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Walking under umbrellas in Beijing, July 2023 - Thomas Peter / Reuters

Who Killed the Chinese Economy?

The Contested Causes of Stagnation

By Zongyuan Zoe Liu; Michael Pettis; Adam S. Posen

FALL GUY

Zongyuan Zoe Liu

In "The End of China's Economic Miracle" (September/October 2023), Adam Posen describes China's recent economic challenges as a case of "economic long COVID." Chinese President Xi Jinping's "extreme response to the pandemic," he posits, triggered "the general

public's immune response" and "produced a less dynamic economy." Posen's analogy is creative and insightful. But his diagnosis misses the chronic diseases that afflicted China's economy well before the COVID-19 pandemic: an exhausted growth model, stunted population growth thanks to the "one-child policy," and, most notably, Xi's failures of leadership.

Xi is not to blame for the Chinese economy's deepest structural problems. He is, however, responsible for the government's failure to deal with them. In 1978, Deng Xiaoping initiated sweeping economic reforms after the end of the Cultural Revolution. Standing apart from previous Chinese Communist Party (CCP) leaders, particularly **Mao Zedong**, Deng took an open and pragmatic approach toward economic development. He rebooted China's relationship with the United States, observing in 1979 that "all countries that fostered good relations with the United States have become rich." When China's economy faltered after the government's crackdown on the 1989 Tiananmen Square protests, he headed off a downward spiral by clearly reiterating the party's commitment to economic reforms, especially during an influential 1992 tour of southern China.

Over the last 45 years, **China** has transformed from one of the world's poorest and most isolated countries into the heart of the global supply chain. That economic rise, however, was built on a system of financial repression that prioritized investment and exports over domestic household consumption, leading to harmful stagnation on the demand side of the economy. Posen identifies the first quarter of 2020 as the "point of no return" for the Chinese economy, but it has faced looming problems for at least a decade. The workhorses of its growth model were already tiring years ago.

When **Xi** became president, in 2013, he had an opportunity to focus on domestic demand-side economic reform by shifting government policy to promote consumption over investment and by developing a more robust social welfare system. Instead, the cumulative policy shocks of Xi's first two terms worsened the structural challenges that were dragging down—but not yet crashing—China's economy. They also badly weakened the confidence that undergirded Deng's opening-up era.

Xi focused on projects that prioritized state-led investment and diverted resources from supporting households, such as the 2013 Belt and Road Initiative and the 2015 "Made in China 2025" strategic plan, which aimed to reduce China's dependence on foreign technology. He greatly expanded the role of state-planned industrial policies and, by emphasizing the role of the CCP and the government in commanding capital management, diminished the space consumer-oriented private entrepreneurs need to flourish.

China's economic rise was built on financial repression.

Posen is justified in warning that Xi's mishandling of the pandemic will likely "plague the Chinese economy for years." But he is wrong to imply that historians will look back on the **COVID-19** era as a critical juncture for China's economy rather than one step on a long path. Well before the pandemic, Xi's aggressive promotion of a military-civil fusion strategy prompted U.S. leaders to enhance investment screening and export controls; these Western restrictions have raised the cost of his drive for technological supremacy, requiring the state to commandeer additional national resources.

China's stepped-up military activity around **Taiwan**, which also predated the pandemic, has stoked a gloomy perception in China that

armed conflict is inevitable. China's one-child generation would shoulder the weight of such a conflict, an immense threat that few families are prepared to cope with. Many China watchers underestimate the degree to which the souring of Western confidence in China has negatively affected Chinese people's willingness to spend and to take economic risks. Pessimism from abroad contributes to the Chinese population's mass loss of confidence, which James Kynge of *The Financial Times* has aptly characterized as a "psycho-political funk."

In essence, Xi did not assemble China's economic time bomb, but he dramatically shortened its fuse. Posen argues that for ordinary Chinese people, the CCP has now become "the ultimate decision-maker about people's ability to earn a living or access their assets." To some degree, this has always been the case in China; what has changed is the way the party reacts to economic difficulties. In the past, it responded with reform and pragmatism. By contrast, Xi's instinct has been to meet every challenge with political and economic retrenchment.

Pessimism from abroad contributes to the Chinese population's mass loss of confidence.

Still, it is premature to imagine that China's economy has peaked. Xi abruptly reversed course on his "zero COVID" policy when its costs became untenable; he should do so on his economic and political strategies, as well—and he may. Historically, the Chinese people have tended not to look back on political upheavals after moving past them.

Posen suggests that the West might benefit from a Chinese decline. But the West has a genuine interest in preventing China's economic downfall. Given the size and importance of the country's economy, a full-blown financial crisis in China would have far greater consequences than other previous emerging-market crises. And a crisis would complicate the West's transition to clean energy since China is the dominant producer of the technologies and minerals needed for that transition.

Instead of looking for opportunities in China's economic struggles, U.S. and **European Union** leaders should communicate their interest in preventing a Chinese economic crisis. One necessary first step is to create a shared entity list to coordinate investment screening and export controls on potential dual-use technologies. This move could minimize the potential that strategically motivated investors will access sensitive technologies. If Washington and Brussels fail to clarify the intentions of their "de-risking" strategies, however—or if they meet Xi's aggression with chest-thumping—they may legitimize his claims that economic containment is to blame for China's economic woes and that further isolation is the only antidote.

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INHERITED TRAUMA

Michael Pettis

Posen correctly identifies the problems the Chinese economy faces, including weak consumption, anemic business investment, surging debt, and rising financial uncertainty among Chinese households. But his explanation of what has gone wrong misses the mark, neglecting the structural sources of China's economic malaise.

Posen writes that China's economic troubles are the result of President Xi Jinping's turn against the private sector in recent years, especially in response to the COVID-19 crisis. Under Xi, he argues, the Chinese

Communist Party "has reverted toward the authoritarian mean." He proposes that in response to "the government's intrusion into economic life" and the increasingly visible "threat of state control in day-to-day commerce," an anxious Chinese public is saving more and spending less, yielding a "less dynamic economy."

This account gets the causality backward. The problems facing the Chinese economy are not the consequence of recent policy shifts; they are the almost inevitable result of deep imbalances that date back nearly two decades and were obvious to many economists well over a decade ago. They are also the problems faced by every country that has followed a similar growth model.

In the 1970s, the economist Albert Hirschman argued that any successful growth model has obsolescence built into it, because it is designed to address and resolve particular economic imbalances. This is the case for the Chinese growth model. In the late 1970s, the Chinese economy was stunted by decades of civil war, conflict with Japan, and Maoism. It was among the most severely underinvested in the world for its level of social and institutional development. The high-savings, high-investment model that the Chinese leader Deng Xiaoping implemented in the 1980s and 1990s succeeded because it closed, faster than in any other country in history, the gap between the existing level of investment and the level the country could productively absorb.

Investment in China has continued to rise, even as it has progressively generated less value.

China closed this gap around 2006. Once it did so, however, it should have switched to a different growth model, one that prioritized consumption over investment. This would have required developing a new set of business, legal, financial, and political institutions to promote the higher household income and stronger social safety net that undergirds a more consumption-driven economy. But like similar countries that reached this pivot point, such as Brazil in the 1970s and Japan in the 1980s, China did not reform its growth model. In fact, from 2006 through 2011, its household consumption as a percentage of GDP fell even faster than it had in the 1980s and 1990s, to 34 percent, compared with over 50 percent, on average, in the rest of the world.

Hirschman would have predicted this. A successful growth model, he noted, develops its own set of institutions, along with powerful constituencies that benefit disproportionately from these institutions, making the model politically difficult to transform. As the elites who benefit from the model expand their wealth and power, Hirschman argued, they become motivated to entrench it.

This is what happened in China. In the past two decades, investment in China has continued to rise as rapidly as ever, even as it has progressively generated less and less value for each dollar invested. Overall growth has increasingly been driven by asset bubbles, especially in real estate, and an unsustainable rise in debt. Worse, over this period, business investment has become constrained by China's extraordinarily low consumption rate, as shaky domestic demand discouraged private businesses from expanding production.

At the same time, the locus of Chinese economic activity shifted away from sectors of the economy constrained by hard budgets and a profit imperative, mainly the private sector, and toward sectors that are not so constrained, such as the public sector and those parts of the private sector with guaranteed access to liquidity—real estate, for example. The turn against the private sector was not the result of Xi's particular ideology. It may have been accommodated by his rhetorical and policy

shifts, but it was driven by something deeper: the growing imbalances in China's economy and Beijing's need to maintain high GDP growth rates.

Government intrusion is not China's biggest problem.

Some economists presume that any rapid growth is, by definition, a consequence of private-sector initiatives and that any slowdown arises from excessive government intervention. But that was certainly not the case in China. On the contrary, government intervention drove China's ferocious growth in its first decades of economic reform. Beijing enacted policies to force up the savings rate and corral the resulting savings into a highly controlled financial system that heavily subsidized infrastructure and the manufacturing sector with very low interest rates, preferential lending, an undervalued currency, and other direct and indirect transfers. These subsidies made China's logistical and transportation infrastructure the best in the world and its manufacturers the most competitive, albeit at the expense of Chinese households. Posen writes of "government intrusion" as if it is something new and unwelcome, but it in fact created the conditions for China's spectacular growth through the middle of the first decade of this century.

Today, even as it raises costs for businesses, government intrusion is not China's biggest problem. Its biggest problem is that it has not substantially adjusted its growth model. Retaining its current high-investment model distorts the distribution of income and keeps domestic demand too weak to support domestic business investment. And because this weak demand constrains the growth of private businesses, China has had to rely on an expanding public sector to deliver the level of growth Beijing deems politically necessary.

Government intrusion, in other words, is the consequence of weak private investment, not its driver. This distinction matters enormously when thinking about how China can fix its economic woes. It must address the demand side of the economy by strengthening the share of its GDP that Chinese households retain. Until Beijing does so, or until it is willing to accept much lower growth rates, the role of the government in the economy must necessarily expand relative to that of the private sector. Even if Beijing decided to reduce government intrusion, growth would not pick up except at the margin, and China's overall growth rate would continue to decline, probably to below two to three percent.

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POSEN REPLIES

Adam S. Posen

Two things can be true at once: China's structural economic issues have reduced its growth rate over time, and increased intrusion into everyday life by the Chinese government under President Xi Jinping has changed the economic behavior of the country's people, reducing the growth rate even further. As any economy develops, its growth rate slows because of the accumulation of capital (including infrastructure), a diminishing rate of urbanization, and, usually, a declining birth rate. This slowdown is expected and inevitable over the long term, and it typically does not disrupt normal commercial life. The emergence of "economic long COVID" in China, however, is a special case. The abandonment of autocratic self-restraint by Xi and the leadership of the CCP was not inevitable, and it drove a marked change in the behavior of Chinese households, as well as in their responses to

government policies.

My analysis is supported by data gathered since Xi took office—and especially since the beginning of the COVID-19 pandemic—on Chinese savings, investment, capital outflows, and durable goods consumption. In their responses to my article, Zongyuan Zoe Liu and Michael Pettis go doggedly narrow; they neglect the importance of Xi's behavior in shaping outcomes and even seem to deny that the economic regime has changed.

Pettis's claim that "government intervention drove China's ferocious growth in its first decades of economic reform" sets the stage for his argument that increased and arbitrary government intervention is merely a continuation of past practice. The important role of government investment in Chinese development in the 1980s and 1990s is undeniable; China's industrial policies, which the CCP borrowed from Japan and Singapore, did help it up the value chain in trade. Those actions alone, however, did not deliver the miraculously high Chinese growth rates from 1980 to 2008.

Total investment, public and private, remains elevated, but it declined as a share of GDP from 47 percent in 2011 to below 43 percent in 2016, where it remained before declining further this year after the collapse of China's real estate sector. Pettis is thus incorrect when he claims that "in the past two decades, investment in China has continued to rise as rapidly as ever." And the evidence does not support his claim that "China has had to rely on an expanding public sector to deliver the level of growth Beijing deems politically necessary." Nonprivate fixed asset investment—the best available proxy for public investment—began to decline in 2016, when it was at 26 percent of Chinese GDP. By 2021, it was down to 21 percent, rising only slightly in 2022, to 22 percent. And it was government regulation that, in 2020, killed the long-running residential property boom, steps the CCP took because the private sector was driving growth in ways the party did not like.

The abandonment of autocratic self-restraint by Xi and CCP leadership was not inevitable.

Simply put, Chinese growth has not been largely, let alone entirely, driven by public and government-directed investment. On the contrary, as the economist Nicholas Lardy established in his 2014 book, *Markets Over Mao,* the market-oriented reforms led by Deng Xiaoping drove growth and restrained the party. The clearest evidence is that between 1980 and 2013, the year Xi took control, China's private investment grew at 2.6 times the pace of state investment. And during that same period, the share of state investment fell from 80 percent to roughly 33 percent of total investment. Similarly, private urban firms employed only 150,000 Chinese workers in 1980, or 0.2 percent of urban workers; by 2012, that number had grown to over 252 million, or 68 percent of urban workers. Put another way, between 1980 and 2012, private firms accounted for 95 percent of the growth in urban jobs in China.

More fundamentally, it makes little sense to lump together the state infrastructure investments in the pre-Xi era and Xi's draconian government intrusions, including the arbitrarily applied "zero COVID" policy and its abrupt lifting, which induced economic and social whiplash. From 1978 to 2012, the Chinese leadership undertook a number of policies that were explicitly market-oriented or supportive of private markets: China's 2001 entry into the World Trade Organization, which allowed the private sector the right to trade internationally; its 2002 "Three Represents" amendment to the CCP charter, acknowledging the need to develop the private sector; a law

instituted in 2007 that codified private property rights; a program of state-owned enterprise reform that took place between 1998 and 2002 and reduced state-sector employment in cities by 30 percent; and many moves over the decades that opened the country to foreign investment.

By contrast, the CCP's policies under Xi have rapidly increased the investment going to state-owned enterprises, and the share of credit going to the private sector peaked in 2015 and has declined steadily since. The party has also intruded more and more into the operations of private companies, including through a September 2020 directive to expand the CCP's role in private firms' corporate governance. Between 2012 and 2019, cumulative growth in credit to private firms was 10 percent, a huge slowdown that brought it in line with growth in state investment. And between January 2022 and June 2023, growth in private investment declined to half the level of growth in state investment, a change driven by the residential real estate collapse.

Liu makes an argument similar to Pettis's—that the structures of the Chinese economy driving growth have remained largely constant. But even she notes additional policy areas in which Xi has increased government intervention at the expense of the private sector and raised barriers to private international commerce, notably the "Made in China 2025" strategic plan and the Belt and Road Initiative. These points support my argument that the present is a deviation from more than three decades of the preceding Chinese leadership's relative self-restraint on economic intervention.

China developed economic long COVID thanks to Xi's shift to more autocratic economic management.

When discussing political economy, it is always wise to cite Albert Hirschman, but Hirschman's logic does not support Pettis's case. If, as Pettis's paraphrase of Hirschman suggests, a successful growth model "develops its own set of institutions, along with powerful constituencies that benefit disproportionately from these institutions, making the model politically difficult to transform," then China's enormously successful private-sector elites should have better entrenched their economic position. But they cannot because the autocratic rulers of China have decided to take away their property rights and livelihoods at will. The relevant Hirschman insight is from his profound 1970 treatise, *Exit, Voice, and Loyalty*, which explains the three choices citizens have when forming a relationship with their rulers. Voice, as in criticism of government policies that could lead to civic political action, has always been severely limited by the CCP, and its use of electronic surveillance and repression has only grown in recent years. Loyalty, essentially accepting that what the party leadership does on policy is right, was and largely remains the default. But that has been the case only as long as everyday commercial life was productive and undisturbed—which it has not been in recent years. That leaves only exit, and people in China have increasingly resorted to that option under Xi's autocracy: Chinese households are building up their liquid savings instead of consuming durable goods; small enterprises are remaining liquid and investing less, to reduce the risk of expropriation; and, in many cases, better-off Chinese citizens are physically exiting by moving their assets, some of their production, and their families abroad.

All the structural problems Liu and Pettis identify in China's economy exist and have long existed. But Xi's deliberate and widening violation of his predecessors' "no politics, no problem" compact, particularly during the pandemic, changed the game. My critics' structuralist approach to analyzing China misrepresents the sources of the country's astonishing past growth and fails to explain the shifts unfolding today.

A narrow, structuralist reading would predict that the Chinese economy would react especially well to measures that stimulate consumption and private credit, since the relative benefits to households of those measures versus government investment would be high. In fact, Chinese consumers have been notably sluggish in responding to the stimulus measures introduced since the end of 2022, even when they targeted subsidies for auto sales or mortgage payments.

China developed economic long COVID thanks to Xi's shift to a more autocratic approach to managing the economy. This syndrome was not inevitable, and it was not foreseen. And it will be very difficult for the autocrat who caused it to cure it.

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