Field Notes from China, October 18, 2024

The Tearsheet

1. The Chinese leadership is concerned about the state of the economy, but is trying to address the issue using supply-side measures.
2. They are being forced to act by a Chinese polycrisis: the combination of a local debt crisis, a youth jobs crisis, and a general confidence crisis.
3. Even after the recent announcements and press conferences, we have not seen the full panoply of government actions.

"You can't really jump down if you're already in the basement."

- That private comment from an economic advisor to Chinese policymakers stuck with me as I reflected on my recent two-week China trip. It revealed two things to me: 1) those adjacent to policymakers and the leadership understand the severity of the economic downturn; 2) the Chinese economy is nearing the bottom of the cycle.
- This was of course before the recent announcements of monetary and fiscal stimulus to juice the Chinese economy, which have validated that the pervasive concerns about the economy are being taken seriously.
- Taking the economy more seriously is one thing, but will the follow-through reflect that sense of gravity? To have a better sense of what the Chinese government is trying to achieve on the economy, it is important to first begin with some context on its diagnosis of the problem.
- I'll approach it by posing three questions:

1. How concerned are Beijing mandarins about the state of the economy?

- I believe they are more concerned than at any time since the global financial crisis, except the genesis and impact of the current challenges are primarily endogenous rather than exogenous. For instance, the immediate impact of the GFC was the collapse of Chinese exports, whereas Chinese exports are holding up today.
- The challenges today are mainly a result of Beijing's approach to structural reforms amid a secular slowdown. To be sure, the Chinese government had long priced in a secular slowdown, having concluded since about 2010 that China would enter a structurally slower rate of growth of 5-6%. The top-level consensus was that China would be able to average ~5% growth throughout the 2020s.
- What was not priced in was "structural reforms with Xi Jinping characteristics." While the Xi administration inherited the secular slowdown, it believes it also inherited an economic model it didn't like very much.
- In simple terms, the Xi leadership believes China needs to move from an economy that is prone to producing excesses to one that is focused on efficiency—hence its latest fixation on "total factor productivity" instead of GDP growth (TFP contribution to GDP is down from 5.5 during 1978-2007 to 2.7 in 2022).
- So structural reforms, which began in earnest around 2017, were about taming the excesses and redirecting capital and resources toward segments that, in the leadership's view, enhance productivity and efficiency of the "real economy."

- I believe much of the government's willful negligence and/or draconian measures on the economy can be explained by the leadership's view of what is in excess. Property, for instance, was one of the excess sectors that Beijing was loath to support, leaving it to its own devices instead of bailing it out. The crackdown on big tech, too, was in the context of those companies having excessive market share and excessive profits.
- Both of these actions, or the lack thereof, were departures from expectations of Chinese government behavior. In short, the Chinese government can no longer be counted on as a reliable backstop to shore up troubled sectors, injecting much more uncertainty around policy expectations.
- But of course, shifting an $18 trillion economy from excess to efficiency requires a long-time horizon and deploying capital into new engines of growth, such as cleantech and advanced manufacturing, to compensate for the decline of old growth engines like property and infrastructure. It is also important to note that this is a supply-side oriented approach, not one that is focused on raising demand and consumption.

2. Why is the government taking action now?

- Such an approach to structural economic adjustment, more or less by fiat, necessarily prioritizes the long game at the expense of the near-term, paradoxically exacerbating cyclical problems instead of addressing them.
- The pursuit of this approach has led to what I think could be aptly described as a "polycrisis moment" for the Chinese economy. It is now facing a local debt crisis (the downstream effect of the property collapse), a youth jobs crisis (the government has stopped publishing this data), and a general confidence crisis (private sector/stock market malaise).
- The recognition of this convergence of cyclical crises has prompted the leadership to address the economy more forcefully in recent weeks. But each piece on its own is quite complex, and it is nearly impossible for Beijing to properly deal with them in equal measure.
- For instance, at MacroPolo we conservatively estimated that local government liabilities are at least $10 trillion, or more than 50% of GDP. It would be unrealistic to simply bail out local governments given the scope of the problem.
- The low-hanging fruit to tackle is the confidence crisis, and the latest spate of monetary actions and fiscal pledges are aimed at bringing back more animal spirits and confidence in the markets. That has been partially achieved, though how long it endures depends on how much more firepower Beijing is willing to unleash.

3. Where does it go from here?

- We do not yet have as much information as we need to fully digest this stimulus cycle, but our informed view is that we have yet to see the full panoply of actions.
- More details and official press conferences are forthcoming, but we quickly outline the contours of potential outcomes here as placeholders to be assessed in coming months:
  - **The Good** – Before end of year, Beijing announces bazooka stimulus (potentially up to 10 trillion yuan) to be spent over the next two years to reflate the economy while also tackling structural challenges.
  - **The Meh** – Beijing will dribble out a slew of "just enough" stimulus to more or less achieve 5% growth for 2024 and revert to its supply-side structural adjustment approach in 2025.

- **The Ugly** – Beijing is unable to rise to the occasion, gets more trapped in the "polycrisis moment", which will exacerbate deflation and all the associated challenges. As such, the economy could face structurally slower growth of perhaps 2-3% going forward.

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