Is Japan China's future?

China could be staring at the start of a deflationary phase similar to the one Japan experienced in the early 1990s

ILLUSTRATION: BINAY SINHA

During a recent visit to China, I had the opportunity to get a sense of where the Chinese economy was heading after the zero-Covid restrictions were lifted in November 2022. These pervasive restrictions on mobility had adversely affected both domestic and external economic and commercial activities. Chinese annual gross domestic product (GDP) growth had fallen to 3 per cent in 2022, the slowest in several years. The property sector, which has accounted for over 30 per cent of Chinese growth for years, has been hit by the imposition of much stricter regulatory measures. The property bubble has "popped", leading to knock-on effects on other related sectors, particularly banking and finance.

It was expected that the removal of Covid-related restrictions would lead to a significant revival of the economy, and this is what reportedly happened in the first quarter of 2023. Chinese GDP growth was 4.5 per cent during this quarter, leading to projections of 5.6 per cent for the whole calendar year. However, growth sharply decelerated in the subsequent quarter ending June. It was 6.7 per cent compared to the same period last year, but this reflects the low base effect. Growth has been less than 1 per cent compared to the last quarter.

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One senior Chinese academic told me that the Chinese economy was in "dire straits" and that the slowdown was likely to persist for at least 3 to 4 years. He added that for the first time in 40 years, Chinese employed in several sectors of the economy were having to accept salary cuts. While there may have been some years when incomes had not risen, this was the first time that a substantial number of people had lower incomes than before and were no longer optimistic about the future. He also pointed to the now well-known phenomenon of youth unemployment, which persists at over 20 per cent. The pessimism was heightened by a much less benign external economic environment, with geopolitical tensions exacerbating economic challenges. All this, he admitted, was generating social tensions, though the Xi Jinping government is under no threat.

A recent World Bank report bears out the strong headwinds buffeting the Chinese economy. It doubts whether the projected growth rate of 5.6 per cent for the current year would be achieved and estimates growth to slow further to 4.6 per cent in 2024 and 4.4 per cent in 2025. The same report says that Chinese debt levels reached an all-time high of 287 per cent of GDP at the end of 2022. This constrains China from deploying significant stimulus measures to boost growth.

What about the property sector? The report reveals that real investment has fallen by 6.2 per cent while housing starts have declined 21.2 per cent during the first quarter of this year. The sale of land use rights by local governments has fallen by 21.7 per cent year on year this quarter on top of a 23.3 per cent decline registered in 2022. This means that the chief source of revenue for local governments has been severely impacted. In a recent report, the Chinese finance ministry said that there were 35 trillion yuans ($5 trillion) outstanding on the books of local governments at the end of 2022. According to some analysts, the actual figure may be higher, possibly double this amount.

This represents a major vulnerability in the economy, and the severely depressed sale of land-use rights by local governments suggests the crunch will continue and possibly worsen.

The woes of local governments pose a threat to the banking sector. Local government financing vehicles constitute 15 per cent of total banking assets. Mortgage loans outstanding at the end of 2022 were 40.6 trillion renminbi (RMB) or $5.7 trillion and constituted 18 per cent of total bank loans. Direct exposure to property developers was much less, just 5.9 per cent of total loans. While the level of non-performing assets (NPA) of Chinese banks is still very low at less than 2 per cent, this could change if the economic slowdown intensifies.

Inflation in China is remarkably low and it is an outlier in this respect. This is the result of weak demand and a fall in producer prices. This could be the start of a deflationary phase of the kind Japan experienced in the early 1990s, brought on by a combination of a property bubble bursting, bad debts multiplying and a rapidly ageing population. Japan went from constituting 18 per cent of the global economy in 1990 to only 8 per cent in 20 years.

Despite repeated policy announcements that the Chinese economy must shift from being investment-driven to one that is driven by rising consumption, this has not happened so far. Consumption is still at a relatively low level of 40 per cent compared to over 60 per cent in most mature economies. The Covid pandemic, spanning three years, has dampened consumer demand, and stagnant or falling incomes have made the situation worse. An article in the *Nikkei* reports that retail sales in China are still 10 per cent below the level reached pre-Covid. Chinese are saving more and these are mainly precautionary savings because the overall economic outlook has worsened. The household saving rate currently is 3 per cent above pre-Covid level, which suggests a continuing reluctance to spend.

The Chinese economy has been written off before and has always belied doomsday predictions. One should therefore be careful in making assessments about its likely trajectory. There is a strong and capable government, which has the ability to adopt difficult policy measures to deal with the looming crisis. It will need to restructure the mounting debt of local governments. It may need to resort to direct income transfers to boost consumption. Technological innovation is part of the solution but the heavy spending on high-end technologies has been less than productive. The Xi Jinping regime has been generally hostile to the private sector, which has been the main driver of growth during the past four decades. Would this be reversed?

In conversations with several Chinese interlocutors, there seemed to be some surprise over India having emerged as a preferred destination for flows of international capital and technology, with its economic prospects appearing brighter than China at this point. It was argued that China had been adversely impacted by trade and economic relations being increasingly influenced by geopolitics and security considerations. That China has itself contributed to this changed environment is not acknowledged.

Indian and Chinese economies are complementary. An improvement in political relations, anchored in a restoration of peace and tranquillity at the border, could open up opportunities for expanded economic and commercial relations between them. But it appears unlikely that China will make that choice.

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