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China's Economy Is in Trouble. Xi Jinping Has Other Priorities.

As policy conclave gets under way, Chinese leader remains focused on economic security, leaving some long-running problems to fester

By Jason Douglas Follow *and Rebecca Feng* Follow

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Chinese leader Xi Jinping wants to fashion China into a manufacturing colossus that leads the world in technological innovation. His pursuit of that vision is increasingly weighing on China's economy.

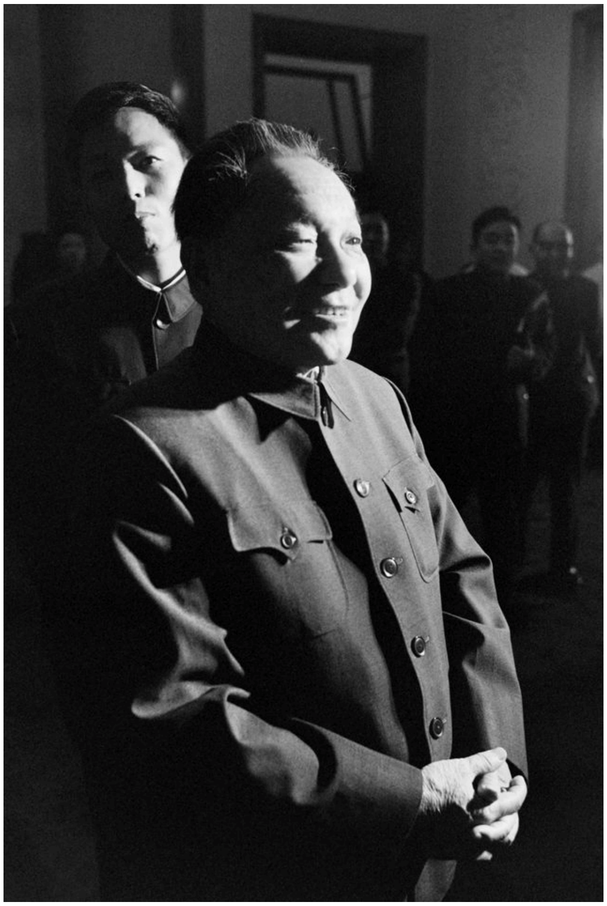
Growth is slowing and becoming more unbalanced, propped up by exports and a gusher of investment into factories, while much of the rest of the economy languishes. Consumers are reining in spending, the housing market is depressed, local governments are swimming in debt and foreign investors are pulling their cash—all at a time when China's population is rapidly aging.

Yet expectations are low for Xi to make a significant course correction at a Communist Party conclave this week, as he continues to put measures to enhance China's economic security above other priorities.

The event, known as the Third Plenum, happens every five years. In the past, it has delivered major economic overhauls that reverberated worldwide, such as when then-leader Deng Xiaoping used the 1978 plenum to shove China onto a path of economic liberalization, paving the way for decades of blistering growth.

This year, however, Xi seems more focused on steps to make China less dependent on Western technology, reduce China's reliance on other countries for semiconductors and other essential goods, and stake out a commanding position in industries he sees as critical for the future, including clean energy, electric vehicles and advanced computing.

To that end, and to prop up economic growth, Xi has been pouring money into China's factories. The results so far have been mixed at best, with weakening growth at home—the economy grew 4.7% year over year in the second quarter, down from 5.3% in the first—and



Deng Xiaoping PHOTO: FRANCIS DERON/AFP/GETTY IMAGES

mounting trade tensions overseas. A tide of cut-price Chinese goods has triggered fears of a new "China shock," a rerun of the early 2000s when cheap Chinese competition swallowed up industries and jobs in the U.S. and elsewhere.

Betting more heavily on manufacturing isn't expected to solve China's problems, economists say, and could even cause additional damage by making relations with the U.S. and other countries even worse.

The plenum is nevertheless expected to put Beijing's political stamp on Xi's vision, ignoring pleas from Western capitals to focus instead on more balanced growth led by more Chinese consumption. Failing to encourage more Chinese spending on goods and services from around the world is a recipe for more squabbles over trade, economists say, after China's surging exports of EVs, steel and other products sparked pushback in the U.S., the European Union and elsewhere.

"The Chinese economy is foundering," said Eswar Prasad, professor of trade policy at Cornell University and former head of the International Monetary Fund's China division. More stimulus to pep up spending and economic overhauls to revive private-sector confidence in China are urgently needed, he said.

Chinese consumers are reining in their spending, exacerbating the country's economic imbalances. PHOTO: NA BIEN/BLOOMBERG NEWS

Some economists have urged the Chinese government to roll out stimulus to boost spending. PHOTO: NA BIEN/BLOOMBERG NEWS

Party time

Past plenums, including those in 1993 and 2003, as well as the opening-up heralded in 1978, have delivered market-friendly overhauls often credited with spurring China's economic ascent. In 2013, top officials said that market forces should play a "decisive" role in the economy and relaxed the country's decadeslong one-child policy.

Economists do expect some effort to tackle some of China's problems this year. They say there could be tweaks to China's tax system to help indebted local governments get their finances on a firmer footing, or possibly some effort to revive China's appeal to foreign investors.

Some hope the government will go further, overhauling China's consumption tax to generate a new stream of revenue for local governments so they can do more to fire up local spending. Others say China's "hukou" system of household registration needs fixing to make sure workers can move to where jobs are without having to worry about housing or education for their children.

The Politburo, China's top policymaking body, is due to meet later in July and may consider a bevy of short-term stimulus measures to ensure China hits its 5% growth target for the year.

Mounting problems

A highway under construction in Jinan, China. PHOTO: QILAI SHEN/BLOOMBERG NEWS

But those steps may not be enough to put the Chinese economy firmly back on track at a time it faces two severe and intertwined crises—the downward spiral in its property market and the looming risks from trillions of dollars of hidden debt accumulated by local governments.

China's real-estate crisis is in its third year after Beijing tightened restrictions on developers to rein in excess borrowing. Property and related industries, which once accounted for up to a quarter of China's annual economic output, are now a major drag, with property investment shrinking 10.1% in the first six months of 2024 compared with a year earlier, data released Monday showed.

Since late 2022, China's policymakers have introduced a slew of measures to try to revive the market, including cutting mortgage rates and scrapping many home-purchase restrictions. Beijing introduced further measures in late May, encouraging local authorities to buy up unsold homes and convert them into affordable housing.

But the medicine doesn't seem to be working. New home sales in the first six months this year dropped 26.9% from a year before. Average new-home prices in China's 70 major cities fell 4.9% in June from a year earlier, according to calculations by The Wall Street Journal based on data from the National Bureau of Statistics.

Meanwhile, millions of presold homes remain unfinished despite government efforts to solve the problem. China's central bank offered a pool of $27 billion in interest-free funding to commercial banks to lend to developers so they could reboot construction projects. But banks have been reluctant to lend, wary of taking on too much risk, and the credit remains largely untapped.

Developers have stopped buying land from local governments for new projects, taking away a significant source of funding for cities. After plunging 33% between 2021 and 2023, income from land sales for local governments declined another 14% in the first five months of 2024 compared with a year earlier, according to data from the Ministry of Finance.

Many provinces and cities are now in dire financial straits, unable to pay back all of the estimated $7 trillion to $11 trillion in off-balance-sheet debts they accumulated in recent years to keep growth ticking over, according to analysts. Interest payments on these debts have limited some local governments' ability to spend on basic services and other priorities.

Other tricky long-term challenges include dealing with an aging population and raising productivity growth.

Factories to the rescue?

Chinese leader Xi Jinping has given priority to investments in tech-led industries like renewable energy. PHOTO: MUYU XU/REUTERS

Xi hopes that boosting manufacturing will create a stronger economy that can weather these and other headwinds. His goals are captured in buzzy Communist Party phrases, such as "new productive forces" and "high-quality growth," referring to tech-led industries that Xi believes can power the next generation of China's growth.

But the downside to his plans is becoming more evident. Boosting factory output without boosting demand has led to months of falling prices and weak corporate profits in addition to the growing international unease over China's burst of exports. More people in China work in services than manufacturing, yet Xi's vision has little to say about boosting their incomes and spending.

Monday's data underlined the unevenness of China's current growth model. China's trade surplus in June hit a record for a single month, while industrial production in the first six months of the year was 6% higher than the same period a year earlier. Retail sales rose just 3.7% over the same period.

The Chinese economy is showing "severe imbalances," said Wei Yao, chief China economist at Société Générale, in a research note Monday. "The economy is limping along on external demand and supply-side push, whereas domestic demand remains very depressed."

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