DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

"China's uncertain economic outlook for 2023"

Washington, D.C.
Monday, March 6, 2023

Guest:

ESWAR PRASAD
Tolani Senior Professor of Trade Policy; professor of economics
Cornell University
Senior Fellow, Global Economy and Development
The Brookings Institution

Host:

DAVID DOLLAR
Senior Fellow, Foreign Policy, Global Economy and Development,
and the John L. Thornton China Center
The Brookings Institution

Episode Summary:

Eswar Prasad, a senior fellow in Global Economy and Development at Brookings and a professor at Cornell University, and host David Dollar discuss the outlook for China's economy in 2023 as the annual National People's Congress convenes in Beijing. Discussion topics include China's economic growth, local finance and real estate, the role of China's private sector in the economy, and what policies might emerge from the meeting.

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DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast *Dollar and Sense*. Today my guest is Eswar Prasad, an economics professor at Cornell University and a senior fellow here at the Global development wing of Brookings. China's National People's Congress will run for about a week starting March 5th. And our topic is going to be China's economy and some of the policies that might emerge from that annual meeting. So, welcome to the show, Eswar.

PRASAD: Thank you as always for having me on your podcast, David.

DOLLAR: So, let's start with general picture. Last year, China grew more slowly than the world economy as a whole for the first time in decades. It's clearly going to bounce back to some extent. What's your general sense for 2023? Where do you see strengths? Where do you see weaknesses?

PRASAD: So, last year, David was certainly a very difficult year. First there was the zero-COVID policy, which was being implemented very stringently, and then that policy was reversed and that led to some disruptions as the economy readjusted to the end of zero-COVID. But now things seem to be stabilizing. And part of the reason we are seeing some good growth momentum, of course, is a snap back from a very difficult 2022.

But it looks like 2023 overall is going to be a decent year for China. The most recent data that came in on manufacturing sector activity does seem quite promising. We've seen the industrial sector overall holding up quite well, especially fixed asset investment. The services sector also seems to be doing quite well.

But there are going to be some challenges over the coming year. In particular, we've seen household consumption be relatively weak over the last couple of quarters and the question is whether the government is going to be able to put in place policies and make the right sort of moves that would give the private sector the confidence it needs for households to go out and save more, and for private businesses in particular to go out and invest more. We've seen investment holding up quite well, but a lot of that seems to be coming from the public sector.

There is a fair bit of room, of course, in terms of macroeconomic policies for the government because inflation is reasonably well contained. CPI is at a modest level and there is in fact producer price deflation. The renminbi seems to be holding together quite well after having gone through some depreciation last year. So, overall, I think 2023 is going to be a decent year for China in terms of all of the components of growth.

DOLLAR: So, as you say, Eswar, consumption was particularly weak in 2022, especially last few quarters of data. And I think there's a little bit of a puzzle there because we also see this data that household deposits in the banking system have risen quite dramatically. There seems to be a lot of pent up saving, as we saw in the United States and some other economies. And then as the COVID measures were taken away, people went out and spent.

In China, I feel like we don't see such a strong rebound of consumption yet. And one thought I've had is that perhaps upper middle-class, wealthier households kept their income and put a lot of money away during the COVID period. But a lot of ordinary households, migrant workers especially, lost their jobs, lost their income, and they don't have pent up demand. So, I wonder if there's something the government can do to really jumpstart that consumption path, get the broad mass of people back consuming on the trend they were on pre-COVID.

PRASAD: That's certainly a striking feature of what happened in China over the last year and even in recent months. As you correctly point out, the savings rate did rise quite significantly, the household saving rate. And of course, this may have been for precisely the reason that you pointed out, that those who still had money were the people with relatively lower marginal propensities to consume, while those at the lower end of the income distribution ended up with much less money.

And we also saw this affecting the services sector. Of course, when you have an economy that is basically shut down, the services sector and spending on services does tend to decline.

Now, the big question is whether there are other overarching forces, such as the degree of uncertainty people might feel and also the implications for their wealth because of what has been happening in the property market. The property market, of course, had a very rough last half of last year, and a lot of Chinese household wealth is tied up with the property sector. And as you have written, of course, it does account for a significant part of China's economy. So, the fact that the property sector is not doing so well affects households' perception of their wealth dynamics, and it also affects their perception about where the economy is going and their employment prospects.

So, I think the degree of uncertainty in the economy right now in both of these fronts might be holding back consumption.

So, this is where, again, what the government is willing to do in terms of its stimulus policies, including potentially some fiscal measures such as tax cuts and so on, that could encourage consumption by households, might in fact help correct some of this balance.

But certainly over the last year or two, we've seen a bit of a setback to the government's objective, a long held objective, of rebalancing growth such that it is driven more by private consumption rather than by investment. I know they are eager to get that balance back, but I think it's going to take some work.

DOLLAR: So, you brought up a couple of good topics for us to take up in a little bit more detail. One is the issue of local government finance and another is real estate, closely related issue of real estate. Why don't we take the real estate first. Do you think real estate can get back to the role it was playing for a long time as a key foundation of their growth, or is in some sense that story largely over? And do you have ideas about what they should be doing in the real estate sector?

PRASAD: So, real estate is quite important to the economy. Now, whether that's such a good thing or not, this is open to debate. Certainly the property sector has been a key player in terms of overall growth in China in addition to accounting for a significant amount of household wealth, directly or indirectly touches a large share of the economy.

But having said that, certainly we've seen a lot of problems in the property sector: relatively large speculative booms in prices, followed by busts as the government tries to manage those speculative booms. We also see this never ending dichotomy in China that you have a lack of affordable housing, especially in many urban areas, while there seems to be overcapacity in certain other areas, and many people had been buying houses as investment properties and ended up not using them as rentals, and so on. So, there are lots of difficult issues with the real estate sector.

And of course, one question is whether trying to, you know, put the clamp on the property sector in order to reduce the speculative run up in prices sets off other dynamics that could lead to financial sector problems. My sense is that, again, there are going to be some ructions in the property market as we go along, and there are certainly some developers who are very exposed. And over the last couple of years we've seen some of them, such as Evergrande, coming to deep financial problems and burst out. And there are some relatively small- to medium-sized banks that are very exposed to those developers. So, I think we will see some problems spillover into the financial sector and the broader economy, but it looks like those can be contained.

So, in the future, are we going to see real estate once again become a major driver of growth? Again, a stable real estate sector that is generating the sort of housing that China really needs might be a probably a good thing. The question again is whether one can do that without having the attendant cause, such as a speculative run up in prices that once again the government has to step in to quash.

One of the key aspects in all of this, as you well know, David, is what role the government plays in the property market. And I think this is one of the elements that has led to volatility in house prices. The question about whether the government is actually going to backstop some of these developers, some of the banks that are very exposed or if at other times, as it has indicated, it wants to stay out of the property market and let market signals, market forces entirely determine the outcomes there.

DOLLAR: Yes, I understand that the government, particularly some local governments, are being pretty active about getting developers to finish half done projects where many people have already paid for the apartments. And I think that was really a pretty serious risk for the economy and for them and for the party, you know, frankly. So, they seem to be pretty interventionist to get those things completed. I'm not sure they're going to be so interventionist going forward.

PRASAD: Yeah, that's exactly right. And I think there are social stability considerations when people have put down deposits for apartments and then the developers that they have put those deposits down with disappeared, there is a sense that the government should perhaps be doing something about it. And of course, when we look at what the government has been doing recently to stabilize the property sector, some of the requirements they put on mortgage holdings and so on, they eased some of those in recent months. So, again, the government does remain quite involved in the sector and that, I think, adds to the instability to some extent.

DOLLAR: I think it's interesting that the topics that we naturally want to talk about concerning the Chinese economy, they're so interrelated. You know, it's really quite hard to divide things up. Local governments have relied very much on revenue from real estate development. They basically auction off undeveloped land. In many cases, it's a pretty clean process. It's a source of revenue for local governments and they've used that to finance a lot of their activities. And now with the real estate downturn, we see in the data that what they're getting from auctioning off property is declined very significantly, and that's a source of their financial troubles.

And then the financial troubles affect people's consumption. You probably saw the stories about pensioners demonstrating because some local governments that are under severe fiscal stress have basically tried to change the rules of the pensions in order to save money. And people, of course, are unhappy about that. And then that's got to affect their consumption. If they stick with those changes, reducing people's pensions, then that's going to have to affect their consumption. So, are there some solutions to the local government finance issue other than going back to the days of real estate bubble?

PRASAD: No, you're right, David, that property revenues from the property sector, from property sales and so on have been very important for local governments and many of them are under significant financial duress.

Now, the longer term perspective on this, of course, is that the central government in Beijing has been trying very hard to inculcate fiscal discipline among the local governments, many of whom had been using local government financing vehicles, LGFVs, to issue debt even after they were put under constraints to limit the amount of debt that they could issue.

But we've seen that trying to manage these problems does create a whole ripple of other problems. In fact, I should probably turn this question over to you, David, because after all, you are the true fiscal expert here, having written extensively on these areas. Do you see an easy way out of these problems that some local governments are facing?

DOLLAR: Well, I feel like people like you and me have said for a long time they need a property tax. And I still think that's true. And it's a little bit surprising that they haven't introduced that in a significant way. That could be a source. But I have seen some recent analysis suggesting that that would only be a small part of the solution, that basically they don't collect enough taxation. The personal income tax collects a very small share of GDP. It may look fairly onerous on paper, but they don't actually collect a lot from the personal income tax. They don't tax capital gains in general. So, they've reached a stage of development where they think they need some serious tax reform that's really aimed at collecting a fair amount of resources from this booming economy.

PRASAD: And in fact, on the central-local government fiscal relations, again, this is a subject you have written extensively on, I think that there are a variety of things that have been talked about for a while but not much progress has been made yet in terms of smoothing things out there.

DOLLAR: Yeah. So, most of the revenue's collected by the center, most of the expenditures at the local level, there's a complicated system of transfers, it doesn't have clear parameters that are fixed in place. I think to devolve some of those taxes to the local level probably makes a lot more sense. But it's a very complicated issue. So they really need careful analysis and careful reform and they need to make sure they're collecting enough revenue and that it's going to the places where the government's providing services, which is often local level.

Aside from 2022 being a poor year overall, I also found it noteworthy, as you said, fixed asset investment overall held up fairly well. But then when you pass that, it's mostly government investment in infrastructure and state enterprise investment. And the figure I saw on the growth of private investment—and this is a nominal figure—was about 2% growth in 2022. So, that's really pretty shocking.

And I think there's a sense that a combination of the shocks like COVID plus the deliberate policy of the Communist Party is putting more favor on public enterprises, public investment rather than private investment.

But then we see something of a charm offensive coming from the senior officials, including Xi Jinping, talking about the importance of the private sector, especially small and medium enterprises, something of a charm offensive. So, how do you see that effort to really reassure private investment, both domestic and foreign?

PRASAD: Yeah, the signals, as you point out, David, had really been quite mixed. As you said, last year was a tough year on the economy more broadly, and then the leadership transition last fall, and many of the signals emanating around those meetings did suggest that China was not going to be that conducive a place for private enterprise.

But then the signals that we have seen in late December over the last few weeks suggests that the government views the private sector as still playing a critical role in the economy. And the reality is that in order to accomplish their growth objectives, both in the medium-term and the short-term, they really need the private sector. If you look at productivity growth in some of the state owned enterprises, it's actually not been that bad.

But the reality is that what China wants to accomplish, especially in the face of many headwinds, such as weakening demographics, less ability to rely on external markets to soak up a lot of China's output, and so on, is that they're going to need to reorient their domestic economy, get more growth coming out of services, and especially from small and medium enterprises in the services sector, but perhaps also in manufacturing in order to generate better employment growth, but most importantly to generate higher productivity growth.

And they have this plan, of course, of trying to move towards more indigenous innovation and other aspects of moving up the value added chain.

All of this can be done with the state sector, but it's much more inefficient to do it that way. And I think in terms of employment generation, the capital intensive, state sector-led growth model has not worked very well. So, of course in China we hear about the fact that the labor force is not only not growing, but in fact might be shrinking by some measures as being a major constraint. But at the same time, we seem to have a large pool of unemployed workers at the moment, and absorbing them is going to be key.

So, we do seem to be getting a signal from the Xi Jinping government that in fact there is going to be room for the private sector, and the private sector will play an important role in many of the objectives that they need, especially if they want to accomplish this goal of becoming an upper middle income economy over the next 10 to 15 years. So, if you think about getting to a per capita income somewhere in the range of $20,000, that's going to take pretty decent growth, and it's hard to do that without the private sector.

So, this slightly schizophrenic approach we are seeing, at least in terms of the statements coming out of the Xi Jinping government, certainly don't inspire confidence in the private sector. So, we'll have to see whether there will be enough in terms of actions and of course, the appointments of people who are seen as reformers and willing to give the private sector some space. And that's going to be very important in the coming months.

DOLLAR: We're going to see the retirement of some pretty effective technocrats, people like Leo Hu and Yi Gang as the head of the Central Bank. These are people who have been friends of ours and we'll find out during the National People's Congress, certainly we already know who the new premier will be: Li Qiang. Some of the other appointments not completely clear right now, and we'll find out. Is this going to have a large effect particularly on the foreign private sector?

PRASAD: I think it is because many of the people that you mentioned—Governor Yi Gang of the PBOC, his predecessor, Governor Zhou Xiaochuan, and Leo Hu—these are people who are seen as reformers and also had a presence on the international stage, so they were apparently willing to say the right thing to their superiors, the top leadership of the Communist Party of China, in terms of reforms that were necessary, and were able to sell those reforms to their domestic leadership but also to the rest of the world. So, I think that was comforting to domestic investors and international investors.

Now, there have been some names bandied about, of course, about who could take over the key financial and regulatory positions that are likely to see some turnover right now. Now, some of the names that have come up are of people who seem to be party loyalists, but some of them also seem to have a tradition of having worked in provinces or in areas where they did encourage the private sector to play an important role.

So, it's going to be a little interesting and important to see not only who the people are that are appointed, but what sort of signals come out of the NPC in terms of what the reform agenda might be, particularly in terms of the financial sector, which of course is a matter of great interest to both you and me, David, because ultimately we need the economy to be allocating resources more efficiently in order for China to accomplish its growth objectives. But also reforms in other areas like state enterprises and so on. But certainly there's been at least modest progress in terms of hardening the budget constraints on SOEs, but a lot more needs to be done.

So, who the people are, what their reformist orientation is going to be, and how effective they will be at pushing that reform agenda are all key questions to which we will start seeing answers in the next few days, but then the next few months are going to be quite important as well in terms of figuring out the direction of policies.

DOLLAR: Right. So, the National People's Congress by itself is not going to tell us that much. We'll get some appointments, but we'll have to wait and see what is actually implemented in terms of policy. And we may get some broad policy direction in some of the speeches, but the details will come later. So, I think I think you're right, we're going to have to see what happens over the next few months.

It's an interesting contradiction that a lot of Xi Jinping's kind of overall rhetoric is state oriented and somewhat discouraging to the private sector. But then, they're determined to grow at a pretty healthy rate. And to do that, they have to implement policies that are somewhat favorable to private initiative and private investment. So, it's an interesting contradiction.

PRASAD: That's right, China does seem to want to have it both ways, make sure that the state sector does deliver in terms of the growth objectives that the government has and the private sector to play a role, but within constraints. And that conundrum, of course, is an important one to see how it plays out, because it's a little difficult to think about the private sector contributing in an effective way to growth and especially to innovation and productivity growth if there are going to be lots of constraints on the private sector.

So, keeping the private sector on a tight leash but at the same time getting the private sector to deliver all the objectives of the government wants is going to be a tough balance to manage.

DOLLAR: So, I've saved for last, Eswar, the thorny question of U.S.-China relations. And I feel like that's also really complicated situation because there's a lot of hostile rhetoric back and forth and there are a lot of specific measures, particularly from the U.S. side, constraining certain types of trade, you know, export of high technology products and putting various Chinese firms on our entity list, which really restricts their ability to interact with American firms.

And yet, 2022 was the biggest year of trade, China-U.S. aggregate trade that we've ever seen. And it's kind of surprising how well trade has held up despite the Trump tariffs, 25% on about half of what we import—those have been left in place by the Biden administration. So is this a stable equilibrium to have pretty tight restrictions in a few areas, but overall trade seems to be booming? Or is this just the kind of inflection point that maybe what we got in 2022 was a lot of momentum from the past, but as these measures bite maybe we'll be on a downward trend? Now, of course, it's impossible to know what's going to happen, but I'd love to hear your thoughts.

PRASAD: Well, David, as you well know, it's very difficult for the two largest economies in the world to dance around each other. That relationship is going to be a little difficult to completely disengage from. But the political dynamics, especially on the U.S. side, do suggest that it's going to be a thorny road. And on the U.S. side we see this combination of technology policy, which is taking the form of industrial policy if you look at the Inflation Reduction Act or the CHIPS Act, tied in with the national security policy, and that's spilling over into trade policy.

And in all of these areas, certainly there are many targets out there, but what the government in the U.S. seems to want to do in terms of making its supply chains more resilient, in terms of its reducing its exposure to need products—pharmaceuticals, electronic products, and so on for the rest of world—that I think is going to lead to further restrictions in China. And of course, sitting here in Washington, you and I know that there seems to be very strong bipartisan support on the Hill to look and act tough on China.

One of the other concerns I have, which again, is an area you've written about, David, is that once upon a time the economic relationship between China and the U.S. was seen as a positive-sum game where both sides could gain from the relationship, while the geopolitical element was seen as a zero-sum game—for China to gain more influence the U.S. would have to lose some of its influence. But the economic relationship acted as a bit of a counterweight to the geopolitical tensions and served as a balancing force.

But right now, even on the economic side, we are seeing escalating tensions. Although there are periodic attempts by both sides to bring down the temperature a little bit. But I think they are going to remain at an elevated level.

So, now the two—the economic tensions and the geopolitical tensions—seem to be feeding off each other. So, I do worry that we're in for a period where there could be even more restrictions from both sides in terms of trade and financial flows between the two countries.

DOLLAR: I'm David Dollar, and I've been talking to my colleague Eswar Prasad about the economic challenges that China faces as it goes into its annual National People's Congress. Tremendous uncertainty, but some green shoots in the various issues we took up, but a lot of risk hanging over the whole China picture. So, thanks for joining me, Eswar.

PRASAD: Always a great pleasure talking to you, David.

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DOLLAR: Thank you all for listening. We release new episodes of *Dollar and Sense* every other week. So, if you haven't already, follow us wherever you get your podcasts and stay tuned.

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Until next time, I'm David Dollar and this has been *Dollar and Sense*.