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China's Disappointing Economic Figures and the Crisis of Confidence

EXPLAINER - SEPTEMBER 2023

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He recently authored the following Institut Montaigne's policy papers: *Cross-border Data Flows: the Choices for Europe* (April 2023, with Viviana Zhu), *China's Change of Economic Model: Not So Fast!* (June 2022), *Rebooting Europe's China Strategy* (May 2022), *Xi Jinping as an Ordoliberal: China's Margins for Growth in 2022* (February 2022) and *China's Economic Rebound: Views from Beijing* (June 2021).

The summer of 2023 saw the consensus on the Chinese economy turn on its head. A long economic boom that had seemed to defy the ups and downs of the international economic climate. Spared from inflation, China was continuing to conquer foreign markets, while it was also expected to transform itself into a consumer and service economy. Today, these clichés have been replaced by an accumulation of bad news, amplified by commentaries. Some of these bad news are actually the continuation of much older trends. But this is how market sentiment is formed, and sometimes reversed. In reality, of the three engines of Chinese growth (domestic consumption, including real estate, industrial and infrastructure investment, exports), only the export component has been driving growth since 2020.

At the forefront of this news is therefore the slowdown in exports since May 2023. Adding to this is a technical price deflation due to food and energy price trends, sluggish household demand and worsening youth unemployment. The real estate crisis persists since 2021, with a sharp drop of investment and lending in this sector, and the ensuing budgetary and financial risks for local governments, "shadow finance" and also Hong Kong and foreign buyers of Chinese bonds: the latter reducing their commitments.

Suddenly, all of this seems to form a coherent whole. There is also **growing skepticism about China's official announcements**. This skepticism is all the more worrying as it is being expressed within the country itself, with doubts about the veracity of GDP and investment statistics, especially at the provincial level. Moreover, the measures taken by the authorities to control and censor data in areas as diverse as youth unemployment and the energy sector are fueling this sentiment. They have the opposite effect to their original intent , which was to maintain a positive climate for the economy.

This skepticism is not only expressed by foreign observers, but even more significantly by Chinese investors and consumers. This is evidenced, for example, by economist and sociologist Sun Liping, who mentions the need for structural changes to resolve a supply glut unmatched by insufficient demand. He also argues the need for a "friendly international environment" (一种友好的国际环境).[1] Others speak of a balance sheet recession: debt and deflation nurture a wait-and-see spiral.

Faced with this self-perpetuating climate, the government is rolling out support measures and reassuring declarations, notably aimed at Chinese and foreign companies. But these are a series of mini-measures that do not detract the Party-state from its overall focus on economic security. National security encompasses the protection of industrially important supply chains, as set out in the 20th Congress report. In addition, there are the ideological and geopolitical tensions bearing Xi Jinping's personal stamp.[2] **Two simultaneous but contradictory policies, embodied by Xi's clansmen and technocrats who are sometimes called back into business but have no political influence, create a credibility deficit.** After the failure of the economic rebound hoped for at the beginning of 2023 when the Covid-19 lockdown was suddenly lifted, there has been no positive feedback to the multiple announcements of economic support made by the authorities since the end of June. The economic outlook is now clouded by a crisis of confidence.

[1] *Sun Liping, "Surplus, that's the real problem we're facing now (过剩, 4这才是我们现在面对的真正问题) », Xueqiu, July 21, 2023, https://xueqiu.com/9976451060/256237312*

[2] *Xi Jinping, "Hold High the Great Banner of Socialism with Chinese Characteristics and Strive in Unity to Build a Modern Socialist Country in All Respects—Report to the 20th National Congress of the Communist Party of China (高举中国特色社会主义伟大旗帜 为全面建设社会主义现代化国家而团结奋斗——在中国共产党第二十次全国代表大会上的报告)", The State Council of the People's Republic of China, October 25, 2022, https://www.gov.cn/xinwen/2022-10/25/content_5721685.htm*

The nature of the current crisis needs to be recognized: it is a balance sheet recession. This was already a credible hypothesis in 2022, as per a June 2022 Institut Montaigne policy paper,[3] and Chinese economists saw its implications: the first being that **it is not so much the amount of public or private liabilities as the expectations of economic agents that lead them to save and reduce debt rather than to consume or invest.[4]**

Does this mean that the situation is hopeless, leading to a crash? By inflating private savings – those of individuals and companies alike – the balance sheet recession also provides a cushion for public authorities to take vigorous action and reverse market expectations. Monetization, the process by which a portion of indebtedness is written off through money creation, is a path open to China, because this indebtedness remains largely domestic, not international.

[3] *François Godement, "China's change of economic model: not so fast!", Institut Montaigne, June 2022, https://www.institutmontaigne.org/publications/economie-chinoise-la-voie-de-xi-jinping*

[4] *Zhu He, "Four common misunderstandings of 'balance sheet recession'", China Finance 40 Forum, June 17, 2022, http://www.cf40.com/en/news_detail/12645.html*

1 Economic policies and growth models: should we really be surprised?

Many elements of the current crisis had been underlying trends for several years. The Chinese economy was changing its main growth engine, but not in the direction anticipated by international analysts: that of an evolution towards an economy based on domestic consumption, services and increased imports enabled by household wealth. Since the end of 2018 – i.e. before Covid-19 – China's economic fundamentals have followed a different path, one that closely links geopolitics and geoeconomics.

From the beginning of 2019 to the spring of 2023, exports and the trade surplus never stopped growing, beating their absolute records of the early 2010s. This trend pre-existed Covid-19 and has outlived it. Export figures since May 2023 are the first to break this trend. The value of China's trade surplus represents almost 5% of the country's GDP, up to 10% for manufactured goods alone, and 2% of global GDP.

[5] *"Trade in Value Added (TiVA) Principal Indicators: 2022 preliminary version (temporary)", OECD, september 2023, https://stats.oecd.org/Index.aspx?DataSetCode=TIVA_2022_C1*

China's trade surplus
and its share of Chinese GDP
(First half of 2019 - first half of 2023)

Source: Statistics published on the website of the National Bureau of Statistics of China.

From 2008 to 2018, the OECD had recorded a decline in the share of external demand for manufactured products compared to domestic demand.[5] Since 2019, however, we have seen the opposite trend: external demand for manufactured goods has risen to over 45% of value added.[6] The competitiveness of "Made in China" is intact, and has even been strengthened by the fall in shipping costs. However, international demand cannot absorb such growth indefinitely. For example, the EU's trade deficit with China reached almost 396 billion euros in 2022.[7] The European recession of 2023, adding to the US customs surcharges since Trump, whose impact is real for the products concerned (and only for them), are beginning to have an effect on Chinese exports. Year-on-year, exports fell by 12.4% in June,[8] 14.5% in July[9] and 8.8% in August.[10]

Different reasons for this can be cited, and also added together: a **slowdown in developed economies**, notably in Germany and Europe, with the United States being the only exception, yet having redirected part of its imports towards other countries (Vietnam, Malaysia); **US restrictions on certain high-tech exports** (semiconductors being China's top import item), which are having an impact on exports of finished products; as well as **reduced confidence on the part of foreign investors**. They had always provided a significant share of China's exports and are now redirecting some of their investments towards South-East Asia. Foreigners are also selling off some of their portfolio investments in Chinese companies, while continuing direct investments.[11]

The export gap needs to be put in perspective. The peak observed in the summer of 2022 only brings down exports to the level of 2021.[12] This is still 25% above 2019, the last year before Covid-19. The demand from the domestic market does not currently make up for this recent shortfall in export growth. The sluggishness of the domestic economy is persistently reflected in a simultaneous withdrawal of imports. The trade surplus, which exceeded $1,000 billion for the year 2022 (€940 billion at the December 2022 average rate), is still of $81 billion in July 2023 (€73.5 billion at the July 2023 average rate),[13] i.e. the month when commentary focused on the year-on-year decline in exports.

Self-sufficiency policies and decoupling, also referred to as "dual circulation" (双循环) desired by the authorities in many sectors, have not led to stronger domestic growth. Various factors can be blamed: the depression caused by Covid-19 and extreme lockdowns; a real estate and credit crisis that is much more than a sectoral phenomenon, as it undermines consumer and borrower confidence;[14] government delivered blows to the private sector and society, especially the digital economy; an abysmal political climate where the term "struggle" (斗争) and preparation for serious international events keep recurring. As evidenced by

[5] *"Trade in Value Added (TiVA) Principal Indicators: 2022 preliminary version (temporary)", OECD, september 2023, https://stats.oecd.org/Index.aspx?DataSetCode=TIVA_2022_C1*

[6] *Andrew Batson, "Breaking down China's manufacturing", The Tangled Woof, June 13, 2023, https://andrewbatson.com/2023/06/13/breaking-down-chinas-manufacturing/*

[7] *"China-EU – international trade in goods statistics", Eurostat, February 2023, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU_-_international_trade_in_goods_statistics*

[8] *"Total value of imported and exported merchandise by mode of trade, June 2023 (USD)", General Administration of Customs of the PRC, July 13, 2023, http://www.customs.gov.cn/customs/302249/zfxxgk/2799825/302274/302275/5150382/index.html*

[9] *"China's import and export grew 0.4% in the first seven months of this year", General Administration of Customs of the PRC, August 8, 2023, http://www.customs.gov.cn/customs/xwfb34/302425/5192192/index.html*

[10] *"Total value of imported and exported merchandise by mode of trade, August 2023 (USD)", General Administration of Customs of the PRC, September 7, 2023, http://www.customs.gov.cn/customs/302249/zfxxgk/2799825/302274/302275/5334378/index.html*

[11] *Hudson Lockett, "Foreign investors sell China shares at record pace in August", Financial Times, August 31, 2023, https://www.ft.com/content/8a6d78e1-fa95-4e7c-aade-47b33f658468*

[12] *"Table of total value of imported and exported goods (RMB value)", General Administration of Customs of the PRC, August 18, 2023, http://www.customs.gov.cn/customs/302249/zfxxgk/2799825/302274/302277/302276/5247323/index.html*

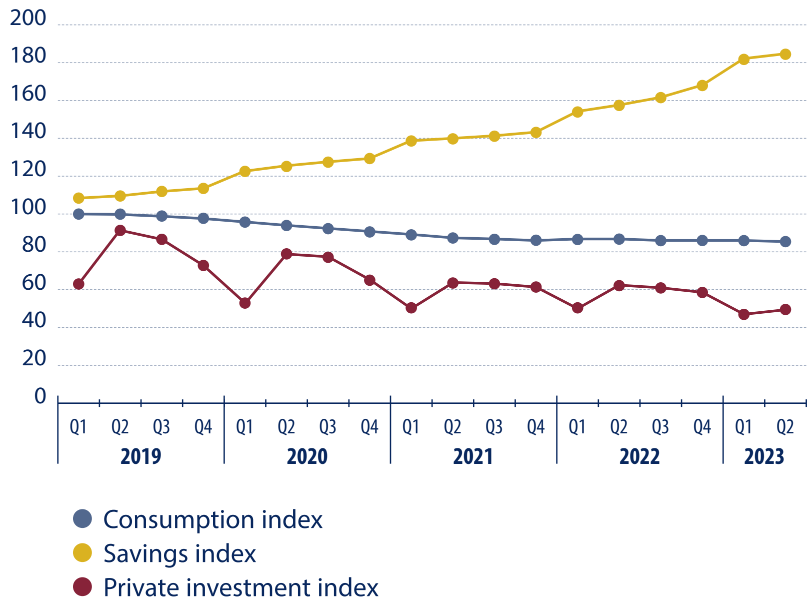
[13] *"China's import and export grew 0.4% in the first seven months of this year", General Administration of Customs of the PRC, August 8, 2023, http://www.customs.gov.cn/customs/xwfb34/302425/5192192/index.html*

[14] *Philippe Aguignier and François Godement, "Evergrande: what are the risks of economic contagion? (Evergrande : quels risques de contagion économique ?)", Institut Montaigne, October 12, 2021, https://www.institutmontaigne.org/expressions/ evergrande-quels-risques-de-contagion-economique*

the record figures for individual and corporate savings, the **consumption and investment rebound of 2023 has not taken place yet**, even though the money is there.

Change in household savings, consumption of durable goods and private investment in Chinese GDP

(Q1 2019 - Q2 2023)



Note: to measure savings, consumption and private investment, the indicators are respectively the amount of personal deposits (个人存款), the year-on-year variations in consumer durables (耐用消费), and the share of fixed assets investments (固定资产投资)) in China's GDP. The first quarter of 2019 is equivalent to 100%.

Source: Author's calculations based on statistics published on the websites of the National Bureau of Statistics of China and the People's Bank of China.

Public debate on the overall economic line virtually fell silent after the 20th Chinese Communist Party Congress in October 2022 and the departure of certain leaders deemed technocratic and more in tune with global economic trends. This predates the authorities' recent injunction for economists to adopt a "positive orientation", and the scarcity of statistics,[15] the latest cases of which concern youth unemployment (21.3% in June)[16] and the energy sector. Whatever remains of public debate has been confined to timid advice on supporting consumption or easing monetary policy. Responsibility for the economy fell to Vice Premier He Lifeng, a close associate of Xi Jinping with no international experience. In a way, the appointment of Pan Gongsheng in July as head of the People's Bank of China (PBoC) is a corrective signal – but the position has never had any major political authority. Strikingly, when the government takes corrective initiatives in favor of private enterprise, as it has just done again recently, it does so **by surprise, without any prior public debate and in the form of directives addressed to officials**, at best through short interviews with private sector representatives. Hence the problem of political credibility.

[15] *Sun Yu, "Chinese economists told not to be negative as rebound falters", Financial Times, August 6, 2023, https://www.ft.com/content/b2e0ad77-3521-4da9-8120-1f0c1fdd98f8*

[16] *"The national economy recovered in the first half of the year (上半年国民经济恢复向好)", National Bureau of Statistics of China, July 17, 2023, http://www.stats.gov.cn/sj/zxfb/202307/t20230715_1941271.html*

2 No "whatever it takes" for China: an orthodox, centralizing, security-oriented course

The so-called economic breakdown in China is not really a breakdown. Growth is holding at a low ebb, even though the property crisis, with its financial ramifications, has not yet run its course. Exports are falling at an unprecedented rate, but while imports are no longer growing, **the machine for generating surpluses is still working, allowing many irrationalities in the domestic financial system**. Insofar as they are reliable, the PMI index and consumer figures point to a slight recovery in August. Debt levels are worrying – but some Western economies are doing worse. Looking further ahead, the collapse of the birth rate without an effective savings management system in place is more serious, as is the imbalance in local finances. For the time being, however, China is experiencing neither the inflation nor the labor shortages that affect developed economies. The fall in the birth rate, even faster than in the rest of East Asia, is certainly a symptom of a loss of confidence in the future. But its consequences are not immediate, except for an ever-increasing propensity to save. Youth unemployment is also higher in India than in China, and comparable to Spain or Italy. Of course, the veracity of the Chinese figures is open to doubt, especially in rural areas.

In the face of both the Covid-19 crisis and the real estate crisis, Xi Jinping has essentially maintained an orthodox monetary and credit policy. This is the opposite of what has come to be termed a "whatever it takes" policy. There are many reasons for this: the financial orthodoxy of a regime well aware of spiraling debt, especially local debt; Xi's absolute (and ideological) rejection of a welfare state that would involve European-style income transfers and the fear of a form of decadence (including the concept of tangping – literally "lying flat", but in reality a right to laziness);[17] finally, fear of financial vulnerability to sanctions and international conflict. Support measures are being taken belatedly, in drip mode, and without calling into question what the hallmark of the Xi Jinping era is: the priority given to "security" over growth, and the centralization of decisions and resources by a "national team" charged with carrying out major projects.[18] In particular, security, as conceived by Xi, is far more extensive than just national defense and related industries: it is the political security of the regime, including its ideology, the avoidance of economic and geopolitical risks, including by making China's partners more dependent, while China becomes self-sufficient as quickly as possible in all fields. This goes far beyond the "derisking" strategies on supply chains and critical materials of the EU and US.

The crisis is therefore more insidious, as it is based on a loss of confidence from many players. The *fait du prince* and the overhanging sword held by the Party-state are nothing new. But Xi Jinping has systematized and almost codified them, extending the stranglehold of Party organs across the entire economy, whereas the CCP used to monitor society rather than entrepreneurs. Adding to this political evolution is a geopolitical turning point but a posture that is not quite decoupling. The regime's aim is to increase the dependence of its partners. What was seen as a choice of export niches has become a strategy of domination that is not just economic. In this sense, **Xi Jinping is abandoning the "get rich" strategy that was so popular under Deng Xiaoping, the acceptance of interdependence of the Jiang Zemin era, and the goal of a "moderately prosperous society" in vogue under Hu Jintao**. Chinese and foreign economic players alike can see this. In Xi Jinping's vision, private actors can be encouraged, rewarded, then punished and robbed, when it serves other purposes.

[17] *Xi Jinping, "Firmly promote common prosperity (扎实推动共同富裕) », Qiushi, October 15, 2021,* http://www.qstheory.cn/dukan/qs/2021-10/15/c_1127959365.htm

[18] *Barry Naughton, Siwen Xiao and Yaosheng Xu, "The Trajectory of China's Industrial Policies", UC Institute on Global Conflict and Cooperation, June 2023,* https://ucigcc.org/wp-content/uploads/2023/06/Naugton-et-al-working-paper-1-jun-2023.pdf

Modernization based on innovation is a goal, but should remain under CCP control and benefit the state economy. As long as the Party-state controls the mechanisms of savings and accumulation, and therefore the levers of investment, it also has the levers that serve its priorities – the world's second-largest military budget, an internal security budget of at least the same size, major technological and innovation projects, foreign influence policies. Under its current leadership, it is futile to expect China to return to the era of market reforms, as it would undermine the power of the CCP. It is in Xi Jinping's experience, on the other hand, to use incentives directed at specific objectives and players, according to the priorities or needs of the moment.

This is the era of reform that Xi Jinping buried when he backtracked to a centralized economy. He has supported state-owned enterprises (SOE), directly or indirectly, via a slow loosening of credit of which they are the primary beneficiaries, and defended the traditional financing of new infrastructure in a country already overflowing with it. He has so far resisted the transfer of debt linked to real estate over-investment – and to the resulting local government crisis – to the central budget.

3 Inconsistencies in statistical and accounting data

The priority given to national security and stability over growth is accompanied by a growing opacity in statistics and economic information.[19] The quantity and quality of accessible sources have become much more limited, while certain sectors – unemployment, energy production – are subject to global censorship. This does not contribute to giving credibility to official announcements. This can also be seen in the growing enigma of foreign currency reserves, which no longer correlate with the balance of payments.

The two phenomena, statistical obfuscation and the puzzling capital account, are quite distinct. At the beginning of 2023, following the unexpected lifting of anti-Covid measures, economic analysts were forecasting a strong rebound in domestic consumption, driven by the catch-up effect of de-lockdown and accumulated savings. Few observers noted that **the new Premier Li Qiang had described the 5% growth target as a "hard-to-achieve" course** (并不轻松, 需要倍加努力)[20]. Month-on-month, growth continued to weaken. Despite a slight surge in Q2, sequential quarterly growth in 2022 and 2023 continues to disappoint: 3.2% in Q3 2022, 0.5% in Q4 2022, 2.2% in Q1 2023, 0.8% in Q2 2023.[21]

[19] *Lingling Wei, Yoko Kubota and Dan Strumpf, "China Locks Information on the Country Inside a Black Box", The Wall Street Journal, April 30, 2023, https://www.wsj.com/world/china/china-locks-information-on-the-country-inside-a-black-box-9c039928*

[20] *"Premier Li Qiang attends a press conference and answers questions from Chinese and foreign journalists (李强总理出席记者会并回答中外记者提问)", Ministry of Foreign Affairs of the PRC, March 13, 2023, https://www.fmprc.gov.cn/web/zyxw/202303/t20230313_11040059.shtml*

[21] *"Preliminary GDP results for the second quarter and first half of the year 2023 (2023年二季度和上半年国内生产总值初步核算结果)", National Bureau of Statistics of China, July 18, 2023, http://www.stats.gov.cn/sj/zxfb/202307/t20230717_1941310.html*

What's more, **doubts persist about the reliability – although not extending to large-scale falsification – of the growth figures** published by Chinese officials. The doubts stem from an overestimation of production data by local governments or from "seasonal adjustments" to statistics.[22] This practice tends to persist, but Beijing is seeking to tackle it.[23] Fernald, Hsu and Spiegel, three economists at the FED in San Francisco, seem to agree, however, that annual growth rate data have become reasonably reliable, unlike quarterly growth rate data.[24]

Nominal GDP, which does not take into account price changes (an opaque deflator is applied to the real GDP, in this case by the Bureau of Statistics), is increasingly favored, although it is no less immune to statistical manipulation. Other signs point to China's growth falling short of its potential. Both the official consumer price index[25] and the official producer price index,[26] which have fallen in recent months, reveal a gap – a gap confirmed by the unofficial indices of the Caixin business newspaper.[27] Another possibility for identifying inconsistencies is to look at Chinese imports, which are immune to any Chinese modifications and tend to be correlated with variations in GDP. However, this approach does not eliminate certain anomalies in the trade balance.

[22] *Thomas Hale, "China's data 'black box' puzzles economists", Financial Times, July 23, 2023, https://www.ft.com/content/f1ce1c09-b4fc-42cf-bc68-fb7d969cbbe0*

[23] *Chen Siwei, "Many places to carry out special control action on statistical fraud. Self-examination and self-correction ends in May (多地开展统计造假专项治理行动 自查自纠5月结束)", Caixin, May 25, 2023, https://economy.caixin.com/2023-05-25/102058873.html*

[24] *John G. Fernald, Eric Hsu and Mark M. Spiegel, "Is China fudging its GDP figures? Evidence from trading partner data", Journal of International Money and Finance, Vol.110, 2021, https://ideas.repec.org/a/eee/jimfin/v110y2021ics0261560620302187.html*

[25] *"Consumer prices fell 0.3% year-on-year in July 2023 and rose 0.2% from a year earlier (2023年7月份居民消费价格同比下降0.3% 环比上涨0.2%)", National Bureau of Statistics of China, August 9, 2023, http://www.stats.gov.cn/sj/zxfb/202308/t20230809_1941863.html*

[26] *"Industrial producer factory prices fell 4.4% year-on-year in July 2023, down 0.2% from a year earlier (2023年7月份工业生产者出厂价格同比下降4.4% 环比下降0.2%)", National Bureau of Statistics of China, August 9, 2023, http://www.stats.gov.cn/sj/zxfb/202308/t20230809_1941864.html*

[27] *Fan Qianchan, "March Caixin China Manufacturing PMI registers 50.0, down 1.6 percentage points (3月财新中国制造业PMI录得50.0 回落1.6个百分点)", Caixin, April 3, 2023, https://pmi.caixin.com/2023-04-03/102015076.html*

The trade surplus figures differ whether referring to the customs numbers or to the balance of payments numbers. The actual amount of foreign currency reserves deserves our attention. Until the end of 2020, the trade surplus reported by customs did not diverge from that of the balance of payments, if not with a slightly higher figure for the balance of payments. **Since the end of 2020, the opposite has been true, and in increasing proportions:** the differential reached \$300 billion (€277 billion) in June 2023. In part, this is due to the decision not to include in the balance of payments exports from special economic zones, and more generally intra-firm trade without capital movements.[28] But even with this explanation, the extent of the divergence remains a mystery.

These accounting choices lead to a significant reduction in the apparent current account surplus. And this reduction partly explains why the amount of foreign currency reserves is largely underestimated in the PBoC's figures. The other explanation lies in the actions of China's sovereign wealth funds and state-owned banks, which purchase foreign assets on the behalf of the state. **China is thus the leading purchaser of US public bonds (other than T-bonds or Treasury Bonds)**, which are not included in the PBoC's assets. The process is not new, but has taken on a new dimension.[29]

[28] *Guan Tao and Liu Lipin, "Are trillions of dollars really 'missing'? (万亿美元真的"不翼而飞"了吗?)", Economists 50 Forum, February 27, 2023, http://www.50forum.org.cn/home/article/detail/id/10213.html*

[29] *Brad Setser, "How to hide your foreign exchange reserves—A user's guide", Council on Foreign Relations, July 29, 2023, https://www.cfr.org/blog/how-hide-your-foreign-exchange-reserves-users-guide*

Through its various state-owned players, China therefore holds around $6,000 billion (€5,428 billion at the July 2023 average rate) in international assets – around $5,000 billion (€4,523 billion) in net position after deduction of Chinese assets held by foreign players.[30] This is a far cry from the $3,193 billion (€2,889 billion at the July 2023 average rate) reported in official figures.[31] A recent IMF study even estimates the value of net assets held by the Chinese state at $12,500 billion (€11,375 billion at the August 2023 average rate), putting China in first place worldwide.[32]

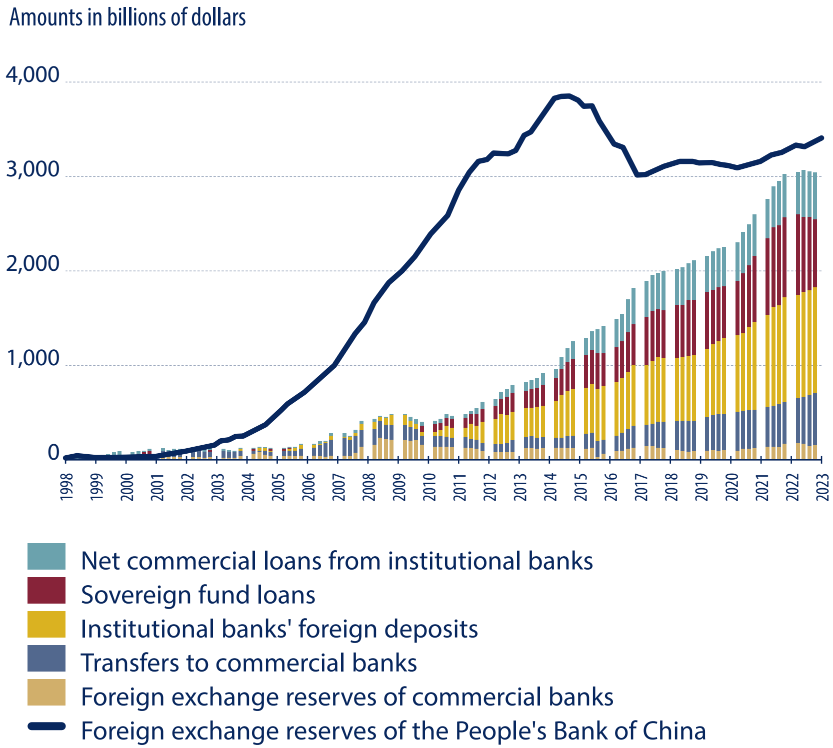
[30] *Brad Setser, "Shadow reserves – How China hides trillions of dollars of hard currency", The China Project, June 29, 2023, https://thechinaproject.com/2023/06/29/shadow-reserves-how-china-hides-trillions-of-dollars-of-hard-currency/*

[31] *"Official reserve assets (官方储备资产)", People's Bank of China, July 2023, http://www.pbc.gov.cn/diaochatongjisi/resource/cms/2023/08/2023080809410839881.pdf*

[32] *Waikei R. Lam and Marialuz Moreno Badia, "Fiscal policy and the government balance sheet in China", International Monetary Fund, August 4, 2023, https://www.imf.org/en/Publications/WP/Issues/2023/08/02/Fiscal-Policy-and-the-Government-Balance-Sheet-in-China-536273*

Official reserves of the People's Bank of China and unofficial reserves of Chinese financial entities

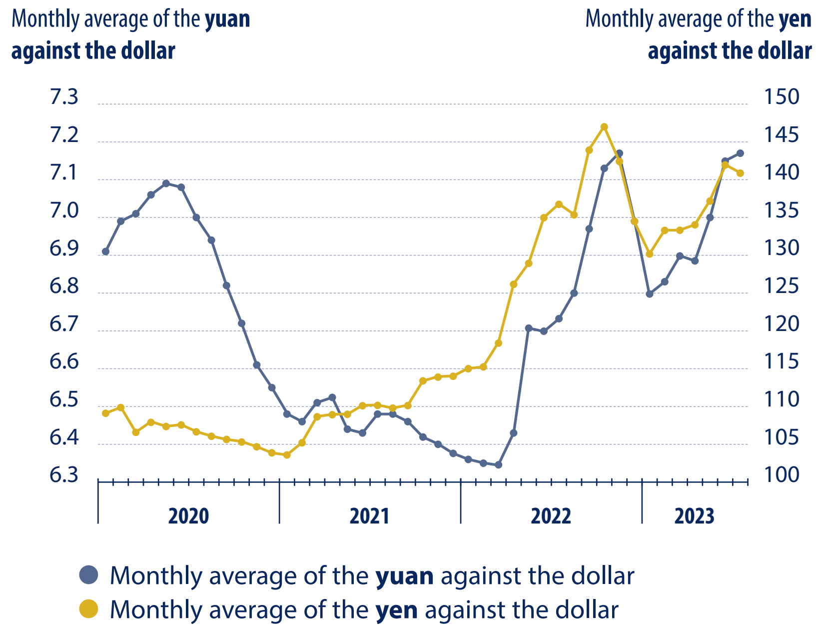
(1998 - 2023)



Source: Brad Setser, "Shadow Reserves – How China Hides Trillions of Dollars of Hard Currency", The China Project, June 29, 2023, https://thechinaproject.com/2023/06/29/shadow-reserves-how-china-hides-trillions-of-dollars-of-hard-currency/

Even if, since 2007, local indebtedness and losses incurred by SOEs have brought this figure down as a percentage of GDP, **China still has considerable scope for intervention, both domestically and internationally**. These figures suggest a strong capacity for indirect intervention beyond the PBoC's actions on the money markets. Following the yuan's sharp fall against the dollar in 2020-2021 – i.e. at the height of the trade surplus boom – this capacity now seems to be used to stabilize the Chinese currency. The Chinese currency has fallen less than the Japanese yen against the dollar since 2020, and has followed a parallel course since April 2022. As with overall monetary policy, **a conservative option of stability is therefore chosen for the currency exchange rate**.

Monthly variations in the yuan and yen against the dollar
(January 2020 - July 2023)



Source: Statistics published on the websites of the People's Bank of China and the Bank of Japan.

The Chinese economy had avoided the currency revaluation that its trade surpluses should have entailed. It is now resisting the temptation of devaluation. The fact remains, however, that **China's financial dependence on the rest of the world, and on the United States in particular, is far greater than official figures suggest.**

4 In the event of a debt crisis, the case for monetization

To avoid a debt crisis and resume or continue growth, China's leaders face a number of dilemmas. So far, Xi Jinping's preferences have prevailed over most calls for a strong stimulus: preference for economic security (closely linked to national security), choice of relative monetary stability, refusal to support household incomes, refusal to relieve local governments of some of their debt linked to the real estate crisis. Taken together, **these imperatives have discredited the numerous announcements of support for private and foreign companies** that the government has been making since July.[33]

These imperatives make it impossible to resort to the kind of solutions put forward by many international analysts inspired by the free market's lessons. An interesting Chinese plea in favor of increased public indebtedness fleetingly acknowledges in conclusion that this route remains a second-best compared to the liberation of private initiatives…[34] The numerous current incentives to the private sector do not exclude an absolute preference for control and the reversal, always possible, of the measures taken.

[33] *"Opinions of the Central Committee of the Communist Party of China and the State Council on promoting the development and growth of the private economy (国务院关于促进民营经济发展壮大的意见)", The State Council of the PRC, July 19, 2023, https://www.gov.cn/zhengce/202307/content_6893055.htm, "Opinions of the State Council on Further Optimising the Foreign Investment Environment and Increasing Efforts to Attract Foreign Investment (国务院关于进一步优化外商投资环境 – 加大吸引外商投资力度的意见)", The State Council of the PRC, August 13, 2023, https://www.gov.cn/zhengce/content/202308/content_6898048.htm*

[34] *"Why we believe there is still room for greater fiscal expansion (为什么我们认为财政仍有较大扩张空间)", China Finance 40 Forum, March 3, 2023, http://www.cf40.org.cn/news_detail/13209.html*

In theory, the liquidation of foreign currency assets would allow a massive stimulus plan for the domestic economy, without any new debt. Allowing the yuan to fall in line with pessimistic assessments of the state of the economy would also enable an export-led stimulus. This was the case in 2015, with a rapid economic recovery. By 2020-2021, direct and indirect policy had countered the revaluation of the yuan. Practice is different, however, and indirect intervention is now moving in the other direction: on September 1, the PBoC announced a reduction in the level of foreign currency reserve requirements for financial institutions from 6% to 4%.[35] By mid-September, sales of foreign currency holdings are indeed reported by state banks, while the central bank makes a declaration warning that it will move on its own time to quell speculation on the yuan. Rising international interest rates (particularly in the US) have destroyed the relative advantage of short-term yuan-denominated currency reserves. The relative advantage of long-term investments is maintained if we take into account the yuan's fall against the dollar. At the same time, the perception of geopolitical risk is growing. Facing the assets held by Chinese institutional banks (such as the China Development Bank or the Export-Import Bank of China), one must also take into account the loans granted by Chinese sovereign wealth funds (the China Investment Corporation, the Silk Road Fund or the Central Huijin Investment, among others), notably as part of the New Silk Roads. **This suggests limited interventionism, and the enduring search for a compromise between stability and competitiveness**.

The mistrust from Chinese economic players, visible in the downturn in consumption and business investment, could easily translate into accelerated capital flight.

[35] *"The People's Bank of China decided to lower the reserve requirement ratio for foreign exchange deposits of financial institutions (中国人民银行决定下调金融机构外汇存款准备金率)", People's Bank of China, September 1, 2023, http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/5050309/index.html*

In the absence of a massive Keynesian stimulus in support of consumption, there remain two solutions compatible with the refusal of increased external dependence. One is a classic recipe, long tried and tested by China to emerge rapidly from an economic slowdown, and also practiced by Japan in the 1990s: **the launch of new infrastructure projects**. It is still approved at the highest level, as evidenced by a position taken on August 16, 2023 in the theoretical journal of the CCP school.[36] Admittedly, this solution had not benefited the Japanese economy, which was already clogged with infrastructure. In January 2023, a Chinese economist pointed out its disadvantages, including the infrastructure glut already existing in sectors such as transport, the declining or non-existent profitability of new projects in outlying regions, their poor management by local governments, and the time lag between immediate funding and much more distant profitability.[37] He does advocate choices focused on innovation – such as digital infrastructure in its broadest sense. To this we can add many other sectors, such as renewable energies, biomedicine and biotechnologies, which are exactly the priorities Xi Jinping has set. This focus on recovery is important if we are to understand that **China is going to move upmarket and not lose out in terms of international competitiveness**. But the impact of such focused and long-term investment on short-term growth rates is limited.

The other solution would be inspired by Japan's winning recipes after the 1990s and the "lost decade" of semi-stagnation. The scale of today's Chinese economy is certainly very different from that of Japan at the time. Still, Japan was the world's second-largest economy back then, and its domestic slump never prevented Japanese exports from flourishing

[36] *"Unraveling eight misconceptions about expanding domestic demand (厘清扩大内需的八个认知误区)", Sina Finance, August 16, 2023, https://finance.sina.cn/2023-08-16/detail-imzhiwrf7662869.d.html?vt=4&pos=108&his=0. The article was translated and analyzed by Pekingnology: https://www.pekingnology.com/p/study-times-op-ed-shoots-down-new*

[37] *Zhang Jun, "Why is there always a call for infrastructure stimulus when China's economy is under pressure? (中国经济承压时, 为何总是呼吁基建刺激?)", Guancha, January 26, 2023, https://www.observersnews.com/ZhangJun/2023_01_26_677340.shtml*

and dominating certain niche markets. Politically, the trinity of Japanese power finds an echo in certain Chinese traits. Bureaucracy, big business and the Liberal Democratic Party – together embodying a "one-party democracy" – led to a flight into more debt and local investment backed by local politicians. Structural reforms, including the introduction of new financial market rules, had already taken place under American pressure in the late 1980s. With no immediate positive impact, the "change of rules" and the unwinding of insider pacts had instead precipitated the financial crisis.

In China, the slow collapse of developers and real estate finance – in a sector that is crucial for local budgets, household savings and the consumption of inputs (raw materials, energy, housing fixtures) – has resulted in a deflationary spiral that is exacerbating the balance sheet recession: better to postpone any economic commitments until tomorrow or the day after tomorrow.

If we follow the Japanese precedent, the way out of the crisis is for the central government – in practice, the central bank – to buy back part of the liabilities. The European Central Bank has followed the same policy with regard to the public debt of its Member States, albeit without adding a second stage, that of issuing currency to extinguish the amounts repurchased. **Japan's originality lies in this second stage, with very strong money creation**. During several years of price stagnation and weak growth, money creation exceeded 15% of the money supply per year. This policy recreates the prospect of rising prices and breaks the deflationary spiral, without requiring high interest rates. And with positive current accounts, it does not necessarily lead to devaluation, although it can eventually facilitate this without direct intervention on the money markets.

Replicating this policy in China runs up against the problem of moral hazard – i.e. the risk of seeing the same reckless indebtedness practices repeated, thanks to an implicit guarantee. However, the purchase of bad debt or doubtful debts is already commonplace. At best, it is carried out by state-owned asset management companies (AMCs); at worst, by state-backed shell companies, as documented in Hong Kong in 2022.[38] Another well-known risk is therefore that of the "zombification" (僵尸化) of the economy, with a large amount of debt hidden away.[39] But in the Chinese experience, and as demonstrated by Walter and Howie, hardly suspected of affinity with the practices of the Chinese financial system, there is an example of successful defeasance: it is the purchase of $170 billion of bad debt from the four state-owned banks by AMCs a few months after the Asian financial crisis of 1997.[40] By cleaning up the balance sheets of these banks without explicitly guaranteeing the liabilities of the AMCs, and thus without adding to the official public debt figures, the operation shifted the bad debts to off-market institutions, and rolled them forward in time.[41]

Subsequently, Chinese AMCs resolved part of the debt (30%) by restructuring SOEs. But there were also major capital injections, from undetermined state sources close to the central bank, which wiped out the rest of the toxic loans. Zhou Xiaochuan, governor of the central bank, was at the helm at the time, along with Prime Minister Zhu Rongji. Zhou had also been credited with a monetary policy decorrelating the yuan from the dollar – at the time in order to revalue the Chinese currency.

[38] *Kenji Kawase, "Bad loan shuffle: How Chinese state companies make debts disappear", Nikkei Asia, April 19, 2023, https://asia.nikkei.com/Business/Finance/Bad-loan-shuffle-How-Chinese-state-companies-make-debts-disappear*

[39] *Wei Jianing, "China's economy faces the risk of 'zombification' (中国经济面临"僵尸化"风险)", Yibao, January 2, 2023, https://yibaochina.com/?p=248922*

[40] *Carl Walter and Fraser Howie, "Red capitalism: The fragile financial foundation of China's extraordinary rise", Revised Edition, Fevruary 2012, https://www.wiley.com/en-ca/Red+Capitalism:+The+Fragile+Financial+Foundation+of+China%27s+Extraordinary+Rise,+Revised+Edition-p-9781118255100*

[41] *Sarah Ho and Thomas Marois, "China's Asset Management Companies as state spatial–temporal strategy", The China Quarterly, Vol.239, September 2019, https://www.cambridge.org/core/journals/china-quarterly/article/abs/chinas-asset-management-companies-as-state-spatialtemporal-strategy/5148BD273D2134D9EE214ED10CFDAB03*

On August 20, unconfirmed sources pointed to a turning point in local debt management.[42] On the one hand, the central government would encourage state banks to lend more, while an emergency fund would be created to extend borrowing maturities and lower refinancing rates.[43] On the other hand, local governments would be authorized to issue $206 billion (€188 billion at the August 2023 average rate) in loans to refinance their debts. Measures are also being taken to support stock prices: lower transaction taxes and curbs on asset sales by large corporations.

These measures are certainly not on the scale of the $7,000 to $8,000 billion (nearly €6,500 to over €7,000 billion at the August 2023 average rate) of public debt, open or hidden, currently estimated. To go beyond this would mean applying the recipe mentioned above: the monetization of debt. Both methods represent a formal break with Xi Jinping's stated credo. But as with the treatment of Covid-19, **advocates of a change of course may argue that this is the best way to ensure economic stability and security.**

Debt repurchase and monetization as a way out of the crisis are implicit in Chinese debates on the Japanese balance sheet recession of the 1990s. They are compatible with the centralization of economic governance sought by Xi Jinping. The numerous measures to rein in local authorities, which constitute a pre-emptive policy to prevent even more serious runaway emission of local debt, could make these moves possible. But **Chinese finance is also unique in that it combines capital control with a high risk of capital flight**, given the country's strong links with the international economy. The gap with American interest rates has become so wide that these risks are amplified. And so far,

[42] *"China local governments to sell $206 billion of financing debt", Bloomberg, August 20, 2023, https://www.bloomberg.com/news/articles/2023-08-20/china-local-govts-to-sell-206-billion-of-financing-debt-caixin#xj4y7vzkg*

[43] *"China urges banks to boost loans to support recovery, cut debt risks", Business Standard, August 20, 2023, https://www.business-standard.com/world-news/china-urges-banks-to-boost-loans-to-support-recovery-cut-debt-risks-123082000617_1.html*

Chinese investments have not disengaged from international markets, even if the official share of dollar-denominated assets has declined in appearance, if not in reality. **The monetization of a part of China's liabilities should probably be seen as a last resort in the event of a financial panic**. As was the case with the Chinese stimulus packages of 2008-2009 and 2015-2016, this would once again postpone the resolution of the economy's structural problems, which in truth are linked to the political system.

5 Implications for Europe

Aside from the hypothesis of a balance sheet recession, what are the implications of the Chinese slowdown and crisis of confidence for China's economic partners, particularly in Europe?

Some are positive. Just as the Asian crisis of 1997-98 was a disinflationary factor for Western economies, **the current situation should benefit energy and commodity prices**. This is not yet the case, due to other factors such as OPEC policy for oil prices, and no doubt because the commodity markets have not yet fully anticipated a lasting drop in Chinese demand. Relative deflation – in fact, a stagnation in industrial prices – should keep the price of goods exported from China in check, even as logistics costs fall. **Some of Europe's objectives, however, may reduce or cancel out this benefit:** for example, the EU's Carbon Border Adjustment Mechanism, or the conditioning of industrial subsidies for EVs to decarbonized production chains will once again raise prices for European consumers. As with US customs surcharges, these measures function in practice as a tax on the consumption of the imported products that are taxed. In other words, Europeans will have to arbitrate between their objectives of energy transition and/or reindustrialization and disinflation. Conversely, **accepting a dependence on Chinese renewable industries may accelerate Europe's energy transition and lower costs for users**. It is also worth noting that Germany and Northern Europe, with their strong presence in the Chinese market, have more to lose from the backlash to implicitly protectionist measures than Southern Europe and France, whose investments and market shares in China are smaller.

Other implications are negative. Maintaining trade and current account surpluses at all costs seems likely, as these serve as ballast for indebtedness and, more generally, for the irrationalities of the Chinese financial system. Contrary to popular belief, it is not Chinese economic growth that is driving the rest of the world, but global demand that is driving the Chinese economy – a trend that has become even more visible in recent years with the boom in exports. Today, exports are threatened only in those sectors where technology denials are holding back innovation in Chinese products – essentially, semiconductors, and therefore the most advanced digital goods. The choice of competitive devaluation is open to China, even if it would place China in conflict with competing emerging economies. In the field of emissions and decarbonization, Xi has clearly chosen, for reasons of economic expediency, to let the massive use of coal continue alongside renewable energy sources. In the name of a "developing" economy, he hardly holds China to the rules set by industrialized economies. Not only does it apply to decarbonization targets, it could also apply to monetary policies.

A policy of devaluing the currency is all the more to be feared as it is perfectly compatible with other Chinese choices: the accentuation of financial support for certain industrial and digital niches for which the Chinese economy alone has the required scale, irrespective of global demand. Faced with a dilemma, the Chinese government has chosen this massive support for innovation rather than rescuing local budgets, whose crisis is having serious social implications. It is futile to hope that the Chinese slowdown will put the brakes on these niches of conquest, as well as the capture of international energy and raw materials supply chains.

The geopolitical implications are less clear-cut. In theory, China is vulnerable to American and European strategies of industry relocalization and subsidies, since it depends on the forward march of its exports. But these current policies of the industrialized democracies also come at a high cost to themselves. As evidenced by the scattered steps taken by European governments, and the succession of visits to Beijing by the Biden administration, these same democracies are still seeking a modus vivendi based on common economic interests. Are Xi Jinping and the CCP likely to seize upon these outstretched hands to ease the geo-economic climate, or are they interpreting these gestures as signs of weakness enabling China to offset the difficulties of its domestic economy with geopolitical aggression? So far, **no concession has been made that isn't a highly circumscribed gift to leading international companies, which Beijing hopes will lobby in its favor, or which China cannot do without.**

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The current breakdown in the Chinese economy, so frequently discussed lately, is not really a breakdown. Beyond the excessive optimism that followed the lifting of Covid-19 restrictions, China's crisis is more insidious: it is based on a loss of confidence on the part of many players, from Chinese consumers and borrowers to foreign investors. What's more, in stark contrast to other economies, China is facing a lack of inflation, huge trade surpluses that cannot grow indefinitely, and a slowdown in consumption. In parallel, the idea of a balance sheet recession with a deflationary spiral is gradually gaining ground.

How is the Chinese government responding to those challenges? Firstly, by rolling out support measures and issuing reassuring statements to Chinese and foreign companies, without ever taking its focus off economic security. However, these various measures and statements have been met with little enthusiasm from households and businesses alike. Adding to this growing skepticism about official announcements is a growing mistrust of the reliability of the statistics provided. It is futile though to expect China to return to structural reforms and more transparent data, as the outcome could undermine the power of the CCP. On the other hand, the largely domestic nature of China's indebtedness and the size of its foreign exchange reserves would allow a bold policy of debt monetization to restore confidence.

Based on an analysis of Chinese-language sources and economists' commentaries, this insight note paints a nuanced picture of the health of the Chinese economy. It also draws lessons for China's economic partners, primarily in Europe. No matter what happens, the backdrop will remain the same for China's leaders: the search for a compromise between stability and competitiveness.

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