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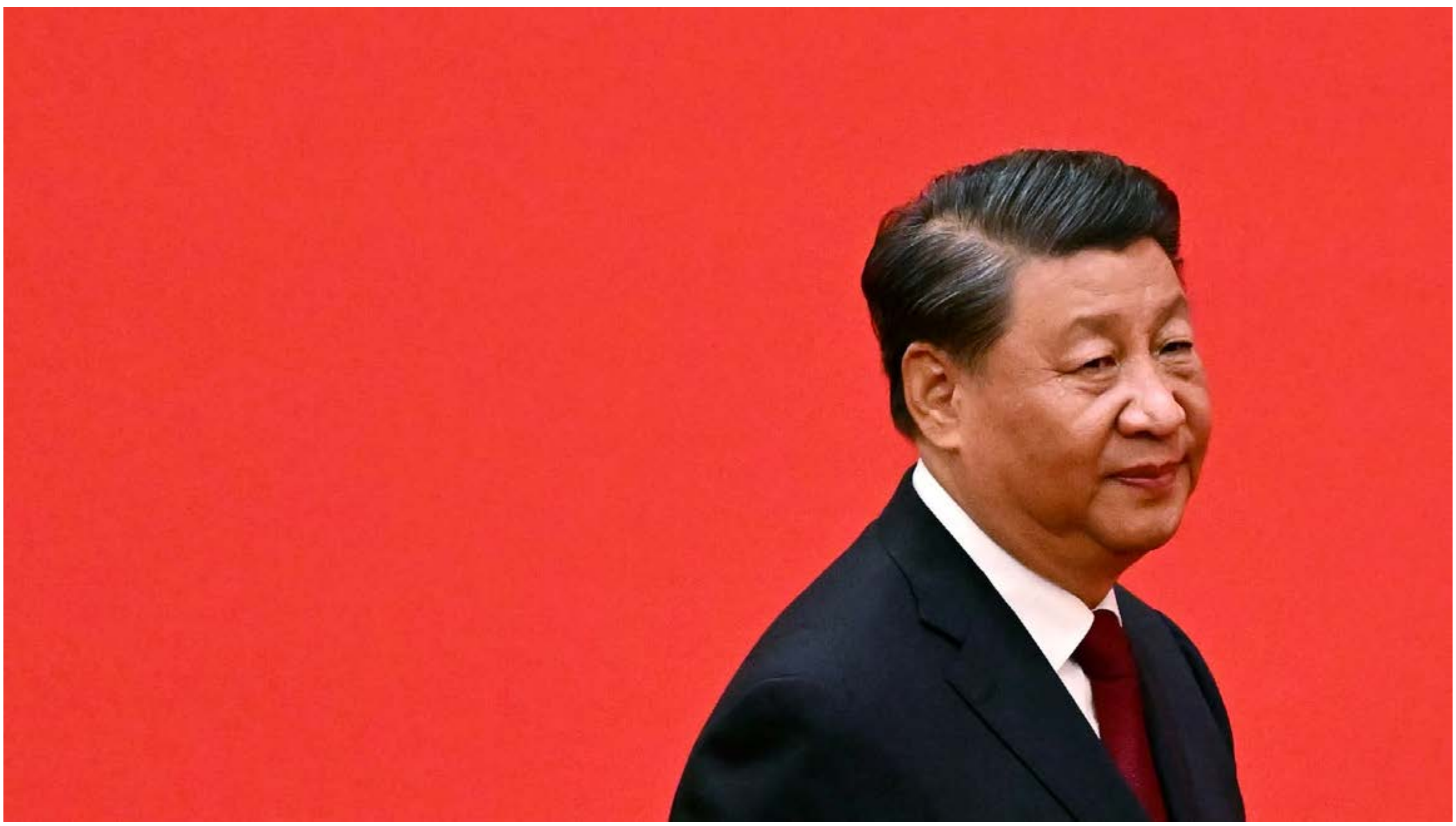
What China's Slowdown Really Means for the West

Xi Jinping is still determined to compete, if not by becoming richer, then through other, possibly more destabilizing means.

By Michael Schuman



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CHINA'S JOBLESS COLLEGE GRADUATES have become an embarrassment to Chinese leader Xi Jinping. The unemployment rate among the country's youth has reached an all-time high, putting the country's severe economic troubles on display at home and abroad. In August, Xi's administration decided to act: Its statistics bureau stopped releasing the data.

But Xi can't hide China's economic woes—or hide from them. The problems are not just a post-pandemic malaise, or some soon-to-be-forgotten detour in China's march to superpower stature. The vaunted China model—the mix of liberalization and state control that generated the country's hypersonic growth—has entered its death throes.

The news should not come as a surprise. Economists and even Chinese policy makers have warned for years that the China model was fundamentally flawed and would inevitably break down. But Xi was too consumed with shoring up his own power to undertake the necessary reforms to fix it. Now the problems run so deep, and the repairs would be so costly, that the time for a turnaround may have passed.

Contrary to the assumptions of many commentators in recent years, China may never overtake the United States as the world's dominant economy if current trends continue. In fact, it's already falling behind.

A downward trajectory in China does not necessarily ensure the future of American global power, however. China may turn out to be a less formidable competitor than once imagined and offer a less attractive model of development for the rest of the world. But economic failure could also heighten Xi's determination to overcome

American dominance—if not by becoming richer, then through other, possibly more destabilizing means.

The demise of the China model is in many ways a function of its tremendous success. When China's free-market reforms were just getting under way in 1980, the country was poorer, per capita, than Ghana or Pakistan. Today, China has an $18 trillion economy capable of devising 5G telecom networks and electric vehicles.

The motor of the China model is investment, and lots of it—into factories, highways, airports, shopping malls, apartment towers, you name it. China was destitute at the outset of its reforms, and much of the new infrastructure was necessary. Better transport systems helped to boost economic efficiency; new housing sheltered families migrating from farms to cities in search of opportunity. The investments turned China into the world's factory floor and produced eye-popping rates of growth.

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Over time, China developed a more advanced economy, but the state and companies nevertheless kept on building. The growth rate stayed high, but now the economy was generating wasteful excess that undermined its health. Logan Wright, a partner at the research firm Rhodium Group, estimates that China has 23 million to 26 million unsold apartments. That’s enough to house the entire population of Italy. Many of these apartments will never be purchased, Wright conjectures, because they were constructed in towns with declining populations. China’s automobile industry, figures Bill Russo, the founder of the consulting firm Automobility in Shanghai, has enough unused factory capacity to make more than 10 million cars (sufficient to supply the entire Japanese car market—twice). Beijing boasts about its extensive network of high-speed railways, already the world’s largest—but the state-owned company that operates it has racked up more than $800 billion in debt and posts substantial losses. The Cato Institute once described China’s rail-building bonanza as a “high-speed debt trap.”

The Chinese “continue to invest beyond what they can actually absorb,” Alicia Garcia-Herrero, a senior fellow and specialist in Asian economies at the think tank Bruegel, told me. “This is why their model went wrong.”

As a result of all this unproductive investment—much of it financed by borrowing—China's debt has expanded much faster than its economy. A decade ago, China's total debt was about twice the size of the country's economy; now it's three times as large. Michael Pettis, a senior fellow at the Carnegie Endowment for International Peace, writes that China has "among the fastest growing debt burdens in history."

Politics have exacerbated the debt problem. The Communist Party has trumpeted high growth rates as proof of its legitimacy and competence, so when growth rates have slipped below targets, authorities unleashed credit to pump them back up. The International Monetary Fund estimates that China's local governments have amassed $9 trillion in debt in the name of financing infrastructure projects.

China's leadership has long known that its investment strategy carried risks. Back in 2007, Wen Jiabao, then China's premier, said, "There are structural problems in China's economy which cause unsteady, unbalanced, uncoordinated and unsustainable development." And Chinese policy makers knew exactly how to repair these problems: China had to "rebalance," as economists say, meaning that it needed to decrease its reliance on investment and foster new engines of growth, especially domestic consumption, which is abysmally low compared with that of other major economies. For that, economists agreed, China would need to liberalize its financial sector and relax the hand of the state on private enterprise.

Early in his tenure, Xi seemed to accept these imperatives. In 2013, he signed off on a Communist Party reform blueprint that pledged to give the market a "decisive" role in the economy. But the reforms never happened. Enacting them would have diminished the power of the state—and thus Xi's own power. China's leader was unwilling to trade political control for economic growth.

The more power Xi has commanded, the heavier the state's hand in the economy has become. Xi has relied on state industrial policy to drive innovation, and he has imposed intrusive regulations on important sectors, such as technology and education. As a result, China's private sector is in retreat. Two years ago, private companies accounted for 55 percent of the collective value of China's 100 largest publicly traded firms, according to the Peterson Institute for International Economics; in mid-2023, that share fell to 39 percent.

Now rebuilding the private sector's confidence is perhaps the most urgent task facing China's economic policy makers, the Cornell economist Eswar Prasad told me: "And on that score they don't seem fully cognizant of what needs to be done, or maybe they're just not willing to do it, and that I think has some fairly serious repercussions for China's growth." Prasad added that the chances of policy makers correcting course are "pretty slim" because they consider private enterprise a "necessary but not really ideal avenue of generating more growth."

At a time when China sorely needed to juice domestic consumption, Xi's draconian pandemic lockdowns delivered a devastating blow to incomes. The China model has cracked under the pressure: So little demand drives the economy that it has slipped into deflation, which, if it persists, could further discourage the investment and consumer spending that the economy needs to revive. The Peking University professor Zhang Dandan recently estimated that the unemployment rate among youth ages 16 to 24 could be close to 50 percent, more than twice the official figure. Real estate was once a major contributor to economic growth and a store of middle-class wealth. Now investment, sales, and prices in that sector are falling. The largest private developer, Country Garden, is teetering on the brink of default as its Hong Kong–listed shares have lost two-thirds of their value since the beginning of the year.

China's economy isn't beyond repair, but fixing it will be costly and painful. The government will have to write off bad debts, close up zombie companies, and introduce sweeping market reforms of a nature that policy makers have so far avoided. Taking these steps would reboot the economy for a new phase of growth—not at the lofty rates of the past, but at a pace that could sustain the country's economic progress.

The Chinese government has shown no interest in adopting these reforms, however. Various authorities have issued multiple-point plans to support the economy that amount to little more than administrative tweaks and vague pronouncements. Xi's confidence-inspiring message to the public is, essentially, "suck it up": "We must maintain historic patience and insist on making steady, step-by-step progress," he said in a speech recently published in the Communist Party's top ideological journal.

Economists are not anticipating that China will soon collapse into a financial crisis akin to the 2008 Wall Street subprime meltdown. But their outlook on growth has turned somber. Daniel Rosen, a co-founder of Rhodium, says that if China were to make the proper reforms, it could endure very low growth during a period of adjustment, but then emerge with annual advances of 3 to 4 percent—not bad for an economy its size. But without those reforms, growth will likely slumber at 2 to 3 percent. Prasad expects that the Chinese economy will grow at 3 to 4 percent for the next several years, but that without more market-oriented policies, it will probably not sustain that pace.

None of these rates are alarmingly low, but they are probably not high enough to allow China to catch the United States from behind, or even to make it a close competitor in years to come. For China's leaders, Prasad told me, "the question is whether that is going to be enough to accomplish what they want."

Xi Jinping has spent the past decade amassing personal power. Now the yuan has to stop with him. In theory, the economy's troubles should prod him into a rapprochement with the United States, to stop economic relations with the West from further deteriorating and keep foreign technology and capital flowing to aid the country's development. But Xi is taking China in a different direction.

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At the latest summit of the BRICS group of developing countries last month, the forum's members—Brazil, Russia, India, China, and South Africa—agreed to add six more, including Iran and Saudi Arabia. Xi appears to envision the BRICS as a counterweight against the West. *Global Times*, a news outlet run by the Chinese Communist Party, opined that "as more like-minded developing countries join BRICS, a stronger collective force will form, emitting a more resounding 'BRICS voice,' driving the world toward good governance."

The language suggests that Xi remains undaunted in his quest to remake the world order, despite—or even because of—the economic troubles confronting him at home. The only thing he has changed is the strategy. "I think this is the plan: 'My economy might not be bigger'" than America's, Bruegel's Garcia-Herrero said, "'but my bloc will be bigger.'"

In other words, if China can't overtake the U.S. on its own, perhaps it can do so in aggregate. But that plan may not work: The economies of the six new BRICS members combined are only a bit bigger than the United Kingdom's.

The determination to compete with the United States has long been a central component of Xi's economic agenda. In recent years, he has doubled down on industrial policies, including state financial support, specifically devised to put Chinese companies ahead of American rivals in such sectors as artificial intelligence and semiconductors. With a focus on "self-sufficiency," he has sought to reduce Chinese vulnerability to U.S. sanctions by substituting homemade alternatives for foreign imports. And his Belt and Road Initiative, a global infrastructure-building program, was designed to open avenues of trade and investment for Chinese business beyond the West. The BRICS are even talking about forming their own currency to decrease their dependence on the U.S. dollar.

China may not have the economic strength to attain all of these goals. The country remains relatively poor, with per capita income of $12,700—one-sixth that of the United States. It may not have the resources to support the continued expansion of its military capabilities, or to underwrite initiatives meant to bolster its influence abroad. State banks have already significantly scaled back development lending to low-income countries, for example.

The slowdown of China's economy may undercut Xi's ideological assault on the world order. By example, China has sought to demonstrate to the Global South that democracy and development are not inseparable, and that autocrats can have wealth, international respect, and political power. Those claims are harder to make with a faltering economy. If anything, China's economic troubles suggest that authoritarian regimes cannot both tighten control and sustain economic progress—that, ultimately, political reform must accompany economic reform.

Read: China doesn't want to compete. It wants to win.

Xi is unlikely to embrace this inconvenient truth. Rather, he will pursue his anti-West agenda with even greater urgency. If he can't point to rapid growth, then he'll have to find some other way to justify his repression to his own people, and a march for global primacy against American imperialists could do the job. Maybe Xi can't (or won't) make China rich—but at least he'll make China great.

For this reason, economic weakness could make China's leaders all the more dangerous—more prone to champion nationalist causes and stumble into foreign adventures, such as a military grab for Taiwan. One can only hope that Xi will look to history and realize that a nation's power can be projected only as far as its economic strength allows.