persistence is victory." *Xinhua* has also shut down suggestions that Beijing will now try "to live with the virus," stating: "China will not and cannot adopt such a defeatist and Darwinian method."

And, most definitely, on May 5, the Politburo Standing Committee met and decided that "our prevention and control policies can stand the test of history," having been "determined by the nature and purpose of the Party." Party cadres, it declared, must "resolutely struggle against all words and deeds that distort, doubt and deny our epidemic prevention policies." So it appears that despite the economic disruption and the public's mounting impatience and frustration, Xi's determination to stick with his so-called "dynamic zero-COVID policy" remains unchanged.

But as long as these lockdowns remain in place, the costs of China's COVID policy on the Chinese economy will continue to compound over time and add to the political and economic headwinds facing Xi in the countdown to the 20th Party Congress in November.

What Sort of Stimulus Response Are We Now to Expect?

The big question faced by Xi for the next six months is how, and by how much, to stimulate the Chinese economy to fill the growth gap left by the cumulative impact of policy failure – on private sector confidence in general; the wholesale assault on the property and tech sector in particular; on production and consumption from rolling zero-COVID lockdowns; as well as from the global economic impact of the war in Ukraine.

However, Xi will not be able to tolerate politically China's official growth data falling radically short of his 5.5% annual growth target when the 20th Party Congress arrives in November. In fact, in April, Xi reportedly told Party officials that it was critical to ensure that China's economic growth outperform the United States' this year, telling them that demonstrating the superiority of China's one-party system to a declining West was strategically essential – and (one can surmise) politically essential as well.

Until late April, Beijing nonetheless appeared relatively reluctant to open the taps on fiscal and monetary stimulus, concerned about undermining efforts to deleverage the economy, reduce systemic financial risk, and transform China's capital-intensive growth model. The People's Bank of China and China's State Council stressed over March and April that they would not resort to "flood-like stimulus" and were committed to a "prudent" monetary policy and keeping macro debt levels generally stable. Indeed, since January, the central bank had only made one slight adjustment to required bank reserve ratios, cutting them by 25 basis points on April 25. That cut released $83.5 billion in long-term equity into the market, but analysts noted that it was far too little to reverse the broader economic slowdown.

However, this conservative attitude appears to have shifted in late April following new orders from the top. On April 26, Xi chaired a meeting of the Central Commission for Financial and Economic Affairs and underlined at length the need to press forward with the construction of new infrastructure – including everything from railroads and rural logistics, to energy pipelines, to flood control systems – as a critical part of ensuring China's national security in the face of potential "extreme situations" (极端情况) facing the country. This clearly signaled to the economy at large a new "national security" justification for recommitting to large-scale public infrastructure investment.

Then, in a key meeting on April 29, the Politburo noted that economic growth was "becoming more complicated, severe and uncertain," and declared that "the pandemic has to be contained, the economy should be stabilized, and development should ensure security." The Politburo stated that it was now necessary to "strengthen macroeconomic policy adjustments to stabilize the economy, and strive to achieve the expected economic and social development goals for the full year." Stressing the need to "expand domestic demand" and back the "healthy development" of the property market, the Politburo concluded that the state "must make good use of a variety of monetary policies and look into additional tools" to stimulate growth. And it pledged to "strengthen infrastructure construction in an all-around way."

This represents a major policy shift. It appears to authorize a new wave of monetary *and* fiscal policy stimulus. It is clear that Xi has therefore made a decision to open the stimulus tap and do what it takes to get growth back to a politically acceptable level for the rest of the year leading into the 20th Party Congress, which is only some six months away.

However, as Liu He and his economic reform team at the Party center are fully aware, stimulus is a short-term political measure that only compounds a long-term structural economic problem. And it fails to deal with China's single most important core economic problem, which is stagnant or declining productivity growth. Only positive productivity increases (in the absence of population and workforce participation growth) offer China long-term drivers of faster economic growth. But given Xi's repudiation of a further round of market reforms after 2013, and his predisposition to quarantine China from the international economy wherever it impedes his statist drive for national self-reliance, productivity growth is likely to continue to languish.

Further Economic Headwinds – The Ukraine Factor

As I argued over the course of 2021, and into the start of 2022, China's economy was already on difficult ground prior to Russia's invasion of Ukraine in late February.

Yet, despite the cost to China's diplomatic reputation in Europe, and the global economic repercussions of Moscow's invasion, there is little reason to expect Xi Jinping to change his current course of tacit support for Putin. That is because, in spite of these challenges to Chinese interests, Beijing retains a core strategic rationale for maintaining its support for Russia.

The groundbreaking China-Russia joint statement of February 4, which declared "no limits" on strategic collaboration, remains in full force. That bilateral agreement is a reflection of the deep personal relationship between Xi and Putin, who routinely refer to each other as "best friends" and who share similar worldviews and nationalist goals of reviving their countries' great power status – while resisting Western liberal-democratic "subversion."

Yet as powerful as this personal relationship may be, China's support of Russia is also grounded in a deeply realist evaluation of China's core national interests. Russia remains Beijing's most important global strategic partner, given its military significance, critical energy and commodity exports to China, and its geographic position along China's vast, exposed northern border, stretching into the equally vast Eurasian continent. If Putin were now to fail and fall as a result of a defeat in Ukraine, or Russia were significantly weakened as a military and economic power, Beijing's strategic judgement is that this would tip the global "correlation of forces" against China and in favor of the United States. That is why Beijing and Moscow are, to use a Chinese idiom, "grasshoppers tied to the same rope" (一根绳上的蚂蚱), with fates that are now closely intertwined.

It is the combination of these various strategic rationales that renders any real change in China's current posture toward Russia improbable. Furthermore, China calculates that current European outrage over Russian action in Ukraine will weaken over time – as it did after 2014 – and that European concern over China's posture on Ukraine will similarly fade as the underlying forces of European strategic amnesia once again come to the fore.

That does not preclude the possibility of China engaging, at five minutes to midnight, in a "diplomatic initiative" orchestrated with Moscow to "negotiate" a ceasefire with Kiev. But that would only occur when Russia was ready to do so – which will be if and when Russia has realized its military objectives in Eastern and South-Eastern Ukraine.

In the meantime, however, China will not violate U.S. financial and military sanctions against Russia as part of its own ongoing economic relationship with Moscow. China does not want to risk secondary financial sanctions being imposed on itself. And so far its financial institutions have remained compliant.

Beijing will continue to expand its energy and agricultural imports from Russia, as these are not precluded under the current sanctions regime. Just as Beijing will sustain its political and diplomatic support for Russia across the UN and the rest of the international community, and campaign against any widening of the current sanctions regime.

But beyond all these factors, what concerns Beijing more than any diplomatic damage it might suffer from its pro-Moscow policy is the impact of the war in Ukraine on global commodity prices, supply chains, inflation, and therefore economic growth amid an already growth-challenged year for the Chinese economy.

Domestic Political Impact

Difficult policy choices now lie ahead for Xi.

Internally, the economic costs of his domestic and foreign policy choices so far are casting doubt on his policy acumen, fueling internal criticism of his political leadership, and eroding public support in the lead-up to the 20th Party Congress.

Across several fronts, there are conflicting questions Xi must now reconcile.

Chief among them is how to arrest the disintegration of the property sector and ensure that the government's deleveraging campaign does not result in a contagion that spreads across the financial sector and the rest of the economy.

Since the beginning of 2021, according to Fitch, Chinese developers have defaulted on $8.8 billion of offshore dollar bonds and the equivalent of $5.1 billion of onshore yuan-denominated bonds, dwarfing the total amount of defaulted bonds over previous years. The situation in the Chinese property market is now even direr than I predicted at the beginning of the year. After more than ten major dollar-denominated debt defaults by property developers over the past year, investor trust is now broken. As a result, both foreign and domestic investors have been exiting the sector. Investors are also uncertain whether Beijing will be able to pull off a difficult rescue mission for the property sector as a whole. Evergrande alone, with its combined estimated debt load of $300 billion, remains an outsized concern.

Continuing to deleverage the entire sector will impose a major cost on overall economic growth. Nonetheless, the financial leadership's view is that deleveraging the property sector has been necessary to reduce the risk of medium-to-long-term financial sector crises. At the same time, Xi at a political level has made it plain that he regards property speculation as part of what he ideologically castigates as the "fictitious" economy – as opposed to the "real" economy, which he equates with advanced manufacturing. Indeed, these two sets of sentiments (reducing macro-financial risk and basic ideological distaste) have combined to make the property sector crackdown of the last year or so particularly vicious.

Yet Xi's new emphasis on stimulus and infrastructure spending will lend itself to once again further inflating the sector as a means to increase overall growth. Ironically, deleveraging the property sector was executed in a year when Xi had made plain that what he most craved was a 2022 of political and economic stability – whereas now – the property crackdown has compounded contracting economic growth.

On balance, I expect therefore that there will be an easing in property market deleveraging during the remainder of 2022, simply because the overall economic and political stakes are now too high.

A second decision facing Xi Jinping is what to now do about the tech sector. Once again both economic policy and base politics have been at play.

Market regulators have been concerned with the massive accumulation of market power by China's tech giants, from the perspective of competition policy, anti-trust, and the interests of consumers. But, at the same time, there is little secret that Xi's common prosperity agenda has long had both the property and tech billionaire classes in its sights. This too has made the tech sector crackdown particularly vicious.

But now there are indications that the political need for economic growth is once again beginning to drive a shift in policy. First, at its last meeting, the Politburo notably pledged to "promote the healthy development of the platform economy," hinting at possible relief for China's embattled internet platform companies. Then, last week China's top internet regulator, the Cyberspace Administration of China, held a symposium with top tech firms to discuss the regulatory campaign.

That meeting revealed that the state appears to have recognized the damage its campaign is doing to investor confidence and is beginning to ease back on its onslaught. Regulators will reportedly now hold off on new regulations, such as planned limits on the time young people can spend on mobile apps, with the message from regulators being that the state wants them to grow and play a role in Beijing's efforts to bolster the economy. Tech stocks shot up following the meetings as investors began to hope the worst is over. But it is not yet clear that investors or Chinese tech executives should rest easy – Xi's deep distrust of the "fictitious economy" is unlikely to wane moving forward.

The final – and perhaps now most important – leadership decision Xi faces is how to balance the large-scale economic and social disruptions of China's lockdowns as he doubles down on the zero-COVID strategy.

Xi has staked his political leadership on zero-tolerance of the virus, having declared victory on the pandemic late last year. But the official growth numbers published for the first quarter of the year do not so far fully capture the unfolding economic toll inflicted on China by lockdowns and other harsh restrictions.

According to Chinese planning officials quoted anonymously by the *Financial Times*, some senior Chinese leaders, reportedly including even Vice Premier Han Zheng, are now growing skeptical enough of the bureaucracy's official data to have begun increasingly turning to alternative data or their own personal networks to quiz the heads of SOEs and private-sector companies about the true state of the economy.

And there are plenty of data points liable to raise deep concerns. Nationwide, freight volumes were down 15% year-on-year in April, for example. Freight traffic volumes in the Shanghai metropolitan area specifically plunged by 81% year-on-year in the first three weeks of April. Jiangsu province recorded a drop of 30%. Even in Guangdong province, where there is no COVID-related lockdown, freight volumes dropped by 17%. Cement production in mid-April was less than 40% full capacity. Excavator sales within China were down 61% in April compared with the previous year. Ford reports that its vehicle sales in China dropped by 19% in the first quarter from a year earlier. Shipments of smartphones also dropped 18% from a year earlier in the first quarter. Such data collectively indicates the economic impact of the lockdowns may be far worse than is being officially acknowledged.

And while Xi may have now chosen to unleash new infrastructure spending as a stimulus measure to try to counteract this slowdown, it's not clear how much new stimulus is going to be able to address the fundamental issue – given that the proximate cause is the imposition of lockdowns that both constrict demand and snarl supply chains, while the deeper cause is the lost confidence of the private sector in the state's overall economic policy settings.

Meanwhile, public discontent is growing. That anger reached a new peak in April when a widely-shared video titled the "Sounds of April" went viral on Chinese social media – before being censored – after it replayed the voices of Shanghai residents desperately pleading for help. Video of Shanghai residents clashing with police also spread widely before being censored. The situation has deteriorated so much that even normally reserved members of Shanghai's academic establishment have begun speaking up and suggesting that Beijing's approach is hurting its credibility.

But state media reaction to any dissent on the zero-tolerance policy, as well as the dire warnings against regime critics using public dissent over the handling of COVID to foment political protest, indicate there is a fundamental clash between defending the political standing of Xi's COVID strategy on the one hand, and a rational adjustment to a policy of "living with the virus" on the other. For these reasons, we should not expect any adjustment to current zero-COVID policy settings until after the 20th Congress – irrespective of the economic cost, including disrupted foreign and domestic supply chains.

Throughout Chinese history, leaders have been attuned to sudden disasters that would result in them losing their grip on the "mandate of heaven." In Xi's case he is acutely aware that the fundamental changes he has made to China's overall political and policy settings have earned him powerful enemies waiting for an opportunity to challenge his political authority – and even supremacy within the Party. On balance, however, despite the formidable economic and foreign policy difficulties he faces in the remainder of the year ahead, my analysis is that Xi is still likely to be reappointed for a third term as supreme leader. His control of the political, security, and intelligence apparatus of the Party, and of the military, make it deeply difficult for others to challenge him effectively.

But one potential implication of the domestic political impact of his flawed decisions over last several years is that Xi's new leadership team in November may end up less beholden to him than he would have preferred. Shanghai's unexpected COVID outbreak and lockdown has, for example, placed one of Xi's most trusted allies, Shanghai Party Secretary Li Qiang, in a very awkward position. Li is rumored to have been a top candidate to replace the outgoing Chinese Premier Li Keqiang, but Shanghai's current plight will dim his chances.

Xi will now be wary of appointing Li and giving critics the opportunity to indirectly question his leadership. This would create a greater opportunity for those not aligned with Xi to weaken the "Zhejiang-Shanghai" faction that has helped Xi consolidate political power during his first two terms.

Other key positions to watch are those who will make up the seven-member Standing Committee of the Politburo, the 25-member Politburo itself, and the wider Central Committee of the Party – where the balance of factional forces reflected following the Party Congress in November will say much about any future constraints on the exercise of Xi's absolute power.

Ramifications for Chinese Foreign Policy in Europe

Another factor impacting the politics of the 20th Party Congress will be the final landing point of the war in Ukraine.

I have already discussed Xi's strategic rationale for supporting Putin and Russia as reflected in Xi's and Putin's Joint Statement from February, which stipulated "no limits" for the future of Sino-Russian strategic collaboration. It was also the statement in which China for the first time took an explicit position in support of Russia against any form of NATO expansion. And it also reflected Chinese support for Russia's "legitimate territorial interests."

Where China may have miscalculated in doing so is the impact this may still have on long-term European strategic perceptions of China. At the EU-China summit on April 1, European Council President Charles Michel and European Commission President Ursula von der Leyen warned Xi and Premier Li Keqiang that China's stance "would lead to major reputational damage for China here in Europe." To Beijing's irritation, the war in Ukraine has pushed Brussels closer to Washington and reinforced the already close EU-U.S. relationship. Indeed, Beijing has already criticized Brussels for acting as a puppet of Washington. So much so that, at the summit, Xi called for Brussels "to form its own perception of China and adopt an independent China policy."

While the reputational damage sustained by China in Europe may be problematic, Xi is likely more worried about the long-term economic costs of alienating Brussels. Since 2020, China has overtaken the United States to become the EU's largest trading partner, accounting for around $777 billion in trade in goods last year. China has become the third-largest destination for EU exports, much of which are automobiles and car parts for China's growing auto sector. Together the United States and Europe consume more than a third of Chinese exports. This makes any future trade sanctions against Beijing (due to Taiwan or otherwise) potentially deeply damaging to Chinese economic growth. If wider economic decoupling from the EU and United States were to accelerate simultaneously in the future, the implications for China would be catastrophic.

For these reasons, future Chinese diplomacy toward Europe will be heavily targeted at avoiding any such possibility. China is banking on Brussels forgetting its current disquiet with Beijing once the Ukraine War has been "frozen" by the Russians in the eastern part of the country – and once the Europeans resume focusing on expanding their economies by growing trade with China.

At the same time, China's leaders are still likely to double down on their stated policy of national economic and technological self-sufficiency to insulate themselves against long-term economic vulnerability to any future Western sanctions regime over Taiwan.

China will also resume its long-standing strategy of seeking to decouple the Europeans from Washington, once the dust settles on the Russia-Ukraine war. They will do so by emphasizing Chinese market access, climate change cooperation, the risk of a return of a Trump-like figure to the White House in 2024, and the stated French-led quest to achieve so-called European "strategic autonomy."

As to whether China succeeds in its overall European strategy is a separate matter. Indeed, it is more likely that recently elected centrist and center-left governments, in France and Germany respectively, will be more skeptical toward Beijing than the traditional center-right and far-right have been in the past. The left is less likely to sweep human rights concerns regarding both Russia and China under the carpet. Whereas the right's traditional links with major European corporates are more predisposed to capitulate on both human rights *and* security concerns to enhance market access.

China, however, remains surprised, and even shocked, by the degree of European solidarity so far with the United States over Ukraine. Europe did not simply fold like a pack of cards as many in Beijing (and Moscow) expected. The 180-degree turn in German defense policy under the Social Democrats will be seen as particularly disturbing in Beijing. As will the remarkable shift in Swedish and Finnish security policy and the real possibility that one or both will join NATO, after decades of neutrality, to protect themselves from the Russian threat. And this would be despite the explicit joint warnings by Russia and China in their February 4 statement opposing any form of NATO expansion. In other words, these Nordic states are explicitly thumbing their noses at both Moscow and Beijing.

China may therefore be underestimating the longevity of emerging European political and strategic resolve – not only in relation to Russia, but also toward China, which has become Russia's most important strategic partner of choice.

The jury is still out on which way Europe will go on China in the medium-to-long term future. That will be determined by the future course of EU and NATO internal politics in Brussels, given the different historical perceptions of China between Berlin, Paris, and London; the skill or otherwise ham-fisted nature of Chinese and American diplomacy towards Europe; and the future of Russian and Chinese policy on Ukraine.

China's Ultimate Conundrum: Party-Political Control Versus Private Sector Economic Dynamism

The near-term question for the remainder of 2022 is whether Xi will back down from his core political decisions on foreign policy, economics, and social control, as well as what impact any policy changes will have in the real economy.

The longer-term question is arguably more important: namely the conundrum that exists between Xi's overall shift to the left on politics and economics domestically, and his shift to the right on nationalism and a more assertive foreign policy internationally, and how these two sets of changes will ultimately be reconciled in the CCP's historical quest for enduring political legitimacy in the eyes of the Chinese people.

In 2022, the biggest elephant in the room on this score remains the economy. The prospect of a faltering economic growth is one that should worry Xi the most, although he has long been tone deaf on how CCP leaders can best maintain private sector confidence in an economy where private firms are already responsible for more than 60% of GDP.

The consensus among most economists is relatively clear: China's reversion back to party and state-centric economic policy that squeezes the private sector will not produce the level of growth that China is seeking for in the absence of significant stimulatory intervention.

Nonetheless, Xi's political and ideological conclusion is that his focus on "common prosperity" to reduce income inequality, "self-reliance" to achieve national technological self-sufficiency, and an overall "New Development Concept" that strengthens party and state leadership over the market, will lay the groundwork for a decade of acceptable growth in China's "real economy" while not threatening political control.

In reality, however, this political and ideological gamble looks increasingly economically fraught. Casting aside China's proven growth engine – the private sector – in favor of more centralized control of the economy risks stunting China's growth momentum at this most critical time. Indeed, as noted above, this concern is evident in the latest signals coming from Beijing via meetings chaired by Li Keqiang and Liu He which have stressed stability – warning officials against attempting to implement any measures that may be counterproductive to growth.

But the crux of the problem does not lie with lesser officials. Rather, it rests with Xi – as has always been the case in the past. It is Xi who unleashed a series of major economic policy decisions in recent years that brought a return of the party-state to the economy. It was Xi who authorized a wide-ranging crackdown on the property and tech sectors amidst his general political rhetoric on the difference between the real economy and the fictitious economy. It was Xi who aggregated these various decisions into an overall policy framework, the "New Development Concept," that has taken the center of gravity of Chinese economic policy to the ideological left. And as I warned in previous addresses during 2021, it is Xi who has risked strangling the goose that, for 35 years, has lain the golden egg.

As a master politician, Xi's political *modus operandi* has always been to double down when challenged: to either crash through or crash. But, on this occasion, time may not be on Xi's side. With each passing day China's economic growth grows weaker.

As noted above, global analysts have already revised their 2022 forecasts for China's economic growth downwards to 4% or lower. And as the IMF said in its most recent report, the real concern is that any short-term downturn in China could expose much deeper structural weaknesses. Those weaknesses had previously led the IMF to forecast that Chinese growth would slow to 4% by 2025.

This adds to a growing number of assessments by economists around the world that China's long-term growth prospects now face serious revision against previous assumptions. This is not just because of Xi's move to the left toward the party-state and away from the market and the private sector in his overall economic policy settings in the last several years. It is because these policy shifts have compounded pre-existing structural weaknesses in China's economic growth model.

Economic growth is ultimately driven by three factors: population growth, workforce participation, and productivity growth. In China's case, all three of these are in structural decline. But rather than ameliorate these three trend-lines by boosting private sector productivity and allowing more head-room for the private sector more generally, Xi has gone precisely in the reverse direction. And as the growth gap becomes more pronounced, he reverts instead to short-term, stop-gap, public sector stimulus rather than long-term, sustainable, private sector growth.

Indeed, an increasing number of international economic assessments predict that China's growth could slow even more significantly, to below 3% by 2030. For example, a recent report by economists Roland Rajah and Alyssa Leng has warned that, on its current course, China is now headed toward a sharply slower growth trajectory, of around 3% by 2030 and 2% by 2050.

Such a trajectory would have significant strategic ramifications. China might never overcome the "middle income trap" and reach developed nation income levels. China might never significantly overtake the United States as the world's largest economy as Xi has assumed as part of achieving the "China Dream." And the engine of global economic growth – China having driven nearly a third of the world's GDP growth in recent decades – would also be badly damaged.

The only way out of this future is for China to make the necessary market-oriented reforms to achieve stronger productivity growth. But as the economist Daniel Rosen astutely put it recently: "China cannot have both today's statism and yesterday's strong growth rates: it will have to choose."

Conclusion

The great questions for the future, therefore, are whether Xi has gotten China's underlying economic and foreign policy direction wrong; whether he has underestimated the combined costs of these two sets of errors to China's longer-term economic growth and to his own personal political legitimacy; whether he is capable of course correction; or whether he will simply double down.

If Xi is proven to be wrong, then China – and the world – may well enter a more dangerous phase. So far, when dealing with potential political and social unrest at home, as well as international challenges abroad, Xi has relied on what he has found to be successful in the past: he has leaned into his ability to call on deeply nationalist narratives to strengthen his political position domestically.

Such nationalism is a dangerous additive to the decade that lies ahead. It is a particularly worrisome prospect as we begin to enter the middle years of the decade. If Xi embarks on an increasingly assertive posture in the region, across the world, and against the United States in particular, at a time when China's economy is beginning to weaken to the extent that it begins to peak as a proportion of global GDP, this may cause China's "man of history" to move faster than he originally planned.

Specifically, he may start taking more calculated risks – including on Taiwan – if he believes that's what is needed to secure his nationalist legacy while the window of history remains open.

Our world is indeed entering a decade of living dangerously, which will require great political wisdom and considerable diplomatic skill to navigate effectively for us all.