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Decoding China's Economic Slowdown

*The Stanford Center on China's Economy and Institutions and the Asia Society Policy Institute's Center for China Analysis recently convened a closed-door roundtable to assess China's economic prospects. Twelve economists and analysts from around the world joined the discussion on the condition of anonymity. The following is a synopsis of their discussion. A more detailed report is available **here**.*

Panelists agreed that China is facing its most protracted economic slowdown in decades. Optimistic predictions of China's future growth rate ranged from 3% to 4% for the rest of this decade. Pessimistic views note China's data is unreliable and suggest its growth has remained near zero since 2022. Panelists also agreed that a range of cyclical, structural, political, and ideological factors have contributed to China's slowdown. Their remarks on each of these are summarized below.

I. Cyclical factors behind China's slowdown

Flagging household demand. For decades, China's economic policies have favored the state sector over private firms and investment over consumption, resulting in a loss of economic efficiency and weak aggregate demand relative to aggregate supply.

The lack of consumer stimulus during the COVID crisis, together with the government's long-standing inaction around building a more robust social safety net, including on retirement income policy, education costs, and healthcare reform, as well as the prospect of higher unemployment, have led households to save more, further dampening demand.

Excessive supply-side stimulus. Top-down policies have driven China's massive investments in manufacturing, technology, and infrastructure. Many of these initiatives have failed dramatically, but some, such as electric vehicles and solar panels, are successful. China's leaders have unveiled yet another supply-side initiative focused on "new quality productive forces," that aims to dominate future industries based on advances in disruptive technologies.

But profit margins are slim in many new industries, raising the question of how they could revive China's economy considering the costs involved, long pay-off times, and pressure on legacy industries.

Despite challenges, decades of investments have built up an extremely competitive manufacturing sector in China with many cost advantages. Though government subsidies have played a role, much of the success is because China's best manufacturers excel at what they do.

Property sector imbalances. The property sector and related industries account for 20 to 25% of China's economy—a very large portion by international standards. The government has indicated it will not intervene significantly to counter the sector's ongoing contraction, citing the need for the sector to shrink. In the coming years, the decline in property prices will negatively impact household confidence and wealth, exacerbating weak consumption demand. Estimates put this process at about halfway complete, with the worst declines likely over. De-risking the property sector has been a long-term concern for China's leaders, and a correction sooner or later was likely inevitable.

II. Structural and policy factors behind China's slowdown

High local government debt. The poor fiscal health of local governments is a key structural factor in China's slowdown. In 2022, average debt servicing was over 100% of revenue in twelve of China's provinces. Tianjin was the most extreme case, with debt servicing at around 200%. Another dozen or so provinces had debt servicing ratios between 50% to 100%. Localities where the problem is most serious will no longer have the wherewithal to compete regionally or experiment with new policies, which could be another drag on growth. These budget constraints make it challenging to roll out a major stimulus package or to set up real estate rescue funds, let alone make significant policy changes that would ease social pressures, such as upgrading the medical system or bringing millions of migrant workers into the urban welfare system.

Over-reliance on exports. Present-day innovations have allowed China's manufacturing sector to expand despite a declining workforce since the early 2010s. The use of robots and automation in manufacturing has expanded tremendously. However, China's surplus in manufactured goods presents problems for developing countries seeking a foothold in simpler industries that China dominates and for developed countries with leading positions in markets for more sophisticated goods. The ensuing trade tensions could derail some of China's exporting success.

III. Ideological factors behind China's slowdown

Policy priority shifting away from growth. In recent years, China appears to have prioritized security, self-sufficiency, technological progress, and social equity, rather than maximizing economic growth. This shift in priorities has undermined the confidence in three key parts of the domestic economy: private firms, due to regulatory crackdowns; households, due to the COVID lockdowns and the property market downturn; and the public sector, due to sweeping anti-corruption campaigns.

Ideological embrace of statism over markets. A rare ideological course correction was announced at the 19th Chinese Communist Party Congress in 2017, when the "principal contradiction" facing China's society was changed from a contradiction between the people's underdeveloped state and the need to unleash the factors of production to one between unleashing the factors of production and addressing imbalances in the economy and society. The last time the Party changed its view on the principal contradiction was in 1981.

Ensuing policies have sought to correct the fundamental structure of the economic base, including by reining in the private sector and asserting more state control. This ideological shift has set up a conflict over whether industrial policy or market forces should be the principal mechanism for allocating resources within the economy. The increasingly constrained policy space for market-oriented reforms could curb the prospects for growth.

IV. Domestic and international implications of China's slowdown

Growing social pessimism. Social consequences of China's slowdown include growing pessimism, social malaise, and rising crime, for which there is increasing anecdotal evidence. Capital flight and illegal migration are other obvious signs of discontent. Serious unrest will likely be contained by the party's surveillance mechanisms and its improved ability to tackle emerging problems.

Fewer resources for industrial policy. Sustained low growth, low corporate investment returns (typical in China's highly competitive markets), and household incomes might inevitably affect the government's ability to carry out industrial policy in the medium to long term. However, big investments may persist in some sectors, such as power generation and transmission, because low electricity prices are key to keeping China's manufacturing sector competitive.

Increased trade frictions. More consequentially, the competitiveness of Chinese manufacturers, from the less sophisticated to the most sophisticated, has contributed to a surge in net exports that poses a formidable problem for the international economy. The huge financial and political sunk costs that the party-state has already invested in China's enormous industrial base mean the government is unlikely to budge in a significant way in the face of European and American protectionism.