The extent of the imbalances in Chinese economic growth: challenges and prospects

A study of China's economic and social imbalances, of how it affects the world at large and of the potential solutions.

Amaury Goguel

July 2023

skema THINK TANK | PUBLIKA

SKEMA PUBLIKA

SKEMA Publika is an independent international think tank aiming to anticipate tomorrow's societal and geopolitical transformations. It fuels public debate and issues recommendations for national and international policymakers.

Affiliated with SKEMA Business School, the think tank addresses political and societal issues connected with public policy. It tackles them from the angle of early signs, anticipates and formulates recommendations for "after". It uses a multidisciplinary and hybrid approach to information processing, combining human and digital intelligence.

Find all our work at: https://publika.skema.edu/

ABOUT THE AUTHOR

Amaury Goguel is associate professor at SKEMA Business School, scientific Director for the MSc Financial Management and Investment. He was previously head of SKEMA's MSc in Corporate Financial Management.

His research is conducted under the auspices of the SKEMA center for Global Risks.

He holds a Ph.D. in Economics from Lille University. He also holds master's degrees from the College of Europe (Bruges), Paris 1 Sorbonne, and Complutense University of Madrid.

He served as a consultant on global finance, European affairs, and political parties.

His main work is a reference book in the field of country risk, Managing Country Risk in an Age of Globalization, published by Springer International edition and co-written with Professor M.H. Bouchet and C. Fishkin.

ACKNOWLEDGEMENTS

The author would like to thank Michel Henry Bouchet for his meticulous proofreading and for sharing so much of his knowledge.

This is a translation of the original report in French.
Publication date: July 2023

TABLE OF CONTENTS

Foreword 4
Executive summary..... 5
Chapter I: Stylised facts: imbalances masked behind major successes 10
1. Major successes..... 11
2. Imbalances recognised and identified by numerous international observers for a decade 12
3. There are both internal and external reasons why the imbalances have not been entirely resolved..... 14
Chapter II: Financing the rebalance the Chinese economy needs 19
1. The problem of total debt – corporate and banking..... 20
2. The property bubble problem..... 21
3. The problem of capital flight 23
4. Could the Chinese economy be financed through international funding?..... 24
Chapter III: Ensuring the economic model is sustainable 30
1. Population shrinkage and the economic aporia 31
2. Social opposition and the diminishing attractiveness of the Chinese economy 33
3. Geopolitical positioning: a project, investments and diplomatic tensions..... 36
Summary of recommendations: What economic policies are required to achieve less unbalanced growth?..... 40
Appendix: Charts 44
Charts of Chapter I..... 45
Charts of Chapter II..... 51
Charts of Chapter III..... 55

FOREWORD

In this report, Prof. Amaury Goguel tackles an important topic in the field of international economics. Building on a comprehensive survey of the relevant literature, Prof. Goguel closely examines several key interlinked economic, financial, social, political, and geopolitical issues that carry significant consequences for the health of the Chinese economy. Based on his thoughtful analysis, Prof. Goguel outlines a range of policy recommendations that can be deployed to address structural imbalances in the economic system so China can get out of its current economic stagnation.

Based on my understanding of the Chinese economy, Prof. Goguel's observations and analysis of the imbalances in this giant economic (as well as political) system are fairly accurate and his findings are highly insightful. In particular, I was impressed by his finding and recommendation on using foreign capital to finance debt. Chinese economic policy-makers may not fathom this presently overlooked solution, but it has the true potential to become a coherent and efficient solution to its debt crisis.

The report is written in an academic style, yet still accessible to the general audience (e.g. firms, government agencies, research institutes, think tanks) who are interested in deciphering the complexity of the Chinese economy. I will be delighted to help promote the report to further enhance its reach and impact.

Professor DOU Wenyu

Professor DOU Wenyu is Academic Dean at SKEMA Business School, China Campus. He is Vice Dean of the International Joint Audit Institute between SKEMA Business School and Nanjing Audit University, and Chair Professor in Digital Marketing and Chinese Social Media.

Professor DOU holds a Ph.D. in Marketing from the University of Wisconsin – Milwaukee (USA), a M.S. degree in Atmospheric Sciences from the University of Wyoming (USA), and a B.S. degree in Meteorology from Peking University (China).

Before joining SKEMA in July 2021, he served as Associate Dean and Director of EMBA-C in City University of Hong Kong for 16 years. He is also appointed as Chair Professor under the Chu Tian Scholars Program with Zhongnan University of Economics and Law (China).

Prof. DOU has published extensively in prestigious journals such as *MIS Quarterly*, *Journal of International Business Studies*, *Journal of Advertising*, *Journal of Advertising Research*, *Journal of Interactive Marketing*, among others. Prof. DOU served as Associate Editor for the *Journal of Interactive Advertising* (2014-2016), and currently sits on the editorial board of the *Journal of Advertising*.

EXECUTIVE SUMMARY

This study is first and foremost an assessment of the existing situation. Numerous reports have been written regarding the imbalances in the Chinese economy. Here, our aim is to offer a broad overview of the majority of the interlinked issues involved – economic, financial, social, political and geopolitical. From this analysis, we have set out the most widely accepted proposals. We are perfectly aware that the majority of them stem from the liberal approach currently favoured by most economists and multilateral organisations. We have also attempted to set out the reasons behind the political decisions made by the authorities and highlight the dilemmas they face.

The recommendations made in this report may appear liberal in nature. Although they are backed by reasoning, we cannot deny that they do partially reflect some of the themes of the Washington Consensus. It is understood that China will do everything it can to avoid remaining boxed into a liberal Western model, with the support of an ever-increasing list of BRICS[1] partners (Argentina, for example, will probably join this club). China questions the instructions of the IMF and liberal economists (Joseph Stiglitz, who is very sceptical regarding the Washington Consensus, is one of the few Western economists to command respect in China). And yet, the IMF acknowledges the errors in the Washington Consensus and the virtues of the Chinese model for the early stages of development. Consequently, the recommendations in this report do not dispute what has been achieved through this "highly regulated and administered" Chinese approach. Its objective is rather to set out a road map for the next stage, for the transition from an emerging economy to a developed economy, seeking to become a coherent and stable part of the mechanisms of international finance. Lastly, it offers some solutions for situations when the degree of imbalance means that state interventionism is no longer sufficient. As financiers say, you can't fight the tide. The legendary American investor Warren Buffet joked that "Only when the tide goes out do you discover who's been swimming naked" (meaning those whose investments are insufficiently diversified and vulnerable to risks). Diversification in political and economic approaches can only ever be a good thing.

BALANCING THE SOURCES OF GROWTH

China's unprecedented successes – 9% annual GDP growth since 1978, 800 million people lifted out of poverty, the world's highest GDP in real terms and second highest in nominal terms – are the result of economic governance that has been acknowledged by analysts and financial strategists. And yet, over the last ten years, behind these positive results have developed major imbalances which the government's interventionist approach will have to tackle.

If it is to overhaul the country's economic structure and achieve more balanced and inclusive growth, the Chinese government has numerous challenges ahead of it. It is against this backdrop that **this report intends, after setting out the current state of Chinese growth and in particular its imbalances, to provide a broad overview of the interlinked issues involved and to develop avenues through which China could achieve a positive outcome.** Chinese imbalances impact the world as a whole, not only through trade and the knock-on effect on global growth, but also because of the way the jolts – or worse – it experiences affect global finance.

WHAT FINANCING PROBLEMS IS CHINA EXPERIENCING?

Firstly, its total debt is unusually high for a middle-income country. It currently stands at over 300% of GDP (against an average of 192% for emerging markets). But beyond its level, it is the composition of the debt that raises questions. Corporate-sector debt is particularly worrying as it equates to more than 160% of GDP. These record levels of debt go hand in hand with a spectacular increase in the value of defaults (failure to repay) on debt instruments. The Chinese government is working to bring the necessary stabilisation to the market. Similarly, bank debt remains high, at almost 180% of GDP (compared to an average of 70% across other emerging

[1] Brazil, India, China and South Africa.

markets). The government's lack of transparency regarding the conditions and the sharing of any losses, and the fragmentation of the banking system as a whole, are a concern for the IMF and the rating agencies.

Secondly, the property sector, a pillar of the Chinese economy (30% of GDP) continues to deteriorate. The concern is that the country relies on it as an economic stimulus, because of its numerous knock-on effects. China has 50 ghost towns and 64 million empty apartments, and the property giant Evergrande is facing potential bankruptcy. The absence of any clear reaction from the Chinese government on Evergrande demonstrates the authorities' uneasiness regarding the sector, which appears to underpin the financial and social fabric of China. Property investments are popular with Chinese households as a way to optimise their pension capital, leading to overinvestment in the sector and apartments purchased as financial investments left standing empty. Consequently, were the financial bubble to deflate too rapidly, the pension system would be pushed off balance, forcing households to save even more and spend even less. **All in all, the side effects of a crisis originating in the property sector may lead to a lasting lack of overall demand, causing the economy to suffer embedded unemployment and a permanent fall in output.**

Thirdly, capital flight is a worrying trend. Although Chinese household savings are constantly increasing (around 42% of GDP in 2021) and will soon account for half of global household savings, the Chinese growth model remains paradoxically dependent on foreign capital. In fact, Chinese investors are increasingly seeking to buy foreign assets. This capital flight, which has reached a very high level since 2014, has been a factor in reducing household savings and consequently the country's official reserves. Between 2010 and 2020, China's foreign exchange reserves fell from 20% of GDP to 10%. The Chinese authorities consider the influx of foreign capital as a solution to the pressures caused by capital outflows, which avoids excessive reliance on the sale of accumulated foreign exchange reserves. **But this capital flight is becoming increasingly structural, and foreign capital inflows increasingly volatile.**

WHAT ARE THE ECONOMIC POLICY RECOMMENDATIONS TO GET THE COUNTRY OUT OF ITS ECONOMIC AND FINANCIAL RUT?

On the basis of this study, the following elements have been identified as priorities:

- Break free from the middle-income country trap.
- Escape the debt trap.
- Keep the growth of credit under control.
- Stabilise the ever-expanding shadow banking system.
- Cut the dead wood from the property sector.
- Deal with the environmental issues that cost the Chinese economy several billion dollars every year (desertification, sandstorms, etc.).
- Limit fraud and corruption. This important topic has already been tackled but consolidation is needed now that the current government looks set to stay in power, with Xi Jinping potentially president for life.

1. Break free from the middle-income country trap

Although China has reached an advanced stage of development, **the country's economy still relies mainly on manufacturing, property and raw materials, with too little focus on high-value-added service sectors** such as financial services and insurance. A pivot towards these new growth drivers would enable China to break free from the middle-income country trap[2]. This is however a difficult thing to achieve, because the primary and secondary sectors are managed by the state through a regulatory framework, with economic financing set centrally by the Politburo of the Chinese Communist Party (CCP), which tends to focus on the sectors historically most apt to provide jobs and growth, in particular manufacturing, energy and property.

[2] Under the World Bank classification, China is considered an upper middle-income country, based on its estimated GDP per capita of $12,556.30 in 2021.

Recommendation: (already expressed by the government, but to be tackled as a priority) separate the private and public sectors more distinctly to encourage the development of services (which are often organised in a more "liberal" manner than industry), give more prominence to innovative SMEs, overhaul finance (put an end to the "pawnshop" approach) and subject non-bank financial institutions to stricter regulation.

At the present time, it appears necessary for China to refocus and rebalance its growth model, which is currently slowing due to structural constraints, in particular a fall in population growth, lower returns on investment and stalling productivity.

2. Stimulate domestic consumption

To this end, the **key means of stabilising growth and making it self-perpetuating regardless of production costs and the population's standard of living would seem to be stimulating domestic consumption**. This also involves a major challenge: the proportion of domestic consumption within wealth created in the country is very low, at around 40% to 50% of GDP depending on the sources consulted. This lack of demand is mainly explained by the population's propensity to save and by low wages. China's gross savings rate is very high at 45% of GDP, mainly due to an ageing population and doubts about pension system sustainability.

Recommendation: domestic consumption should be boosted in a progressive and sequential manner, in tandem with a reduction in investment to avoid causing even higher levels of debt.

3. Escape the debt trap

Consumption remains less significant than investment within the components of Chinese GDP. Investment does not dominate in the same way in developed countries.

*Recommendation: **implement an efficient solution to the corporate debt issue**: classify receivables, recognise losses, share the burden, strengthen the legal framework around insolvency, facilitate the transition out of unemployment and active policies to combat it, widen unemployment benefit coverage, facilitate market entry and improve local government financing.*

4. Use foreign capital to finance debt

One of the solutions envisaged by the Chinese government is to develop the bond market further, by widening the investor base currently mainly made up of domestic institutional investors to include international investors. It thereby hopes to keep the lid on interest rates despite the overall level of debt, as incoming bond investments will serve to support official reserves. **To attract this international investor base, it will be necessary to improve the transparency, liquidity and above all taxation of renminbi-denominated bonds.** China has made major progress in many of these areas, but is still struggling with certain transparency issues, unconditional free movement of capital and interest rate liberalisation. **Of course, one of the consequences of internationalisation will be deeper integration with global markets, meaning that shocks will be transmitted more easily between China and the rest of the world (in both directions).**

*Recommendation: **Chinese financial markets need to encourage more international portfolio investments.** This must be achieved through:*

- *Independent legal institutions.*
- *Clarification of creditor rights.*
- *Standardisation and transparency of financial and non-financial (sustainability) reporting standards.*
- *Prudent regulation of financial market players.*
- *More cautious and gradual classification of the risks linked to financial assets.*
- *Active market makers to ensure sufficient liquidity.*

- *Clear requirements as regards information.*
- *Independent rating agencies (the Dagong agency's methodology remains bewildering and lacks transparency).*
- *A progressive liberalisation of Chinese interest rates.*
- *A withdrawal of the Chinese government from credit allocation interventions.*
- *A need to maintain, or even restrict, currency inflows and outflows, due in particular to the ongoing exchange rate volatility.*

5. Tackle population decline

At the same time, China is facing a significant decline in its population. In 2022, the population of China fell by 850,000. It has already been overtaken by India as the world's most populous country, and numbers could reduce very quickly, to drop below the one billion threshold by 2060. The fertility rate has been falling since the 1970s and is now at a very worrying level of around 1.16 children per woman in 2021. The causes are the very high cost of education and childcare, and social pressure regarding extracurricular activities. A drop in the population of this magnitude will have at least a triple impact on the Chinese economy: 1) **colossal government spending**, to encourage couples to have more children (subsidies for education, preferential mortgage rates, tax relief, equal parental leave for both parents and construction of childcare centres), 2) **lower production capacity**, leading to a mechanical fall in exports and therefore a fall in the foreign currency income which is necessary to counterbalance the structural capital outflows and capital flight, and 3) **an inability to fund the social pension systems** due to the ratio of retired people to the working-age population, compounded by low diversification in the financial system and savings bogged down in sectors of the economy suffering payment defaults (property, etc.).

Recommendation: tackle the crucial demographic issue. Measures need to be taken to counter the excessive cost of education and housing, which are a result of extremely strong urban pressure and a property sector which remains too inaccessible. China must continue its multidimensional pro-birth policy by making massive use of financial subsidies (raise allowances, subsidise extracurricular activities, extend maternity leave and add paternity leave) and media strategies to rebuild the positive image of large families, including in urban settings. The internal migration that is sometimes mooted remains a purely political question.

6. Increase the Potential for Growth

The fall in the Chinese working population (down 1.5% in 2021), lower growth in productivity gains and weaker potential for economic growth (that does not generate imbalances, inflation-stoking overheating or debt) at around 2% to 2.5% have **reduced the country's economic attractiveness for numerous multinationals**. To boost its potential for growth slightly, China needs to modernise and optimise its use of resources and at the same time upgrade its production processes by developing automation and tapping into synergies to achieve economies of scope and network effects.

Recommendation: China should therefore:

- *Accelerate the dissemination of advanced technologies and existing innovations.*
- *Encourage entrepreneurship and start-ups.*
- *Invest in human capital and make support for innovation and entrepreneurial spirit more targeted.*
- *Optimise the management structure of businesses.*
- *Put in place antitrust legislation to cover groups in dominant positions.*
- *Reinforce competition in markets for products and factors of production and ensure fair competition for all investors.*
- *Eliminate zombie companies that no longer have the funds to invest, train staff, innovate, etc.*

7. Tackle the country's economic and social challenges

Chinese people are irritated or concerned by slowing growth, the numerous wealth inequalities within the country and concerns regarding the pension system, the perceived inadequacy of public services and the relatively high level of public-sector corruption. Signs of social opposition mushroomed during 2021 and 2022, in particular in opposition to the government's Zero Covid policy, since abandoned.

Recommendation: to respond to the population's social concerns, China could:
- *Continue to explore supplementary pension systems.*
- *Make the healthcare system, and in particular treatment for young children, more financially accessible.*

8. Ensure the country's economic model is sustainable as it becomes more integrated into global financial markets

Over the last few years, China has put the accent on the fact that it shares a land mass with both Asia and Europe, with the New Silk Road project which involved over 40 countries and included overland as well as maritime trade corridors. In parallel, China organised a sort of "non-Western front" when it founded the Shanghai Cooperation Organization in 2001. It is therefore ploughing considerable sums into all-in-one turnkey infrastructure projects including financing, design, accelerated implementation, engineering, staff training, operation-ready infrastructure, on-time delivery, etc. This model is very attractive for numerous poor and developing countries because no other country or international organisation is capable of providing comparable services. **Through this, China has become the planet's leading creditor, ahead of the FMI, the World Bank and the Paris Club. And yet, slowing domestic Chinese growth suggests that this external investment will slow, and a rigorous or even severe collection programme will be put in place to recover money due from debtor countries.**

Alongside these financial claims on developing countries, China is simultaneously becoming **financially dependent on FDI** (foreign direct investment) from the West, despite the diplomatic tensions between Beijing and for example the US and Australia.

Recommendation: it is now more important than ever for China to reinforce its economic fundamentals to ensure the stable circulation of international capital and encourage growth which will lead to balanced economic development.

CHAPTER I

STYLISED FACTS: IMBALANCES MASKED BEHIND MAJOR SUCCESSES

I. STYLISED FACTS: IMBALANCES MASKED BEHIND MAJOR SUCCESSES

1. MAJOR SUCCESSES

Since the economic reform of 1978 and the move to a market economy, Chinese GDP growth has reached an average of over 9% per year and 800 million people have been lifted out of poverty. This is a historical fact and it is important to acknowledge that no other country has achieved such a feat in so little time. The reforms began to pay dividends in 1995 and did so spectacularly until 2007. GDP per capita quadrupled in less than fifteen years, increasing from $2,694 in 2007 to $12,556 in 2021 (see Appendix, chart 1). Access to health, education and other services also improved considerably over the same period and the complete programme of reforms was implemented with great enthusiasm.

China is now a higher middle-income country: it has the world's highest GDP in real terms (adjusted for purchasing power) and the world's second-highest GDP behind the USA in nominal terms (prices in China are 30% to 40% lower than in the USA), but it still lies in 52nd place worldwide by GDP per capita, despite rapid progress over the last few years.

Over the last 20 years, financial analysts and strategists have praised Chinese economic management. The Chinese authorities showed great pragmatism in the way they bounced back from the 2008 financial crisis, even though China's trade opportunities were very heavily exposed to the USA, the country in the eye of the subprime loans storm. Since then, China has accentuated a hybrid form of capitalism, the socialist market economy, hailed by certain economists (such as Aldo and Lazzarini in 2012) for several characteristic traits: less marked recessions, a focus on long-term investment (Stiglitz explains this very well in his 2008 article *China: Towards a new model of development*) and an increasing number of global market-leading businesses. In 2019, China overtook the USA in number of Fortune Global 500 companies, i.e. those with the highest turnovers in the world (see Appendix, chart 2).

In fact, China seems to be reaching for the sky in numerous areas. It is one of the world's foremost industrial and space technology powers and has developed the world's leading telecommunications network (and in particular the planet's most advanced 5G network). It is also pioneering the development of digital assets: the digital yuan created by the People's Bank of China is far more advanced than other central banks' digital currencies (some Chinese cities have started paying civil servants in digital yuan[3]).

Chinese rail and motorway infrastructures are among the world's best, and it has some of the planet's largest ports (Ningbo-Zhoushan, Shanghai, Tangshan, Guangzhou, etc.). China has the world's largest electric car market. In artificial intelligence, its supremacy is rivalled only by the USA[4]. More industrial patents are filed in China each year than in any other country. However, China does have a tendency to draw heavily on Western patents or production methods for its products. The first Chinese commercial aircraft (the C919 from Comac, a state-owned enterprise) which was put into service in May 2023 is very similar in design to the Airbus 320 and all the subcontractors involved in producing it are European or American. The Chinese domestic flight market is now the largest in the world, ahead of the USA.

Despite being the world's biggest polluter, China is at the forefront of green technology. It has more wind turbines than any other country and the world's largest solar energy production capacity. It produces 70% of the

---

[3] Nikkei Asia, *Chinese cities begin to pay public employees in digital yuan*, May 5, 2023: https://asia.nikkei.com/Business/Markets/Currencies/Chinese-cities-begin-to-pay-public-employees-in-digital-yuan

[4] SKEMA Publika, *Artificial Intelligence: A Political Subject. The main world powers and the place for France among them:* https://publika.skema.edu/fr/intelligence-artificielle-sujet-politique/

world's photovoltaic panels[5] (see Appendix, chart 3). China is also engaged in colossal "green" projects. Examples include the world's most ambitious forest-replanting programme[6] to fight the expansion of three deserts in the north of the country, including the Gobi Desert. These projects are vital, because desertification and climate-related problems (sandstorms, pollution, etc.) cost China billions of yuan every year. A report by Greenpeace puts the cost at $900 bn per year, the highest cost of atmospheric pollution due to burning of fossil fuels suffered by any country in the world[7]. Last but not least, China is the world's undisputed EV market leader (see Appendix, chart 4).

Behind the positive – although sometimes paradoxical – publicity surrounding the public policies in place, China is developing major imbalances that government intervention alone may be insufficient to correct. This report will put forward avenues through which China could find its way out of a degree of economic and financial rut.

2. IMBALANCES RECOGNISED AND IDENTIFIED BY NUMEROUS INTERNATIONAL OBSERVERS FOR A DECADE

The Chinese economy is still reliant mainly on manufactured goods (27% of GDP), property (30%) and raw materials. The latter are "historic drivers" of growth, generally relied on in the early stages of a country's economic development. In contrast, the Chinese economy as yet relies little on high value-added services, such as financial services and insurance. Economists talk about "new drivers" of growth to refer to the second wind that middle-income countries need to find by redirecting their growth strategy to avoid being caught in the "middle-income trap".

Most of the country's "old drivers" of growth are managed by the state via a regulatory framework and economic financing decided centrally by the Chinese Communist Party (CCP) Politburo. All the leaders of large companies are also members of the CCP and the border between the public and private spheres is highly porous. Most of the country's major banks are public and allocate credit based not on decentralised decisions but according to direct or indirect instructions from government bodies. The Chinese government has a majority shareholding in banks representing more than half the Chinese banking system's assets, mainly in the form of a 60% to 90% holding in each of the five largest commercial banks[8].

This ultra-centralisation of economic decision-making leads to increasingly complex choices which go hand in hand with the development and inherent complexification of the country's economic structure. Some of the economic aporia described below undoubtedly demonstrate the growing number of inefficient economic choices.

Given that GDP growth has been set in advance as a sacrosanct target, all financing and investment are geared as a priority towards the activities historically most apt to provide jobs and growth, in particular manufacturing, energy and property. This allocation of resources tends to perpetuate past patterns, delaying the process of refocusing the economy on other sources of growth.

---

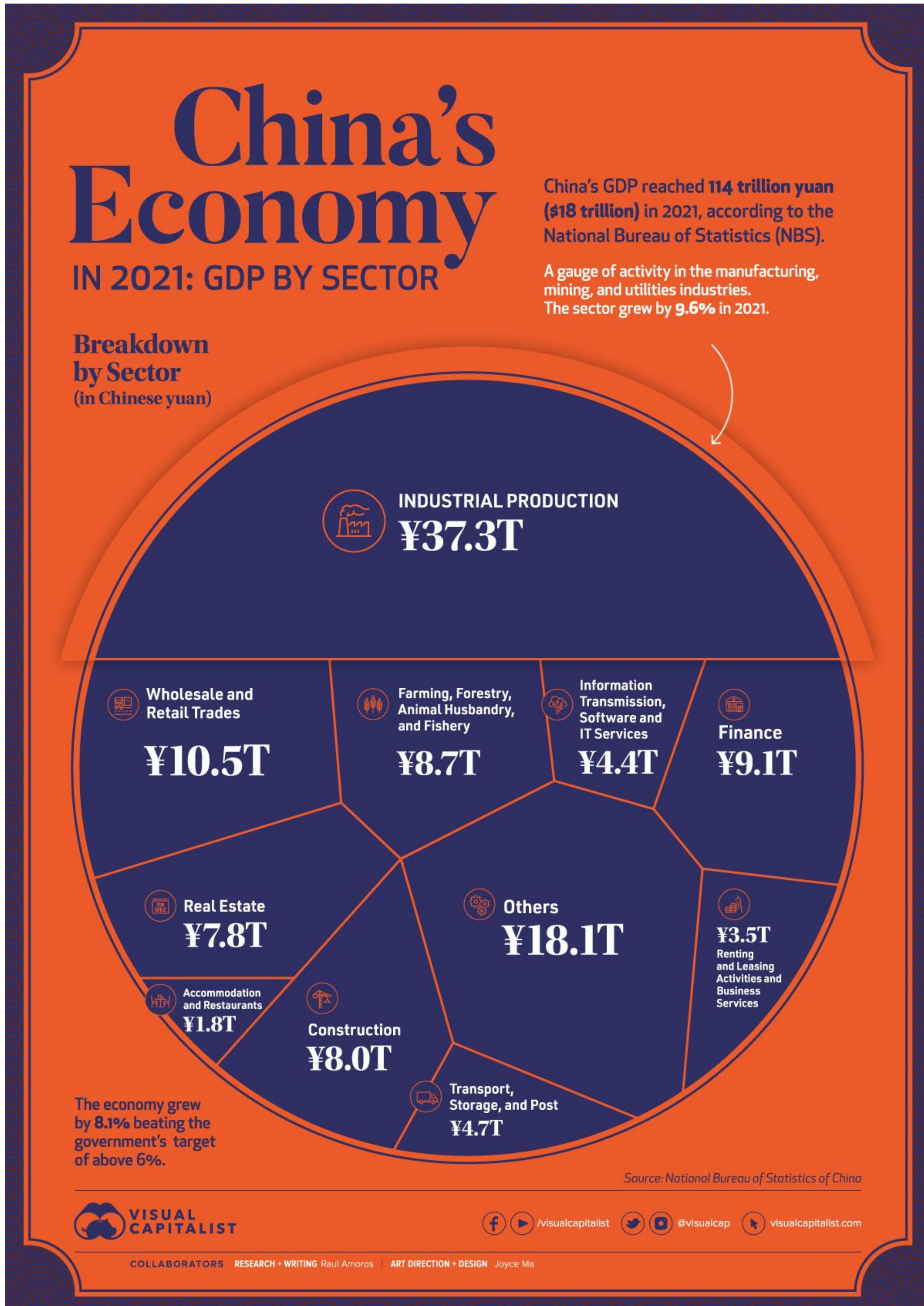
[5] Le Point, *Panneaux solaires: l'écrasante domination de la Chine*, (Solar panels: China's overwhelming domination) 12/10/2022: https://www.lepoint.fr/monde/panneaux-solaires-l-ecrasante-domination-de-la-chine-12-10-2022-2493541_24.php#11

[6] GÉO, *Chine : des milliards d'arbres pour contrer l'avancée du désert*, (China, billions of trees to fight desert expansion) 09/07/2018: https://www.geo.fr/environnement/chine-des-milliards-d-arbres-contre-l-avancee-du-desert-190387

[7] Eco-Business, *US$900 billion a year: China is bearing the world's highest cost of air pollution from fossil fuels*, 14/02/2020: https://www.eco-business.com/news/us900-billion-a-year-china-is-bearing-the-worlds-highest-cost-of-air-pollution-from-fossil-fuels/

[8] Grant Turner, Nicholas Tan and Dena Sadeghian, *The Chinese Banking System*, Reserve Bank of Australia, Bulletin September Quarter 2012: https://www.rba.gov.au/publications/bulletin/2012/sep/pdf/bu-0912-7.pdf

Chart A: The industrial sector remains highly dominant. In 2021, according to the Chinese National Bureau of Statistics, the manufacturing, mining and utility industries actually grew by 9.6%.



Source: https://www.visualcapitalist.com/visualizing-chinas-18-trillion-economy-in-one-chart/

Over recent years, potential growth has slowed due to structural constraints, in particular slowing population growth, falling returns on investment and stalling productivity. This leads to an ever-higher level of debt to support investments that as a whole are becoming less efficient and profitable.

According to the World Bank[9], to reduce these imbalances China needs to adapt the structure of its economy by shifting from manufacturing to high-value-added services, from investment to consumption and from high carbon intensity to low carbon intensity.

Although Xi Jinping has said he wants to refocus and rebalance growth in this way, such a shift comes into conflict with the third path within the market economy established by China since the Deng Xiaoping era.

From 2012 onwards, numerous intellectuals such as Michel Aglietta[10] pointed out the need to reduce the size of the public sector and loosen the government's hold on the economy. Although 70% of Chinese GDP is generated by private companies, the public sector is responsible for major distortions in access to finances. In addition, there are insufficient boundaries between the private sector's governance structures and the CCP's political interests. **More separation between the private and public sectors appears necessary, for several reasons:**

a) to encourage the development of services, which are often organised in a more "liberal" manner than industry
b) to give more prominence to innovative SMEs and not just large groups, which do have innovative projects but organise these within strict development and timing frameworks
c) to overhaul finance.

All these would automate the operation of the economy and steer it out from under the tutelage of the CCP. The boss of an SME may potentially have no links at all with the CCP, in contrast with the leader of a large group who is required to maintain such links. Finance, and in particular international finance, tends to act as a counterweight to political power, or even a dominant force over it.

China's leaders continue to set the essential political objectives: growth rates, the factors governing the trade war and strategic inputs, the keys to energy sovereignty and ecological survival, the financing of the economy, the challenges of urbanisation, etc. The economy needs to be managed through regulation that is more indirect than direct, but it is currently highly centralised with Beijing playing the role of "central planner". The government is absolutely determined to maintain its hold over finance while levels of debt remain at their current high, the pension systems are not stabilised and extensive infrastructure work is still required to implement the urbanisation plan. It exercises this hold through capital controls and strong regulation of the traditional banking sector, which means that it is easier for companies with traditional assets (buildings and machines) to secure financing than for promising start-ups based on intangible assets such as intellectual property.

3. THERE ARE BOTH INTERNAL AND EXTERNAL REASONS WHY THE IMBALANCES HAVE NOT BEEN ENTIRELY RESOLVED

In short, the realisation over the last decade that China needs to refocus and rebalance its growth model has only been translated into action in a very fragmented way. Among the four traditional drivers of growth – 1) domestic consumption, 2) investment, 3) public spending and 4) ongoing international trade including imports and exports – only domestic consumption seems in a position to stabilise growth and make it self-perpetuating above a certain level of development in the country, regardless of changes in production costs and standards of living.

---

[9] Word Bank website, *The World Bank in China*: https://www.worldbank.org/en/country/china/overview

[10] L'Humanité, *Michel Aglietta. La Chine peut inventer un système original d'harmonie sociale,* (China can invent an original system of social harmony) 01/11/2012: https://www.humanite.fr/michel-aglietta-la-chine-peut-inventer-un-systeme-original-dharmonie-sociale

Exports are destined to fluctuate in response to geopolitical issues and fall as production costs and wages rise. And yet higher wages are a prerequisite to growth in domestic consumption, and also a natural consequence of a lower birth rate and longer life expectancies. Similarly, investment fluctuates in response to financial difficulties, whether they are domestic or international, capital movements and interest rate and credit risk parameters (levels of debt, etc.). Lastly, investment is less apt to stimulate growth and generate debt because yields on it fall as the country's level of development and the capital stock already present rise. As the amount of infrastructure and the number of machines already present increase, the additional effects produced by further investment (marginal effects as economists call them) becomes less useful and productive. The fact that growth depends on ever-increasing levels of investment and debt can be seen very clearly from 2007 onwards (see Appendix, chart 5).

Chart B: The fall in economic growth since 2007 (blue curve) is a mirror image of the reduction in the efficiency of investment (pink curve)

Source: https://www.ft.com/content/1abd9d4b-8d94-4797-bdd7-bee0f960746a and https://www.ft.com/content/e592033b-9e34-4e3d-ae53-17fa34c16009

As Paul Hodge highlighted in March 2021[11], "Even if we leave aside the problems associated with China's GDP data – uniquely for a major economy, it is reported almost immediately and never revised – we're still faced with a key issue. Each dollar of debt fails to increase GDP by the same amount."

Similarly, as society becomes more complex and as in all countries, public spending generally becomes less and less efficient and/or reduces the efficiency of private spending and the commercial sector.

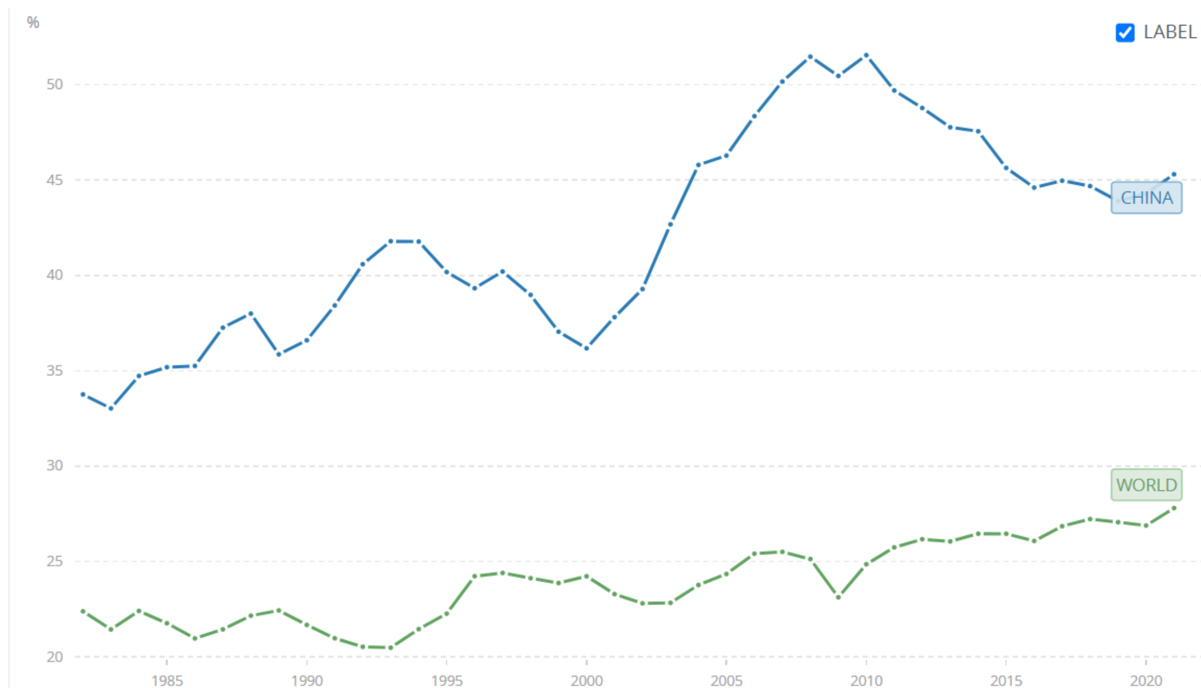
The fundamental problem is that Chinese household consumption only accounts for around 40% or 50% of GDP, depending on the sources consulted. The share of household consumption in GDP fell sharply in 2000 and has never recovered to its previous level. Compared to similar BRICS countries, the share of domestic consumption in the wealth created in China is very low (see Appendix, chart 6). This lack of demand is also explained to a significant degree by a propensity to save and by low wages.

Per capita disposable income is fairly low, with the national average standing at just 32,000 yuan ($4,665) in 2020. As China has one of the highest income inequalities of all the world's large countries (significantly higher than the USA), the middle classes, who in most countries contribute the lion's share of consumption, remain too small. At the same time, household consumption and the savings rate are mirror images of one another, showing as would be expected an inverse correlation between these two variables (see Appendix, chart 7).

[11] ICIS, *China's dual circulation policy aims to reduce debt reliance*, 14/03/2021: https://www.icis.com/chemicals-and-the-economy/2021/03/chinas-dual-circulation-policy-aims-to-reduce-debt-reliance/

The gross savings rate in China is 45% of GDP, as against 18% in France and 5% in the USA. Savings rates are generally perceived to be convex in comparison to the level of development, implying that the relative share of savings per additional unit of wealth falls above a certain threshold. This model does not seem to apply in China, no doubt because income inequalities are increasing more quickly than human capital (education, etc.) accumulates. The richest in society are disproportionately responsible for excess savings.

Chart C: Chinese savings continue to soar way above global averages (as a % of GDP)



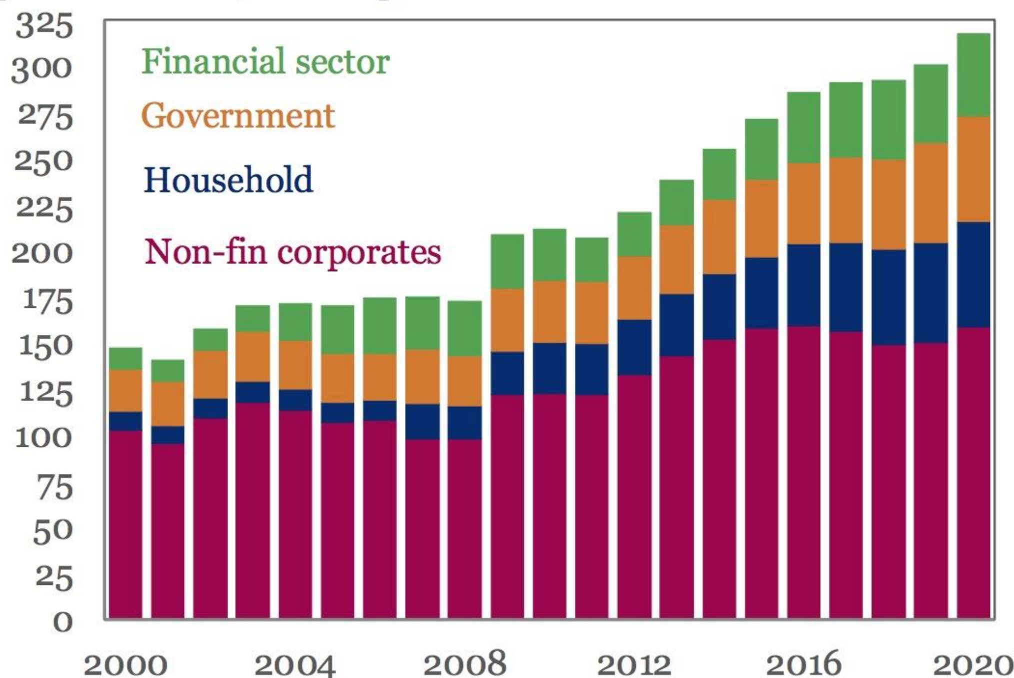
Source: World Bank, Adjusted savings: gross savings (% of GNI) – China, World, 1982-2021, https://data.worldbank.org/

Wages for all workers are expected to increase in the medium term as the working population shrinks rapidly. And yet domestic consumption may not change noticeably in the immediate future. This is because, given the ageing population and doubts about pension system sustainability, households are saving an increasing proportion of their revenue.

In addition businesses, and especially property companies, are having to reduce their debts because they are selling fewer homes. This logically leaves them with little margin to increase wages. Consequently, domestic demand can be expected to remain weak for some time to come. Currently, domestic demand growth (around 1.5%) is no higher than in the European Union or the USA, which reduces the incentive for international companies to operate in China. The rise in new passenger car sales has slowed since 2015, demonstrating this weakness in purchasing power and a relative decorrelation with economic growth (see Appendix, chart 8).

Since 2007 and the subprime mortgage crisis in the USA, Chinese growth has actually held up well by pivoting to the domestic market. Unfortunately, the focus has been put on investment, with insufficient attention paid to consumption. As a result, consumption remains less significant than investment within the components of Chinese GDP. Investment does not dominate in the same way in developed countries (see Appendix, chart 9). Chinese debt will inexorably increase; consumer credit will rise with it, but not to a sufficient degree (in particular in comparison with other components of debt).

Chart D: Although household debt (blue block), a fundamental driver of consumption, is rising, it still contributes only a small part to total debt



Source: https://twitter.com/Schuldensuehner/status/1261665846663024641

Chinese debt is mainly carried by non-financial businesses, such as property companies. This contrasts with the situation in the USA, where debt is more evenly spread, with household debt one of the three main components (see Appendix, chart 10).

The only long-term answer to this imbalance is to boost domestic consumption. This must be achieved very progressively, sequentially and in combination with a reduction in investment to avoid causing even higher levels of debt.

Back in 2014, the Chinese economic and monetary authorities put in place a strategy to rebalance the drivers of the country's economic growth by increasing loans to boost household consumption, thereby reducing reliance on investments and income from exports. Despite this, a large proportion of the riskiest loans, in particular loans to local authorities and property developers migrated to the shadow banking system, consisting of financial institutions not licenced as banks but which provide liquidity in a very similar way, without being subject to banking regulation. The end result of this was to increase the risk of financial destabilisation without particularly succeeding in stimulating domestic consumption.

If a country consumes a small proportion of the goods and services it produces, it will automatically have high exports and accumulate a surplus of savings and reserves (foreign financial assets). The share of China's exports

within gross output has been falling for several years but remains substantial[12]. In addition, over the last two years exports have ticked sharply upwards as the world has recovered after Covid (see Appendix, chart 11), partially masking the impact of excess investment, in the property sector in particular, and the urgent need to refocus the economy on domestic consumption. Having been the world's factory, China continues to suffer from structural excess manufacturing capacity. This reduces financial margins and the potential for income redistribution. There is "excess" competition on several markets with an excessive number of businesses. This limits their pricing power and is generally disadvantageous for Chinese growth, although it keeps inflation at low levels. In April 2023, CNN even ran the headline, "China has an inflation problem. It's way too low!"[13]

The weakening of the yuan against the dollar in 2022 (7% fall from $6.36 to $6.86) strengthens the attractiveness of external demand at the expense of domestic demand because imported goods are more expensive (as China's currency is worth less).

The Chinese government therefore seems to be up against both structural and cyclical constraints in its efforts to overhaul the country's economic structure.

There is consequently a combination of internal and external reasons why the country's efforts to rebalance its growth are behind schedule. There are still numerous challenges to tackle to rebalance the economy. These are laid out in the next chapter.

[12] McKinsey Global Institute, *Globalization in transition: The future of trade and value chains*, 2019: https://thedocs.worldbank.org/en/doc/207011562781675834-0080022019/original/20190710GlobalValueChains.pdf
[13] CNN, *China has an inflation problem. It's way too low*, 25/04/2023, https://edition.cnn.com/2023/04/24/economy/china-deflation-economy-intl-hnk/index.html

CHAPTER II

FINANCING THE REBALANCE THE CHINESE ECONOMY NEEDS

II. FINANCING THE REBALANCE THE CHINESE ECONOMY NEEDS

1. THE PROBLEM OF TOTAL DEBT – CORPORATE AND BANKING

China's total debt consequently remains above 300% of GDP, and rose particularly sharply during the pandemic. The Chinese government, like many others, was forced to boost capital investments to maintain positive GDP growth. Nevertheless, the GDP growth of 2.3% reported in 2020 came at a cost (an increase of at least 20 points in the debt to GDP ratio). Although advanced economies have total debt averaging 300% of GDP, the figure is generally lower in developing countries, where the average stood at 192% of GDP in 2021[14]. Beyond its level, in both absolute and relative terms (as a proportion of GDP), it is the composition of China's debt that raises concerns. Corporate-sector debt is particularly worrying as it equates to more than 160% of GDP (see Appendix, charts 12 and 13).

These record levels of debt go hand in hand with a spectacular increase in the value of defaults (failure to repay) on debt instruments (see Appendix, chart 14). China has been attempting for years (and in particular since 2017) to eliminate bad corporate debts from its the books[15]. Although some progress was made before the pandemic, the task before it appears to be never-ending. It is nevertheless crucial for the country's long-term economic development: to support the economy, it is always important to purge detrimental elements that cause suspicion and mistrust among economic stakeholders. The Chinese government is at great pains to explain that it wants to see better market discipline and a transparent process through which businesses can be allowed to fail without causing the financial system to break down. International investors with exposure to Chinese equity and bonds are also eagerly awaiting this effort to clean up the economy.

The International Monetary Fund (IMF) laid out back in 2016[16] steps the government could take to efficiently deal with the corporate debt issue. The strategies listed below have not been put in place. It has to be said, however, that remedies of this type are more commonly seen in liberal economies:

- **Triage**: Identify companies in financial difficulty and distinguish between those that should be restructured and those "zombie" companies that have no hope of survival. Because of the existing links between state-owned banks and corporations, a new agency could be created to perform this role.
- **Recognise losses**: Require banks to recognise and manage impaired assets. So-called shadow banks – trust, securities and asset-management companies – should also be forced to recognise losses.
- **Share the burden**: Allocate losses among banks, corporates, investors and, if necessary, the government.
- **Harden budget constraints** – especially on state-owned enterprises – by improving corporate governance and removing implicit guarantees to prevent further misallocation of credit and losses.
- **Improve the legal framework for insolvency**: But large-scale and expedited restructuring also requires out-of-court mechanisms to complement the existing framework.
- **Ease the transition**: Broaden unemployment insurance coverage, provide income support for displaced workers and help them find new jobs. The social safety net should be improved because closing or restructuring loss-making companies in industries such as coal and steel (which still exist and employ large numbers of workers in China) could result in substantial layoffs.
- **Facilitate market entry**: Dismantle monopolies in services such as telecommunications and health care and foster greater competition.

[14] Vitor Gaspar, Paulo Medas, Roberto Perrelli, *Riding the Global Debt Rollercoaster*, IMF blog, 12/12/2022: https://www.imf.org/en/Blogs/Articles/2022/12/12/riding-the-global-debt-rollercoaster

[15] The Wall Street Journal, *China Shifts Stance, Letting Dying Firms Go Bankrupt*, 07/03/2017: https://www.wsj.com/articles/china-shifts-stance-letting-dying-firms-go-bankrupt-1488586442

[16] Joong Shik Kang, Wojciech S. Maliszewski, *China Must Quickly Tackle its Corporate Debt Problems*, 16/12/16: https://www.imf.org/en/Blogs/Articles/2016/12/16/china-must-quickly-tackle-its-corporate-debt-problems

- **Improve local government finance**: Ensure sufficient taxing powers and revenue sources for local governments to discourage off-balance-sheet borrowing.

Putting these measures in place is central to a liberal economy. It is very difficult to imagine a stable future for the Chinese economy without these elements to underpin its structure.

China's credit-funded economic growth has left the country with high levels of bank debt, which now stand close to 180% of GDP. The average figure across other emerging markets is 70%. The IMF and rating agencies are very concerned about soaring Chinese bank debt, in terms of both its level and a lack of transparency regarding lending conditions and the sharing of any losses. This lack of transparency also applies to the restoring forces intended to limit access to credit. The Chinese banking market is highly fragmented between the big four banks (including the Postal Savings Bank) which enjoy strong government support and implicit guarantees, the (small) commercial and rural banks with little autonomy and the mid-sized joint stock banks which have more freedom but lack big, stable depositors. Consequently, they need to take on a higher level of risk to capture funding and extend loans[17].

These debts are not confined to traditional banks, but also concern numerous non-banking financial institutions (NBFIs) generally known as shadow banks. This unregulated finance sector has developed extremely quickly in China, which can be explained fairly simply by the proverb, "Nature abhors a vacuum." NBFIs fill a gap in a complex system (i) dominated by large state-controlled banks, (ii) subject to a variety of regulations and formal and informal guidance, (iii) which has mandated low interest rates on deposits and (iv) which has imposed restrictions on loans to certain industries. It is estimated that two thirds of all NBFI (shadow bank) lending in China constitutes "bank loans in disguise". These institutions also bypass the central bank's expensive reserve requirements and limits on the amounts they can loan[18].

An index of "financial repression"[19] (a sub-heading of the aggregate index of financial freedom), created by the highly liberal The Heritage Foundation, places China among the most repressive of the world's major economies. It is classified as slightly more financially repressive than Russia or India and considerably less liberalised than advanced economies (see Appendix, chart 15).

2. THE PROPERTY BUBBLE PROBLEM

Property accounts for 30% of China's GDP. People often say, "Growth in China is all down to property!". The entire Chinese economy has been built using property as the ultimate lever for stimulating the economy (because of its many knock-on effects).

The property sector has been deteriorating for more than a year now, since the first mooting of the bankruptcy of property giant Evergrande, described by some as "China's Lehman Brothers". Too big to fail? Evergrande is part of the Global 500, meaning that it is also one of the world's biggest companies by revenue. It made its name in residential property and is proud to "own over 1,300 developments in more than 280 cities" across China. It has invested in electric vehicles, sports and theme parks. It even has a food and beverage business.

The absence of a clear reaction along the lines of "let it exit the market, let it go bankrupt" is evidence of an uneasiness on the part of the authorities that extends well beyond the property sector. It seems as though the entire Chinese social and financial system is at stake. China puts just 4% of its GDP into its pension system, even though its population is ageing far more quickly than that of France, which puts in 14%. Not only are the sums set aside low in comparison to the demographic challenge ahead, but enormous pools of pension savings are invested in property. A part of the population seems to have become aware of the danger and questions are

[17] David Keohane, *Big is beautiful, China banks edition*, Financial Times, 28/03/2017: https://www.ft.com/content/44df8bc3-85cf-31a3-a848-4469db9ffa78

[18] Eliott, Krober and Qiao, *Shadow banking in China: A primer*, Brookings Institute, March 2015: https://www.brookings.edu/wp-content/uploads/2016/06/shadow_banking_china_elliott_kroeber_yu.pdf

[19] Index of Economic Freedom, https://www.heritage.org/index/about

being raised on social media channels such as WeChat and Weibo. The government is seeking to avoid panic by limiting transparency regarding the property sector's real difficulties. The entire Chinese banking and social security systems are potentially under threat.

If the financial bubble were to deflate too rapidly, the Chinese pension system would be pushed off balance, forcing people to save even more and spend even less. This is similar to the situation experienced in Japan when the Tokyo property bubble burst in the 1990s. What followed was twenty years of near-zero growth and more importantly Japan's loss of its status as the world's leading economy – it had been on the point of overtaking the US economy in 1989. This is a terrifying analogy for the Chinese authorities.

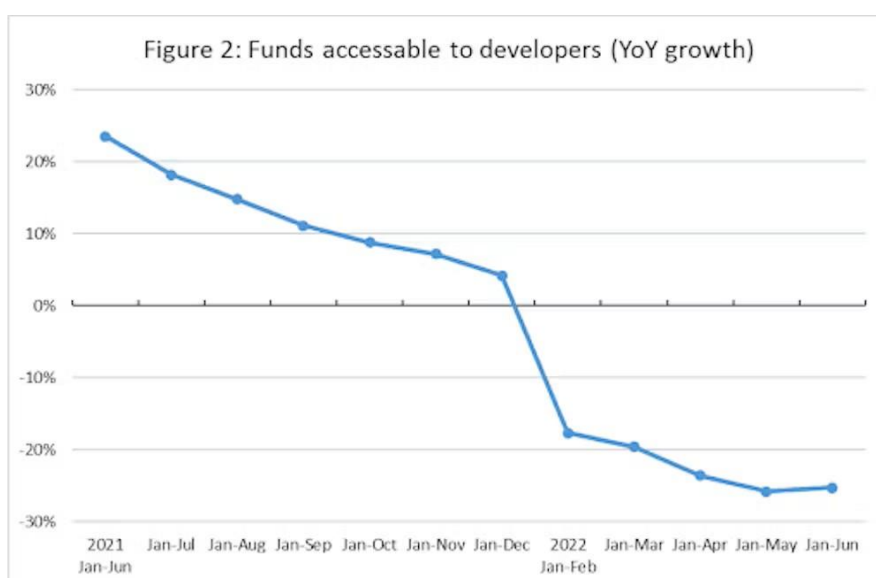
Chinese people do not have a plethora of investment options through which to save for retirement. They have therefore used property investments as a way to optimise their pension capital, leading to overinvestment in the sector and apartments purchased as financial investments left standing empty. It is estimated that the country currently has no less than 50 ghost towns (completely uninhabited) and 64 million empty flats (one for every person living in France).

Given these very deep-rooted, systemic ramifications, this crisis is unfortunately likely to leave psychological traces in the minds of Chinese economic players. To use a job market analogy, a potential "hysteresis effect" would suggest that the cyclical effects of this crisis will leave structural marks that traditional economic policies might be insufficient to erase. All in all, the side effects of a crisis originating in the property sector may lead to a lasting lack of overall demand, causing the economy to suffer embedded unemployment and a permanent fall in output.

The property sector is continuing to decay due to the lack of clear rules on bankruptcies. Sales of new homes started to fall sharply in October 2020 and the debts falling due in 2022 were simply out of the reach of Chinese developers and major property groups. Bailing out property developers seems to be the only solution, but the cost is staggering (see Appendix, chart 16).

Property developers have no option but to sell homes at any price (some are even giving away a car with the purchase of a flat!). As developers choke financially, completion of units that have already been sold has been halted. Some buyers have stopped making payments on their mortgages – in what some commentators have described as a "wave of mortgage strikes" – because units have not been delivered, causing a knock-on effect on the banking system.

Chart E: Property developers can no longer access funds and cannot complete properties



Source: *https://theconversation.com/china-property-crisis-why-the-housing-market-is-collapsing-and-the-risks-to-the-wider-economy-189082-*

To date, investment in construction continues to fall. The Chinese Central Bank's interest rate cut will not be sufficient to reverse this trend. There appears to be very little room for manoeuvre given that property is not the only sector affected by doubtful debts and "hidden debts". In addition, low inflation is doing nothing to reduce the value and burden of the debt. Certain property debts are backed by local authorities, but do not appear on their balance sheets. The hidden debts are carried by financial vehicles created to circumvent restrictions on borrowing and used to channel funds destined for infrastructure spending. In 2022, according to analysts at Mars Macro, an economic research firm based in Hunan, these hidden debts could reach 65,000 billion yuan, or more than 50% of China's GDP (and 20% above the estimate made by Goldman Sachs in 2021).

3. THE PROBLEM OF CAPITAL FLIGHT

The Chinese experience shows that over and above a very high savings rate, seen as a damper for economic shocks (which generally inspires confidence among investors), the real question to be asked is where these savings are invested. In China, the management of the population's savings, which constantly rise (around 42% of GDP in 2021), is a booming market with almost unlimited potential. Chinese household savings will soon account for half of the world's savings. And yet, the Chinese growth model remains paradoxically dependent on external capital.

Reserves at the People's Bank of China have suffered a worrying fall. From almost 20% of GDP in 2014, they fell to just under 8% in 2023 (see Appendix, chart 17). These reserves are an important buffer in the fight against both financial and monetary instability. In 2003 and 2005 for example, foreign currency reserves were used to recapitalise commercial state banks. But will they suffice to meet the current challenges:

- Break free from the middle-income country trap.
- Escape the debt trap.
- Keep the growth of credit under control.
- Stabilise the ever-expanding shadow banking system.
- Cut the dead wood from the property sector.
- Deal with the environmental issues that cost the Chinese economy several billions every year (e.g. desertification and sandstorms).
- Limit fraud and corruption, etc.

Between 2010 and 2020, China's foreign exchange reserves fell from 20% of GDP to 10%. In absolute terms, 10% remains a comfortable cushion, but the trend is worrying. A first wave of capital flight in 2014 accelerated the fall in reserves, and further falls followed in 2018-19, both before and as a result of the appearance of Covid-19 and the numerous Central Bank interventions it necessitated (both to recapitalise commercial banks and to shore up the currency). Usually, countries see capital flight in response to increasing economic imbalances, distrust of domestic banking systems or as a rejection of a political regime or the way a country is governed (corruption, fiscal pressure, etc.). Capital flight has been a factor in reducing household savings and consequently the country's official reserves.

Large-scale currency inflows (which increase reserves) come mainly from a balance of payments surplus (primarily net exports). But these inflows appear increasingly insufficient to offset capital outflows, which have been very high since 2014. Chinese investors looking to purchase foreign assets are increasingly looking for geographical diversification. This is exacerbated by the fact that the wealth generated in China is not shared equally, and the system of protection for individual property rights is not solidly anchored.

The Chinese authorities consider the influx of foreign capital as a solution to the pressures caused by capital outflows, which avoids them relying excessively on the sale of accumulated foreign exchange reserves. But this capital flight is becoming increasingly structural, and foreign capital inflows increasingly volatile. The history of capital controls suggests that if the transparency and security of domestic assets become insufficient, players in the economy will always find ways around the controls, however strict they may be. This pressure/attractiveness of foreign assets is accentuated when the value of domestic currency falls (pushing up the value of assets denominated in foreign currencies, making them more attractive). Since the beginning of the Ukraine War, the dollar has strengthened considerably, including against the Chinese yuan. Substantial capital flight is therefore

inevitable due to structural factors, and it has been amplified over recent years by cyclical factors (see Appendix, chart 18).

China's capacity to transfer funds between the PBOC (the People's Bank of China, the country's central bank) and state commercial banks is no secret. But the exact mechanisms through which the China Development Bank and the Exim Bank of China were recapitalised remain murky. The commercial state banks controlled by the central government – including the China Development Bank, but not the Exim Bank of China – have more than $1,000 billion on their balance sheets, pointing to high-value transfers.

To complexify the situation yet further, China has at least three different sovereign funds. The largest is the China Investment Corporation, created in 2007, which manages a proportion of China's foreign currency reserves and invests in a portfolio of diversified assets at global level. There is also the State Administration of Foreign Exchange Investment Company which manages a part of China's currency reserves and transactions (value of the currency) and the National Social Security Fund which invests long-term to support the country's social security system.

4. COULD THE CHINESE ECONOMY BE FINANCED THROUGH INTERNATIONAL FUNDING?

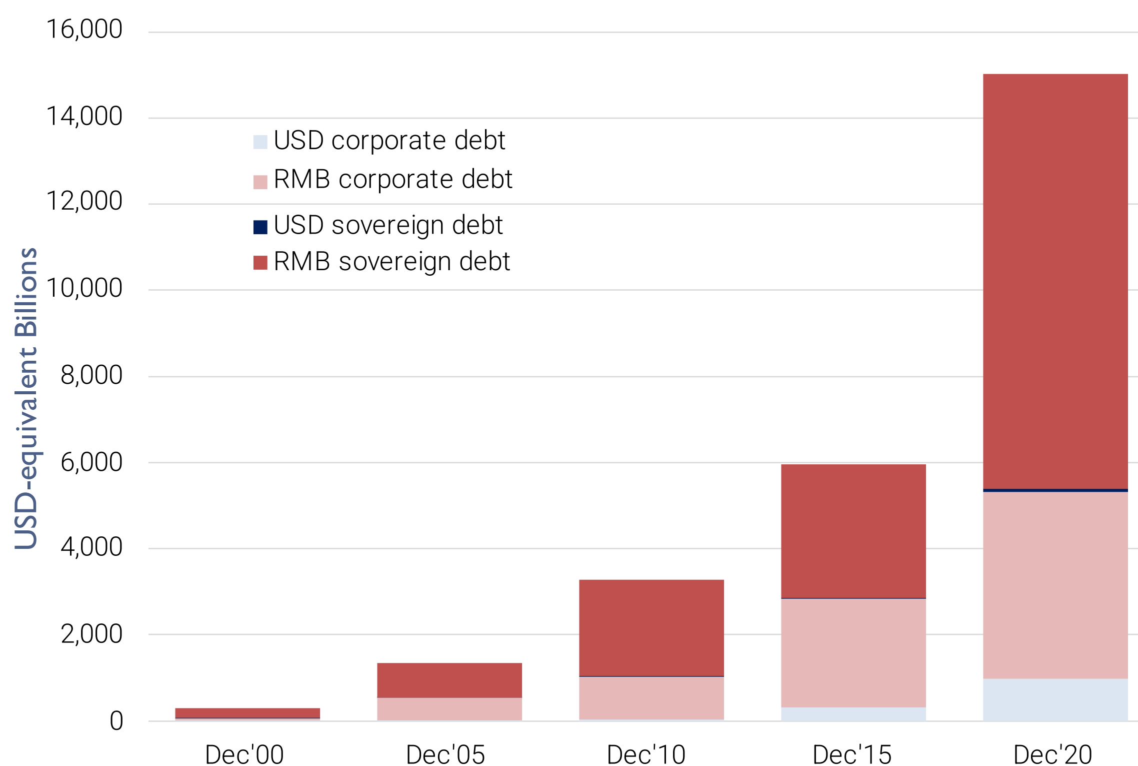
Faced with the downward pressure of the stock of international assets, the government is seeking to increase its fire power by boosting the bond markets for both national institutional investors and also some international investors. The reasoning is simple: the wider the investor and financer base, the more interest rates can remain contained even in the face of higher overall debt levels. The inbound flow of bond investments will also serve to support the level of official reserves.

In terms of size and debt levels, the Chinese bond market has surpassed the Japanese market, but remains far smaller than the US market, at around 40% of its size. And above all, it is far more domestic and less internationalised (see Appendix, chart 19).

So Chinese bond markets have clearly boomed over the last few years. They may appear large in absolute terms, but they remain small in comparison to the size of the Chinese banking system. As well as being insufficiently large as yet, the bond markets – like the equity markets – are above all highly domestic. Foreign investment in Chinese tradeable debts is rising, but remains very marginal (between 3% and 5%, see Appendix, chart 20), despite average maturities on debt instruments being lower than the Asian country average. The market is dominated by Chinese institutional investors.

This relative disintermediation of finance is crucial, because it limits the systemic risk of interdependence between the health of banks and the availability of credit and finance in the economy. Bond markets are sometimes seen as a liquidity "spare wheel" for the banking system. What they definitely do offer is longer-term funding and the opportunity to achieve a wider intertemporal spread of the debt.

Chart F: Dollar-denominated Chinese debt is starting to become visible, even within sovereign debt



Source: https://www.seafarerfunds.com/commentary/the-evolution-of-chinas-bond-market/

Under pressure from markets and interest rates, the amount of corporate debt denominated in dollars is growing, and dollar-denominated sovereign debt was even issued for the first time in 2020. But the vast majority of Chinese bonds are still denominated in renminbi, for reasons of prudence and stability. On the other hand, two thirds of the bond markets developed in China deal in sovereign debt, whereas corporate debt dominates in the country. Initially, corporate bond issues were limited to listed companies, but since the China Securities Regulatory Commission issued its regulatory framework in January 2015 it has become possible for both listed and non-listed companies to issue bonds. This change is a result of China's declared financial objective to reduce the ties between state-owned enterprises and the public banks.

The widening of the investor base will theoretically reduce the pressure on corporate debt and sovereign debt yields. But to attract this international investor base, it will be necessary to improve the transparency, liquidity and above all taxation of renminbi-denominated bonds.

Thanks to cross-border platforms such as Stock Connect, Bond Connect and China Interbank Bond Market, introduced and extended over the last decade, foreign asset managers can now access the Chinese financial markets without having to establish a presence in the country.

With Shanghai-Hong Kong Stock Connect, created in 2014, the Shanghai Stock Exchange is leading the internationalisation of the Chinese securities market. The Stock Connect programme has been extended to include capital markets in Germany and Switzerland. (It enables institutional investors to open trading accounts directly to trade bonds on the stock market).

Other barriers to entry have also been eliminated, in particular the requirement for asset trading and management credentials. Equally, previous restrictions have been removed so that qualified foreign investors can now designate as many depositary banks as they like. They are also authorised to invest in a wider range of yuan-denominated investment products.

These market reforms helped convince certain index providers, such as FTSE Russell and Bloomberg Barclays World Aggregate, to start including Chinese debt in their indices from January 2019.

Certain global institutions have expressed fears regarding the risks surrounding repatriating and transferring funds to and from China. Very specifically, undertakings for collective investment in transferable securities (UCITSs) are not authorised to invest in countries where there could be barriers to liquidity due to restrictions on the movement of capital.

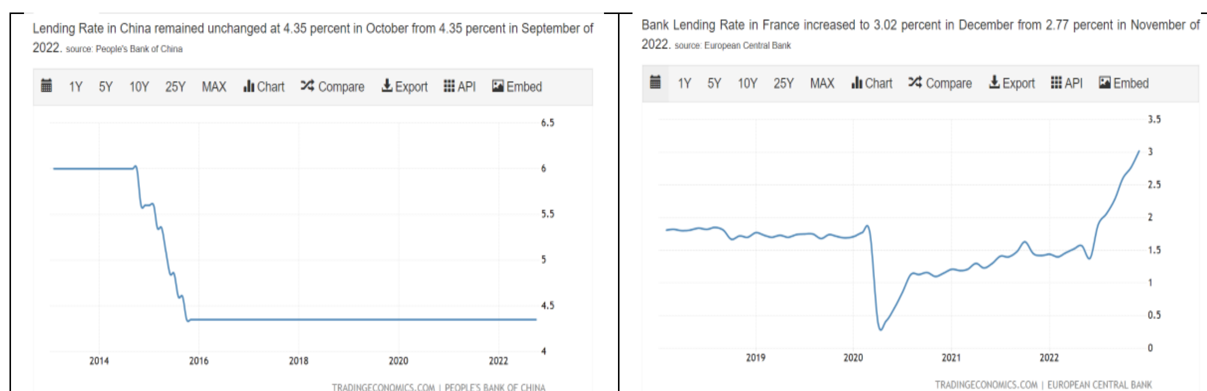
Concretely, it is mainly long-term investors, such as central banks and sovereign funds that are showing an interest in Chinese assets. There are also international groups setting up onshore Chinese subsidiaries to obtain mandates and licences to enter China's enormous retail investing and asset management market.

China could boost international portfolio investments through:

- Independent legal institutions.
- Clarification of creditor rights.
- Standardisation and transparency of financial and non-financial (sustainability) reporting standards.
- Prudent regulation of financial market players.
- More cautious and gradual classification of the risks linked to financial assets.
- Active market makers to ensure sufficient liquidity.
- Clear requirements as regards information.
- Independent rating agencies (the Dagong agency's methodology remains bewildering and lacks transparency).

China has made major progress in many of these areas, but is still struggling with certain transparency issues, unconditional free movement of capital and interest rate liberalisation. All this would require the government to scale back its credit allocation interventions. More international use of the renminbi is offset by the requirement to maintain, or even restrict, currency inflows and outflows, due in particular to the ongoing exchange rate volatility. The price to pay for internationalisation will be deeper integration with global markets, meaning that shocks will be transmitted more easily between China and the rest of the world (in both directions). As the well-known finance principle says, "There's no such thing as a free lunch." Given the importance of the leverage effect (debt levels) in the Chinese economy (and the levels of margin debt borrowed from brokers on the equity markets), China's integration into global markets will make it more sensitive to external shocks, reducing the stability of the global economy. As a consequence, USD-CNY volatility can be expected to increase as the Chinese capital account (balance of payments) becomes more open. It may also be amplified because Chinese interest rates move more sharply than US interest rates. One of the reasons is that beyond the official Chinese figures, Chinese growth may actually be far more volatile than US growth. The other reason is that Chinese interest rates remain very tightly administrated, so that they adjust far later, and by steps.

Chart G: Interest rates in China (left) are clearly administered in comparison to French rates (right)

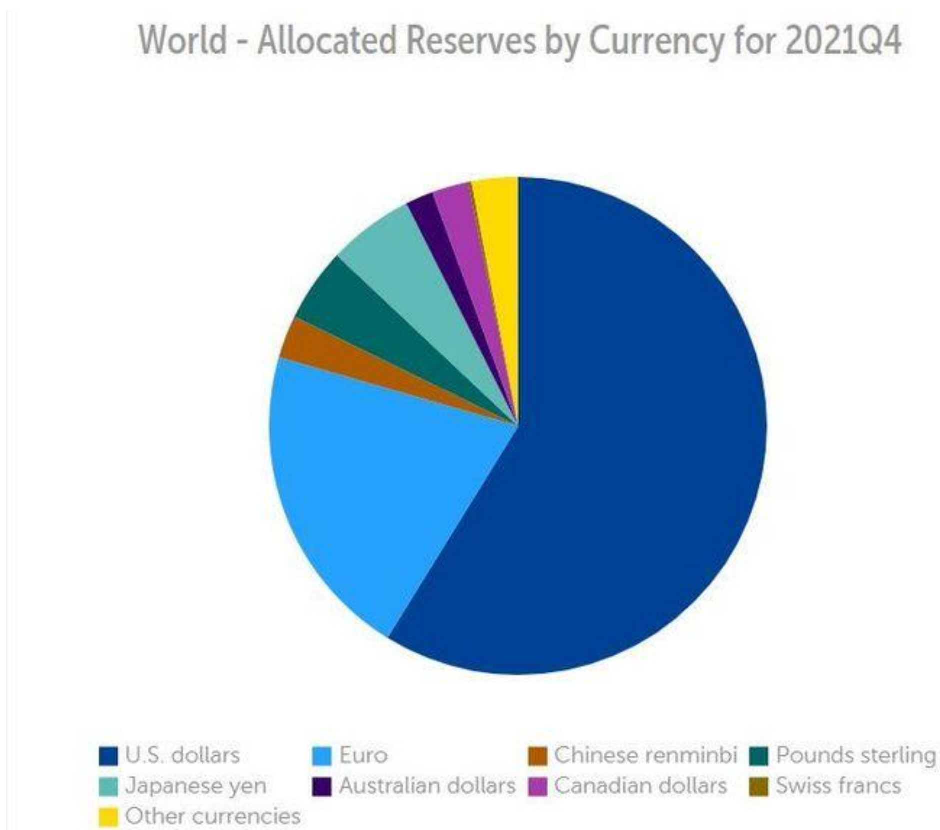


Source: https://tradingeconomics.com/country-list/bank-lending-rate

It is clear to see that interest rates in China are administered, with sharp adjustments and long steps. At 4.35%, current rates are very high in comparison with debt levels and growth perspectives. When interest rates are higher than the growth rate, the level of debt builds up more quickly than economic growth can provide capacity to repay it. While forecasts for 2023 suggest that growth could exceed 4.35% – thanks to the rebound in consumption following the lifting of the blockages caused by the Zero Covid policy – China's natural potential for growth over the coming years (long-term balanced growth without excessive use of public policy stimuli) would be closer to 2 or 2.5% (based on 3.5% annual productivity growth, but with the working population diminishing by 1.5% every year). It is therefore clear that China's potential for growth is weakening structurally. Interest rates will therefore need to be able to fall substantially in the long term, while remaining attractive for foreign investors and despite the risk premium engendered by the debt. **Squaring the circle – except if the Chinese currency becomes one of the main international reserve currencies sought by investors and central banks across the world.**

If interest rates are higher than the economy's growth rate, savers receive a higher share of national revenue than if interest rates are lower than the economy's growth rate. There is a risk that this will once again encourage saving rather than spending. Consequently, the Chinese interest rate can only be liberalised very gradually. The volume of debts accumulated hinders and delays this process. As a result, although China is the world's leading trading nation, its currency is completely incapable of competing with its American, Japanese and European counterparts.
In 2015, the yuan became one of the five currencies officially recognised by the IMF as "reserve currencies", and as such is included in Special Drawing Rights (SDR) valuation calculations, but it has the lowest holdings of the five reserve currencies. In late March 2023, Russia adopted the renminbi as one of its main currencies for reserves, trading and even some personal banking services. That same month, the French company TotalEnergies settled an LNG trade in yuan for the first time. More widely, China has been proudly invoicing its oil and gas exports in renminbi for several years now.

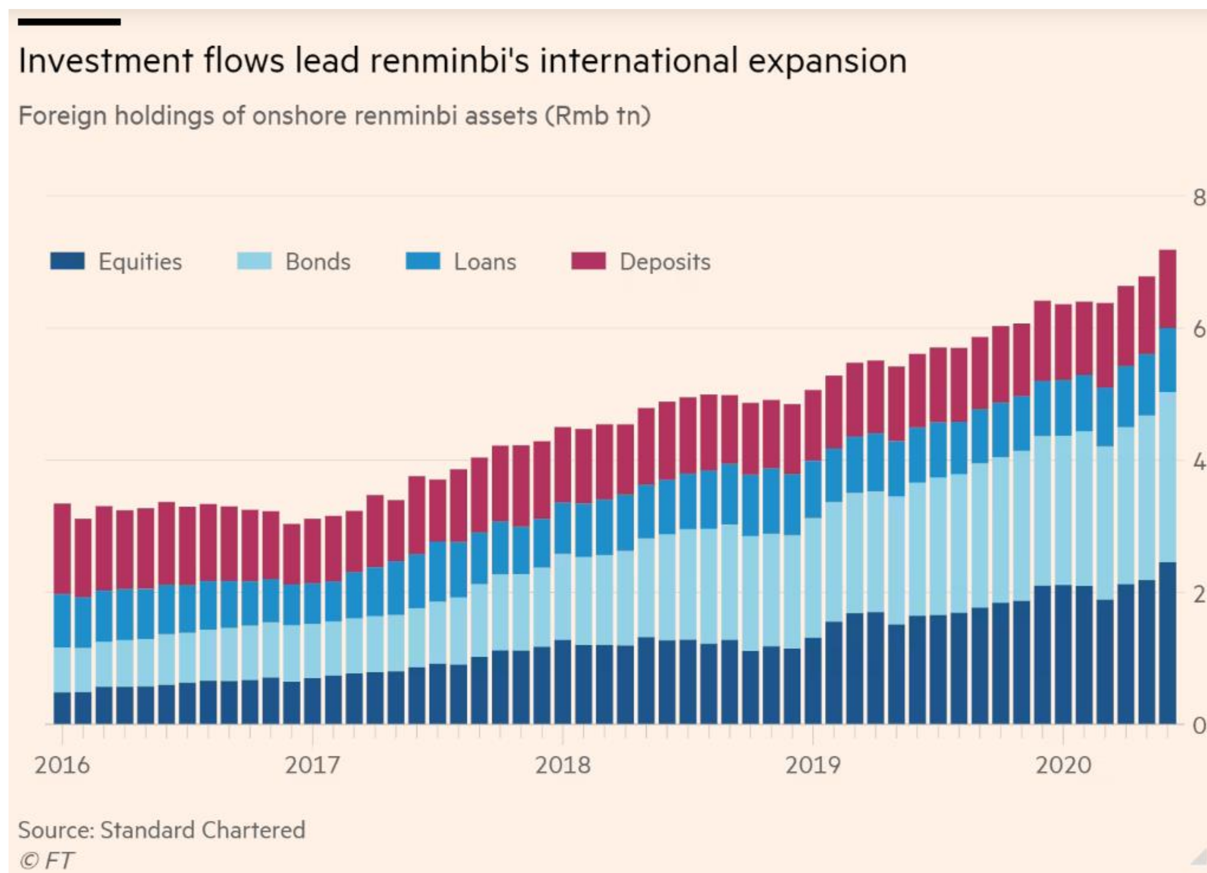
Chart H: China's renminbi is now the fifth most-held currency in official central bank reserves



Source: https://www.marketwatch.com/story/rise-of-nontraditional-reserve-currencies-diminishes-dollars-dominance-11654181294

But beyond official holdings, private international investors remain very circumspect (numerous deposits are held in cash as indicated by the chart below) and hesitant to hold Chinese financial assets.

Chart I: Foreign holdings of Chinese renminbi-denominated assets



Source: https://www.ft.com/content/4b4f1aa2-6938-473c-95cf-235478a45976

As regards Chinese debt securities, it should be noted that:

- Foreign holdings of onshore assets in renminbi are increasing, but remain fairly small.
- The proportion of foreign holdings in Chinese government bonds is higher, at around 7.9%.
- As China is one of the few emerging countries whose interest rate has very little correlation with that of the USA, it nevertheless remains a good diversification option for debt investors (as a short-/medium-term tactic more than as a long-term strategy).

As regards Chinese corporate equity and similar assets, it should be noted that:

- Only 3.2% of shares are Class A. Consequently, the correlation between Class A shares and the S&P 500 is one of the least constant.
- Chinese companies only make up 3.6% of the MSCI All Country World index (which tracks stocks from around 50 countries), against 60.4% for US companies and 5.6% for Japanese companies.
- Equity markets are highly volatile, and equity buyers are highly leveraged (margin debt ratio with brokers to GDP).
- The authorities do not have a clear position as regards the markets, alternating between supportive and laissez-faire postures.
- The markets remain relatively opaque. Few companies likely to attract investors comply with standards in terms of sustainability, account transparency, etc.

International institutional investors who do not wish to decide between Chinese companies and are primarily attracted by the country's macroeconomic dynamism are often advised not to opt for indices or ETFs reflecting the Hong Kong stock exchange as it is overweight in technological stocks, making it fairly volatile. They are advised to focus their attention on Shanghai, which announced once again at the Global Investors Conference 2022 that it was growing its toolbox for cross-border asset allocations. It is indeed important to move on from the last three years, during which the government has been seen to take a thoroughly ambivalent stance as regards capital markets and their international dimension.

Over the last three years, the international business community has seen the economy taken back in hand by politicians, leading to reaffirmed political control and lower profits for businesses.

The failure of attempts to bring openness, internationalisation and liberalisation to capital markets was highlighted to the world by the three-month "disappearance" of the Alibaba founder and CEO Jack Ma, one of China's richest billionaires. As well as its gigantic e-commerce platform, Alibaba also runs electronic data storage and AI services. For this, it owns several FinTech companies. One of them, Ant Group, says that it is seeking to "revolutionise the Chinese banking sector", by moving away from the systems and working methods of traditional institutions. On 24 October 2020, Ant Group was ready to launch in Shanghai the world's biggest initial public offering on the stock exchange. According to the BBC[20]: "The Alibaba founder said Chinese banks operated with a 'pawnshop' mentality. He had also claimed that the authorities were trying to 'use the way to manage a railway station to manage an airport' when it came to regulating the new world of digital finance." The reigning in of Jack Ma was taken as a warning. Jack Ma said what everyone in the country was thinking, and went as far as to state that "the lack of a healthy financial sector is a risk for the country".

Other giant tech firms (the BATX, or "Chinese GAFAM") have also been hit with fines and investigations into anticompetitive practices. Does the Chinese communist party consider them too big, and too free?

The theory of the collective interest, which predominates in China, appears difficult to square with the way finance works, based as it is around maximising individual profit functions. Huge firms such as Tencent are on various international stock markets, but in China they are listed only in Hong Kong!

Ant Group's decision to list on two Chinese stock markets at the same time was a first. Hong Kong is known as the place to attract international capital, whereas Shanghai is the place to tap into Chinese savings. In Shanghai, Chinese people have access to a very limited portfolio of securities and the investment sector is in its infancy. And yet, investment is becoming relatively popular with Chinese city dwellers and it is estimated that 7% of the Chinese population invests in the stock market. It is reckoned that one Hong Kong resident in five applied for Ant Group shares in advance of the flotation, and many of them used margin accounts (enabling them to invest more money than they were actually holding on the account). As a result, demand for Ant Group shares was 400 times higher than the number of shares sold to the public in Hong Kong and 800 higher times in Shanghai! In the end, the floatation was blocked by the government.

Since 2022, the authorities appear to be backpedalling, and returning to a more accommodating approach. But the guidance as regards financial markets and the business world is unpredictable and fragile, to say the least. Once again, the authorities seem to be caught between too many apparently incompatible constraints.

---

[20] BBC, *Why did Alibaba's Jack Ma disappear for three months?* 20/03/2021: https://www.bbc.com/news/technology-56448688

CHAPTER III

ENSURING THE ECONOMIC MODEL IS SUSTAINABLE

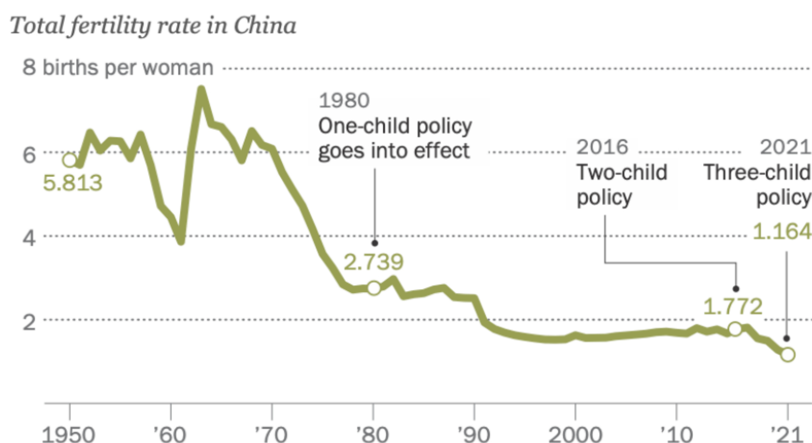
ENSURING THE ECONOMIC MODEL IS SUSTAINABLE

1. POPULATION SHRINKAGE AND THE ECONOMIC APORIA

China's population fell by 850,000 in 2022. It has already been overtaken by India as the world's most populous country, and numbers could reduce very quickly, dropping below the one billion threshold by 2060 (see Appendix, chart 21).

The Chinese fertility rate is very worrying, and it is important to note that it was already falling before the one-child policy was introduced. It is usual for the fertility rate to fall as a country develops economically and urbanises. With the exception of a short rise lasting a year in 2016 when the government allowed and encouraged couples to have a second child, China's fertility rate has continued to fall (and the "third-child" policy introduced in 2021 is unlikely to make any difference). The Youhe[21] demographic institute concluded that China is one of the most expensive countries in which to raise a child, due to the cost of schooling and childcare and the pressure surrounding extracurricular activities. According to certain studies[22], it costs 25,000 yuan (around $3,623) per year to meet a child's needs until they are 22, a sum almost equal to the country's average income. In addition to the financial challenges, there are major inequalities and quality imbalances between schools in urban areas and their rural counterparts (to the disadvantage of the rural schools). And in urban centres, the frantic pace of work discourages parents from planning a second child.

Chart J: The fertility rate of Chinese women is very worrying



Source: https://www.pewresearch.org/short-reads/2022/12/05/key-facts-about-chinas-declining-population/ft_2022-12-5_china-population_02/

[21] Pew Research Center, *Key facts about China's declining population*, 05/12/22: https://www.pewresearch.org/short-reads/2022/12/05/key-facts-about-chinas-declining-population/

[22] French.people.cn, *Quel budget pour élever un enfant en Chine ?* (What budget is needed to bring up a child in China?) 18/03/2017: http://french.peopledaily.com.cn/VieSociale/n3/2017/0318/c31360-9192018.html

The Beijing-based YuWa Population Research Institute estimated the average cost of raising a child to the age of 18 in China in 2019 at 485,000 yuan ($76,629) for a first child, equal to 6.9 times the country's GDP per capita for the year. China was placed second among the world's 13 most expensive countries included in the study, behind South Korea which has the world's lowest birth rate. In parallel, the proportion of public spending China allocates to education is on a downward trend, and this does not appear to be a priority for the country (see Appendix, chart 22).

Given the high-pressure educational environment and the culture of success, many families choose to put their children in the far more costly private school system. Tutoring firms are also flourishing.

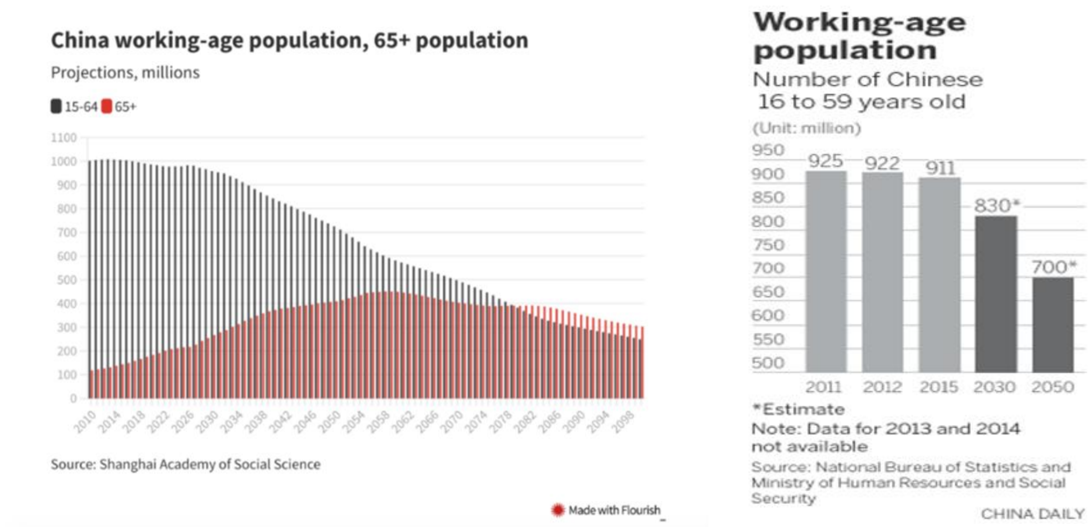
The YuWa Institute warns that the falling birth rate will "profoundly affect" China's economic growth potential, its capacity to innovate and the country's "well-being". A drop in population of this magnitude will have at least a triple impact on the Chinese economy:

- **Colossal government spending.** The YuWa Institute estimates that the country spends at least 5% of its annual GDP on encouraging couples to have more children through, for example, subsidies for education, preferential mortgage rates for housing, tax relief, equal parental leave for both parents and the cost of constructing more childcare centres. As a guide, 5% of GDP is equivalent to the Chinese military budget (France aims to spend 2% of its GDP on its military).

- **Lower production capacity**, leading to a mechanical fall in exports and therefore a fall in the foreign currency income which is necessary to offset structural capital outflows and capital flight. A perception of corruption within a country and an authoritarian regime or elements of financial repression always lead to attempts to get around the system and capital flight from the country.

- **An inability to fund the social pension system** due to the ratio of retired people to the working-age population, compounded by low diversification in the financial system and savings bogged down in sectors of the economy suffering payment defaults (property, etc.).

Chart K: The Chinese working population is set to continue its decline, falling off at a rapid rate



Source : https://www.weforum.org/agenda/2022/07/china-population-shrink-60-years-world/ and https://www.weforum.org/agenda/2016/07/china-working-ageing-population/

The Chinese working population began to edge down, almost imperceptibly, in 2011. From 2025 or 2026, the fall-off will have a noticeable impact on production capacity. By 2080, the retired population (aged over 65) is

set to exceed the working population (aged 15 to 64). Already, China's population of pensioners is almost equal to the entire population of Europe. And this is all the more critical given that the country's pension systems appear to be underfunded, with figures on the topic rather opaque. The number of retired people is expected to continue to increase for several decades due to lengthening life expectancy and a sharp rise in the number of people aged over 85 from 2040 (see Appendix, chart 23).

In addition, emigration accentuates China's demographic woes – this is in contrast to other countries such as Germany, which compensate weak population growth by high immigration. (see Appendix, chart 24).

"China would benefit from fully scrapping the internal migration restrictions. On the social side, the rural population is disproportionately composed of children and elderly people. Schools are much better in cities, allowing the workforce of the future access to better education. While some elderly people will prefer to remain in rural areas, others perhaps would like to move to cities closer to their adult children and to high-quality medical care," according to comments by the IMF[23].

China seems doomed to intensify the solutions that it has so far tried in vain:

- Increasing allowances.
- Subsidising extracurricular activities.
- Extending maternity leave and introducing paternity leave.

Faced with the middle classes' low purchasing power and the need to counter the excessive costs of schooling and housing, caused by extremely strong urban pressure and property prices that are still too high, the government is forced to compensate with a multidimensional pro-birth policy including massive use of financial subsidies, a media strategy to rebuild the positive image of large families, including in urban settings, etc.

2. SOCIAL OPPOSITION AND THE DIMINISHING ATTRACTIVENESS OF THE CHINESE ECONOMY

From the end of the 1990s until 2008, the Chinese economy grew rapidly, at 7-8% per year. For big international groups, a presence in this key market was vital. However, while at that time the Chinese working population was growing at a rate of 2% per year, it is now shrinking at an annual rate of 1.5% and this fall is set to accelerate. If productivity gains can achieve growth of 6% per year (which is about the highest that could be expected and masks very diverse productivity rates between the country's different provinces), potential economic growth (i.e. growth that does not generate imbalances, inflation-stoking overheating or debt) is now reduced to 2 or 2.5%. It is therefore clear that China's potential for growth is weakening structurally. It stands at a similar level to the USA and other developed countries. With the exception of firms in certain sectors such as luxury which are cashing in on economic inequalities and the immense increase in the number of super-rich Chinese people, for many multinationals, China is no longer "the place to be".

And so the reduction in China's potential economic growth is a result of both a falling population and slower productivity growth. This slower productivity growth seems to be an unavoidable trend affecting all developed countries. One of the reasons traditionally put forward is the transition of the workforce into less productive service sectors, such as retail and hospitality and non-market services. Services are currently growing fairly rapidly in China. Moreover, they are proving indispensable to the development of Chinese domestic consumption. In the IMF's opinion, a more service-oriented economy is better placed to increase its labour share of GDP.

To increase its growth potential, China will need to modernise and optimise the use of its resources[24], and upgrade its production processes:

---

[23] David Dollar, Yiping Huang, and Yang Yao, *Global Clout, Domestic Fragility: China's long-term success will depend primarily on addressing its internal challenges*, Summer 2021: https://www.imf.org/external/pubs/ft/fandd/2021/06/the-future-of-china-dollar-huang-yao.htm

[24] World Bank website, *The World Bank in China*:

- Increase automation.
- Capture synergies.
- Harness economies of scope and network effects.
- Accelerate the dissemination of advanced technologies and existing innovations.
- Encourage entrepreneurship and start-ups.
- Invest in human capital and make support for innovation and entrepreneurial spirit more targeted.
- Optimise the management structure of businesses.
- Put in place antitrust legislation to cover groups in dominant positions.
- Reinforce competition in markets for products and factors of production and ensure fair competition for all investors.
- Eliminate zombie companies that no longer have the funds to invest, train staff, innovate, etc.

In certain ways, China is as yet more competitive than it is productive, but this hiatus due to relatively low costs is not destined to last. The productivity challenge is therefore key.

The average annual salary in China has grown rapidly to CNY 106,837 or €14,567 (see Appendix, chart 25). That said, an average salary has little significance in China given the inequalities in the country and the wealth amassed by the very richest in society. A study by the University of Beijing[25] in 2016 found that the richest 1% of people own 33% of GDP and the 25% least rich own just 1%. These inequalities have grown considerably since the pandemic (as they have in all countries, in fact). According to the Gini Index, the generally accepted measure of inequality, China is one of the world's most unequal countries (see Appendix, chart 26).

There is a major differential between the incomes of urban and rural workers. In cities, many Chinese workers have incomes that rival those of their Eastern European counterparts (in Poland, Lithuania and Estonia). This is the case in Shanghai, Beijing and Shenzhen, which remains the high-tech factory for a large part of the world (the Chinese Silicon Valley). There are now more billionaires in Shenzhen than in New York.

Overall, the increase in revenues is an additional cost for businesses, but does not necessarily translate into higher purchasing power or an increase in consumption for the majority of the population. The very rich tend to invest their money abroad (in Singapore for example), contributing to capital flight.

Due to a sharp increase in costs (pressure on bonuses and variable pay is also increasingly strong), Apple in 2022 accelerated its delocalisation process, moving even more of its Chinese iPhone production operations to India.

Given that the Chinese government has more of a hand in running the economy than other governments do, analysts and investors also look closely at political imbalances and issues. The Fund for Peace, an American think tank, provides a number of measurements and indices in this field. Across these measures of state and social fragility, China comes out below its rivals, although trends since 2015 do appear less favourable for the USA and the UK. The indicator highlights fragmented elites and divisions between groups in society (see Appendix, chart 27).

At the highly symbolic 20th National Congress of the Chinese Communist Party in October 2022, President Xi Jinping, conscious of the fragmentation of the elites, surrounded himself with a totally loyal team that shares his political approach. This was a sign of some discontent among the leaders of the CCP, with an increasing number of conflicting opinions. The President also used the event to announce that he intended to be more specific and stricter regarding regulations in China, in particular in the field of finance.

The situation is similar across most political and economic indices, with China in a relatively unfavourable position. Consequently, the state legitimacy index is[26] falling, the brain drain continues and public services remain insufficient, despite being on an upward trend, and the corruption perceptions index in the public sector remains

https://www.worldbank.org/en/country/china/overview#3

[25] The Diplomat, *Report: China's 1 Percent Owns 1/3 of Wealth*, 15/01/2016: https://thediplomat.com/2016/01/report-chinas-1-percent-owns-13-of-wealth/

[26] Fund for Peace, State legitimacy index: https://www.theglobaleconomy.com/rankings/state_legitimacy_index/Asia/

high. Transparency International places China 65th out of 180 countries in terms of corruption in 2022 (see Appendix, charts 28, 29 and 30).

In short, Chinese people have plenty of reasons to be irritated or concerned:

- **Fears about pensions.** Pensions could grow from 5% to 20% of GDP over the next ten years, and the working population could fall by three million per year[27]. Faced with this scissor effect, a redistributive "pay-as-you-go" pension system appears arithmetically untenable (especially as women are entitled to retire from the age of 55 and men from the age of 60). Although it is a sticking-plaster solution, the development of a personal pension system could be envisaged, although this is a liberal-style approach.

- **The public sector is only moderately efficient and still subject to corruption.** The healthcare system needs to be made cheaper – especially paediatricians and treatment for young children. Public-sector businesses in particular often carry excessive levels of debt and do not make efficient use of their capital employed.

- **A gulf between urban and rural incomes and lifestyles.** China accounts for around one fifth of the world's population, but only 7% of land in rural areas is used for arable farming.

- **Questions regarding the healthcare system.** When Covid-19 appeared in 2019, China lay in 73rd place globally in terms of per capita healthcare spending.

- **Frustration during long periods spent confined to home due to the ultra-strict lockdowns** decreed during the pandemic ("Zero-Covid" policy).

- **Refusal of certain lifestyles and social practices which do not fit with the "socialist philosophy".** Tattoos are forbidden, videogaming is limited and subject to strict rules and although homosexuality has been decriminalised, it is still frowned upon outside the largest cities. Overall, there is minimal acceptance of anything that could be regarded as a "drift towards the Western way of life" and anything that does not fit with "socialist values", of which work is an essential pillar.

- **Very strong educational pressure on young people in China** with an increasingly visible countermovement. A New York Times journalist[28] spoke to numerous young Chinese people who support the "Lying Flat Is Justice" movement – or "TangPing" as it is called in Mandarin. "I haven't worked for the last two years, I'm just hanging around and I don't see anything wrong with that. […] I can live like Diogenes and sleep in a wooden bucket, enjoying the sunshine. I can live like Heraclitus in a cave, thinking about "logos". […] Lying flat is my philosophical movement. Only by lying flat can humans become the measure of all things." "The standards of success that run deep within Chinese society represent only stress, fatigue and weariness."

- **A desire for social control strengthened by heavy use of technology.** China has run pilot programmes for the "social credit" system in several cities and regions (among them Shenzhen, Rongcheng and Suining). It uses cameras and digital systems to automatically identify and monitor individuals. When someone commits an "offence", they lose points, reducing their social and civic rights. Below a certain threshold, the person is publicly shamed (faces are displayed in cinemas) and their civil liberties are restricted (access to public transport refused, etc.).

---

[27] Groupe Crédit Agricole, "Après une année 2022 noire, la Chine souhaite se relancer" (After a bleak year in 2022, China is looking to boost its prospects), *Perspectives, Apériodoque – n° 23/028 – 27/01/2023*: https://etudes-economiques.credit-agricole.com/previewPDF/179488

[28] New York Times, *The Chinese Millennials are 'Chilling' and Beijing Isn't Happy*, 10/10/2021: https://www.nytimes.com/2021/07/03/world/asia/china-slackers-tangping.html

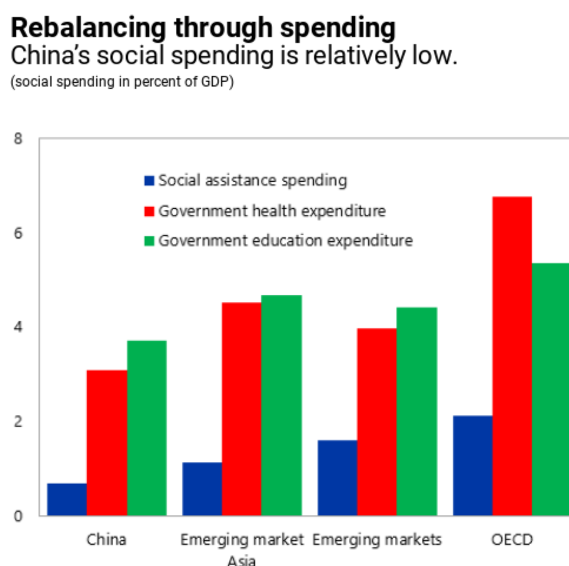
Faced with all the elements set out above, a societal trend towards increasingly vociferous protest movements is appearing[29], with acts of civil disobedience and numerous "popular demonstrations" in the streets and in factories in 2021 and 2022.

3. GEOPOLITICAL POSITIONING: A PROJECT, INVESTMENTS AND DIPLOMATIC TENSIONS

Given the imbalances discussed above, the need to rebalance its growth and develop better quality, more inclusive growth, China will have to considerably increase domestic spending over the next few years. To quote just two examples: 1) the Covid tests required of city dwellers every 24 to 72 hours for more than a year alone will have cost the Chinese state more than 2% of GDP, and 2) military spending to support the country's South China Sea strategy has risen tenfold over the last twenty years: from $25 bn in 2000, it exceeded $250 bn in 2020 (see Appendix, chart 31).

Also and above all, China's spending on social assistance, health and education is lagging. As a percentage of GDP, spending in these three areas is below the levels in comparable emerging countries, inside and outside Asia, and completely out of phase with OECD countries.

Chart L: China has immense social assistance, health and education expenses ahead of it



Source: https://www.imf.org/en/News/Articles/2018/07/25/na072618-chinas-economic-outlook-in-six-charts

This spending is both domestic and international. Over the last few years, through the "New Silk Road", China has been at pains to stress the fact that it shares a land mass with Asia and Europe. Although China does not provide official figures, a 2017 report by Morgan Stanley estimates that the investment could reach $1.3 trillion by 2027.

Chart M: Overland and maritime projects pursued by China as part of the new Silk Road

[29] Foreign Affairs, Xi Versus the Street: The Protests in China Could Herald a Turbulent New Era, 30/11/2022: https://www.foreignaffairs.com/china/xi-versus-street

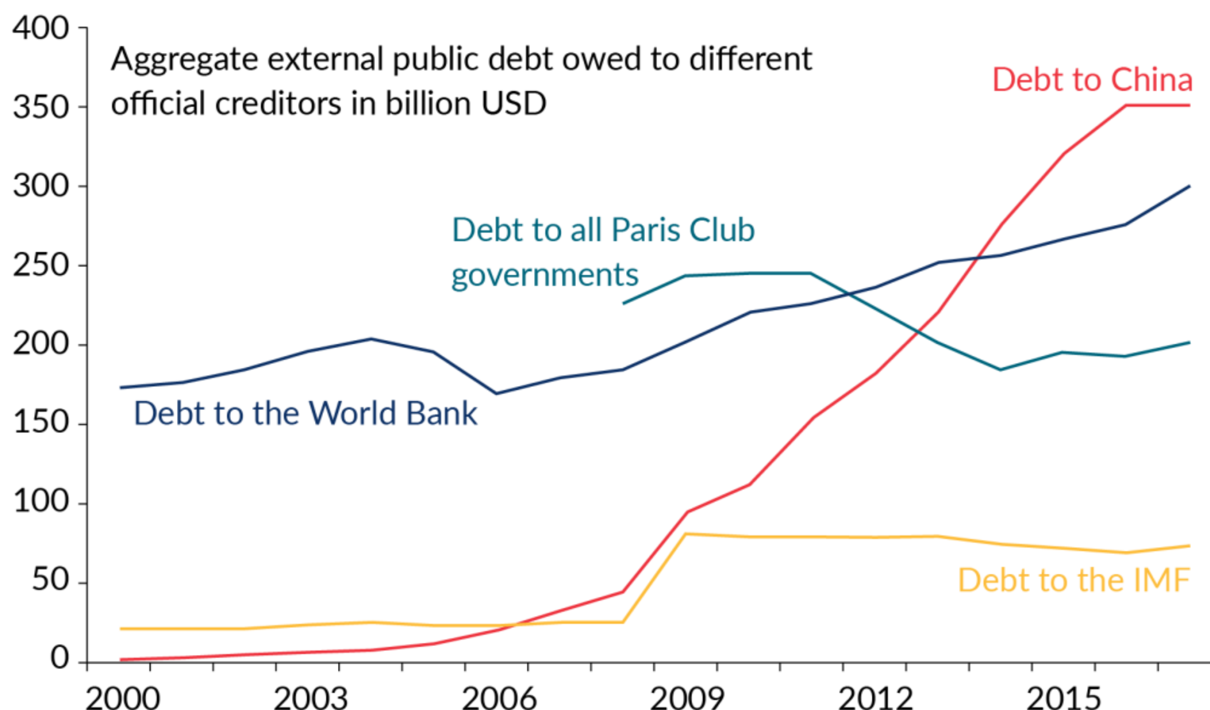
Source: [*https://www.dw.com/en/chinas-new-silk-road-faces-resistance-from-india-partners/a-44056399*](https://www.dw.com/en/chinas-new-silk-road-faces-resistance-from-india-partners/a-44056399)

The Shanghai Cooperation Organisation created in 2001 by China, Russia and four central-Asian countries is the result of this "pan-Asian project", also more explicitly described as a "post-Westernism" project. This security and economic cooperation agreement covers more than 50% of the global population (since India joined in 2016). The "Silk Roads" link China to more than 40 countries, some reached overland and others by sea. These routes counted on the cooperation of the Russian army to protect the infrastructure. "Who rules Eurasia rules the World" as Mackinder advanced in 1904 in his article *The Geographical Pivot of History* and Zbigniew Brzezinski, an advisor to US President Carter, said in his book "The Grand Chessboard", published in 1998.

As part of the "New Silk Road" initiative, China is ploughing considerable sums into all-in-one turnkey infrastructure projects (financing, design, accelerated implementation, engineering, staff training, operation-ready infrastructure, on-time delivery, etc.). This model is highly attractive for numerous poor and developing countries, which have colossal infrastructure needs. Objectively, no other country or international organisation is currently capable of providing comparable services.

Slowing domestic Chinese growth suggests that this external investment will decelerate and a rigorous or even severe collection programme will be put in place to recover money due from debtor countries. China has become the planet's leading creditor, ahead of the IMF, the World Bank and the Paris Club, which groups together the aggregated debts owed to all the rich OECD countries.

Chart N: China is now the planet's biggest lender to developing countries, ahead of the World Bank and the Paris Club of OECD creditors



Note: This figure shows aggregate public debt to different official creditors for all 122 developing and emerging market countries contained in the World Bank International Debt Statistics (excluding China). Debt to China is estimated by Horn, Reinhart and Trebesch (2019). Debt to all 22 Paris Club governments is taken from the [Paris Club website](#) (available since 2008). Debt to the IMF and the World Bank Group (IBRD plus IDA) is from the World Bank's International Debt Statistics.

Source: https://www.cgdev.org/publication/chinas-overseas-lending-response-our-critics

Chinese investments are found not only in African and Central Asian countries, but also in Latin America. For example, the increasingly strong links with Argentina – a potential candidate for entry into the BRICS group of which China is a relative leader – show how China is now active on the American continent, the historic preserve of the USA.

Through the "Silk Roads", China is also seeking to anchor its influence more firmly, have these countries adopt its technological standards (China files more technology patents than any other country in the world) and guarantee supplies of critical ores. China produces within its territory supplies of a large number of strategic manufacturing inputs (semi-conductors, batteries, etc.). However, it is not self-sufficient in all ores. In lithium ion for batteries, for example, although China has the world's largest market for electric vehicle sales, it can only cover one third of its requirements domestically. In this situation, it purchases operational mines all over the world. China also holds a significant share of the world's rare earth reserves. It accounts for around 60% to 70% of the planet's rare earth production and around 80% to 90% of rare earth refining. Western countries are therefore highly dependent on China for supplies of rare earths.

With the incontestable advantages of projects financed by China comes a high level of dependency on the part of certain developing countries, who are deeply indebted to China under powerful bilateral agreements, both commercial and financial.

According to the newspaper Les Échos[30], “Under projections by the Green Finance & Development Center, this year the 68 countries considered as the poorest on the planet will spend almost $53 bn on payments to their creditors. According to data published on Monday by this Shanghai-based research centre, $14 bn, almost a quarter of this sum, will go into the pockets of China, which remains streets ahead in the list of these countries’ main creditors. In 2020, China made a most unusual move by supporting the G20’s Debt Service Suspension Initiative for the planet’s poorest countries. As part of this, it agreed to defer around $5.7 bn of debts between May 2020 and December 2021.”

As set out above, in addition to developing countries’ debts, China is also financially dependent on FDI (foreign direct investment) from the West. These reciprocal dependencies would tend to act as a pacifying factor. With its structurally weak domestic demand, Chinese commerce is once again largely driven by exports. For the moment, all of this increases China’s dependency on the West. Chinese capital flight has been partially compensated by inflows of foreign capital. The advantage of FDI is that it fosters business links but generates no (or very little) financial debt.

FDI between China and the USA remained very high in 2022 despite the numerous areas of dissent between the two countries on a diplomatic level. This shows that the business community does not believe in a break-off in relations/all-out war between China and the USA (nor a military escalation of the Taiwan issue).

So we can only hope, without any certainty, for some degree of realisation of the sterility of the trade war between China and the USA, which began under President Trump in 2018 and is now heightened. In 2020, and again in April 2022, the USA sanctioned East Asian companies that sold products which improved China’s technological capabilities – for example, it imposed high-tech export controls on the Taiwanese chip manufacturer TSMC to force it to stop selling to a subsidiary of Huawei, the Chinese telecommunications market leader, and prevented the American firms Nvidia and AMD from exporting chips for artificial intelligence to China. China itself has put in place a de facto boycott of Australian products after the Australian government joined Washington’s calls for an investigation into the origins of coronavirus.

The rest of Asia may not wish to find itself locked into this zero-sum game between Washington and Beijing. Despite pressure from the two giants – China further restricting access to its market and using coercive economic tools, and the USA taking advantage of its access to its banking system, its extraterritorial legal framework and the fact that trades are settled in dollars – 11 countries signed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (or CPTPP), without the involvement of either the USA or China.

All these elements have come at a high cost for China, which now has to work on repacifying its external relations. As China becomes weaker economically, its political power is ebbing mechanically. Does that mean that the USA will win the war of “hegemony” against a China bogged down in its internal imbalances? It is important to remember that the USA is also battling its own serious social and debt issues. The unipolar world where the USA is the only superpower no longer exists, but it has not necessarily been replaced by a multipolar world with China as the leader on the Eurasian continent, balancing the West. In fact, the ambitions of Asian and Middle Eastern countries cannot be considered homogeneous, either politically or economically, and even less are they a structured anti-Western front. So we are not in a unipolar or multi-polar world, but more in an apolar world with multiple unstable and volatile equilibria.

[30] Les Échos, *Dette : la Chine va recevoir 14 milliards de dollars des pays les plus pauvres en 2022*, (China set to receive $14 bn from the poorest countries in 2022) 21/03/2022: https://www.lesechos.fr/monde/enjeux-internationaux/dette-la-chine-va-recevoir-14-milliards-de-dollars-des-pays-les-plus-pauvres-en-2022-1395065

SUMMARY OF RECOMMENDATIONS

WHAT ECONOMIC POLICIES ARE REQUIRED TO ACHIEVE LESS UNBALANCED GROWTH?

SUMMARY OF RECOMMENDATIONS:
WHAT ECONOMIC POLICIES ARE REQUIRED TO ACHIEVE LESS UNBALANCED GROWTH?

Chinese governments are known for being rational and holding economic growth in high regard. When the growth figures are below target, a no-holds-barred approach is applied to economic policy. With inflation moderate (around 2% in 2022), the authorities still have room for manoeuvre in terms of budgets and monetary policy. That said, the imbalances that have accumulated over the years have become structural constraints, leading, in the minds of certain commentators, to attempts to square the circle. Some even talk of economic aporia, describing a situation in which political talent or will may prove insufficient. Is there a positive route out of this apparent stalemate?

As Michel Aglietta was already pointing out in 2012[31], "Western intellectuals struggle to admit that it is possible for China to use a pathway different from our formal democracy to establish a relationship between politics and civil society capable of overcoming the issues of the 21st century."

The Chinese government has already put in place numerous reforms, but many of them remain unfinished. The winter 2019 edition of The China Dashboard, which tracks the reform plans born out of the Third Plenum in 2013, shows that, in eight areas out of ten, reforms are not progressing. One of the areas where the reforms are falling behind is the overhaul of public companies: the role of state-owned enterprises in the allocation of resources is increasing, while that of the private sector is diminishing. This is mainly because public companies have preferential access to credit, in comparison to the private sector.

The recovery in consumer spending was once again a major focus of the Central Economic Work Conference held in mid-December 2022. This annual conference is seen as particularly important, because it was held just after the 20th Party Congress and so can be viewed as a declaration of intention on the part of Xi Jinping's new government. In the longer term, Beijing intends to achieve its "common prosperity" objective by considerably increasing the number of people in the "middle income" range. Several analysts see in this a return to pragmatism in the way economic policy is written after a drift towards state control over the last few years. During the congress, Mr Xi clearly expressed the need to "provide an environment that is favourable to private enterprise".

This study identifies all of the elements below as priorities. Unfortunately, the list is something of a hotchpotch, whereas the current economic imbalances call for strong and multidimensional responses. The aim is not, however, to distort the Chinese historical approach to economic reform: gradualism and experimentalism, or "crossing the river by touching the stones"[32] (as illustrated by the famous Special Economic Zones).

It is, however, becoming urgent for China to:

- Break free from the middle-income country trap.
- Escape the debt trap.
- Keep the growth of credit under control.
- Stabilise the ever-expanding shadow banking system.
- Cut the dead wood from the property sector.
- Deal with the environmental issues that cost the Chinese economy several billion dollars every year.
- Limit fraud and corruption, beyond the simple goal of securing the long-term future of the current Xi government, as Mr Xi is now potentially president for life.

[31] L'Humanité, *Michel Aglietta.* "*La Chine peut inventer un système original d'harmonie sociale*", (China can invent an original system of social harmony) 01/11/2012: https://www.humanite.fr/michel-aglietta-la-chine-peut-inventer-un-systeme-original-dharmonie-sociale

[32] China Briefing, Economic Reform in China: Current Progress and Future Prospects 03/05/2019: https://www.https://www.china-briefing.com/news/economic-reform-china-opening-up-future-prospects/

It will not be possible to achieve these objectives without developing the service sector – which is often organised in a more "liberal" manner than industry, giving more prominence to innovative SMEs, overhauling the finance sector (and bringing an end to the "pawnshop" mentality) and introducing stricter regulation for non-bank financial institutions.

In no particular sequence or order of priority, the reforms must:

- **Implement an efficient solution to the corporate debt issue**: classify receivables, recognise losses, share the burden, strengthen the legal framework around insolvency, facilitate the transition out of unemployment and active policies to combat it, widen unemployment benefit coverage, facilitate market entry and improve local authority financing.

- **Tackle the crucial demographic issue.** Measures need to be taken to counter the excessive cost of education and housing, which are a result of extremely strong urban pressure and a property sector which remains too inaccessible. The government therefore appears to have no choice but to intensify what it has so far attempted in vain: raise allowances, subsidise extracurricular activities, extend maternity leave and add paternity leave. The idea of abandoning the sinification of the provinces with non-Han populations and giving internal migration free reign is also sometimes suggested, but this is a highly political issue.

- **Finally, moving on to liberal approaches, Chinese financial markets should encourage more international portfolio investments.** This would be achieved through:
    - Independent legal institutions.
    - Clarification of creditor rights.
    - Standardisation and transparency of financial and non-financial (sustainability) reporting standards.
    - Prudent regulation of financial market players.
    - More cautious and gradual classification of the risks linked to financial assets.
    - Active market makers to ensure sufficient liquidity.
    - Clear requirements as regards information.
    - Independent ratings agencies (the Dagong agency's methodology remains bewildering and lacks transparency).

Under these conditions, the government would have all the tools at its fingertips to regulate a mixed economy that would serve the country's interests. In addition, these interests would align with the interests of the international financial community. The value of Chinese debt and the unavoidable opening of the economy to foreign capital would increase the "echo chamber" effect and the resonance effects between the Chinese, Japanese and Western capital markets.

In parallel, China should continue to develop its digital currency[33]. As mentioned above, it aims to be the first major country to issue a sovereign digital currency, the e-yuan. Large-scale tests have begun in the country, where mobile payments are already popular. In December 2021[34], it became possible for customers to pay in e-yuan in 10,000 shops in the city of Suzhou. The hidden economic policy agenda in the long term is undoubtedly to put an end to cash payments and thereby reach an ultimate goal practically unattainable by any other method: to make all payments traceable and stop the majority of frauds and illicit payments, under-the-counter arrangements, small-scale tax dodges and illegal payments (drug trafficking, terrorist financing, etc.).

However, an ageing population and the challenges of learning to use digital currency are delaying these latter objectives.

---

[33] Amaury Goguel, *Monnaies digitales privées et publiques, l'avenir de la monnaie ?*, (Digital money, private and public – is this the face of the future?) 07/02/2022: https://knowledge.skema-bs.fr/monnaies-digitales-privees-publiques-avenir-monnaie/

[34] Les Échos, *A Suzhou, la Chine prépare la fin du cash,* 05/01/2021 (China prepares for the demise of cash in Suzhou): https://www.lesechos.fr/monde/chine/a-suzhou-la-chine-prepare-la-fin-du-cash-1278091

- Circumvent any blockages in bank credit channels.
- Stem shadow banking.
- Bypass the interbank markets and avoid disrupting bank interest rates.

It is important to remember that Chinese imbalances impact the world as a whole, not only through trade and the knock-on effect on global growth, but also because of the way the jolts – or worse – it experiences affect global finance. China is clearly no longer an emerging country; it is a country that has emerged. And that makes some of the imbalances even more visible and impactful.

The recommendations made in this report may appear liberal in nature. Although they are backed by reasoning, we cannot deny that they do partially reflect some of the themes of the Washington Consensus. It is understood that China will do everything it can to avoid remaining boxed into a liberal Western model, with the support of an ever-increasing list of BRICS partners (Argentina, for example, will probably join this club). China questions the instructions of the IMF and liberal economists (Joseph Stiglitz, who is very sceptical regarding the Washington Consensus, is one of the few Western economists to command respect in China). And yet, the IMF acknowledges the errors in the Washington Consensus and the virtues of the Chinese model for the early stages of development. Consequently, the recommendations in this report do not dispute what has been achieved through this “highly regulated and administered” Chinese approach. Its objective is rather to set out a road map for the next stage, for the transition from an emerging economy to a developed economy, seeking to become a coherent and stable part of the mechanisms of international finance. Lastly, it offers some solutions for situations when the degree of imbalance means that state interventionism is no longer sufficient. As financiers say, you can’t fight the tide. The legendary American investor Warren Buffet joked that “Only when the tide goes out do you discover who’s been swimming naked” (meaning those whose investments are insufficiently diversified and vulnerable to risks). Diversification in political and economic approaches can only ever be a good thing.

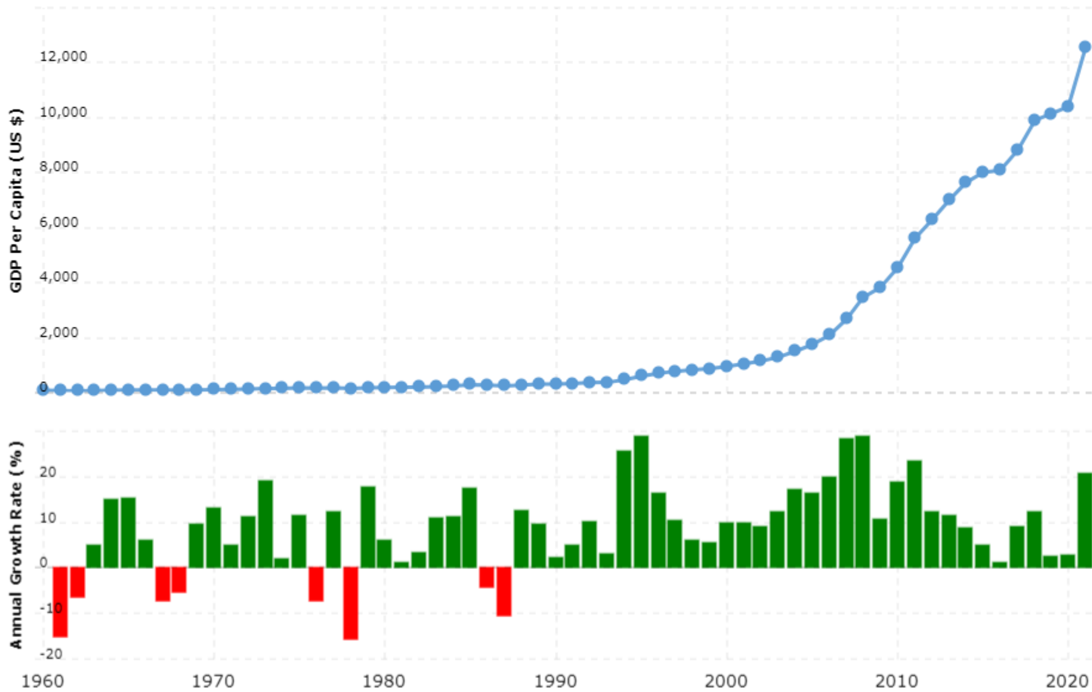
°°°

APPENDIX

CHARTS

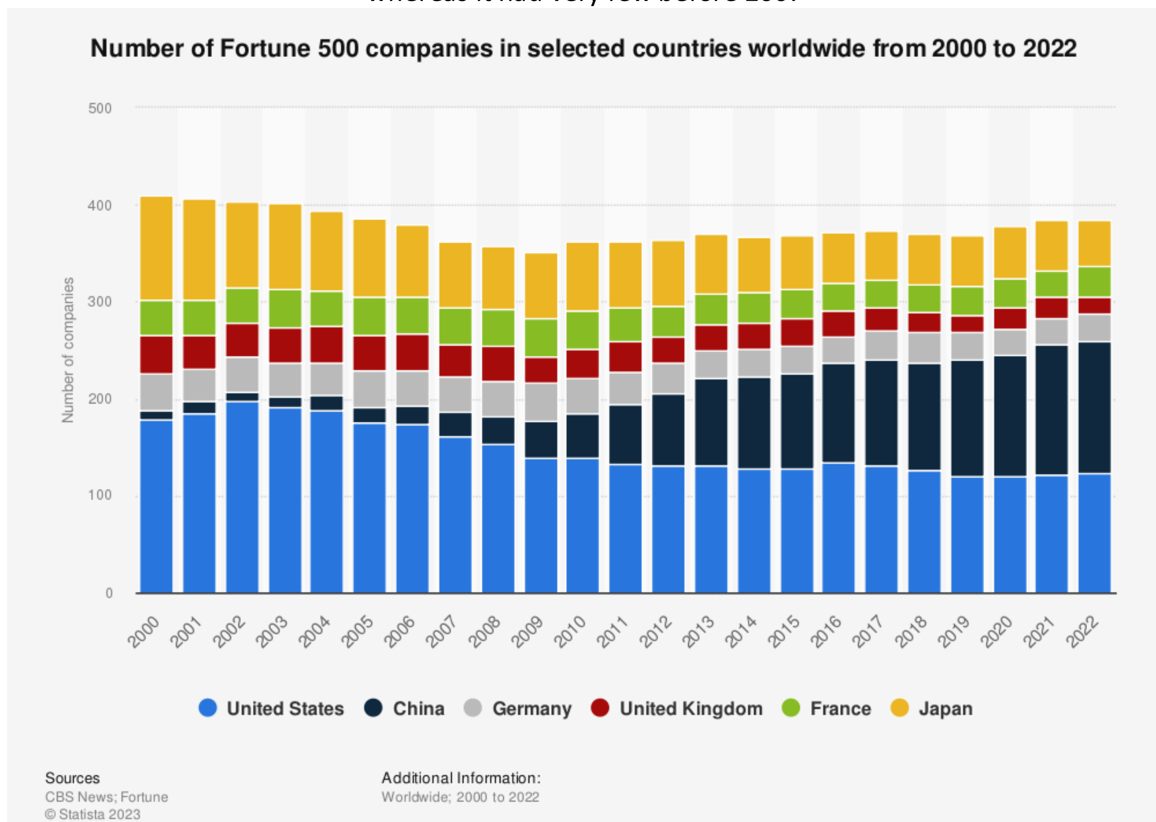
CHAPTER I: STYLISED FACTS: IMBALANCES MASKED BEHIND MAJOR SUCCESSES

Chart 1: Growth in GDP per capita. A spectacular increase since 2007.



Source: *https://www.macrotrends.net/countries/CHN/china/gdp-per-capita*

Chart 2: Since 2020, China has surpassed the US in numbers of Fortune Global 500 companies, whereas it had very few before 2007



Source: https://www.statista.com/statistics/1204099/number-fortune-500-companies-worldwide-country/

Chart 3:

China, the leading global producer of most forms of renewable energy (solar, wind and hydroelectric)

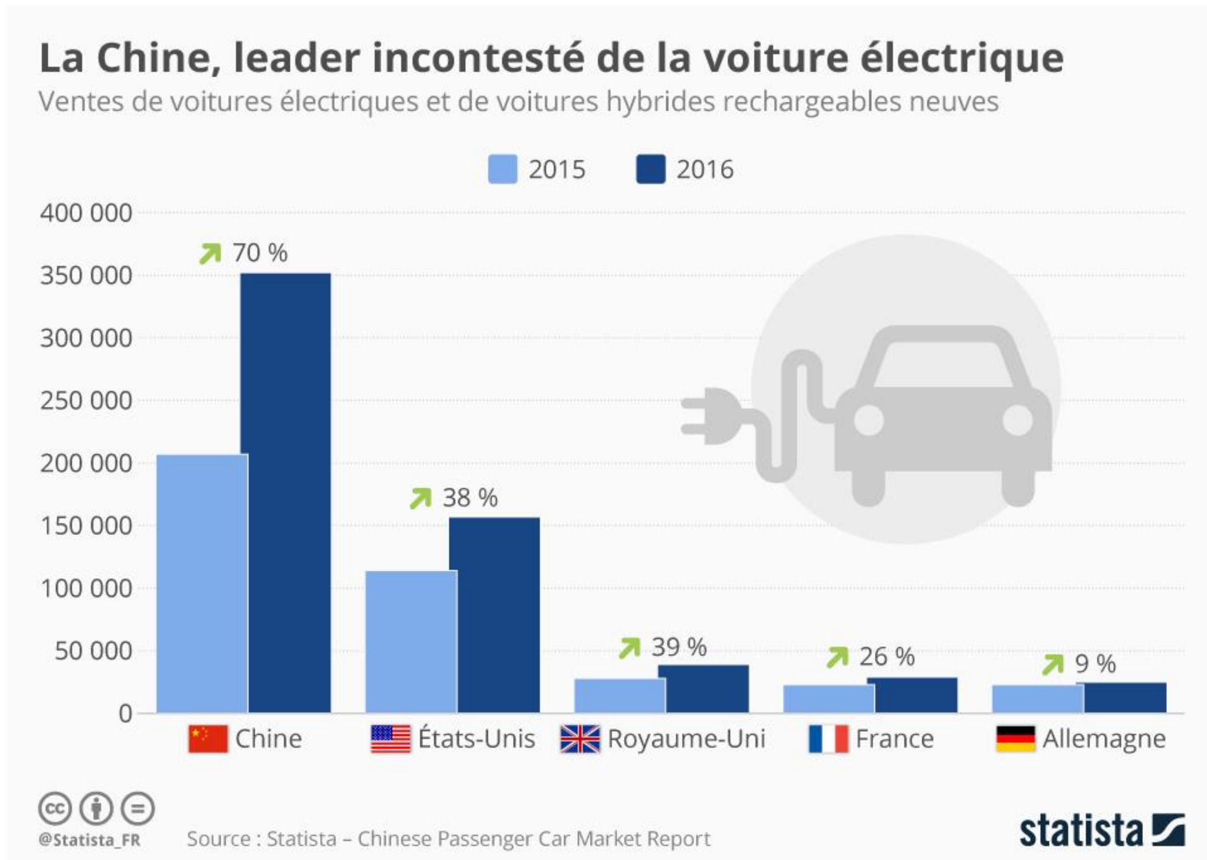
Countries ▲ ▼	Solar electricity capacity, 2020 ▲ ▼	Global rank
China	254.36	1
USA	75.64	2
Japan	67	3
Germany	53.78	4
India	39.21	5

Countries ▲ ▼	Wind electricity capacity, 2020 ▲ ▼	Global rank
China	281.99	1
USA	118.38	2
Germany	62.18	3
India	38.56	4
Spain	27.09	5

Countries ▲ ▼	Hydroelectricity capacity, 2020 ▲ ▼	Global rank
China	338.67	1
Brazil	109.24	2
Canada	81.82	3
USA	79.92	4
Russia	48.53	5

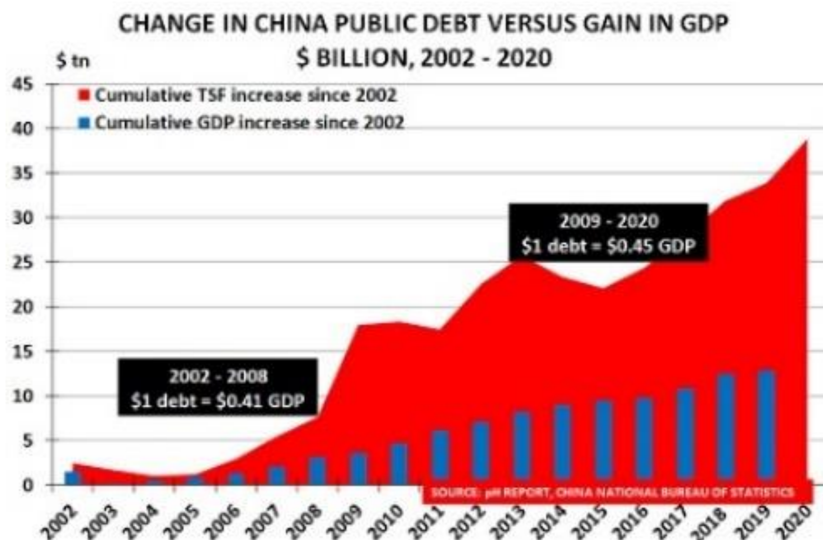
Source: https://www.theglobaleconomy.com/

Chart 4: China is streets ahead of the competition in terms of sales of electric vehicles. The batteries to power them continue to be produced mainly using carbon-intensive energy sources, despite the rapid construction of numerous, but as yet insufficient, nuclear power plants.



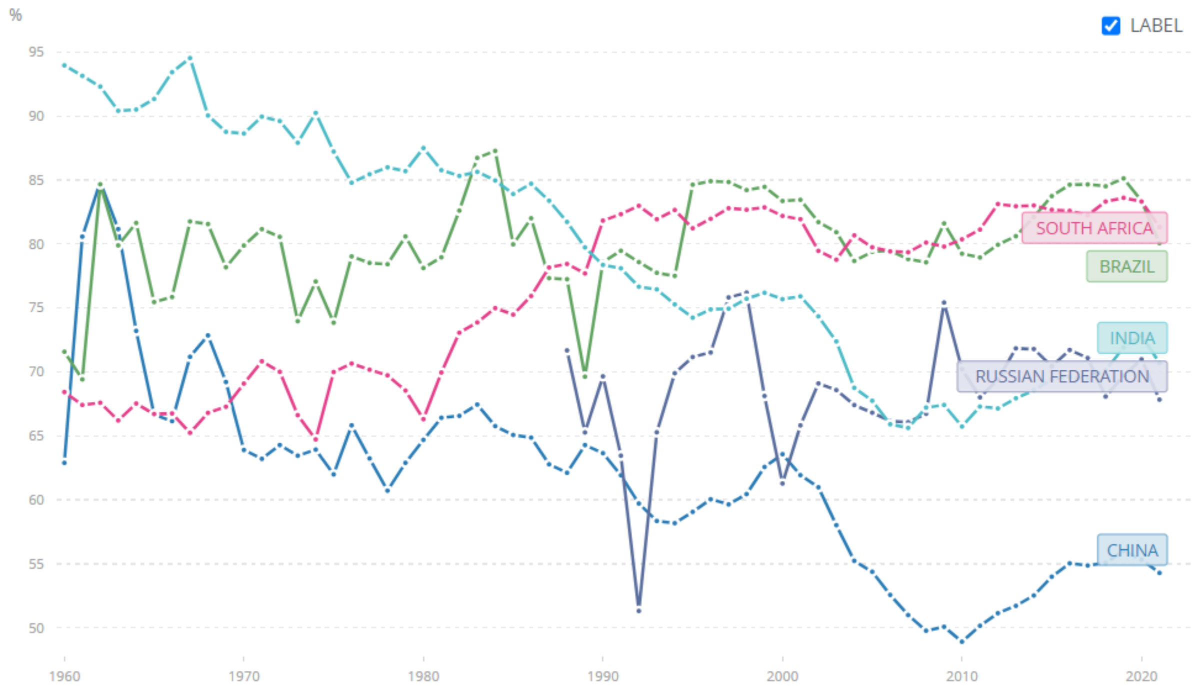
Source: https://fr.statista.com/infographie/11305/la-chine-leader-inconteste-des-voitures-electriques/

Chart 5: Since 2007, each unit of growth has required more and more units of debt (in $bn) between 2002-2022



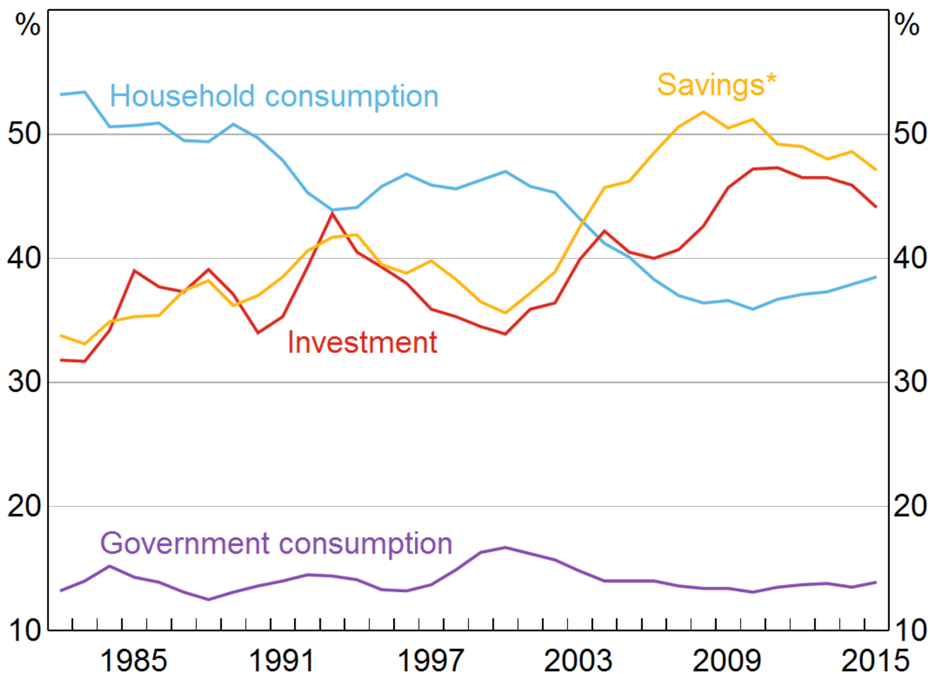
Source: https://www.icis.com/chemicals-and-the-economy/2021/03/chinas-dual-circulation-policy-aims-to-reduce-debt-reliance/

Chart 6: The contribution of domestic consumption (% of GDP) remains very low compared to the other BRICS countries



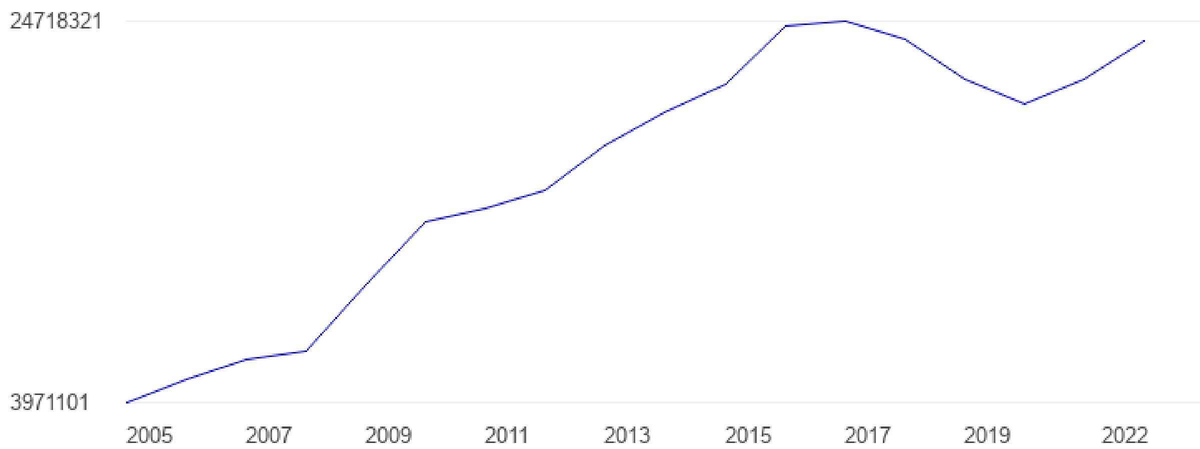
Source: World Bank, Final consumption expenditure (% of GDP) – China, Brazil, Russia, South Africa and India, 1960-2021, *https://data.worldbank.org/*

Chart 7: Household consumption (blue curve) and savings rate (yellow curve) are mirror images of one another, showing as would be expected an inverse correlation between the two variables



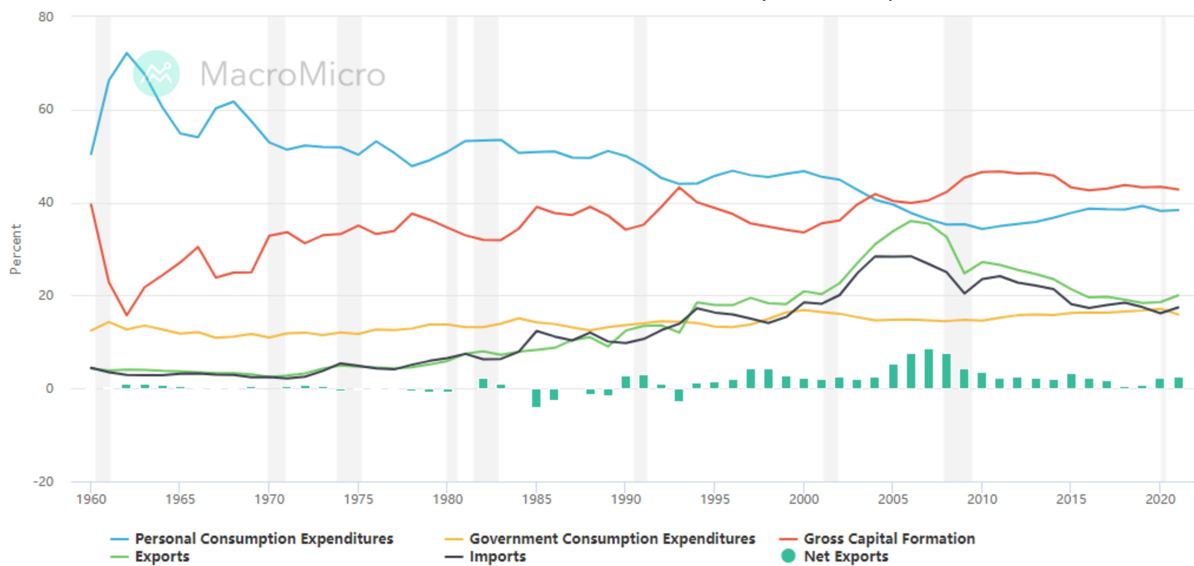
Source: https://www.rba.gov.au/speeches/2016/sp-ag-2016-06-16.html

Chart 8: Since 2015, Chinese growth is no longer resulting in the same increase in purchasing power, as shown by stagnation in new passenger car sales



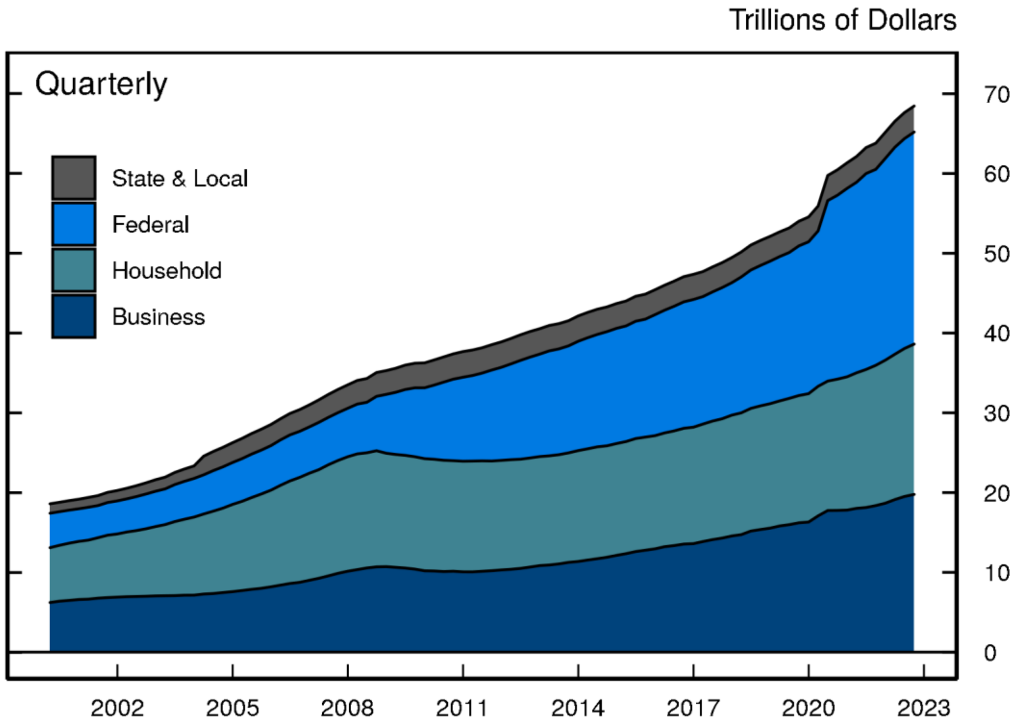
Source: https://www.theglobaleconomy.com/China/passenger_cars_sales/

Chart 9: Consumption remains less significant than investment within the components of Chinese GDP. Investment does not dominate in the same way in developed countries.



Source: https://en.macromicro.me/collections/22/cn-gdp-relative/984/cn-gdp-percentage

Chart 10: Household debt (green area) makes a significant contribution to US debt



Source: https://www.federalreserve.gov/releases/z1/20221209/html/recent_developments.htm

Chart 11: Exports have ticked up again since 2020

Source: https://tradingeconomics.com/china/exports

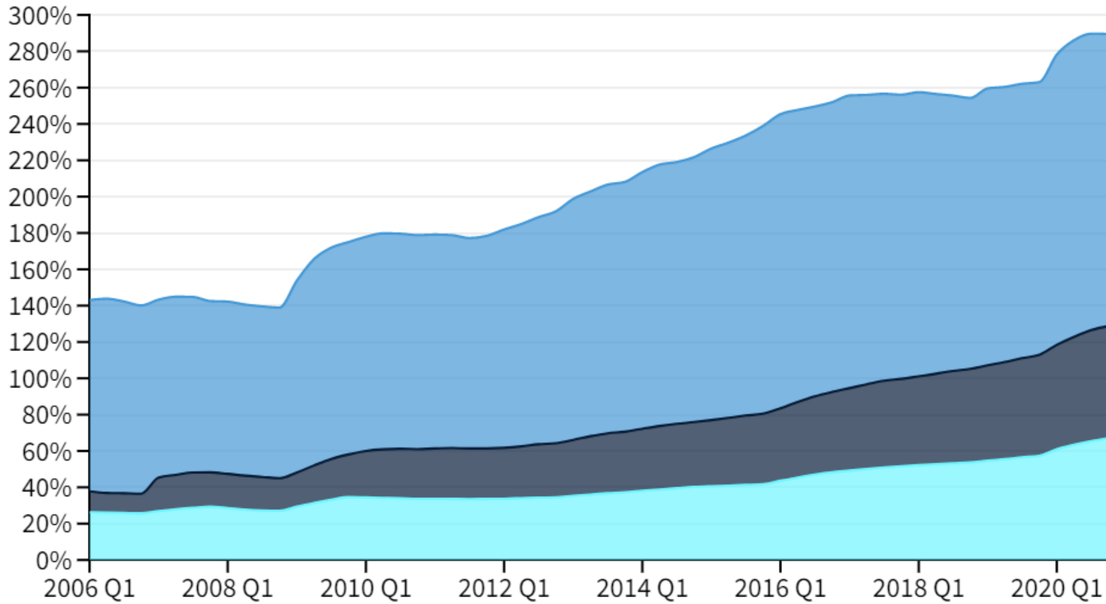
CHAPTER II: FINANCING REBALANCE THE CHINESE ECONOMY NEEDS

Chart 12: Totalling more than 160% of GDP, corporate-sector debt is particularly worrying

China's domestic debt

Debt-to-GDP ratios of the three main components

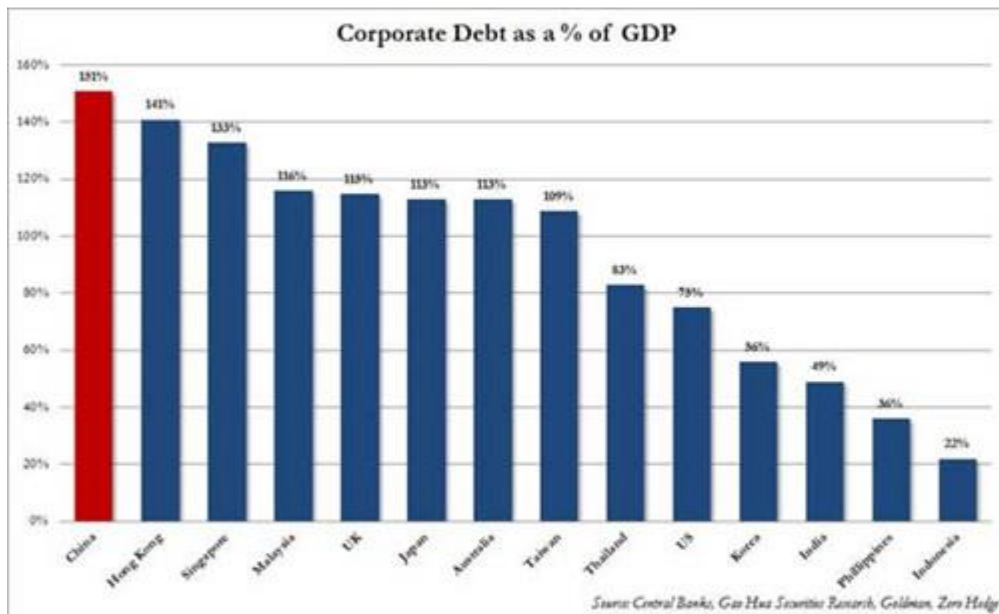
General government ■ Households* ■ Non-financial corporations



Source: Bank of International Settlements • * Data include non-profit institutions serving households

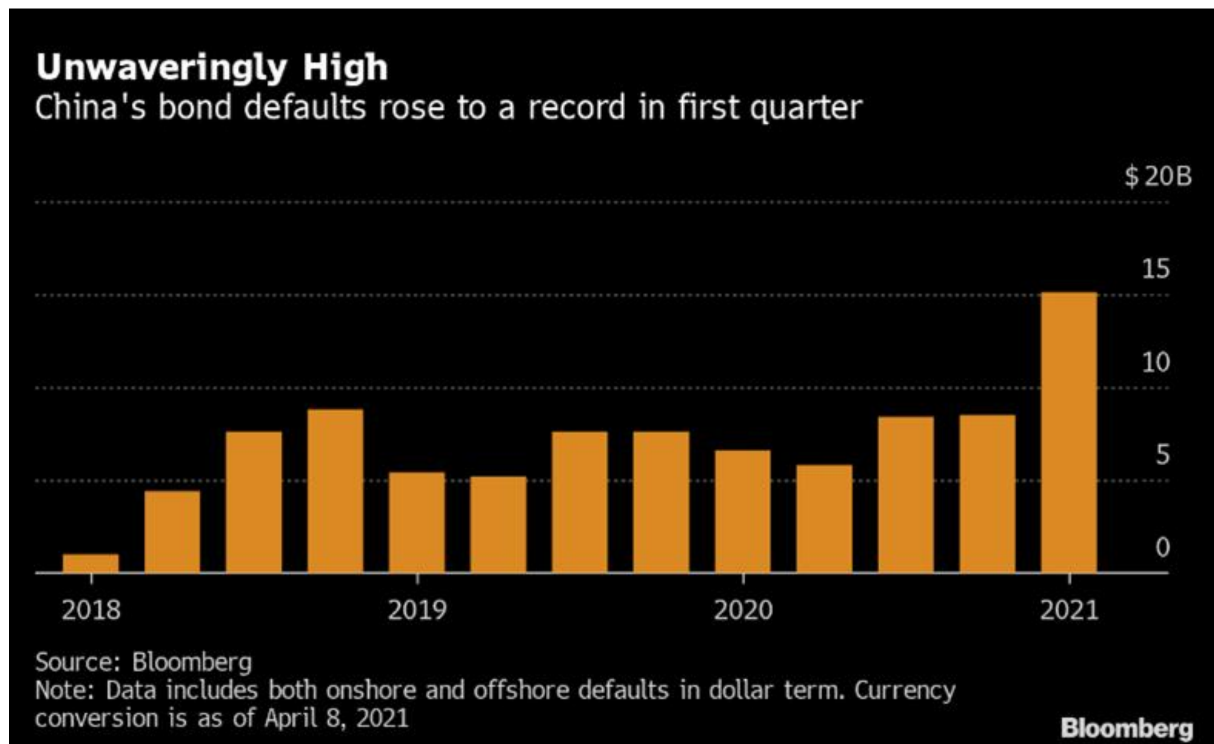
Source: https://www.cnbc.com/2021/06/29/china-economy-charts-show-how-much-debt-has-grown.html-

Chart 13: China and Hong Kong have higher corporate debt than other countries



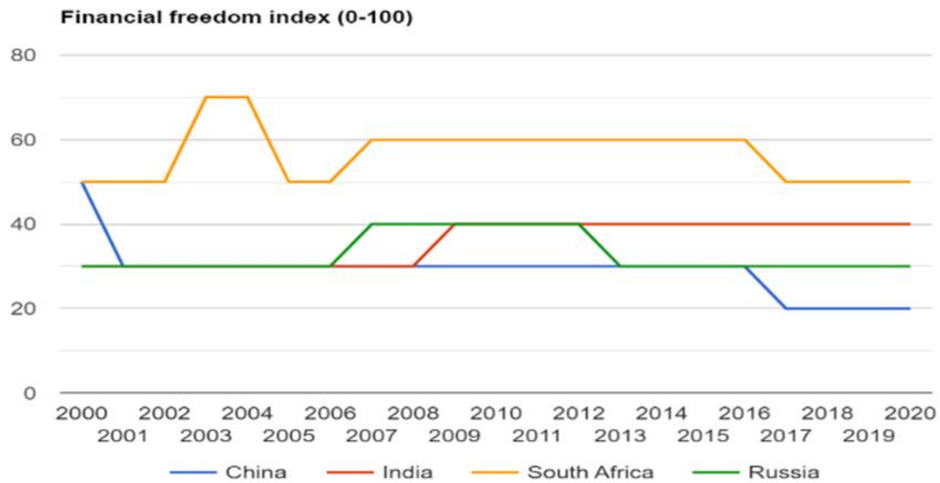
Source: http://www.ecns.cn/business/2012/11-07/34190.shtml

Chart 14: The total value of defaults has soared since summer 2018



Source: https://www.bloomberg.com/news/articles/2021-04-09/china-s-record-surge-of-defaults-driven-by-property-developers#xj4y7vzkg

Chart 15: China consistently takes last place in the financial freedom index, and its ranking fell even further in 2017



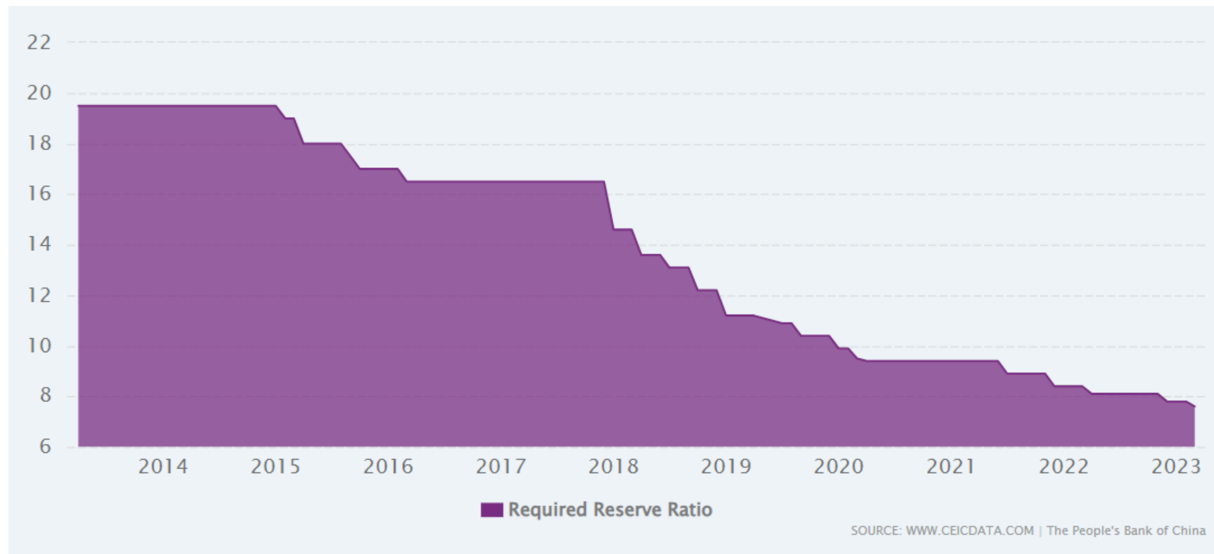
The Financial freedom index evaluates: the extent of government regulation of financial services, the degree of state intervention in banks and other financial firms through direct and indirect ownership, the extent of financial and capital market development, government influence on the allocation of credit and openness to foreign competition. Higher index values denote banking efficiency and independence from government control and interference in the financial sector.

Source: https://www.theglobaleconomy.com/

Chart 16: Bailing out property developers seems to be the only option, but the cost is staggering

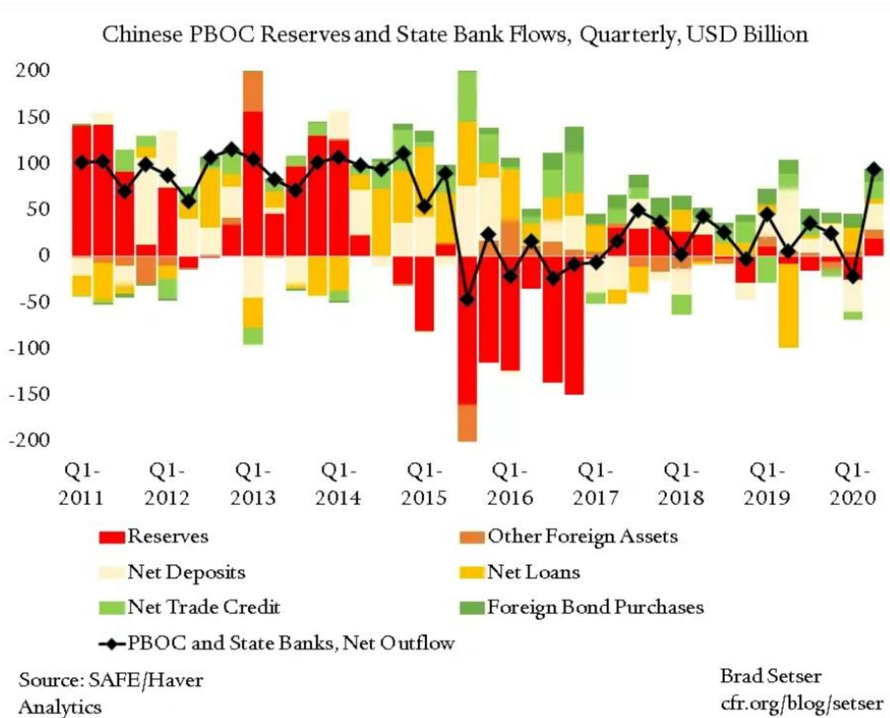
Sources: https://fortune.com/2021/12/02/chinese-real-estate-investing-home-ownership-evergrande/ and https://geopoliticalfutures.com/real-estate-is-chinas-biggest-economic-vulnerability/

Chart 17: Official reserves of the People's Bank of China, % of GDP – a worrying fall



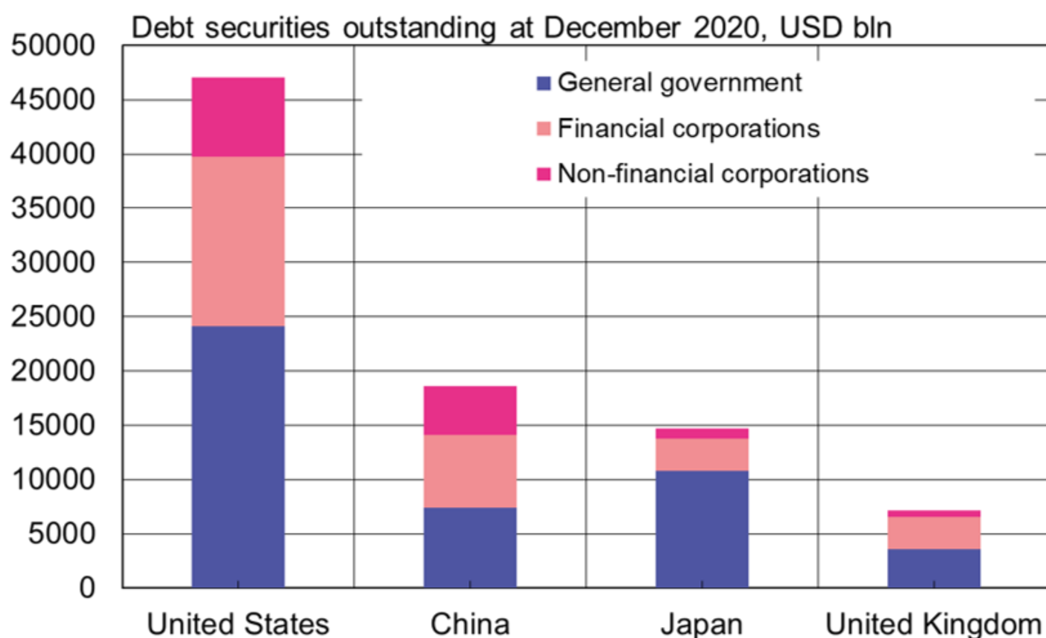
Source: https://www.ceicdata.com/en/indicator/china/foreign-exchange-reserves--of-gdp

Chart 18: Chasing shadows in China's balance of payments data



Source: https://www.cfr.org/blog/chasing-shadows-chinas-balance-payments-data

Chart 19: China's bond markets are larger than Japan's, but less internationalised



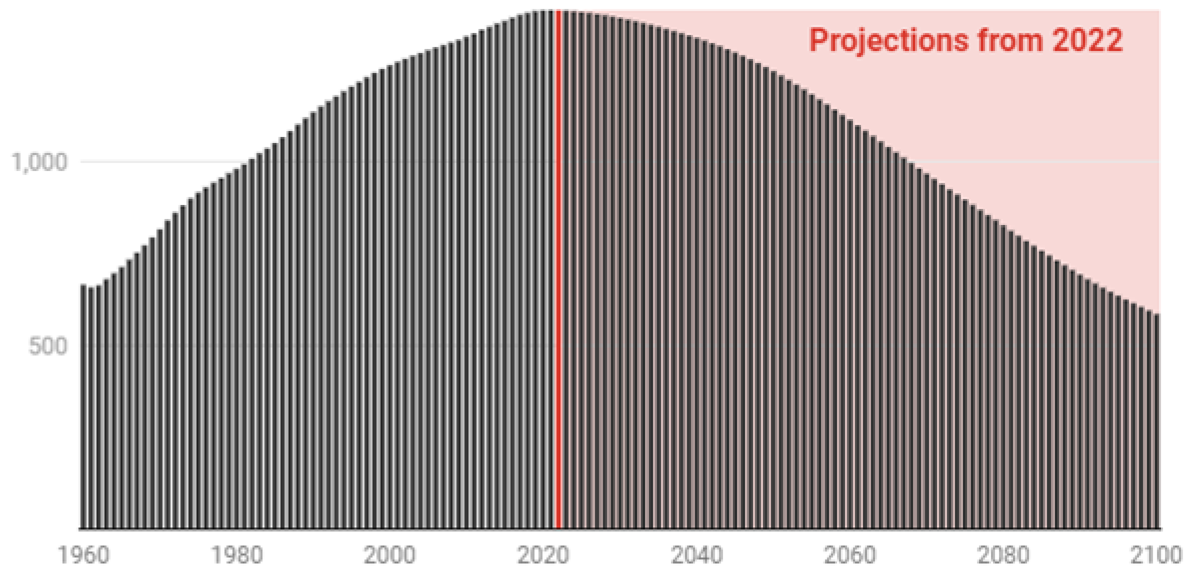
Source: https://www.bofit.fi/en/monitoring/weekly/2021/vw202130_2/

Chart 20: Foreign investment in Chinese tradeable debts is rising, but remains very marginal. The market is dominated by Chinese institutional investors.

Source: https://www.ft.com/content/7e2d1cae-8033-45b1-811c-bc7d4a413e33

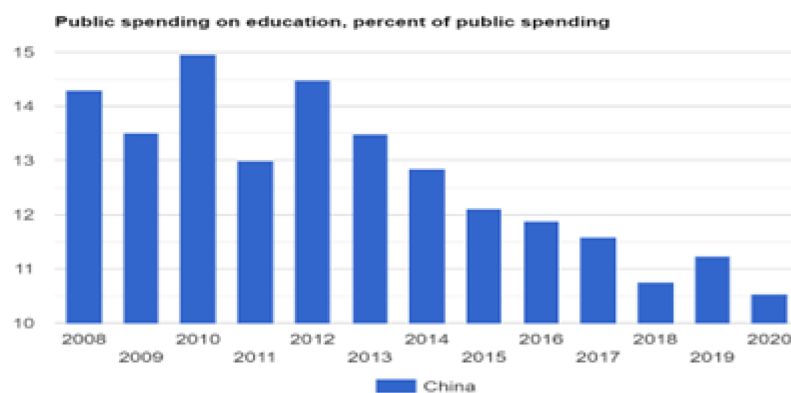
CHAPTER III: ENSURING THE ECONOMIC MODEL IS SUSTAINABLE

Chart 21: The Chinese population could shrink as quickly as it grew between 1960 and 2020



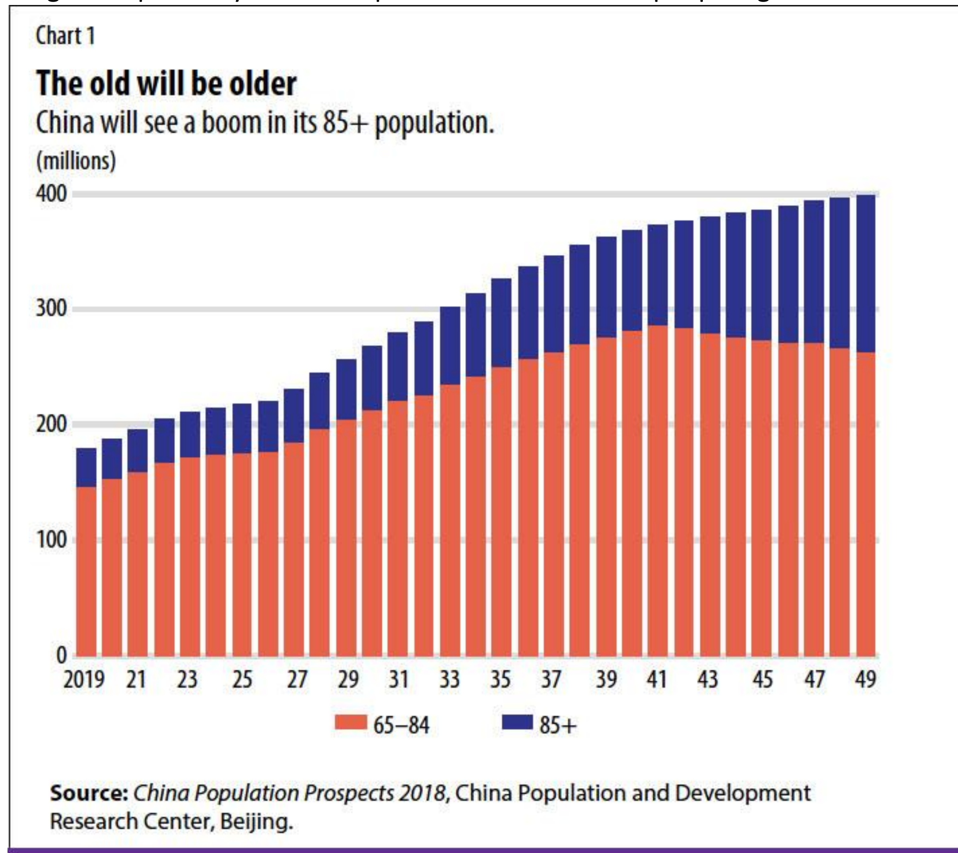
Source: *https://www.weforum.org/agenda/2022/07/china-population-shrink-60-years-world/*

Chart 22: The proportion of public spending allocated to education is on a downward trend; it does not appear to be a priority



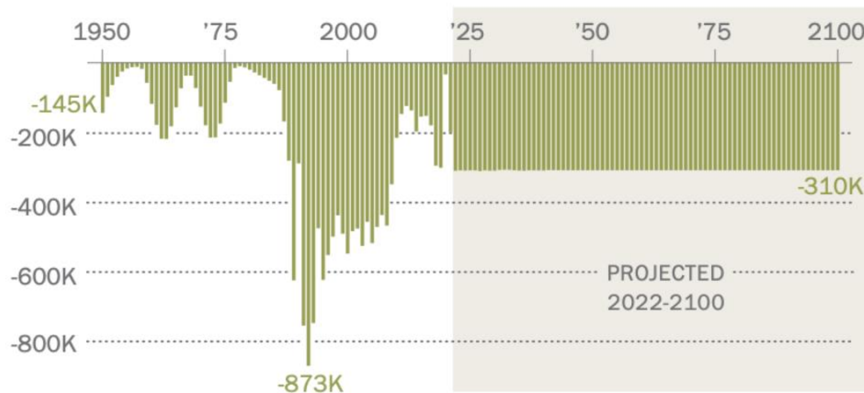
Source: *https://www.theglobaleconomy.com/compare-countries/*

Chart 23: The number of retired people is expected to continue to increase for several decades due to lengthening life expectancy and a sharp rise in the number of people aged over 85 from 2040



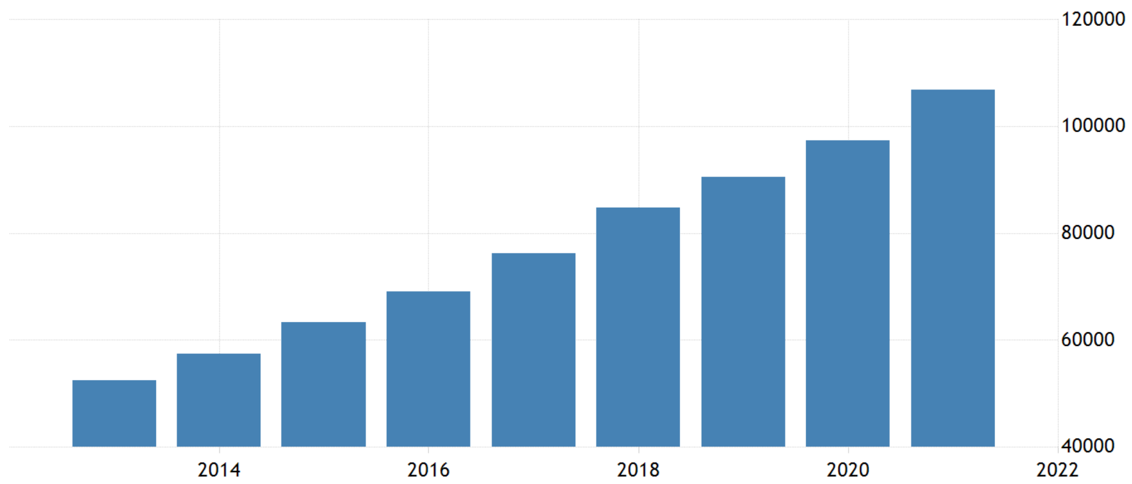
Source: *https://www.imf.org/external/pubs/ft/fandd/2021/06/the-future-of-china-dollar-huang-yao.htm*

Chart 24: Emigration accentuates China's demographic woes – this is in contrast to other countries such as Germany where weak population growth is compensated by high immigration



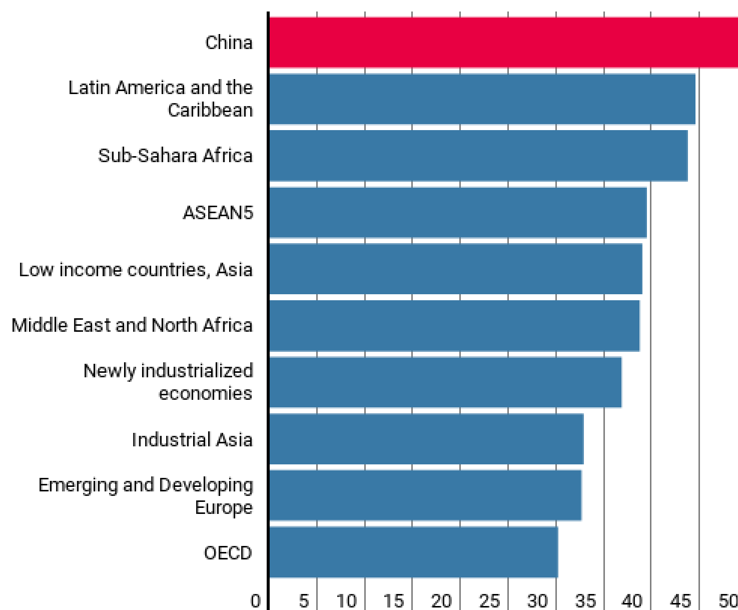
Source: *https://www.pewresearch.org/short-reads/2022/12/05/key-facts-about-chinas-declining-population/ft_2022-12-5_china-population_05/*

Chart 25: "Average wages" are rising very rapidly in China, although the term means little



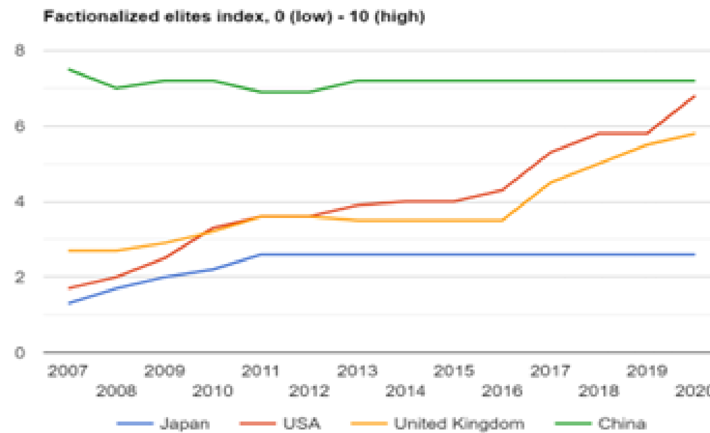
Source: https://tradingeconomics.com/china/wages

Chart 26: According to the Gini Index, the generally accepted measure of inequality, China is one of the world's most unequal countries

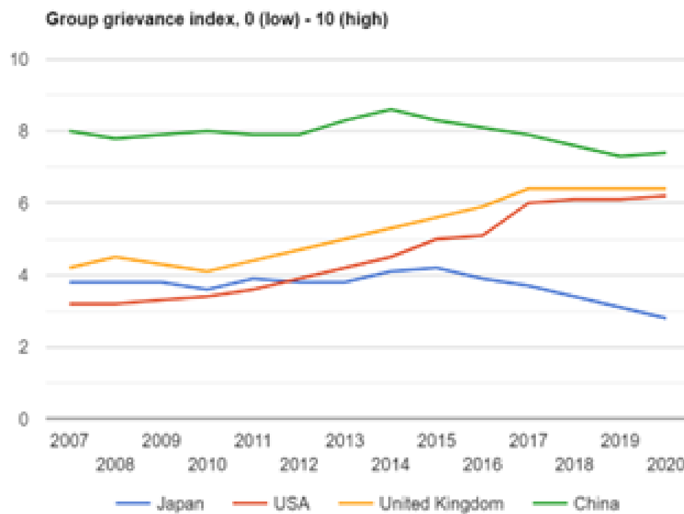


Source: Standardized World Income Inequality Database (SWIID) Version 5.1; and IMF staff calculations/
Note: The Gini Index is calculated using income after taxes and transfers.
ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.
OECD = Organisation for Economic Cooperation and Development.
Source: https://www.imf.org/en/Blogs/Articles/2018/09/20/chart-of-the-week-inequality-in-china

Chart 27: The indicator shows factionalized elites and a division of groups in society



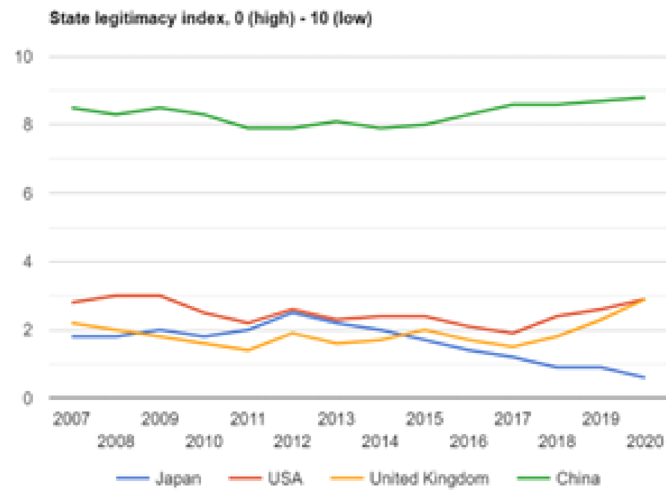
The Factionalized Elites indicator considers the fragmentation of state institutions along ethnic, class, clan, racial or religious lines, as well as brinksmanship and gridlock between ruling elites. The higher the value, the more fragmented the country's institutions. It can be seen that US society and the country's political class is becoming dangerously polarised, drawing closer to the Chinese situation.



The Group Grievance Indicator focuses on divisions and schisms between different groups in society – particularly divisions based on social or political characteristics – and their role in access to services or resources, and inclusion in the political process. The higher the value of the indicator, the deeper the divisions between groups in society in the country.

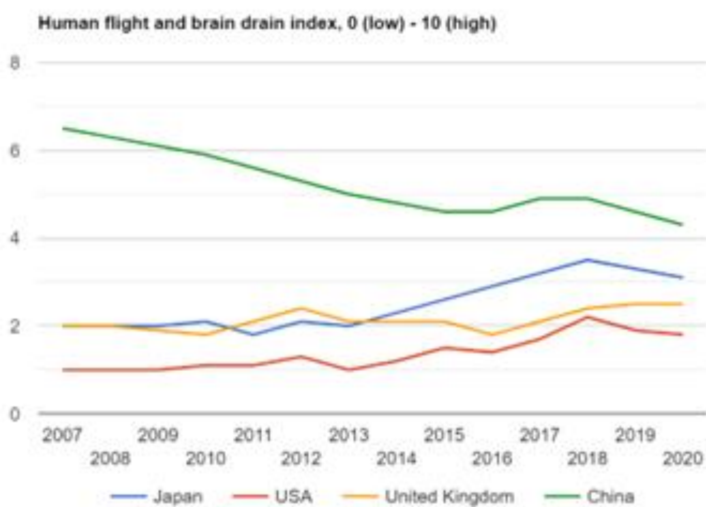
Source: https://www.theglobaleconomy.com/

Chart 28: Deterioration in the State Legitimacy Indicator coupled with a brain drain



Measure: index points
Source: Fund for Peace

The State Legitimacy Indicator considers the representativeness and openness of government and its relationship with its citizenry. The indicator looks at the population's level of confidence in state institutions and processes, and assesses the effects where that confidence is absent, manifested through mass public demonstrations, sustained civil disobedience, or the rise of armed insurgencies. The higher the index, the lower state legitimacy in the country.

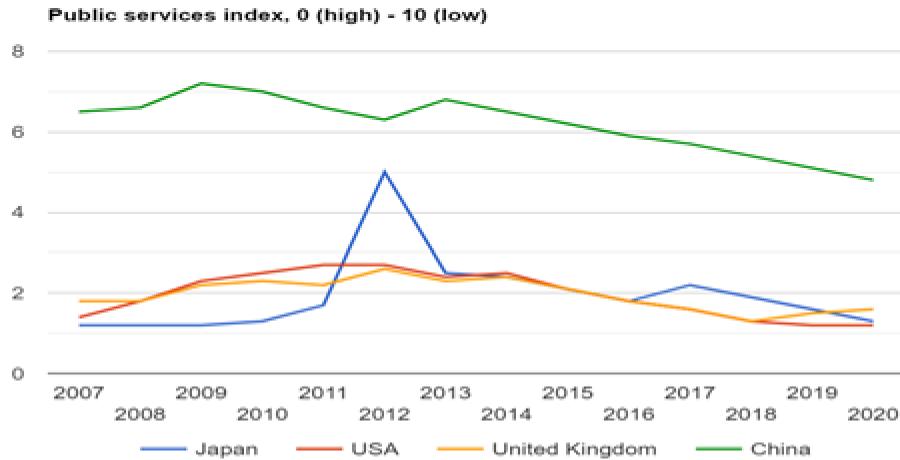


Measure: index points
Source: Fund for Peace

The Human Flight and Brain Drain Indicator considers the economic impact of human displacement (for economic or political reasons) and the consequences this may have on a country's development. The higher the index, the greater the human displacement.

Source: [*https://www.theglobaleconomy.com/*](https://www.theglobaleconomy.com/)

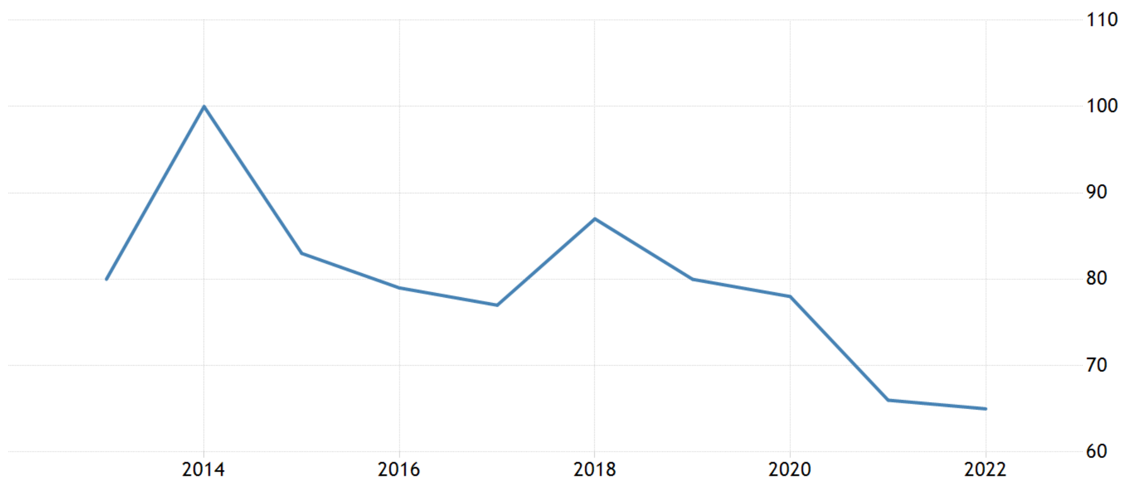
Chart 29: Public services remain insufficient



The Public Services Indicator refers to the presence of basic state functions that serve the people. This may include the provision of essential services, such as health, education, water and sanitation, transport infrastructure, electricity and power, and internet and connectivity. Despite a gradual improvement, the overall level of public services remains insufficient compared to standards in developed countries.

Source: [*https://www.theglobaleconomy.com/*](https://www.theglobaleconomy.com/)

Chart 30: China was ranked 65th out of 180 countries as regards corruption in 2022, according to Transparency International

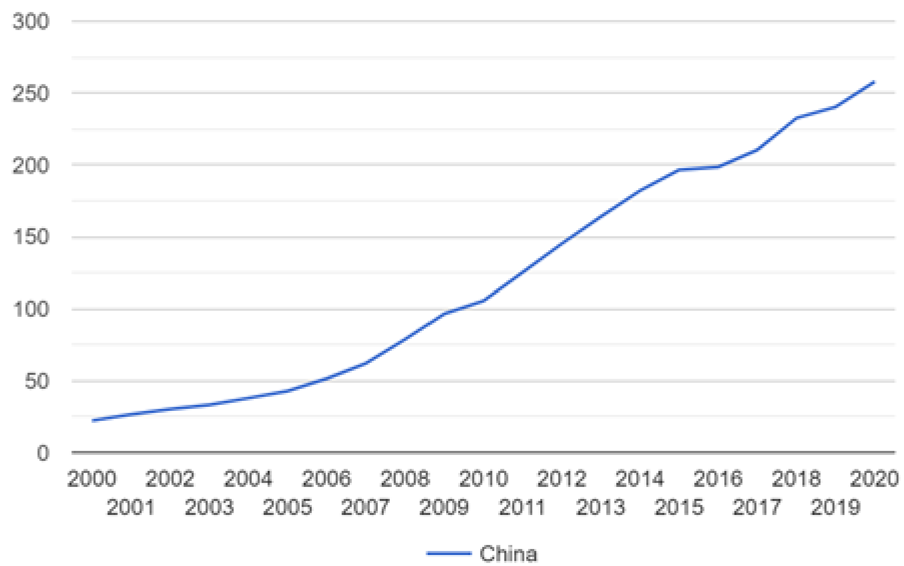


China's corruption perceptions index was 55 points in 2022. The scale stretches from 0 to 100. The higher the score, the more corrupt the country's public sector is perceived to be. China lies in 65th place (with a below-average score, despite a moderate improvement over the last decade).

Source: [*https://tradingeconomics.com/china/corruption-rank*](https://tradingeconomics.com/china/corruption-rank)

Chart 31: Significant increase in Chinese military spending

Military spending, in billion U.S. dollars



Measure: billion U.S. dollars
Source: Stockholm International Peace Research Institute

Source: https://www.theglobaleconomy.com/

All our publications can be found at publika.skema.edu
Contact: publika@skema.edu

skema THINK TANK | PUBLIKA