The True State of the Chinese Economy

ASIA’S PATH FORWARD

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INTRODUCTION

The Chinese economy is able to maintain a certain level of growth. From the second half of this year [2020] through next year, the trend will be obvious. But over the years, as chronic issues take their toll in the wake of the pandemic, this growth will look insignificant. While GDP started to show growth in the second half of the year, more precise economic indicators such as Total Factor Productivity [TFP] show a decline in growth from 2013 onwards, calling into question whether official GDP growth will measurably improve the standard of living. Post-pandemic, in order to protect economic growth and basic government operations, all levels of the government will reinforce the model of government-led economic growth. This low-productivity growth model will further contribute to the economy’s structural imbalance. At the same time, the ruling party will further consolidate power. Against the backdrop of this “inner cycle,” all levels of government will increase support for state-owned enterprises (SOEs), and SOEs will take over even more of the living space of the private economy; the piling on of multiple factors will further skew the already imbalanced economic structure, income distribution, and local government debt, and will have a fairly large impact on foreign exchange and employment. If left unchecked, these economic problems will evolve into social and political problems.

INTENSIFYING THE CENTRALIZATION OF POWER

The underpinning logic of this article is that under a non-electoral, authoritarian system, political actors and the ruling party must first secure their own political survival. It is commonly held that within such a system, political actors are able to ensure the maximization of their own power.¹ Under this premise, the economic policies of authoritarian regimes are entirely in the service of political survival. The economic policies of both the era of the planned economy and post-Reform-and-Opening follow this logic. The reason economic policy has changed so much is that the external environment and the internal power structure have undergone change themselves. The external environment [includes], for example, relations with the US. The power structure of the Mao era differs from the era of Deng Xiaoping as well. This explains why we see such enormous change in much of China’s public policy, including its economic policy. To take official reporting as an example, the official take on private enterprise changed dramatically from 2015 to 2019. From 2015 to 2018, discussion of “private enterprise exit theory” still lingered; but as the trade war with the US dragged on, on different occasions between 2018 and 2019

Chinese leaders also declared that "private enterprise is on our side." Analysis of these phenomena requires both the logic set forth in this paper and information regarding real-life political actions in China.

After decades of fast-paced economic growth, China settled into a "new normal" beginning around 2012. Since coming to power, Xi Jinping has purged the bureaucracy in the name of fighting corruption. Through his own formidable will, after amending the constitution's provisions on term limits, Xi has come to essentially wield total control within and beyond the Chinese Communist Party both in theory and practice.

Any analysis of Xi’s consolidation of power must look at his behavior in the context of the centralized control of the ruling party and the bureaucracy as a whole. It is common to the whole Party and the central government. Starting from the tax-sharing system, the centralization of power was apparent in the economic realm. By the end of Hu Jintao and Wen Jiabao’s administration in 2008, state power had steadily crept into civic life.\textsuperscript{2,3} Xi’s rise to power, on the other hand, has bolstered the role of the Party and its particular role in terms of political consolidation.

The continued concentration of power has also impacted all fundamental national and social relationships: central and local, state and civil society, government and market. The state and the government hold the upper hand, and have transgressed on the autonomy of society and the market. Hayek and others hold that "是信息，而非市场效率，才是经济增长的关键." When power is monopolized by an individual and the bureaucracy, and fear silences society, valid market information will diminish, and economic downturn will be inevitable. Against this backdrop, the din of the "private economy exit theory" and "the nation’s advancement and the people’s decline" has reverberated through public opinion since 2017; during COVID-19, the PRC has employed "Mao Zedong-style" social controls as part

\textsuperscript{2} Prior to the tax-sharing system, the financial administration implemented local fiscal responsibility systems (caizheng baogan), though which localities accumulated massive financial resources. The central government accounted for 20% of national fiscal revenue but was responsible for 30% of national expenditure, meaning that it had to borrow from local governments. To get itself out of this predicament, the central government carried out tax-sharing reform. General tax-sharing reform included two main components: reform of the tax system, i.e. the redistribution and restructuring of tax categories; and reform of the financial system, involving the redistribution and readjustment of the respective financial and administrative powers of the central and local governments. These reforms have effectively improved the central government’s ability to use financial tools to regulate economic development and income distribution.

\textsuperscript{3} Zhou Feizhou, Yi li wei li: Caizheng guanxi yu difang zhengfu xingwei [Profit for profit: fiscal relations and local government behavior] (Shanghai Sanlian Chubanshe, 2012).

of public health policy. While the outbreak was quickly brought under control, the bureaucracy and Party organization, enormous to begin with, penetrated deeper into society. Post-pandemic, “Mao-style” social controls will gradually turn into normalized social governance policy. (Addendum: “Mao-style” social control as used here indicates a social trend, but a return to the Mao era is not necessarily impossible. However, there are some Mao-era policies that have reappeared in the past few years, such as using household registration (hukou) to limit urban-rural migration. A spate of municipal policies to drive out the “low-end population,” the rise of large-scale facial recognition systems, and the soon-to-launch digital RMB are all essentially strengthened civic controls, and may be seen as Maoist techniques of social control.) Xi’s consolidation of individual power has also grown more pronounced in the wake of the pandemic, and it is difficult for a third party to alter this dynamic of personal power.

**IMBALANCED ECONOMIC STRUCTURE**

The pandemic is essentially under control in China, and economic life has also been basically restored. According to data released by the Ministry of Finance in September 2020, the national general public budget revenue increased by 5.3% year-on-year in August 2020, continuing a positive increase of three consecutive months. Cumulative data from January through August show that the national general public budget revenue still fell 7.5% YOY, an indication that the pandemic has still pummeled administrative income. It will be quite a challenge to meet the annual economic growth target of 2-2.5%.
Let us look at the statistical data. On the supply side, the value added of industry at the national scale and above grew YOY 0.4% from January to August, the first turn from negative to positive growth since the start of the pandemic. On the demand side, January-August national fixed assets totaled -0.3% YOY, within which real estate investment grew 4.6% YOY, infrastructure investment fell 0.3% YOY, and investment in manufacturing fell 8.1% YOY; analysis of the investment structure shows that the growth of investment in manufacturing lagged behind investment in real estate and infrastructure. On the consumer end, total retail sales of consumer goods January-August were only 23.8 trillion RMB, or -8.6% YOY. Looking at the data on foreign trade, exports increased 0.8% January-August, while imports fell 2.3%. The trade surplus was 416.6 billion yuan, growing somewhat during this period. From the data, retail sales of consumer goods, which best reflect resident income, still shows negative growth, indicating that the economy is still in the process of recovery. After all, economic growth data can be obtained through "infrastructure investment" and "real estate," but the numbers on private consumption must come from stable employment and a secure source of income for the general population. Although China's economy has gradually recovered overall, economic structural imbalances have become more pronounced. Comparing data for the whole of 2019, consumption as a whole contributed 57.8% to GDP, reaching 41.2 yuan. Based on the latest trends, it is impossible to ignore the negative growth of consumption over the year. In order to meet the goal of overall positive growth for the entire year, you would lean more on investment and exports.

The above data comes from the National Bureau of Statistics, but the quality of its statistics is a matter of controversy. For instance, conventional industry statistics reflect "above-scale" enterprises, but this designation only includes a fraction of small enterprise, not the millions of micro-enterprises. Yet it is these "below-scale" enterprises that provide tens of millions of jobs, while facing challenges far beyond those "above-scale" business must deal with. Furthermore, to take the unemployment rate as an example, unemployment is nationally defined as working less than 1 hour in the week preceding the survey. If, however, the threshold for unemployment is set at 10 hours, the unemployment rate may increase exponentially. The real state of the economy could therefore be far worse than statistics show.

This article will now proceed with specific analysis of investment, consumption, and net exports.

First is consumption. This article argues that the political factor is the greatest cause of the discrepancy in China's reported and actual economic growth. We previously discussed the current power structure—the centralization of political power--whose economic impact is manifest in the degree to which the central government supports SOEs, and in the monopolistic foothold SOEs are gaining across industries; this trend is even more apparent post-epidemic. In the past few years, “56789” has been used
to describe the contribution the private economy to economic development: private enterprise accounts for at least 50% of tax revenue, 60% of GDP, 70% of tech innovation, 80% of jobs, and over 95% of total enterprises. Since 2013, under the basic policy of “going big and strong” with SOEs, the living space for private enterprise has been progressively encroached upon by SOEs. On the one hand, China’s state-owned enterprises are financially guaranteed at all levels. In particular, a significant number of SOEs still have financial structures, such as urban investments and stock market investments, set up by local governments. They not only have resource monopolies in their respective domains, but have started to reach into finance, real estate, and other spheres. On the other hand, the pandemic has worsened conditions for private enterprise. According to a report published by the Peterson Institute of International Economics, credit has fallen for the private sector and risen for public sector over the past few years. In 2013, 35% of non-financial corporate bank credit went to SOEs, while 57% went to private enterprise; in 2014, 60% went to state-owned enterprises and 34% to private enterprise. (The remainder went to foreign capital or joint ventures.) By 2016, the distribution imbalance was even worse: 83% went to state-owned [enterprise] or to state-owned holding companies, leaving only 11% for privately owned businesses. When the pandemic hit, ordinary citizens and small- and micro-sized enterprises proved far less resilient to risk than high-income groups and SOEs; private businesses often must declare bankruptcy, close up shop, lay off staff, or cut salaries. This has had an enormous impact on employment and income, which of course limits consumption.

Addendum: In China, policies that discriminate against private enterprise exist at all levels of government as well as in the state-owned financial sector. The reason: The first consideration for an SOE is not turning a profit, but accomplishing political tasks. SOEs have two main functions: One is political absorption, drawing people of all social strata into the system, commonly known as buying loyalty; the other is to fulfill specific political tasks. As an example of the latter, every SOE pitched in to fight the pandemic, without any regard for cost. For instance, First Automobile Works (FAW) primarily manufactures cars, but produced face masks during the epidemic.

Each SOE has a corresponding level in the Chinese bureaucracy. To take real estate as an example, local transportation and railroad investment groups are majority funded by local governments, and the legal staff of these companies are all local officials. Similarly, private and state-owned enterprises both apply

for loans from financial institutions, but the institutions prioritize SOEs. These discriminatory policies have ramped up since 2013. When the new government announced the “go big and go strong” strategy for SOEs, talk of the “private enterprise exit theory” also appeared in the public sphere. These accumulating factors have eaten away at private enterprise’s living space.

The Chinese government’s attitudes toward private and state-owned enterprise may also be seen in the current constitution:

   Article 7. The state sector of the economy, that is, the sector of the socialist economy under ownership by the whole people, shall be the leading force in the economy. The state shall ensure the consolidation and development of the state sector of the economy.

   Article 11. Non-public economic sectors that are within the scope prescribed by law, such as individually owned and private businesses, are an important component of the socialist market economy. The state shall protect the lawful rights and interests of non-public economic sectors such as individually owned and private businesses. The state shall encourage, support and guide the development of non-public economic sectors and exercise oversight and regulation over non-public economic sectors in accordance with law.

(Here “non-public economic sectors” generally refers to private enterprise.)

This applies specifically the COVID-19 public health crisis.
After 2013, the central authorities pushed the ‘go big and go strong” SOE strategy, which further eroded the living space for private enterprise. This also sent a message to local governments: encouraging and assisting the growth of SOEs is “politically correct,” and moreover is a political task; this explains why so many local governments have been so rough with the private economy since 2013.
The above is the impact of central policy on the private economy, which determines the living space of the private economy; over the years, it has become de rigueur for local governments to manhandle the private economy with campaign-style, one-size-fits-all methods that violate market principles. The behavior of local governments can determine the fate of the private economy. Localities started to apply these tactics to environmental protection around 2015. In the Yangtze River basin, local governments have started to impose strict supervision of water-rich areas in order to prevent animal and other wastes from polluting waterways. In some places, they have even banned livestock. Instead of giving pig farmers time to upgrade their facilities to meet the new standard, local governments simply tore down the farms. As a result, the number of live pigs in the south fell dramatically and forced the industry to move north. Pigs raised in the north are then shipped to the south for sale, in consequence of which African swine fever has spread to most of the country in less than a year.
Second, on the export end, China has maintained a certain amount of growth since the pandemic. Calculated in US dollars, the trade numbers for August show 9.5% YOY growth in exports, up 2.3 percentage points from July; while imports fell 2.1% YOY, widening the gap by 0.7 percentage points from July. According to the New York Times, China’s share of global exports rose to nearly 20% in the second quarter.  

This article contends that there are two main reasons for China's continued export growth: On the one hand, China's manufacturing sector is sufficiently robust, as exhibited by its low cost, stable intensive labor force and the efficiency of its infrastructure. It is also evident from the additional loans the state-owned banking system provided to small and medium enterprises (SMEs) in response to the pandemic. At the same time, China's long-standing domestic mercantilism and work culture, along with the limited ability of labor unions to negotiate prices, have objectively given China a competitive edge in manufacturing; on the other hand, Europe and America have been exhausted by the pandemic, whereas China has enough of an industrial chain to produce mass quantities of personal protective equipment (PPE), home goods, and consumer electronics. Due to this combination of factors, Chinese exports continued to show fairly good growth during the pandemic in spite of the trade war. According to the above analysis, this was China’s chance to make good on its international obligations and burnish its global image. Instead, it "ideologized" masks and other pandemic materials, so that China supplied goods only so long as they played to its advantage. This in turn has forced Western countries to consider national security. In the future, they will reduce their reliance on Chinese manufacturing. Next year, as Europe and North America gain control over the pandemic, one can predict that more manufacturing will move out of China; this is already happening in the US, Europe, and Japan. The deterioration of the domestic business environment will also force manufacturing out of China, a trend that actually began in 2017. Cost is no longer the only consideration, either. The escalation of the trade war and the introduction of the National Security Law in Hong Kong have accelerated capital flight. China’s low prices and ready-made industrial chain will contribute to economic growth and employment in the short term, but not by much; as Yu Yongding said at the 2020 NetEase Annual Economics Conference in September, "Net exports make up a fairly small proportion of the GDP. Even in 2018 it was less than 1%. While the acceleration in net exports this year is relatively high, it won’t

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contribute much to the pace of economic growth.” (Addendum: Net exports refers to the difference between the total value of exports and the total value of imports, so the 1% here is the contribution of net exports. Imports and exports can contribute up to 50% of China's GDP. Exports have remained stable at around 30%, which is a big piece. In addition to contributing to GDP, exports are directly responsible for creating a lot of jobs. China therefore emphasizes control of the labor environment in order to attract more foreign companies to invest in China.)

From the analysis of the economic structure, we conclude that in order for China to maintain the pace of positive growth this year, it must continue to expand public investment. However, most of these are unproductive investments that will only accelerate the depletion of China's economic strength. Under current conditions, economic backsliding is unavoidable. Yet government officials love to throw themselves into public investments. On the one hand, investment-driven GDP can earn them a

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promotion, on the other, such public investment is by nature is a kind of economic redistribution, also known as distributive politics. Officials stand to gain huge economic benefit for themselves; after all, only a few can move up in the bureaucracy. Of course, any public policy has costs and benefits, but it is members of the bureaucracy or associated groups who stand to benefit, while the cost of investment is borne by society and ordinary citizens. To take income distribution as an example, according to the latest study by Li Shi's team at Beijing Normal University, in 2019 about 100 million households in China had an average monthly income of 500 yuan or less; about 310 million had an average monthly income of 1000 yuan or less; and about 710 million, 2000 yuan or less. If we follow the National Bureau of Statistics' standard definition of middle income, then 9.1 million Chinese are low income.

This may also explain why China has touted structural economic change for so long yet has continued to rely on government public investment. In this model of economic growth and distribution is, it is the ordinary citizen who bears the cost of development. With unsustainable growth in both exports and consumption, in theory China can only rely further on public investment in order to maintain economic growth. This theoretical analysis is gradually being confirmed by reality.

In the third quarter of this year, several scholars in Jiangsu Province told me that "From January to August, several regions near Shanghai showed double positive growth in both their [local] economies and in fiscal tax revenue. This demonstrates the economic vitality of the eastern part of the country; however, there are hidden dangers behind this growth." They believe that pre-pandemic thinking and behavior have persisted in the region’s economic construction and social governance. They said that despite current disruptions and out-migration of the industrial supply chain, and the potential for a huge downturn in domestic investment and consumer demand, the government is still pushing economic growth as an all-out infrastructure project. For example, infrastructure projects that were already confirmed before the pandemic have adjusted to the onslaught of COVID-19. On the contrary, there is a tendency and incentive to further expand infrastructure investment, especially by stimulating real estate investment. This approach not only puts enormous pressure on local resources but is likely to lead to a further increase in the local debt burden, to the point that it may exceed that locality’s capacity. From the mid- and long-term views, this does not bode well for long-term local development.

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8 Zhou Li’an, Zhuanxing zhong de difang zhengfu [Local government in transformation] (Shanghai gezhi chubanshe, 2017).
9 Zhang Qi and Liu Mingxing, Quanli jiegou, jingji zengzhang he zhengzhi jili [Power structures, economic growth, and political incentives] (Shanghai gezhi chubanshe, 2018).
They further stressed that since the beginning of the pandemic, this regional economic growth has largely been founded on rising home prices.

At the same time, looking at the nation as a whole, this is not a one-place-one-policy phenomenon. Since local governments' internal interests and behavioral mechanisms that determine its operations are relatively stable, dependence on a government-lead, investment-driven approach to stimulating the economy is likely to play out across the country. This implies that problem of local debt is likely to worsen, especially in less economically advanced regions. More urgently, China's fiscal revenue structure is such that its main sources of tax revenue are the Yangtze and Pearl River deltas, Jiangsu being part of the former region. If the Yangtze River delta, China's most economically dynamic region, continues to rely heavily on land financing for economic growth and fiscal tax revenue, then the problem is not simply that the region has an outsized impact on the financial revenue of the central and local governments: if the central government is no longer able to guarantee the continuation of transfer payments, then the northern provinces, which are heavily reliant on money transfers from the central government, will plunge into even greater financial duress. Anyone familiar with China's economy is aware that for many years the northern provinces have lacked market opportunities and social dynamism, that nepotism has prevailed, and that local social governance has been a far cry from
those of the Yangtze and Pearl river deltas. As soon as there is a shortfall in transfers, these local governments will further extend their ‘plundering hands’ to society in order to make ends meet.

Finally, returning to the issue of employment, this year's picture is a dire one, thanks to the current political-economic structure, the pandemic, the worsening external environment, increased downward economic pressure, and a whole host of accumulating factors. According to the data, 6.17 million new jobs were created in urban areas from January to July, a decrease of 1.96 million compared to the same period last year and a cumulative YOY decrease of 22.6%. In August, the national urban surveyed unemployment rate was 5.6%, and the urban surveyed unemployment rate in 31 major cities was 5.7%, both down 0.1 percentage point from July. In theory, tertiary and secondary industries could provide more employment, especially the former; however, with shrinking domestic consumption and a sluggish manufacturing industry, people will eventually return to primary industry, which does not provide many jobs. In addition, 8.74 million people graduated from university this year, an increase of 400,000 from last year. According to the author's understanding, this year's college employment rate is rather unpromising. When the economy was still able to maintain growth, many social problems were covered up. As the economy stagnates or declines, these social conflicts will become more acute and more difficult to resolve.

To conclude, despite numerous changes in economic policy, the core logic behind this policy is to consolidate the power of the supreme leader. Going forward, the direction of the economy or of employment will depend on the following factors: Foremost is Sino-US relations. If the US continues to exert pressure on China, as we can already see, domestic ideology will increasingly emphasize Mao-era rhetoric, and public policy will trend toward conservatism. Specifically, economic policy will further reject market reforms, and the outflow of foreign capital will increase. If Sino-US relations warm and the two sides are able to talk through their market conflict, the overall environment in China could turn for the better. The second factor depends on Xi Jinping’s approach to power and his willingness to expand opening and domestic reform, including political reform. If not, the economic situation could get much worse.
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