



***The Beijing Brief* podcast
The Brookings Institution**

“Is China’s economy broken?”

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Episode Summary:

Why is China’s economic growth slowing despite rapid technological breakthroughs and dominance in the manufacturing sector? Brookings Nonresident Senior Fellow Mary Gallagher and Rhodium Group Partner Logan Wright join Jon Czin on The Beijing Brief to unpack what is driving the slowdown, how it is reshaping state-society relations in China, and what it means for Western economies grappling with China’s export surge.

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CZIN: Hello. You're listening to *The Beijing Brief* from the John L. Thornton China Center at Brookings, part of the Brookings Podcast Network. I'm Jon Czin, fellow and the Michael H. Armacost Chair in the China Center. *The Beijing Brief* is a biweekly podcast focused on unpacking the forces shaping US-China relations and China's political, economic, and technological ambitions. My colleague and co-host, Ryan Hass, is currently traveling in Asia, which is a pretty good alibi to have, but rest assured he will be back for our next episode.

For this week's episode, we are talking about the Chinese economy, which remains one of the most controversial and confounding topics in the China field. On the one hand, China's exports are surging, and on Monday, Beijing reported 4.5% GDP growth for the third quarter, beating forecasts and keeping its annual target within reach. On the other hand, consumer demand remains quite weak.

Households are saving rather than spending after the property crash. Property investment is down nearly 20% this year alone. Retail sales are barely growing, and youth unemployment hit nearly 19% in August. And some analysts, including our guests today, think the real, the real growth rate is far, far lower than the actual numbers suggest.

During our last episode, we had Evan Osnos from *The New Yorker* on to discuss China's dynamism and its dysfunction. On today's episode, we want to further break down this tension in the economy, and we want to focus on three topics.

Number one, why is China's economic growth slowing, and how is that being felt by ordinary Chinese citizens? Number two, given the positive stories of China's technological advancements, how do you take a holistic view of the economy? And number three, what are the practical and political implications for China, the United States, and the world?

To discuss these topics, I have two wonderful guests. Logan Wright is a partner at Rhodium Group, where he leads the firm's China markets research work. He spent years as an analyst on the ground in Beijing, and he has testified before Congress on China's economic slowdown.

And he is, of course, most recently the author of a brand-new book, "Broken China: How the Economic Miracle Shattered and What It Means for the World." Logan, thanks for coming on the show.

WRIGHT: Thanks, Jon. Happy to be with you. Appreciate it.

CZIN: And we are also joined today by my Brookings colleague, Mary Gallagher. Mary is a nonresident senior fellow here at the China Center at Brookings, and she is also the Marilyn Keough Dean of the Keough School of Global Affairs at the University of Notre Dame. She is one of the country's leading scholars on China's labor market, law, and state-society relations, and the author of *Authoritarian Legality in China*.

And as a bonus, Mary has just returned from a trip to China, so she'll have some fresh on-the-ground perspectives. Mary, thanks so much for taking the time to join us today.

GALLAGHER: Thanks, Jon. I'm happy to be here.

[2:42]

CZIN: Okay. So just to level set, I wanted to get a sense of how both of you would grade China's economy on a scale of one to 10, one being, you know, maybe broken or undead, and 10 being robust and strapping. And number two, I want to get your take on how Beijing would grade its own homework on the economy. Mary, would you like to go first?

[3:02]

GALLAGHER: That's a, that's a hard question to answer. Generally, I would say that the Chinese government is probably well aware of the problems. However, externally, I think it's very important for this government and the Communist Party to exude a lot of confidence.

And so, what you find in the domestic news media and particularly the external media is is a much higher ranking than they would give internally. I think for on the ground for people living through it, I think there's a sense, the way I describe China right now is very subdued. People seem to have put their heads down, not particularly optimistic about the future.

But at the same time, if we compare China to countries that are undergoing something like hyperinflation or run on banks, no, China's not in that condition either. So, I would say middling, but certainly underperforming the expectations that people used to have for the Chinese economy.

[4:00]

CZIN: Logan, what about you?

[4:01]

WRIGHT: Yeah, if I had to pin it down on a sort of one to 10 scale, I would say that the actual state of the economy is around a 2. Beijing probably internally thinks about it as roughly a 5 because they're thinking about different kinds of metrics of success. And externally they're trying to project it as kind of a 7 or 8, just as Mary said.

I think the underappreciated aspects of what Beijing misses in their own diagnoses is the importance of downstream demand, the importance of aggregate demand, and the real threat from deflation to the ultimate health of the economy and how that creates certain pathologies that make it harder and harder for China to escape their current trap.

[4:44]

CZIN: That's very helpful. So, we want to start by getting right to the very succinct thesis of Logan's book about China's economy being broken. And Logan, I would like to hear, you know, your argument about why you think China's economy is fundamentally broken rather than just experiencing the the kind of natural slowdown that we see in a lot of maturing economies.

[5:04]

WRIGHT: Sure. I mean, I think what's different is that the tools that China has used in the past to generate economic growth and to control their economy, the fiscal and financial system, can no longer serve that function because they have been essential to facilitating China's growth during an unprecedented credit expansion.

And now they are basically paying the cost of all of that malinvestment and bad debt, the costs of basically allowing financial risk to accumulate as an offset to political risk. And so, we think very differently about economies and state capacity in emerging economies where they're in the middle of or the start of a of a credit expansion and when they're at the end.

At the end of credit expansions, you typically see constrained fiscal positions. You typically see difficulties in responding countercyclically. You see deflation, you see limited private sector investment. And these are all the things we sort of see in China today.

Simply put, China had one of the largest single country credit expansions the world had seen in at least the last century, possibly much longer. And the consequence of managing that is rather than allow for significant bankruptcies and defaults, and there have been bankruptcies and defaults, they've essentially tried to manage the decline by continuing to extend credit to state-owned enterprises and local government financing vehicles.

So, the challenge now is who loses in this process? How do they let some of these loss-making enterprises go? And the dilemma, and why I say it's broken, is that this has started to infect the fiscal system as well. There's been a huge decline in fiscal revenues that have been linked to the old investment-led growth model. There hasn't been a rebalancing of the economy toward domestic consumption.

And so, as a result, the ways in which countries would ordinarily respond to these kind of cyclical downturns, are impaired in China. You can't really expand the fiscal deficit considerably, and you can't ramp up the financial system, that rate of credit growth within the financial system because you have already exhausted its capacity to do so.

They have options to fix it, but the options all involve much slower growth in the meantime as you write down the capital stock and as you decide who loses.

[7:29]

CZIN: Mary, I want to bring you into the conversation, especially since you were, as we discussed, just on the ground. You know, what is your diagnosis of the malaise in

China's economy? And, you know, from the Chinese perspective, especially of everyday people, where do you think they would locate the start of the problems?

[7:45]

GALLAGHER: That's a great question, and I really like how Logan's book goes back to the global financial crisis and how China responded in the aftermath of that crisis. China did not have a financial crisis. It had an export crisis, and it had large layoffs in the export manufacturing sector right after the recessions began in the U.S. and in Europe.

But what it also did, which is what the book starts off with, is just massive amounts of investment to find another source of growth in China. I was living in China in 2012, 2013, and that was a very interesting time to be there because China was really booming in those years, and it was all around real estate and the industries around real estate.

So, it wasn't just building and construction, it was also... it was furniture, it was household design. It was, people just feeling this, you know, immense ability to feel better off, feel wealthy, and to use that money in this sector. It also seemed as if, and I think this was true of the case, that there was quite a lot of consumption in China also around real estate.

So, when I think about the crisis and when it started, it really started out of this sense of how do you get off this addiction to the property sector as the source of growth, which was both fueling the investment that Logan is talking about, but was also fueling the ability of Chinese households to consume in this sector.

[9:05]

And you see that, you know, the Xi Jinping administration, which comes into power in 2013, starts to really address that in its second term. And you see the attempts in, on the stock market, and then you see in 2021, of course the real estate and the property sector being affected.

One thing I would also mention, which is interesting about 2021 as a really critical year, that's also the year that Xi Jinping launches the Common Prosperity campaign, which I followed really closely because I was quite interested in what it would turn out to be on the social insurance and policy side.

And it was a real dud in that regard, but it really did change the way in which I think wealthy people in China, and particularly entrepreneurs, felt about the government, and it was a real, if we think about pessimism and where pessimism starts, I think it starts in different points for households versus this sector, and 2021 was a really critical year for people in China with a lot of capital starting to feel very insecure.

[10:06]

CZIN: That's interesting. I'm struck that in both of your diagnoses, this almost feels like a long hangover from the global financial crisis and how China responded to it. And I want to get the sense if if you think that's right.

And number two, Logan, I was really struck by something you said, that it didn't have to be this way. Right? That the leadership, and especially Xi Jinping, had other choices that they could have made along the way, aside from this kind of stringent deleveraging.

So, I'm I'm curious to hear you unpack that a little bit, you know, and hear you discuss, you know, what what would've been some of the plausible or viable alternatives to deleveraging that the leadership could have chosen instead?

[10:42]

WRIGHT: Sure. I was on the ground in China throughout this time and watching this sort of process play out, and even from the earliest days of 2009, right after the global financial crisis, you see all this credit flow out the door, and you see financial technocrats getting very concerned about the potential for a credit bubble and the potential for overbuilding and bad loans and an impaired financial system. Even from, you know, May, June 2009, you started to see some of these concerns circulated.

[11:14]

But the point was that the leadership wanted to make sure that we weren't sure where the global economy was going to go. We wanted to ensure that there was enough momentum in the Chinese economy that we could safely say that policy worked and we had a meaningful response, and that we weren't going to be victim to some of these external forces and that China could sort of lead the world out of recession and that if there were negative consequences, we could manage those later.

[11:39]

But if we wanted to err, we wanted to err on the side of more growth, more confidence, in the short term. And when you rely upon investment for growth in that kind of short period of time, it creates these political, path-dependent processes that are more difficult to stop. I mean, first, you basically put local governments sort of in the commanding heights of the economy so they can kind of hold Beijing hostage. They can say, "You need to keep funding these projects because if you stop, basically you'll have these huge fiscal obligations. We'll have a bunch of half-finished bridges and tunnels and subway systems and, you know, that's not good for anybody, so we need more money to keep this going." So, no one wants to cut that off.

And the other thing is that this can offset political risk. I I make this argument in the book that the financial risk essentially supplanted political risk because you can keep loss-making enterprises afloat. There's enough credit to do that. You don't have to unemploy people. You can just have more production even at lower prices.

[12:38]

So, the real story of why was this not reined in earlier is, I think, a political question, which says that ultimately there are more forces at the local government level that

sort of reverberated into a consensus-driven political system at the central government level in which it made a lot more sense just to keep this investment-led growth model operating rather than to make more aggressive reforms earlier.

So even though you had the Third Plenum reform agenda in 2013, which is, you know, you can take different views about this, but it is, I think, fair to say that this was a reasonably coherent sort of structural reform agenda across both the fiscal and financial system. You have a lot of the proposals in that agenda basically, you know, petering out or being actively reversed by 2015, 2016.

And so that's what I mean when I say there was a lot more agency that Beijing had in what they could have done to offset this. They could have controlled credit growth much earlier. But they thought that, you know, ultimately the consequences of slower growth were more severe, politically or otherwise, than the consequences of continuing this financial expansion. And the net result is basically that they exhausted their capacity to, uh, use the financial system as a shock absorber for the political system decade later rather than in the early 2010s.

[14:11]

CZIN: That's really interesting. I wanted to come back to the property sector piece of this equation. And and Mary, I wanted to get your sense in particular about, you know, why has the fallout in the property sector had such widespread ramifications for for China's economy? And welcome your perspective too on on how you see this playing out on the ground and how it's driven both firms' and individuals' spending choices and savings choices.

[14:35]

GALLAGHER: You know, some of the things that Logan was just talking about are really important about how the property sector and the use of land for local government financing is really important for the underlying part of the economy in terms of this is where local governments are getting their getting their fiscal revenue from overwhelmingly, and that really collapses.

And that has huge impacts on what the government can do. On the the household point, what I would say is, you know, as with what happened after the financial crisis here in terms of people being underwater, there's a sense for households in China of feeling much less wealthy, because the the houses that they own or the apartments that they own have declined in value very, very rapidly. And that overwhelmingly has affected how how wealthy they feel overall.

There are other things going on with the economy generally slowing down. Income growth has been slower. There's lots of other ways in which people just feel less optimistic.

[15:31]

So, that decade from from about 2012 to about 2021, or even, I guess, maybe just starting with the pandemic, that period of time where the real estate and property sector was really fueling not just growth and the feeling of local governments having

investment that they could that they could use, it it really overwhelmingly was the sense of just general optimism in Chinese society and a sense of Chinese cities becoming developed.

So, I think for what people are are undergoing now is a sense of sudden loss, and I think probably also a sense of not quite understanding what has actually happened. And and I don't know, and I think this is an important thing, even though I've just recently been in China, it is hard to know who people blame for that and and actually do people think this is as serious a structural issue, or do they see this as China's having trouble cyclically or coming out of the pandemic?

I guess I just would say, the role that that property has in Chinese society is also really important for how we think about marriage and fertility because in Chinese society, generally speaking, parents are expected to furnish apartments for their sons, and having an apartment and a stable job is fundamental to being marriageable. And that has then drop-down effects on the marriage rate as well as the fertility rate.

So, there are other sort of long-term implications, I think, for Chinese society if this sense of sort of low growth, pessimism, and precarious employment goes on.

[17:13]

CZIN: That's so interesting. Logan, I wanted to get your take on what you talked about: the political dimension of this. Right? because part of this fallout in the property sector is a reflection or stems from the Chinese government tapping the brakes, right, on the credit expansion in in the housing sector.

[17:28]

So, I want to get your understanding of what motivated that decision in the first place. And number two is the fallout has persisted, and it seems like the property market hasn't found its bottom yet. You know, why do you think the leadership has let this go on, especially given what Mary just said about how important property is, not just in a in a material sense for the economy, but how culturally and socially significant it is? Like, why has the leadership been so unwilling to kind of cauterize the bleeding?

[17:54]

WRIGHT: Yeah. I... There's a lot of interesting politics here, and I can't agree with Mary more about, the social implications of this because property was this massive wealth-generating engine in China for a long period of time. And I I mean, I say this in the book, but if you bought a property in one of China's six largest cities in the 2000s, by the end of the 2010s, you were a U.S. dollar millionaire almost certainly.

And there's just been very few kinds of engines of growth that you have seen over that timeframe. And I think what's missing right now is the obvious question of, like, what is the new engine of growth that will actually deliver prosperity and rising living standards to millions and millions of people?

And this is one of the reasons that you see such low consumer confidence alongside, you know, China's new growth strategies are basically capital intensive rather than labor intensive. They do not generate a lot of employment. They do not even generate a lot of household income even within the industries themselves.

But getting back to your question about the politics of this, I have a, I think, a very different view. I think there's a conventional view that says Beijing saw the property sector as too large. They burst the bubble. They have been resolute in trying to restructure the economy and have been willing to deal with the consequences of that restructuring. Now they're pivoting to new strategic industries that will offset the property sector.

My argument is totally different. Beijing had been trying to control the growth in the property bubble since 2010. They never really controlled this on the way up. There were meaningful purchase restrictions put in place in 2010 and 2011.

What sustained the property bubble was the credit expansion. Once the credit expansion stopped, after the de-leveraging campaign, you had an unusual transformation of credit growth in which developers repaid shadow banks by starting to borrow from homebuyers in the form of pre-construction sales.

[19:51]

And so, the construction boom continued into 2017, 2018, 2019, 2020, 2021, even though the fundamentals of the property market in terms of household formation, in terms of, you know, numbers of marriages were declining.

And so that disconnect between the pace of construction and the actual number of people that could occupy apartments, basically was the cause of the adjustment. And people blamed the three red lines in August 2020, but there were property developers defaulting well before the three red lines. We wrote a piece in late 2020 talking about all the financial risk events that were developing in China's system, because of the, of the fallout in the property sector that was already materializing. Because this pre-construction sales model was becoming impossible to sustain at higher and higher prices because people just could not go into enough debt to sustain it.

Now, there's another argument though, which is why hasn't Beijing responded more forcefully? Why haven't they stopped the bleeding? And there's interesting things here as well. In late 2021, they were starting to respond already, whitelisting certain developers, making sure they had access to liquidity. What happened then? The COVID lockdowns.

And the COVID lockdowns completely collapsed the pre-sales model whereupon by the time, you know, you can't actually get out of your home to buy anything. So, this is a credit crunch. It's a credit crunch from households to developers, and that's why you have such a rapid deceleration in construction activity, why housing starts fall forty percent in 2022, why construction activity just plummets.

But then you have a different problem if you're Beijing because now you have to bail out all these homebuyers. And then why do you want to bail out the developers?

Shouldn't you just be transferring the projects to local governments? Well, you start doing that, but that's a slow process because the local governments have their own constraints. And so, it becomes a difficult political question about you are primarily bailing out property investors, not necessarily owner-occupiers. There's a lot of owner-occupiers, but the market has become so speculative in the later stages that, like, who do you really want to bail out? And so, this is, I think, what explains the reluctance to come in with a much more aggressive kind of purchase program.

And now I would argue it's over. Like, it doesn't make a difference what they do now because in a macro sense, construction's down 80%, sales are down 60%. The impact has happened. We have seen the implications of it externally. It will probably rally cyclically, but what you do probably isn't really that decisive one way or the other in terms of offsetting, offsetting the impact.

And the market is bifurcated. In interior cities, there's tons of supply. Probably no one's moving into those cities. Probably you're going to repurpose a lot of that supply into other local government social services and other usages and social housing and things like that.

In coastal cities, actually you have a shortage of housing because nothing's been built for three years, and so you have a mismatch because the secondary market, people want to sell their flats and people who own secondary market houses want to buy new ones that are cheaper, but you don't really have a lot of new supply that's available and that demand is very patient, so it's a very slow adjustment that's taking place.

It's just unclear what Beijing can really do about that. But, um, the the point being there's a large school of economic thinking in China right now that says China's problems are just about the property sector, and if we just stabilize the property sector, everything would be okay.

And I think the point I would make is, first, that's probably not going to happen. Second of all, it's a much broader problem beyond the property sector itself that's been entrenching deflationary dynamics in China that have been discouraging private sector investment well beyond this.

It's kind of a convenient excuse to say we only have this problem with one sector. We don't have a macro problem with our development strategy.

[24:06]

CZIN: That's a great point. I want to address another aspect of the economic slowdown, which is the high youth unemployment, which as of August was 19%. And Mary, I want to get your take on why is this number so high in the first place. And number two, how is that affecting how young people think about their future, about their future in the workplace, and what this means for their prosperity going forward?

[24:28]

GALLAGHER: Yeah. On, on unemployment just generally, I guess what I would say, because I, I want to address the youth unemployment, which is important, but I also

want to just first touch on employment in general. And, you know, China's official unemployment rate, doesn't move very much. It tends to hover around 5%. And it's partly the way in which the government measures unemployment.

The youth unemployment has now been reported as as high as over 20%, then it was recalibrated right now I think at 19%. Just generally on on unemployment, what I would say is, the unemployment rate undercounts people who are rural in China, who generally are not gonna claim unemployment. They're not gonna show up in that rate. They tend to just go back to the cities or hometowns where they're from and and leave the big coastal cities where they might be working, so they're not gonna be captured.

And the other thing is that what has happened with employment is that a large, almost half of the working population is now not in the formal sector, which means that they are not formally employed. They don't have labor relations with a firm. So it could be that they are working for a platform. It could be that they're independent contractors. It could be that they're sort of, you know, broadly speaking, in the gig economy.

And there's been a very, very rapid expansion, I would say, over the last 10 or 15 years of this sector of of the labor market where people might... would not show up in unemployment, but they are employed in such a way that they are very precarious, and they don't have security, and also they're not paying into the social insurance systems where they would when they retire, get a substantial, pension. It also has impacts, of course, on their on their medical care.

[26:15]

So overall, I think the the labor market in China has a lot of signs of being under stress, and that's not just, youth unemployment. On the youth unemployment, there's lots of interesting things about this, and I think part of it, and I'll just say first because it sort of mitigates this very, very high number, it is the case given the kind of pessimistic outlook for this generation of of people graduating from college that their parents, and particularly urban households, are going to be able to take care and sustain their young adults.

So as in the United States, this was a big social issue after the global financial crisis, like failure to launch, that sort of thing. That's a big aspect, I think, of this high unemployment rate because there are many kids who are staying home with their family and they also may be part of this gig economy and we don't, you know, really understand how they are making money. They might be doing lots of things in which they're making some kind of, some kind of income.

The other thing that is really important about China's youth unemployment rate is that China's labor market is still very, very segmented. So, you will not see college graduates going out for the same types of jobs that say a rural migrant with maybe a middle or vocational school education. And and that also I think feeds into it's better to be unemployed than to go work in a factory.

That that dividing line between sort of urban *hukou*, highly educated versus rural *hukou*, household registration, where they're, where they're located in terms of their

household registration and education. That also I think is an important reason for why you see youth unemployment on so high, including people with high rates of education.

CZIN: That's great. So, we focused so far in the conversation a lot on the downbeats in China's economy. But I wanted to pivot to talk a little bit more about what we see in the official narrative. Right? Where there is this focus on the technological advancements China's making. Obviously, its export growth has been blockbuster over the last couple of years.

And we talked about this, like I mentioned, with Evan Osnos when we had him on on our last episode to talk about how we reconcile these elements of dynamism and dysfunction in the system.

And, Logan, I want to turn to you first. What do you make of the argument, not just the official argument in Beijing, but, you know, I think there's an alternative theory about how this looks, at least from Xi's perspective, that he's making a bet and that he's making a big one. Right? And that what we're talking about in the property sector and in the financial market, this is the price Beijing has to pay for an economic transformation, as they go through a transformation to new economic drivers, and that when they reach the other shore, he thinks that Beijing will be in a stronger perspective.

What do you make of that argument, and what do you think is missing from that perspective?

WRIGHT: Yeah. I think that that is sort of this internal view, and you see this sort of through the the He Lifeng industrial policy sort of view of the world. It's a different kind of macroeconomics than what we're used to seeing in the West. And it's a bit, as I said, I think it's disconnected from where the ultimate sources of aggregate demand are. I mean, the disconnect in China's strategy, it says, we want to be self-reliant, we don't want to be dependent upon the rest of the world for anything in our industrial development, but in doing so, we will become almost entirely dependent on the rest of the world for economic growth.

Because the marginal demand for everything we're producing is still outside of China rather than inside of China. And that is, I think, the big disconnect in that strategy.

But what does the leadership see? I think the leadership has a view that is sort of Marxist infused kind of development model where they they say, Look, what's important is the investment in advanced productive technologies and in these investment in these advanced technologies will produce productivity growth. That historically investment has therefore generated additional jobs and has generated additional consumption. It's generated services growth along with this investment.

So, from there will come higher wages. And so, we just have to wait and develop these things and have confidence. I think that's a very coherent internal view. But what it overlooks is this, you know, if you're managing investment within different parts of an input-output table, ultimately there has to be an end consumer at the end of this industrial chain. And currently, there's a limit to how much China can rely upon, overseas consumption for everything that's being produced.

[30:45]

And so, I think that's the question that we're all grappling with is: what are the limits to China's export growth, and do you get an internal pushback against this model because it's not generating very much employment, and very much consumption growth, or do you get an external pushback against this model?

Either one might not cause Xi to change course because they've invested quite a lot in this bet, just as you say. What I think it misses is the fact that deflation really, really alters the incentives within this model because it means that you're depleting the wherewithal you have to sustain these industrial policy bets. You're depleting your own fiscal resources. And you're eviscerating private sector investment demand at the same time, as long as you're producing more and more at lower prices.

But that has been underappreciated throughout this entire discussion over the last few years of China's export competitiveness, is that this has not been a parallel phenomenon to the decline in domestic demand. It's the same phenomenon. Most of the growth in export competitiveness is because of lower prices, accumulation of certain industrial clusters, investment in those clusters, and exporting to gain market share at lower prices as well.

[32:02]

CZIN: That's a great explanation. Mary, I wanted to get your perspective on how do you reconcile these elements of dynamism and dysfunction when you look at China's economy?

[32:13]

GALLAGHER: Yeah, and I think it's really important what Logan's point was, and I think this point has been also made by Meg Rithmire, who's at Harvard Business School, that these are really two sides of the same coin, that we need to think of these things as related as opposed to functional China and dysfunctional China, because they're actually very, very related. And this gets also to how households in China feel regarding sort of precarious employment and unemployment.

The the competition that we see internally in China in some of these advanced technology industries like, say, electric vehicles, where China's doing very well overseas, although also facing a lot of pushback from some economies, right now, particularly in Europe, is that that kind of, what the government often calls disorderly competition, which leads to overcapacity and production beyond what the market will bear, especially in China, but perhaps even globally, is that this kind of disorderly competition also has an impact on how people feel at the workplace, which is that wages are also not rising alongside this, like, great performance of these of these industries.

And people do not necessarily feel like they are benefiting from China doing well because the excessive competition between firms keeps profit margins very, very thin. And then that puts pressure on wages and on treatment, and conditions for workers.

The sad thing about understanding the dynamics within China is, like, they're just less well understood nowadays because, you know, most foreign journalists have left China. The media in China, generally speaking, cannot report on stories that are extremely negative and that tend to deflate confidence. And so, I think it's just, it, it's an underlying part of the story that is not as well understood, because of the information, gap, I think.

[34:03]

CZIN: I wanted to pull on the thread about how then this affects the United States, because I, I think your point's well taken that the dysfunction, the dynamism, it's almost a dialectical relationship, right, between the two of them in the Chinese system.

But it seems to me that what the United States and even Europe experiences is the strengths of China's system rather than its weaknesses. Right? And this is one of the paradoxes that I found really troubling over the last couple years, and I think you both made this point, right, is that their weaknesses are actually, in some ways, you know, compounding China's geopolitical reach, right, as their exports take up more and more market share and hollow out Europe, right, and have a pernicious impact in other parts of the globe.

So, I just wanted to get your take on this, on on the global ramifications on this, and in particular, whether you think there will be some kind of pushback, because I, I... this is something I hear over and over again, that it's not sustainable, but yet every time the numbers come in each quarter, they're bigger and bigger. And even with the pushback from Europe this year, right? I think Finbarr Birmingham from South China Morning Post pointed this out, that Germany had a 200% growth in Chinese imports, even as they were gearing up for some kind of pushback against the PRC.

So, Logan, do you want to take a crack at this first about the sustainability question and the kinda global ramifications of the China's internal dysfunction?

[35:18]

WRIGHT: Yeah, so I I think these are, very much two sides of the same coin. The threat we face as the United States and in Europe, I think from China, is just fundamentally different than it was four to five years ago. It's no longer really about a well-functioning, sustainable economic, systemic rivalry in the same way in terms of China will be able to continue to achieve all of its goals and its objectives, and therefore we need to be concerned about what its goals and objectives are.

The challenge is deindustrialization. The challenge is China will basically successfully fight over a shrinking pie of global demand, because that pie of global demand is being compounded by the export pressures that are coming out of China itself.

And so, this is kind of the the dilemma that the rest of the world faces. There are clear needs to protect yourself with trade defenses against these deindustrialization pressures, but it's not at all obvious exactly where you start. It's not at all obvious

exactly how much you need to invest in your own industrial policies in order to protect from Chinese deindustrialization pressures.

And the debate in Europe right now is super interesting because they are starting to draw lines, and the recent auto, you know, the safeguards arrangement that, that was reached is an important signpost, and I think more of these cases will come about.

But it's a very different debate over protecting your existing industries versus trying to counter deindustrialization pressures that are already far advanced and sort of catching up at the same time.

[37:00]

So, the sustainability question is exactly this. Right now, the global AI trade is really central to global imbalances, no matter how you look at it. It is rising costs of consumer hardware that are inflating Chinese exports in value terms, not in volume terms. Chips, but also, you know, other types of consumer electronics. Also, labor-intensive goods where China can actually export at higher prices and pass on rising fuel costs that they cannot pass on domestically.

But fundamentally, it's difficult to see how this sustains itself over time. Because if you're China and you continue to make inroads into other countries' exports year after year after year, eventually different political alignments pop up that stop that. It's not that countries, even if they are sort of hamstrung by internal dysfunction in one year, that doesn't mean that's gonna continue into the next year.

And if this is happening in multiple countries around the world, it's harder to see how China successfully plays them off against one another just to keep this going for just a little bit longer ad infinitum.

And so, I'd argue there there are sectoral limits to China's export growth, there are macroeconomic limits in terms of trade deficits, and there are political limits, and we're starting to see some of the political limits, especially in Europe right now.

[38:22]

CZIN: Okay, so last question. Given those challenges to sustaining this growth path, what does China's economy look like five years from now if it stays on its current course? And if the leadership, either under Xi or under a future leader, wanted to change course, what would that look like? What would they have to do in order to change China's trajectory in the coming years? Mary, would you like to go first?

[38:42]

GALLAGHER: Well, I think just on the last point that Logan was talking about and your your point about the the relationship with the United States in particular, I think it is really important to, although very, very difficult to understand kind of the the issue of blame attribution within the Chinese, within Chinese society.

Like, there are—and I think it depends on who you ask, and I obviously survey, public opinion polling in China is very, very fraught. I would say anecdotally, I think

that people probably at the lower and middle economic classes are probably more likely to buy the regime's narrative that this is really about Donald Trump, the trade war, and the desire to stymie China's rise.

And so, overcapacity really becomes a trap in that regard because desire to protect the economy, the domestic economies in Europe or in the United States and to boost employment there basically reiterates the regime's narrative about stopping China's rise and also hurting them through these, through tariffs, of course, and now through perhaps things like voluntary export restrictions.

So, what what does that mean for the future? I think what I would say about how people assign blame, I think for people who have capital in China and for many, many private entrepreneurs, I think this is really a Xi Jinping story, and I think it really does matter who's in office in five years.

That would of course be his fourth term. And I don't think that there's confidence that he has the ability or, or really even the understanding or the desire to address these structural changes. I think Xi Jinping is is perhaps ill-informed on the economy, but he is also, I think, willing to double down on this strategy, which will undermine relations with other parts of the world, and that's just fine by him. And so, I think if he's in office still, that will probably be very difficult for the Chinese economy, but it will also mean that relations with the rest of the world haven't improved.

I think on the other hand, if there is a new leadership that can signal a change, a change in orientation, it would have to be a fairly significant change, and I don't know how that would actually happen, given that he's taking a fourth term, I believe.

But I think there would be a lot of interest around a new, a new orientation, both from other countries and also, I think within Chinese society.

[41:13]

CZIN: That's great. Logan, what, what might that new orientation look like? What would it take, you know, for the Chinese leadership to change course? What would that look like? Would it look like a refresh of the 2013 Third Plenum document, or has that horse left the barn?

[41:27]

WRIGHT: Yeah. I mean, to a certain extent, you're not gonna have the same impact as you would've in 2013. But, as I like to say, there's, there's nothing that stops Xi Jinping from going on television tomorrow and saying, you know, the fiscal and financial system worked well for us for the last 10 to 15 years, but it's not gonna work for the next 10 to 15 years.

So, we're gonna make this better for all Chinese citizens. We're gonna tax the rich. We're gonna break up SOEs. We're gonna put SOE shares into the the pension funds. We're going to equalize migrant workers' pensions, which they have the capacity to do.

So, these options are there. But that would all entail slower growth in the meantime. That would all entail, you know, weaker investment growth as these companies

would no longer be viable, so it would slow China's overall growth rate. So why doesn't he do that? Well, A, I don't think he really believes that China has that much of a problem. I don't think he really believes that their, that their constraints are really that fundamental at this point.

B, ideologically, it's not clear exactly if the East is rising and the West is declining, can the ideology, can the propaganda sustain this kind of an adjustment in policy or in orientation away from their current strategy?

And three, strategically, if you're engaged in competition with the United States, and you're trying to push back against de-risking momentum, you want to say that the economy's still vibrant and it's still worth trading with us, even if the U.S. puts export controls or sanctions on some of our companies.

And, so, you know, there's a, there's an entirely different logic that sort of keeps this locked in at this point. But ultimately, the the consequences of the model failing, and I think the model fails most obviously when there is export pushback, because the deflationary pressures intensify. Investment is almost certainly going to slow.

Where Beijing has agency is sort of how much they want to shore up consumption by at least attempting some of these rebalancing, steps and, you know, how much they want to actively embrace an adjustment in investment by cutting off other elements of the legacy economy further. How much they want to get in the process of writing down the capital stock and deciding who loses.

Those are the uncertain bits, and I think for, frankly, my personal opinion is it's hard to see Xi Jinping changing course, but it doesn't really matter whether it's Xi or someone else. It probably just takes time. Even if Xi was replaced overnight, I'm not sure that there would be a dramatic change in approach, although that would probably be more possible than, than if we just continued this.

CZIN: Well, Mary, Logan, thanks so much for sharing all of your insights. We've gone a little bit longer than we typically do, but I think that's because this is such a meaty, protein-rich topic. And I think you gave— you definitely gave me a lot to chew on, and I hope you gave our listeners a lot to chew on as well. So, thanks again for taking the time to join us today.

GALLAGHER: Thanks so much, Jon.

WRIGHT: Thanks, Jon.

[music]

CZIN: On behalf of the team at the John L. Thornton China Center, thank you for listening to the Beijing Brief. This podcast is produced by the Brookings Podcast Network. For more in-depth analysis from our team, please visit the China Center on the Brookings website at [Brookings dot edu slash ChinaCenter](https://www.brookings.edu/china-center/). You can also subscribe to our monthly newsletter, the China Bulletin, for the latest updates.

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