Q. & A.

DID AUTHORITARIANISM CAUSE CHINA’S ECONOMIC CRISIS?

An erosion of trust between the government and its people now threatens the country’s decades-long boom.

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China's economy, the world's second largest, is facing its most serious setback in a generation. During the past two years, economic growth appears to have been cut nearly in half. After emerging from the "zero COVID" policies that Xi Jinping, China's leader, ordered early in the pandemic, the country now faces a real-estate crisis and faltering confidence from both its own citizens and overseas businesses. The problems have sparked debate among economists about whether Xi's increasingly autocratic regime is to blame, and what a major slowdown could mean for the rest of the world.

To talk about China's economy and the possible causes of its malaise, I recently spoke by phone with the economist Eswar Prasad: a professor at Cornell University and a senior fellow at the Brookings Institution, an expert on the Chinese economy, and the author of "The Future of Money." During our conversation, which has been edited for length and clarity, we discussed why Xi may be hesitant to implement significant economic reforms, how serious a threat a crashing Chinese economy is to the rest of the world, and the lasting impact of China's pandemic policies.

What do you think has gone wrong with China's economy, and why has it manifested itself so clearly now?

The Chinese economy has been beset by a combination of short-term problems as well as longer-term structural challenges, all of which seem to be coming to a head at the same time. It has long been powered by investment, and investment certainly sounds like a good thing, because if you invest more, the economy can grow faster. But China has had relatively inefficient investment. A lot of it has been undertaken by state-owned enterprises that are not necessarily investing in the most productive way. China has in particular relied a great deal on investment in the real-estate sector, so the property market is now beginning to unravel a little bit because there was a lot of speculative activity in that market.

Then there is the problem that some parts of the economy, including local governments, have a lot of debt, a lot of fiscal pressures. There is also a longer-term challenge: China has an aging population and a labor force that is already beginning to shrink. If there isn't a path to higher growth via investment, and if the labor force is shrinking, the only way you can generate growth is through more productivity, and they're not able to do that.

On top of that, global demand for China is weak, so it's not able to export as much to support its economy. China took away its "zero COVID" policy, but consumers and businesses seem quite nervous about the country's economic prospects. Businesses—private businesses in particular—aren't investing and consumers are not spending that much. All of this is now leading to another problem, which is deflation, or falling prices.

In an economy with these types of problems, what are the solutions that a government would normally try to implement?

It can use fiscal policy. In other words, the government can go out and spend more. It can give people money, it can spend more on investment and on buying things, and that can stimulate economic activity. It could also do things like cut taxes, which leaves more money in the pockets of people, in the hope that they will go out and spend. Then, the central bank can make money cheaper, essentially —by cutting interest rates and flooding the economy with money, they can make money cheaper for both businesses and consumers and also reduce the cost of that money.

The difficulty that China faces right now is somewhat larger in scope, because even if you give people money to spend, if you make it cheaper to borrow, if you give them government handouts, people need to be confident about their future economic prospects so that they go out and spend rather than save. Right now, China could use its traditional policy tools, but I think the fundamental problem that the Chinese economy is beset by is really a lack of confidence, and we've seen this in a variety of measures. Private investment has essentially collapsed during the last year, although a lot of that is attributable to the real-estate sector. Retail sales, especially of big-ticket items, such as cars, have gone down a bit. The real problem seems to be that businesses and consumers don't quite have confidence in the government's ability to turn things around.

There's been a big debate going on with a number of very prominent economists about the degree to which China's current problems and difficulty finding solutions really stem from its authoritarianism. China's obviously been an authoritarian country for a long time, but it's got significantly more authoritarian in the last decade under Xi Jinping. How do you think about the contours of this debate, and why is this debate important?

It is certainly the case that the command-and-control mentality of the Chinese government has made it somewhat harder for them to recognize problems as they arise and to tackle them in a frontal way. Additionally, state-owned enterprises, which still comprise a significant share of economic activity, are under the direct control of the government, as is much of the financial system, especially the state-owned banks. The government seems to believe that it can manage its way out of any problem.

What I think is the real problem for China is that they're stuck halfway. I'm not saying that a fully command-and-control model would be ideal, but what China wants to do is let the markets work to some extent, and that is a bit of a problem. It's very challenging to have markets work when you don't have the necessary institutional reforms. What that means in plain language is that you need the rule of law. You need good corporate and government transparency. You need good auditing and accounting procedures. Without those attributes, which China doesn't have, the market cannot really function well, so we've seen a lot of volatility in stock markets, in land prices, and so on.

The other problem is that when things are not going well in the part of the economy led by the private sector, the government steps in and tries to set things right directly. Now we have a situation where people think the government will step in, but they're not quite sure, so this creates even more volatility and uncertainty.

The case that Chinese authoritarianism is causing problems goes beyond just the factors you have cited. There have been reports in the *Wall Street Journal* and elsewhere that Xi is for ideological reasons unwilling to orient the economy toward more consumer spending. There's been concern that Xi's crackdowns on foreign business have sorely hurt international confidence in China.

There is certainly a sense that Xi tolerates private enterprise but sees state-owned enterprises as the bulwark of the economy. During the last year and a half, especially, that tightening has been very apparent. We have seen high-flying tech companies get cut down to size. We have also seen crackdowns on private funds in the medical and educational sectors. There is a very clear sense that, while the government is willing to tolerate private enterprise, it doesn't want private entrepreneurs to become so successful or have their firms become so big that it makes it difficult for the government to control them.

This is a problem for the Chinese economy. Going back to where we started this conversation, China cannot grow anymore through investment or through an increase in the labor force, because both of those are not happening. It needs more productivity, and the reality is that private enterprises have been much better at generating innovation, which in turn generates more productivity. Small and medium enterprises are much better at generating employment growth. There is almost this cognitive dissonance: the government seems to understand that it needs the private sector in order to accomplish all of its economic objectives, but it's not willing to be seen as encouraging to the private sector.

I'd add that, in the early part of this year, the government did change its tune. It started saying, "We are very much in favor of private enterprise." The problem is that all the actions that they took during the previous eighteen months have essentially shattered the confidence or reduced the confidence of private businesses, and all the soothing words that they've heard from the government in the last three or four months have not been enough to assuage their concerns.

You seem to be saying that ideological rigidity explains a lot of this, because China knows what needs to be done and Xi or the people around him don't want to let the rope go and give up the power that making the fixes would require.

That's a fair characterization, but, again, it has to be balanced with the recognition that the system sort of has worked quite well for thirty years. Just to think about this in terms of context, the Chinese economy is now a nineteen-trillion-dollar economy compared to the U.S., which is about twenty-five trillion dollars. That's a huge economy, and to have an economy of that size even grow at four to five per cent in inflation-adjusted terms—if it was any economy other than China's, we would call it a remarkable, ongoing success. We've got used to China growing in the eight-to-ten-per-cent range, so suddenly four to five doesn't seem that spectacular, even though it's still remarkable. Having said that, China is still a middle-income country, and their goal of doubling the 2020 G.D.P. by 2035, for instance, is going to be very difficult to achieve on the present trajectory.

So even if Xi doesn't want to give up power for ideological reasons, he may not think that the way things are going is a complete failure because of the past thirty years of success?

That's exactly right. The feeling in Beijing is that their economic model has been validated, because many analysts and scholars, including myself, have been arguing for years, if not decades, that the economic model was not sustainable, that there were all sorts of financial risks building up, there were various problems emerging in the system. And it's true that they've gone through very difficult periods, such as 2014 to 2015, when the currency was collapsing, but they have got through them and have delivered much better economic performance, no matter how you measure it, compared to any other economy, including the most advanced ones. To them, what these circumstances call for are tweaks to their policy rather than fundamental changes. They have a very different perspective on all of this—that it's not really an economy on the verge of collapse.

If what we get are tweaks rather than fundamental changes, how concerned are you about what will happen?

It becomes increasingly difficult to sustain this model. It's just in the last two or three years that the labor force has started shrinking, and that's going to start biting into economic growth quite seriously. The Chinese government has a plan in place to try to, as they put it, move up the value chain, move up to higher-value-added manufacturing, to encourage the services sector, and so on. The objectives are all sensible ones, but in order to accomplish this, they need more innovation, they need more dynamism, and it's really the private sector that delivers all this.

It seems to me that the economic objectives they have in mind are going to become increasingly difficult to reconcile with the reality on the ground without major policy changes. Those changes are not just making the private sector feel more welcome, but also getting the financial system fixed so that the private sector gets the financing that is necessary to thrive. It's not clear whether the government can see that it really needs the private sector and will agree to do what is necessary with actions rather than words to support it.

Is it your sense that there's an ideological objection to consumption-driven growth?

That's not quite right. What China's had is a goal of what they call rebalancing consumption, because especially during the period around and right after the global financial crisis, investment was the key driver of growth. The government recognized that inefficient investment causes risks and problems in the financial sector, so they've had a plan of trying to do two things: get household consumption to play a bigger role in economic growth, and have the service sector play a bigger role in the economy. Service-sector growth is seen as more environmentally and economically sustainable than low-scale, low-wage manufacturing.

They made significant progress on both of these aspects of rebalancing in the previous years, but in the COVID period and right after there's been some backsliding. It is not true that they are ideologically opposed to household consumption. They've been explicit in their objectives, and have supported them with various policies to try to encourage household consumption. It's not quite where they want it to be, but there's certainly been progress during the last ten to fifteen years.

Do you expect the popularity of the Chinese model, in Southeast Asia and elsewhere, to take a hit if these problems continue to fester?

Yes, and I would characterize it less as popularity of the Chinese model than disillusionment with the free-market-oriented capitalistic model that the West, especially the U.S., has long propounded as the approach for all countries to follow. I think there is a general recognition that you need to have markets work well, but of course there are many countries where the state still plays an important role and is seen as being necessary to stabilize the economy and to maintain reasonably stable growth. Certainly if the Chinese economy were to take a big hit now, that would almost inevitably shift the balance of the debate toward the sense that market-oriented economies generate better economic outcomes.

Are there specific aspects of China's economic crisis right now that have led to less concern about worldwide contagion? It feels like people are worried about China's economy, but not too worried about a catastrophic spread.

China's financial markets are quite big, so to have them take a tumble should be a cause for concern. But the reality is that the world is now a little less exposed to China than it used to be even a few years ago. The direct links of Western financial markets to China's are actually quite limited. If the Chinese stock market were to crash, it's not obvious that it would have a huge negative effect on the U.S. stock market. One reason, of course, is that the U.S. economy at the moment is doing quite well. U.S. exports to China are limited, so even if China stopped importing both goods and services from the U.S., there are certain sectors, including education, that would take a bit of a hit, but, over-all, the dampening effect on the U.S. economy is likely to be limited.

If China were to demand fewer goods from the rest of the world, one thing that might happen is that commodity prices are going to be much weaker, and for commodity-exporting countries, oil-exporting countries, that's a problem, but for many of the major Western economies that are importers of many of those commodities, having commodity prices fall may actually help in holding back inflation.

You mentioned that some of the issues around household spending were impacted by the "zero COVID" policies. Even though those policies have now been lifted, do you expect to see any long-term effects?

The important one, I think, is going to be the scarring effect on confidence. When China first instituted a "zero COVID" policy, it did certainly limit the number of COVID-related fatalities. But then it became increasingly clear that it was an untenable policy, both in economic terms and just in terms of the effects on society. There was a lot of pushback. The government stuck to its policy well after the point where I think it made sense, and then there was this very abrupt reversal, which, again, the economy had to get used to.

I think the sense that the government is somewhat inflexible with its policymaking and tends to hold the line beyond the point that makes sense and then makes these very abrupt policy shifts has been a real damaging factor when it comes to private-sector confidence, and that I think is going to be the real problem. The true long-term effect is really going to be in terms of what it did to the private sector's perception about the government's somewhat wayward policymaking process.

Just to go back to the discussion we were having earlier about whether China's economy is suffering because of the overhang of this ideological rigidity and authoritarianism, wouldn't the people making that argument say, "Well, there you go, business confidence during 'zero COVID' is a huge problem for China going forward, and that policy stemmed from the ideological rigidity of the Xi regime?"

Yes, I think that would certainly be consistent. At the time, it did kind of make sense, but you're right that the rigidity of the policymaking soon became apparent, and the government, because of its ideological rigidity, was not able to flexibly change policies. If you don't have an open and transparent government that is accountable on a regular basis to the citizens that it seeks to represent, messages become much harder to get through to the top.

We've been talking about China's period of strong economic growth during the past several decades. Do you think it's worth bracketing the last ten years as part of a different era?

There has been a significant and important break in the approach: I think we have seen increasing state-oriented policymaking beginning to take hold. That has certainly not been an abrupt change, but the signs have been quite apparent that the reformist era predating Xi is over. During the last ten years, it's not that we have not seen any reforms at all, but major reforms in terms of the real side of the economy, especially state-owned-enterprise reform, and reforms in terms of the institutional framework, the rule of law, the independence of the central bank, the policymaking imperative—on those fronts, we have seen very little progress. In fact, we've seen some backsliding. This did not seem to have negatively affected growth in the early years of the Xi administration, but I think that the lack of reform momentum might be beginning to exert a significant toll. ♦

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