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TRANSCRIPT

Event

“China's Economy: How Bad Is It?”

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FEATURING

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Scott Kennedy: Good morning, or good afternoon, or good evening, wherever you are. Welcome to this CSIS event, "China's Economy: How Bad Is It?" That is a very unfair question. It's very unbalanced, but I think that's where we need to start this morning to talk about China's economy.

I visited China this summer for several weeks and went to many parts of the country, and was astounded by the technology progress that I saw in different companies in several sectors. But the real economy, the macroeconomy, seemed like it was on its back. The word "involution" – "neijuan" – is the word of the year in China: Mindless production for which there is no demand, with built-up inventories. And consumption seemed down just about everywhere I went, north and south, and the housing market seems like it's in bad shape.

So how bad is it? This does seem also like a perennial question on China. And what's the data show? Let me – let me show you a little bit of data for everybody watching live right now on the program.

This is China's GDP growth numbers, both real and nominal. And to some extent what you can see is a(n) overall downward trend in growth for the last 20 years, but that's really not what I want to show everybody.

What I want to show is the last few years, in which real growth and nominal growth not only both are really low, but there's a period in which real growth is now ahead of nominal growth, meaning that that gap must be deflation, right, that difference. And if you look at China's consumer price index and producer price indices, you'll see that there is – that consumer prices have been very flat lately and producer prices are negative, and they've been that way for several years now.

If you look at the composition of China's GDP – what's contributing to growth – you're going to see that for a while it was the investment and even consumption were contributing, and that it wasn't exports. But now we're seeing that net exports are a considerable portion of growth now because of insufficient domestic demand. I think everybody who follows China knows that that financial system cranks out a bunch of credit that goes to private and state-owned companies, as much as they need, and we're keep – this number keeps heading north. We're now at least over – we're around 300 percent. And this is the official data, not the unofficial estimates.

One of my favorite statistics which I like to follow regards the productivity of capital, and it's basically how much output do you get per investment of capital. And so the marginal productivity of capital of China keeps going down. I think if you look at this through the incremental capital output ratio, you'll see similar types of things. If we had the total factor productivity number, you'd see a similar challenge as well.

One of the things that really worries me is that for a long time private companies were doing better than state-owned companies. They would have a better return on their assets, higher profitability, and that was always a sign that China was heading in the right direction. Well, they're now doing as poorly as their state-owned cousins. And so that's a concern for me and some of the things that I saw this summer.

So, again, the question is: How bad is it? Do we believe that data that I just showed you? What's cyclical? What's structural?

Of course, one last datapoint that I didn't show you is, despite all of that, the Shanghai stock market has finally woken up. After 15 years of being in a coma, the market is up 17.3 percent this year and the Shenzhen market is up 25.6 percent, right as the economy seems to be stuck in neutral. So, to flip things around, with gaudy returns like that, how bad could China's economy actually be?

So to analyze what's going on I'm joined by four of the sharpest minds on China's economy, and let me briefly introduce each of them.

Arthur Kroeber is founder of Gavekal Dragonomics, a China-focused economic research firm with offices with Beijing and Hong Kong, and a partner in its parent firm, Gavekal. Before establishing Dragonomics in 2002, he spent 15 years as a financial and economic journalist in China and South Asia. His book "China's Economy: What Everyone Needs to Know," published by Oxford University Press 2020, the second edition, is THE best primer there is on China's overall economic trajectory. And everyone should read the article he just co-authored with Dan Wang on China's economic model in the current issue of Foreign Affairs.

Tianlei Huang has been with the Peterson Institute for International Economics since 2019. He current is a research fellow focusing on issues of economic development and is China Program coordinator. He previously held positions at Johns Hopkins SAIS, the Brookings Institution, the Hudson Institute, and the World Resources Institute. Tianlei has an M.A. from Johns Hopkins University SAIS and a master's of law from Tsinghua.

Kiyoyuki Seguchi is the research director of the Canon Institute for Global Studies. His research focuses on the Chinese economy and relations amongst the United States, China, and Japan. He worked for the Bank of Japan from 1982 to 2009 and was their chief rep in Beijing from 2006 to 2008. And he received his bachelor's degree in economics from the University of Tokyo.

Jahangir Aziz is J.P. Morgan's head of emerging market economics research. He led Asia Emerging Market Economics from 2013 to 2016 after having

joined the firm in late 2008 as the India chief economist. Prior to that he served as principal economic advisor to India's minister of finance, having spent 12 years at the IMF where he headed the China Division from 2004 to 2007. And he holds a Ph.D. in economics from the University of Minnesota.

Each of you, thank you so much for being with us this morning/evening, wherever you happen to be on the globe. It's really great to have you all here.

I want to ask each of you an initial opening question and we'll take the answers in the way that I introduced you all at the beginning. On a scale of one to 10, with one being an economy in total collapse and 10 being a booming economy with long-term upsides, what would you rate China's economy today, and why? So we're going to start with Arthur, then go to Tianlei, Jahangir, and Seguchi-san. Arthur, over to you.

Arthur Kroeber: OK. Well, it's hard to boil a big economy like China's down to one number. But taking up your challenge, I'd put it at a six. And the reason for that is all of the negatives that you outlined are absolutely correct. You have a significant problem of persistent deflation, excess capacity in industry, declining profits, a weak job market, and a property market that's in very poor shape. But you also have a government that last fall came in with economic support measures that have succeeded in stabilizing growth. They've made it very clear that they are going to hold the line there. And I think the other crucial thing is that we are, I think, probably getting towards the end of the maximum excess capacity phase in industry and moving into what is likely to be a very protracted consolidation phase where some of this excess capacity gets squeezed out of the economy. I don't want to sugarcoat that; that's going to take a long time. But I think we're reaching the limits of the kind of investment-intensive deflationary growth pattern that we've seen over the past two or three years and are starting to move in a slightly different direction.

And then, on the other side if you look at this, the export economy and the technology economy is incredibly vibrant. Protectionism from the United States and other countries has turned into a paper tiger. Basically, Chinese exporters are able to compete both on price and increasingly on technological quality all over the world in a wider range of sectors. And the technological progress is a very, very positive force in the economy that I think is going to continue to pay dividends in the years to come.

So there are a lot of problems. It's not vibrant from a consumer standpoint. But from a productive standpoint, there's a lot that's going right.

Dr. Kennedy: All right. So Arthur gives China's economy a six for a variety of reasons on the up and down side.

Tianlei, are you in the same position as Arthur or are you going to give us a different number?

Tianlei Huang: No, I'm roughly in the same position with Arthur. As you described at the beginning, Scott, there are indeed a lot of challenges that the Chinese economy is facing now. It's facing the bursting of a housing bubble, weak consumer demand, you know, all those challenges. Export growth is also slowing down amid the trade tensions with the U.S. But the economy, obviously, is also not collapsing, and it managed to grow at 5.3 percent in real terms in the first half. It's not double-digit, but 5.3 percent is not a bad number. And I think it's actually amazing that the economy got to grow at 5.3 percent given all the challenges that it's facing now, and parts of the economy do look amazingly resilient. If we look at the data, let me just give you a couple examples.

Although real estate development investment has been shrinking for several years and continues to shrink, but manufacturing investment has been growing. Last year it was growing nearly 10 percent. Of course, that strong investment in manufacturing is leading to a rapidly growing manufacturing capacity which has created all kinds of other problems, including overcapacity.

Then even in consumption – we often talk about China's underconsumption problem, but private consumption in the last two years was growing faster than GDP. And private consumption as a share of GDP now is nearly 40 percent. It is very low internationally speaking, but for China it's already the highest since 2005.

And in terms of technology, as you mentioned, Scott, the emergence of DeepSeek really boosted morale earlier this year. And I think that's a vivid illustration of the kind of entrepreneurship that the Chinese private sector has, which is a huge advantage that China has.

So, overall, I would probably give it a five. There are both upsides and downsides.

Dr. Kennedy: All right. So you're very close to Arthur, a little bit below.

I don't know if we're going to get a consensus or not. That's not what I was aiming for. So, Jahangir, help us out here.

Jahangir Aziz: Look, I'm going to – I'm going to stick with Arthur and say that I'm going to be in the five or six range, right?

But the problem that I see is twofold, one which you raised at the beginning. One is, what's the cyclical nature of the economy versus what's the structural nature of the economy? As far as the cyclical nature of the economy is concerned, about three years back we sort of shifted our views and said that, look, generating 4 or 5 percent real growth figure is not a problem in China. You just produce things. The problem is producing 4 or 5 percent growth rate while avoiding deflation. And what you have seen over the last few years as you – as your chart showed, the red line and the blue line; the red line being real GDP growth and the blue line being nominal GDP growth. It is nominal GDP growth that's come down. And that is really where the problem is.

And the structural side of it is that the way in which they are approaching the problem, this anti-involution problem, reminds me very much of what they did to the housing sector. So they basically said, look, we understand that you can't let housing prices adjust very abruptly to its level that is needed to wipe out the inventories, therefore we shall slow down the adjustment in the pricing because that has a, you know, huge negative effect on the net worth of individuals. So to protect the net worth of individuals, we'll slow down the price adjustment in housing. And what did we get? We got what – you know, what overall economics will tell you, which is that the quantitative adjustment gets delayed, prolonged, and extended. And that's what we've been seeing, continuous bleeding and hemorrhaging in the housing market because the inventory's still just not adjusting.

If we look at the anti-involution – let us – first of all, I'm not sure exactly what it means, but let's put that aside. It's very fully sort of, you know, focused on, quote/unquote, the “new economy” – the new economy that was supposed to have replaced the old economy of real estate and pushed China to its, you know, higher-productivity path. That was the 2014 vision 2025, which I'm guessing is not vision 2025 sort of, you know, blueprint. But in that – in the anti-involution projects, I mean, the policy is exactly the same thing: Let's stop the decline in prices by doing all sorts of policy measures on the tax side, et cetera. But then all you're going to do is you're going to extend the inventory adjustment. But thankfully, in the EV space, for example, the obsolescence is so quick that, you know, you're probably going to get that inventory adjustment very, very quickly. You wait for one year and you're – look, the EV model that haven't been sold is essentially obsolete.

However, as Arthur pointed out, there will be a serious consolidation that will take place. “Consolidation” is a nice euphemism for talking about foreclosures and bankruptcies, et cetera. And the question there is that how will the government then deal with all of these things. And that's where my structural concerns are, that structurally you – they are pushing the economy again – not that they don't have alternative policy choices. They have alternative policy choices. If you want to, we can talk about that. But without

going into that, they are pushing the economy into one more long, delayed, prolonged adjustment alongside that in the housing market so that both the sector they were trying to reduce – remember, in 2014 that was a huge rebalancing, right? Let's move away from real estate because it's highly leveraged. Let's move to the new economy. But back in the – so they are continuing with the adjustment in the old economy, the real estate sector, and now they're introducing a similar kind of adjustment in the new economy. And that's my concern over the medium term.

Again, over the medium term my problem is not that they can't get 4 to 5 percent growth rate. They can get it; you just produce more things. But they cannot get it without getting rid of deflation, and that's where the real concern is.

Dr. Kennedy: All right. That's very, very helpful.

So even though we're still all around – you three have voted around similar numbers, your reasons are slightly different even though I see a lot of head nodding. Seguchi-san, who has joined me in the studio here at CSIS Headquarters in Washington, D.C. all the way from Tokyo, we typically encounter each other in China or we both just done a trip and we compare notes on our trips. And I know that you were in China recently as well. So, Seguchi-san, how do you vote?

Kiyoyuki Seguchi: Yeah. My view is a little bit pessimistic than others. I'd like to say four, because I am focusing the degrees of confidence of Chinese businesspeople. Still, or after the end of rapid-growth era in 2022, many people or most businesspeople cannot recover their confidence at present.

In addition, everyone knows real estate market is sluggish and local government fiscal income problem is existing. And real estate market affect to the consumption. So there are so many negative impact. And we cannot see some sign of recover of all of these major negative impact.

But I can see some small signs of new development fields. One is high-tech industry. Everyone mentioned about that. Recent recovery of the – or, recent innovative action of Chinese companies, obvious. And when I went to Wuhan and Chengdu, I can – I could see the new increase of consumption in inland major cities; very different from Shanghai, Beijing, Guangzhou, or Shenzhen.

So, in such a balance, and still they keep 4 percent or 5 percent growth rate, so I can when I focusing sluggish situation of confidence, I cannot say five. I'd like to say four. Thank you so much.

Dr. Kennedy: All right.

You brought some data with you. Do you want me to put that data up to show folks?

Mr. Seguchi: Yes, later.

Dr. Kennedy: Later? Hold onto that?

Mr. Seguchi: Yeah.

Dr. Kennedy: OK. Super.

So, all right. So four, five, six. We have no uber-optimists, we have no uber-pessimists in the – in the group. So – and I want to see if I can still shake some differences out of you by talking about data issues. The thing that's most exciting to most viewers is getting down deep in the weeds on data – (laughs) – but let's do that.

So when I was in China this summer and on previous trips, you know, I talked to folks about GDP data and folks always tell me they're a little skeptical. So the 5.3 percent number that Tianlei mentioned is impressive or the 40 percent of consumption. I hear a lot of pushback when I talk to certain types of experts who look at the Chinese economy. But there's lots of different sources of data, lots of different kinds of data. And I'm curious if – I know you all are economists who consume lots of different kinds of data, compare and contrast, and that's a really good way to follow China or any economy. If you're going to follow the U.S. economy now, you obviously can't just look at our labor data; apparently there's something wrong with the labor data, so you've got to look at a variety of different things. But I'm curious, when you all look at China and try and figure out, you know, what is the one or two numbers that really indicate to you where you think things really are going what you lean on.

And I'll tell you a little bit about what I heard from folks when I was in China first. But let me turn to Jahangir, and then we'll go to Tianlei, Arthur – Seguchi-san, and Arthur for the statistic that you all, or one or two of them that you think are really important, and why.

Mr. Jahangir: Right. So I think you know, obviously, as you mentioned, there's a spate and an explosion of alt data, and we do, like everybody else, look at alt data. But the alt data isn't really as comprehensive as the official data is by its very nature, right?

So I personally stick to two sets of data that I, essentially, track, which is industrial production – which has been there for a very long period of time and there's a reasonable amount of faith in the industrial production, even though sometimes industrial production does not really capture, for

example, the weight of the new economy, right? So these are datasets that have certain weights which were done five years back. Five years back, the Chinese economy was very different from what it is today. So there is no continuous upgrading of the weights that they use in industrial production, but you know, you can take industrial production numbers given its history and credibility seriously, and I do that. So that gives me the supply side, right?

And on the demand side, I don't really worry too much – I mean, I do look at retail sales and FAI data and everything else, but given the fact that we have nothing on inventories I really do not know, you know, what exactly is sale – retail sales or FAI investment is doing. So I essentially look at just the customs data. It's timely. It's just in and out. Once I get the customs data, you know, use a formula to convert that into national accounts trade data because the two of them are not the same, but broadly you can then get what the rest of the economy will do. You have a problem that we can't distinguish between retail sales and investments and inventories. I lump them together. But broadly, the story holds together. If retail sales and investment are not doing, you know, well, inventories are going to pile up. And that you will know by looking at PPI, are inventories piling up or not.

So, broadly, these are the two official datasets that I sort of, you know, hold onto.

The other one that I see as a way of looking at – and we didn't talk about it, you know – the private sector that's missing in action over the last three or four years is what is happening to private-sector credit growth. So you look at overall credit growth, you strip away what is government, what is broadly SOE-related, and look at private-sector credit growth, private-sector credit growth in China has turned negative – not has, had turned negative back in second quarter of 2024, if I'm not mistaken, and continues to be negative. What is even – and if you don't want to even look at that, just take away interest income from monthly bank-loan growth. So bank-loan growth used for both paying interest payments and for new investments, let's say. Just take out interest payment; bank-loan growth is now running at 3 ½ percent ROI without doing any private sector, public sector, right? Just that.

So those are the datapoints I look at. And, obviously, from those datapoints the storylines, for me, still remains the same: They will deliver 4 or 5 percent growth rate even in next year. Deflation will continue.

Dr. Kennedy: All right.

Tianlei, what's your favorite datapoints?

Mr. Huang:

Well, I am particularly interested in how the private sector is doing, and I think that tells us a lot about how the overall economy is doing. And here at Peterson with a colleague, Nicolas Véron, we have been tracking the private-sector share among China's – (coughs) – excuse me – largest companies since Xi Jinping became president. And what we found is that the private-sector share among China's largest 100 listed companies peaked around mid-2021. That was around the time when the crackdowns on private internet platforms and after-school tutoring was just starting, and after that the private-sector share has been declining for three consecutive years. And since mid-2024, the private-sector share picked up again, and it has been growing ever since up until now. And that's probably since to the government-supported policies in September last year. So I think that's – we found it a very useful indicator of how the overall economy – how the private sector is doing and how the overall economy is doing.

In terms of official data, I just want to say that, of course, no doubt there are plenty of problems with the Chinese official statistics. There is outright falsification, and – but at the same time, there are also many technical problems that remain unresolved, and I can see that the government statisticians are actually trying to improve the quality of at least some data series.

For example, in investment we all know that China's official investment data in the past, it was hugely inflated, right? But in recent years, fixed-asset investment has been converging towards gross fixed-asset formation, which is the key component in expenditure GDP. That suggests to me that the government statisticians are trying to squeeze the water out from the official series gradually.

Another example is how the services provided by owner-occupied housing are measured. In the past it was for a long time measured by historical construction cost and later changed to current construction cost, but either way vastly underestimated the value of services provided by owner-occupied housing. And the reason is the NBS has been revising the methodology, trying to compute it based on imputed rents. So that's another example of how – of an area where the government is trying to improve the data series.

Another point I wanted to make very quickly is that, aside from the quality of data, I am equally if not more worried about the disappearance of some data series. We all know what happened to youth unemployment, and that's just the tip of the iceberg, right? A lot more series have disappeared. Some of those disappeared – some of those data series that have disappeared probably are not that important – how many plants are there on the streets of Guangzhou – but some are indeed probably quite important. You know, Jahangir earlier mentioned private-sector credit. You know, we used to get

yearly data on how many bank loans the private sector in total get from the banking sector.

Mr. Aziz: That's right.

Mr. Huang: Now the PBOC doesn't publish that. Another example is how many migrants are actually enrolled in public pension program and public medical program. We used to have that data from the Social Security Ministry. We no longer know that. So there are an increasing number of questions that we are unable to answer simply because of the lack of data, and that's equally concerning to me.

Mr. Aziz: May I add something on this, Scott, to Tianlei's point?

Dr. Kennedy: Yeah. Go ahead.

Mr. Aziz: Yeah. I mean, Tianlei's going into the weeds in depth, and I agree with you that, you know, there have been improvement. I mean, but look at the data that every country publishes, and that's the biggest data, quarterly GDP. China does not publish quarterly GDP breakdown between consumption and investment, you know, government spending – (laughs) – net exports. We get this thing called share of growth, which sort of is meaningless. So just that in itself is a huge problem that you know, you can talk about weaknesses, we can talk about excess asset investment, we can talk about trade on a monthly basis, but then how do we match it? There is – there is no way of verifying what we are seeing at the – at the same government public statistics at the monthly level makes any sense with the quarterly level.

Dr. Kennedy: All right. You guys are now making me even more worried, and I'm worried about your original votes.

But let's ask Seguchi-san your favorite datapoints.

Mr. Seguchi: Yeah. I often say it's very difficult to choose one specific – one or two specific data to analyze the Chinese economy, because when I talk with my good friends in Chinese government they always watch comprehensive data and they continue to see each data's small difference, small change, and analyze the current situation of the Chinese macroeconomy. So when and what part start to change no one knows. So we should watch all the macroeconomic data comprehensively, and then we can see – we can say something.

So I choose only one data as a comprehensive analysis, probably it will be GDP. Probably this is – this include many problems because they don't publish (deflator ?) in each component, and the calculation way is different from Western side. But still, this is comprehensive data. And from that figure we only – we always start our discussion with Chinese government officials,

and they also are very carefully watching that result of the GDP growth rate, and then they decide their next economic policy. So still I think GDP is relatively better. (Laughs.)

Dr. Kennedy: Arthur, where do you land on this?

Mr. Kroeber: Yeah. Well, I'd like to echo what – something that Seguchi-san said. I mean, it's – no one would, frankly, take anyone seriously if they said, you know, about the U.S. economy what's the one data series that we should look at that tells us everything. Everyone understands in a large, complex economy you have to look at a thousand different things. And these – the composition of the economy's going to change over time, so what's important varies over time. So the – it is very much a mosaic. The things – the list of things that we look at closely, very close, I think, to what Jahangir was talking about.

I would emphasize the industrial survey data is generally of pretty high quality. It gives you a lot of information about the state of corporate balance sheets and profitability, and you can segregate between private and state-owned enterprises in very useful ways. And that has been consistently useful in understanding the business cycle.

We look pretty closely at the consumption side. The demand-side data is very poor. But we look, actually, at a weighted average of the employment purchasing managers' indices, which are pretty well-linked to survey data on household income and consumption on a leading-indicator basis. So that is somewhat helpful.

And then, finally, I would agree with Seguchi-san that GDP is useful particularly if you look at the nominal GDP numbers. I basically stopped looking at the real numbers. The nominal numbers tell you what people are feeling and I think they tell you, you know, a pretty dramatic story on sort of a two-year rolling average basis.

From 2016 or so through 2022 China was growing in nominal terms at between 8 (percent) and 11 percent a year quite consistently and that has collapsed to 4 (percent), right. And so you don't have to make up elaborate stories about data falsification or what not. All you have to do is look at the nominal GDP data and that tells you that we've entered a slower growth and a much more significant deflationary growth pattern.

Dr. Kennedy: Those are all very helpful. I want to defend the question of why we – why I asked this, knowing that it's a(n) oversimplification, and I think that's because of the general skepticism that people have about data, and Tianlei went through some of the specifics of some of the skepticism and some of the things that have been removed.

And so people, because of that general skepticism, look for shortcuts, things that can fill in the gaps in their sense of uncertainty, and so it wouldn't be the favorite thing we do and I think the U.S., as it's looking at how it manages data, maintaining confidence in data is the foundation of keeping people interested in looking at the entire picture, and once you start chopping away at confidence then this is what you get to.

And so if the U.S. wants China data like anxiety that generates us looking for that specific thing then it should take note.

I guess the second thing is I was talking to Chinese economists who work in the government this summer and asked them the same question and one of the really interesting answers I got was on purchasing PPI and the prices going down.

For them that was a huge sign of whether it's built up inventories for which we don't have data for or other kinds of things. It's an indicator that the production machine is generating a lot of supply which is not going to be taken up. It's counted in the GDP data but, nevertheless, it's still not a reflection of the strength of the economy.

Something that I look at, and it's not a quantitative thing but – because I talk to a lot of private companies about their investment plans and they're all – the ones I'm talking to mostly are holding back. They feel uncertainty. They feel that the light is not at the end of the tunnel yet, and so that is reflected somewhat in data on credit.

In the fixed asset investment from private companies, which has grown a lot slower than fixed asset investment from state-owned companies but, again, it's – we're in this murky world where we have sort of partial visibility and I think that's what's – that's the motivation behind my question. I appreciate everyone playing along.

Let me ask –

Mr. Aziz: But, Scott, everything is relative, right?

Dr. Kennedy: Yes.

Mr. Aziz: You know, you look at India. You look at China data. You probably feel far less anxiety with China data.

Dr. Kennedy: Yes.

Mr. Kroeber: Yes. (Laughs.)

Dr. Kennedy: Yes. I take that. Good point.

Mr. Aziz: I mean, India had a 7.8 percent growth rate last quarter. Come on, I mean. (Laughs.)

Dr. Kennedy: All right. Well, I need to be more comparative, but having lived in the China economy environment for a long time and being in Washington and other places, talking to my friends on Wall Street who can give me ridiculously detailed data about certain segments of certain states in the United States and certain industries, yes, I should take – I shouldn't take this for granted where we are.

Let me ask a question about the structural versus the cyclical. We have the – we've had several sessions over the years on China's economy and when we did this in 2023 – early 2023 – you know, China was just emerging out of the pandemic, right?

The conversation that we were having with the panel just about everybody focused on the structural challenges. The debt, demography, all of those kind of things.

I haven't heard anybody here talk about demography. I haven't heard anybody talk about finance that much. None of you said that financial data from Chinese banks or other things were the data that you go to. The type of things that you hear from others talking about the financial challenges that China says – there's no more monetary policy space, et cetera – what I hear you all saying is China is in this – got a downturn, it may be near the bottom of that downturn, and that we should focus more on the cyclical. There's been too much conversation about the structural.

Am I overinterpreting what you all are saying, Seguchi-san, structural versus cyclical? Do you think that a lot of the challenges that you all are talking about are more cyclical in nature, and that a year from now things will look – or two years from now things will look better?

Mr. Seguchi: Yeah. It's very difficult to foresee the cyclical change will push up the Chinese economy because, as I said, still negative impact of the end of rapid-growth era more than 30 years or 40 years. That is too strong. In addition, property market and local government fiscal problems are very serious. All of them are under structural problem. And so it's very difficult to find cyclical power as a resilience for the Chinese economy at the present.

So, still, it will keep sluggish situation, but not only sluggish part but also bright part is also existing in structural problem. As everyone mentioned, innovation we can see. In addition, I'd like to introduce the recent change of the – local development model is changing. So can I –

Dr. Kennedy: Sure. Yeah, we're going to put up a slide that Seguchi-san sent us. I've got it now on my iPod, and if you could chuck it up on the screen there. Perfect.

Mr. Seguchi: Thank you.

Because I listed Chengdu, Wuhan in this – in this year, I felt their economic situation is very difficult. They're very different from the coastal area. So – and I checked the figure – these figures.

So, as for gross rate of consumer goods sales of this – the first half of this year, Beijing, minus-3.8 (percent); Shanghai, 1.7 (percent). Very low. But Chengdu, Wuhan, 6.1 (percent) and 7.3 (percent). So very high. So this is still a rapid-growth age, seems like.

And I checked again permanent population growth rate. Beijing, Shanghai all zero, or in five years from 2018 to 2023. But the Chengdu, Wuhan, Chengdu 13.5 (percent) and Wuhan 31.3 (percent). So because many skilled workers changed – moved from coastal area to inland major cities. So this is a new development of the major cities in inland cities. And their driving force is excellent workers – excellent skilled workers, not only from coastal area but from those – but from major universities in those major cities. So Sichuan University or Wuhan University, there are some very excellent universities. So they are studying Silicon Valley model around the very excellent university, and using excellent students they are expanding their cluster in inland area.

But still, coastal area power – power of coastal area was so strong. So the power of inland area is not – cannot catch up with such a very huge power of the coastal area. So the crude growth rate still cannot reach 5 percent around this year. If I see – if I see the quarter-to-quarter growth rate, the first quarter 4.8 (percent), the second quarter 4.4 (percent), and probably third quarter also that cannot reach 5 percent. So the power is not enough. But small – smaller driving force is existing in inland area. This is my view.

Dr. Kennedy: So, Seguchi-san, thank you. So what you're suggesting is – and my question didn't touch on this – is that there's some structural elements of positive sources of continued development and rebalancing of the economy in a more healthy direction. When I was thinking of this question about cyclical versus structural, I as actually thinking about some things that Arthur had mentioned in his initial comments. And so, Arthur, let me turn to you about structural versus cyclical, and how you manage those thoughts in your head.

Mr. Kroeber: Yeah. To be frank, I find it sometimes difficult to separate the two. In part because, you know, as Jahangir said, there's a tendency in China for the

government to manage the cycles in such a way that they extend the cyclical adjustments so that they seem structural, right? So I guess – and partly I think the conversation bounces back and forth between these issues depending on what the conditions are at the moment. So I think the reason that people – conversations about China have tended to focus on the shorter-term factors recently is because we wound up in a situation last year where the government felt that it had to intervene, make some pretty significant policy interventions, and you have a clear kind of deflationary force that's going on right now.

So there's a lot of policy adjustments in play. So people are tending to focus on, OK, well, what is the impact of this going to be, you know, in the next one or two quarters? And some of the longer-term corrections, like demographics and long-term debt sustainability dynamics, have faded into the background. They haven't gone away. Just like the subject of conversation, I think, is driven more by cyclical concerns, because that's where we are in the policy cycle. We're in an active policy cycle. To go back to before last fall, the government basically had no policy for, like, a year and a half after coming out of COVID. They just sat around and did nothing. And so a lot of the conversation that people had was about the longer-term structural issues.

So they're both there. You know, I think that the government probably should be a little bit more active both on the fiscal and monetary side than they are right now. To manage the cycle they should be focusing a little bit more on propping up nominal growth. But at the same time, you know, I think what they're motivated by is a desire to manage what they consider to be a very large and complicated structural transition from an economy that was driven principally by property and infrastructure investment to one that is driven principally by investment in high-tech industries. And so they've set up a policy regime which is focused on making a very complicated, large-scale structural transition, even though it comes at some short-term cost.

Dr. Kennedy: Jahangir, at J.P. Morgan do you all try to delineate between structural and cyclical? Or are the reasons you gave, and some of those that Arthur gave, makes that impossible?

Mr. Aziz: It does. And so we sort of delineate policies or reforms between that which is macro policy versus those that are non-macro policy. So fiscal and monetary, as you might want to call a cyclical or short term, and others which do not fall into this bracket. And if you look at all the other problems, Seguchi-san talked about housing markets, all of those things require policies outside of just putting out more fiscal deficit or cutting interest rates. The housing market requires, you know, local reforms to central states, transfers being reformed, changes in rural collective ownership rules, et cetera, et cetera, et cetera. It is not that there are no solutions, but those are the kind of solutions

that are needed.

There is an – you know, you if you want to get China’s potential growth or medium-term growth up, you necessarily have to get back the private sector. And not only do you need to get back the private sector, you need to get the private sector not in another set of manufacturing stuff, which is what the government is promoting, but in the non-manufacturing and services. And that is where the solution to this high youth unemployment lies. These days you can expand factories and have – you know, create, you know, highly productive, innovative factories, et cetera. But they’re not going to hire very many people. Hiring is in services, as we have learned the hard way in the U.S. That’s what is the biggest employer.

And if you look at what happened as one of the byproducts of the 2020 and 2021 policy changes, which – you know, where private sector sort of moved away from it, from the economy, it is the service industry that actually went down. And with that, you’ve seen a, you know, steep rise in unemployment. We know what the levels are. But unemployment is – among educated is very high. But those are all nothing to do with fiscal policy. Maybe has a little bit to do with fiscal policy, but very – not much. And almost nothing to do with monetary policy. So that’s the way we separate the two of them. That is not structural versus, you know, cyclical, but really what is macro policy versus non-macro policy?

Dr. Kennedy: Tianlei, is that how you look at things?

Mr. Huang: I think there are definitely a lot of structural impediments in the economy. I mean, even as you mentioned earlier, Scott, the over-capacity problem is exacerbated by some structural distortions in the economy, such as the support of local governments behind many companies that do not exit, even if they have – they’re making huge losses. And dealing with those issues would require deep, deep reform, sometimes even political reform. But that doesn’t mean there’s nothing that the government can do. I mean, just to deal with deflation, my view is China needs to do a lot more, both fiscal and monetary-wise, to deal with falling prices.

In terms of monetary policy, if you look at the real interest rate now, real interest rates now are actually quite high. It’s higher than the average in the past two decades because of falling prices in China. But the authorities were not cutting interest rates aggressively enough, out of probably concerns on the growing pressures on the financial system. And in terms of fiscal policy, yes, they’re launching – they’re being more and more aggressive in terms of setting fiscal deficit ratios and dealing with local government debt. But I believe there is still sizable fiscal room that the central government has to launch a bigger fiscal stimulus to deal with falling prices.

And going back to structural problems, even some of those structural problems that we sometimes consider as a given, they don't have to be permanent problems. I mean, I still think that China has sizable, what I will call, policy dividends that are yet to be released. For example, one thing I think China really needs to do to foster the rebalancing of its economy is to empower its consumers, right, especially those rural and low income. And one way to do that, I think, is to give rural residents more property rights.

For example, can rural residents, rural collectives sell their rural construction land, just like local governments have been selling state-owned land plots in cities, right? That would break the monopoly – long-time monopoly that the state has in supplying land. And it would be a very good thing, I think, for those big cities that constantly are short of land supply quotas. So I don't think the Chinese economy is doomed. I think its trajectory does, to a large extent, depend on the choices that the policymakers make.

Dr. Kennedy:

So those are all really helpful comments. Let's see if I can pull a couple of these things together. I think one of the challenges about this structural versus cyclical conversation is I think when we're having – I think there's two different kinds of conversations about structural that that we often hear. One is, what is China's overall growth trajectory, right? And because of demographic shifts, because of debt or other kinds of challenges, and just simply by dint of math, that it's grown a long time, that the incremental potential growth rate has to be heading downward. That you hear this. And so we can never go – and so the sentence we often hear is China can never go back to X year or X growth rate. That's one kind of structural conversation.

The other kind, which I think we hear even more now, is what is the – if you take that middle line of what the most likely growth rate is, if they got the policy mix better how much higher growth could be? If they get it worse, how much lower would growth be? I think we hear both kinds of conversations about – which both use the word “structural.” And so sometimes those second kinds of “structural” are political. That is, people frame some of those choices as policy choices. They're not going to empower the consumers that Tianlei says need to be, because this is a pro-producer political regime and oriented that way. Or, they're not going to give – they're not going to force financial institutions to loan on a commercial basis, because the state needs this fiscal – this financial system to work for it, and there's too many risks.

So those are the different ways I hear people talk about structural. I think a second point Tianlei just mentioned again, which echoes something he mentioned earlier, is that there are some – we often hear, all the low-hanging fruit is gone and it's only hard choices now that are going to get growth. And I think Tianlei is saying, there is some low-hanging fruit. But others would say, well, there's political obstacles to picking that low-hanging fruit. It may

be hanging low, but there's other things that are getting in the way. Maybe political choices.

One thing I wanted to ask you all about, which came up on my travels this summer and which I've continued to read about with regard to involution, is the question of how to address this challenge of overcapacity and over supply. And I heard a phrase when I was in China this summer, and have kept reading about it, called industry self-discipline, "hángyè zìlǚ." In talking to industry associations and companies and reading, there seems to be an encouragement for associations to organize to set limits on production or prices, to somehow rein in price wars or overproduction.

And when I was first doing research on China in the late 1990s for, at that point, sorry to reveal my age, my dissertation, China had just come out of – was in the middle of experiencing the Asian financial crisis, where there was lots of overcapacity challenges. And during that point, associations were actively organizing their members to limit production. But all of those efforts failed. And one of the lessons that came out of that was that you can't organize producers that way. China's too fragmented. There's low consolidation and low concentration across industries. And it'd be anti – and that's anticompetitive behavior. And so China passed an anti-unfair competition law. It updated its price law, and thought we were on the way towards a more mature view of the market.

And now we hear similar language coming back over 25 years later about vicious competition, unhealthy competition, price competition, and an encouragement of associations to get in the way again. Does this suggest that China hasn't made any progress whatsoever in a quarter century in how the government thinks about the role of the market? Or is the comparison to 25 years ago overly superficial? Does anybody want to give some reaction to that prompt?

Mr. Kroeber: Yeah, I'll jump in there quickly. So, first of all, it's not like they talked about, you know, trying to reign in competition 25 years ago, it didn't work, and then they didn't do that for another 25 years. They've done that repeatedly in the intervening decades. National development, forum commission, the planning commission. Every few years there's some industry that they think has too many competitors, too much competition. They try to organize some kind of constraints. Supply side structural reform was big slogan in 2016 and 2017, where there was an organized effort to control capacity in steel, and cement, and a few other things. So this is a constant theme.

The problems are more severe now, for various reasons. And I think the thing that I would point to as the problems they have not really addressed, which is kind of a structural difficulty in the Chinese economy, is why do you have all of this excess capacity, all this excess production? It's basically soft budget

constraints at the local government level. So essentially, yeah, it's very easy. Barriers to entry in many industries are low. Easy for people to get in. But then, once they're in, they don't exit very quickly because local governments have a lot of ability to funnel resources towards them to keep them afloat, even if they're not very profitable.

And what has been a persistent issue, waxing and waning over time but never going away, is the unwillingness or inability of the central government to really attack that fundamental issue of soft budget constraints at the local government level. And that is what creates these kind of persistent cycles of expansion, of investment, excess capacity, and kind of deflationary pressures. And so we're now seeing is, I think, a more severe variant of something that's been there for quite a long time.

Dr. Kennedy: So János Kornai still matters.

Mr. Kroeber: Indeed.

Dr. Kennedy: Indeed. So let me go – we're just about at the end of the hour, so let me give everybody a minute to sort of highlight the most important takeaway that they want people to leave with when they're thinking about the Chinese economy. Maybe that's part of the conversation we've just had, or what you're looking out for in the coming months to see whether you might raise your – the number may go up, stay the same, or go down. Let's start with Seguchi-san.

Mr. Seguchi: Yeah, still I'm focusing on property price. And as for the five-year plan, the targeting of growth rate is very important. If they fix the five, that's very dangerous. We also experienced in Japan. So if they can fix less than 4 percent, then we can see relatively stable Chinese economy in the future.

Dr. Kennedy: So Seguchi-san is referring to the 15th five-year plan, the outline of which will be issued most likely in late October. Let's go to Tianlei next.

Mr. Huang: I would just say that I think the biggest problem that the economy still faces now is the bursting of the housing bubble. It has losses for more than four years and has yet to bottom out. In some aspects, it's actually worsening. And it has huge implications on the entire economy. Some of you may have read in the news that just in recent months at least four private entrepreneurs have committed suicide, all of them – most of them are in businesses somewhat related to real estate, including furniture making, home furnishings, and elevators, right? I think that's very, very worrying.

And as long as the housing slump continues, while continue to shrink household demand, undermine financial stability, and local government finances, and drag the overall economic growth. And we haven't seen a

financial crisis yet. Usually, a housing crisis happen hand-in-hand with financial crisis. But while there is indeed growing pressures on the financial system, I guess before the sector really bottoms out, we cannot rest assured that there won't be a financial crisis, or at least probably there will be some localized, smaller crises. Yeah.

Dr. Kennedy: Thank you. Jahangir.

Mr. Aziz: So I would just say that, look, it may not look like from afar, it may not sound like by listening to us, but this is one of the most adaptive economies I have seen in my career as an economist. And it takes time for China to adapt to its new reality, but it does adapt to its new reality. That's how it has survived. That's how the Communist Party has survived, far more importantly. And I think as long as the Communist Party keeps that adaptation going, it will survive. And with that, the Chinese economy will survive, whether you like it or not. This is not a command-style – Soviet-style command economy, that was very ossified. So given that, I would not write off the second largest economy in the world. And others who might do that will do that only at their peril.

Dr. Kennedy: Arthur, you get the last word.

Mr. Kroeber: OK, thank you. So basically, just one thing, which is that you have to, I think, looking at China, have two pictures in your mind simultaneously. So the macro economy, as we've discussed today, has a lot of problems. It's kind of blah. It's got a deflation problem. It's got a confidence problem. These are not fatal, but they're very serious. They're going to take a long time to resolve. At the same time, you've got a technology economy that is incredibly vibrant, competitive, and globally much more significant than I think any of us would have thought even five years ago.

And I think that the key thing there is that the reason for this deflationary economy, the macro economy, all the problems, and the reason for the strength of the technology economy, are at root the same. You've got an extraordinarily competitive environment within China, which creates deep, deep pressures. Very hard for people to stay ahead of their competitors. And that's what leads to the deflation component, and all of the problems that we're talking about. But it also leads to the production of really world-class companies that have proved an ability to innovate and improve technologically at a much more rapid pace than I think most of us would have thought a few years ago. So they are two sides of the of the same coin. And some of the problems that you see in the macro economy are reflections of growing strength in the technological side.

Dr. Kennedy: This has been a fascinating conversation. My initial question is, and the program's question, how bad is it? I think what I'm hearing from all of you, in

different ways, is it's mixed. But the answers you gave are far from muddled, actually very clear about the ways in which you see the strengths and the weaknesses, which we will need to be watching in the coming weeks and months. Not only as China issues its 15th five-year plan, but as they get to the end of the year and start putting together their plans for next year. And seeing how they address some of these challenges, whether it's the overcapacity issue, the housing market, and how – and what kind of upsides they have, whether that's in technology, or the regional changes in terms of where there's growth in parts of the country that particularly have lagged behind the coast.

Fascinating picture from all of you. So I want to thank Arthur, Jahangir, Tianlei, Seguchi-san. Thank you for joining. For all of you out there, we welcome your feedback. And wish all of you, wherever you are, a good evening, good morning, or good afternoon. Take care.

(END.)