**Xi Jinping and the High Wire** **Michael Gill**

During our research programme for Dragoman's China 2060 project, a number of our Counsellors highlighted the unusual circumstances and ambitions of China's domestic policy agenda. The phrase "high wire act" was used to describe President Xi's strategy.

Not only is China aiming to create next-generation global industries across a range of sectors, Xi and his colleagues are shifting fundamentals that have characterised growth over recent decades, undoing flows of subsidies and free money that have fuelled China's urbanisation and rapid upgrading of infrastructure and industrial capacity. Xi is enacting this at a time when the influence of the pandemic has imposed constraints that markedly increase the disruptive effects of policy change.

Implicitly, this is a hazardous and uncertain endeavour. Yet Xi, at the same time, has been cast as the man who has more personal power than any leader since Mao Zedong. A paradox? Or two sides of a coin?

At the heart of China's agenda is its remarkable economic record since the 1980s. Year after year of GDP growth above 10 percent lifted hundreds of millions of people out of extreme poverty and delivered investment that today puts China at the centre of virtually every global supply chain.

Along the way, construction and property became an ever-growing component of China's investment, fuelling the demand for industrial output in fundamentals like steel and cement – but also providing a rich stimulus to provincial government revenues through land transactions. Capital investment in residential property boomed, rising from around 7 per cent to 12.5 per cent of China's GDP – at a time when Australia's housing boom accounted for about 5 per cent of its GDP. In total, construction and property have contributed between 25 and 30 per cent of China's GDP in recent times.

**The construction stimulus ran out of steam**

Inevitably, heavy public investment-led growth must run out of steam and from the 2010s, GDP growth began slowing, despite ever more investment. In effect, the investment was no longer lifting overall performance. Declining productivity on robust investment inevitably fed into rising *systemic* financial risk: most notably for China's banks, but also for businesses and households. Chinese authorities began reining in the excess in property and construction, after some earlier false starts, in 2020.

Guidance to banks, closer control of local government property financing and generally predictable measures to bring the property bubble risks downwards quickly produced effects that made clear the scale of the challenge. Sharp declines in property value, serious liquidity problems for large developers, mortgage payment 'strikes' by home buyers, evident risk in some of China's 4000 or so small banking institutions and a sharp slowdown in property sales were all signs of a big problem that would threaten China's growth targets. In the past such a drag on growth would likely see reaction, but this time there was no policy U-turn.

Even though China's growth rate is unlikely to exceed half the official target (5.5 percent GDP), Beijing has taken no forceful actions to restore property investment. Targeted liquidity support, asset management support and specific measures such as substantial asset purchases by local government financing vehicles have been employed for amelioration. In general, the central government has avoided large scale intervention. A program of bond guarantees involving State enterprises has been floated, but reports to date suggest that few developers will be able to meet its conditions. China can clearly avoid a debt crisis, but it remains to be seen how the holes in many very large balance sheets will morph into restructurings and losses that are either imposed or allowed to fall onto segments of the economy.

Unsurprisingly, one consequence of the property boom's reversal is a serious contraction of provincial government revenues, 41 percent of which came from land sales in 2021. Local government financing vehicles, which appear to have been a primary target for contraction, are reportedly having difficulty meeting obligations on their commercial debts. In the fiscally weaker provinces, there have been reports of cuts in local government wages and curtailment even of military pensions. Nationally, youth unemployment has been around 19 percent for some months. Despite these potentially unsettling signs, Beijing clearly intends to limit the ability of local authorities to borrow their way out of a hole. So it may be that the eventual outcome is to carve out local government financial resources to a point that is sufficient to balance the losses of a burst property bubble. But there may be two edges to that blade.

**Top down policy can run into bottom up reality**

A surprising response to the tight provincial outlook came from Inner Mongolia, which has "suspended" electricity subsidies for strategic industries such as photovoltaics and hydrogen. Given the effort Beijing has expended to drive innovative new industries and the high priority they appear to have, Inner Mongolia's response to tight fiscal conditions might be an attempt to make the central authorities blink. Or it may be the harbinger of a very different Chinese energy market wherein inter-regional competition over subsidies is markedly reduced, in which case the consequences will be profound. Certainly, on that last point, the reforms on national electricity markets introduced late in 2021 have considerable potential to provide China with a serious improvement in power system performance and cost.

A less surprising development has been the reported intervention by local government financing vehicles (LGFVs) in otherwise troubled property developments. To the extent that they are propping up worthless projects, LGFVs are simply deferring and enlarging their own burden. Of course, some may be sustaining valuable projects caught up in the market's burst bubble.

LGFVs have been central players in China's economic success, largely as financiers of large scale infrastructure. More recently, their rapid expansion of bond issuance (the 2021 total was 26 percent up on 2020) was a fuel that drove construction and property activity to its recent peaks. According to Huafu Securities Ltd, LGFVs had 45 trillion yuan (US$6.3 trillion) in outstanding interest-bearing liabilities at the end of June, bonds and loans from banks and other financial institutions, an amount roughly 50 percent more than total local government debt (34.8 trillion yuan, US$4.8 trillion).

On one reading, China's fiscal chickens have come home to roost. Local governments have been highly interventionist throughout China's period of sustained growth. For much of that time their investments in infrastructure and housing added substantially to economic welfare and productivity and their property transactions paid for industrial subsidy and other fiscal lures designed to attract investment, both domestic and foreign. However, as the economist Hyman Minsky noted, such asset-based growth in values will, over time, often create a feedback loop of illusion that overshoots into highly risky habits of behaviour. Individually, citizens, developers, local governments and banks adopted the booming property market as "stability". To the point where – in China's case – that assumption built risks which now drive instability. China's property market has had a "Minsky moment" – when reality bites.

The systemic issue in China is not simply about the potential for waves of failure among various players in property markets. Because local government finances were fuelled by booming property revenues – and local governments are key financiers of industry, not to mention public payrolls - China's deflating property bubble raises problems well beyond property.

**Xi's accumulated power is directing the strategy**

On the evidence to date, Beijing's approach has been to encourage the massive deleveraging of construction and property and to allow the bulk of the problem to fall to local government. Paradoxically, this appears likely to strengthen control at the centre since the contraction of property and construction activity is also a contraction in the primary financial resources of provincial governments.

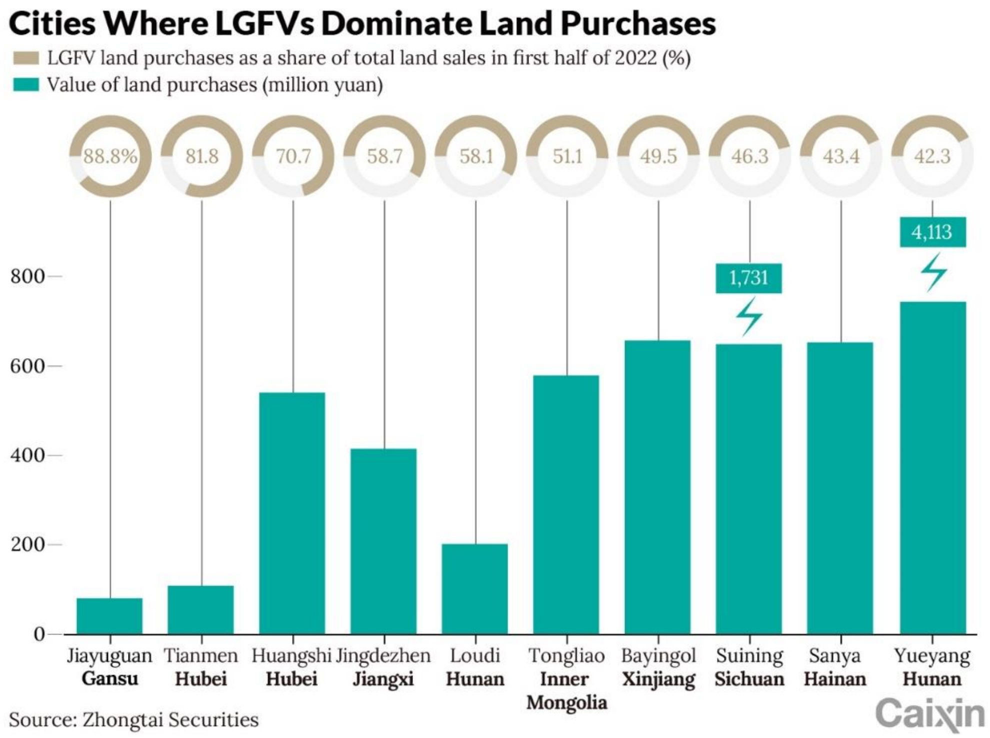
Beijing has become far more influential under Xi Jinping, whose leadership since 2012 has coincided with deconstruction of the shared leadership model fostered by Deng Xiaoping, replaced with a far more concentrated power base centred on Xi. Xi's engine room is the Commission for Comprehensively Deepening Reform, which has core executive power and is one of several key commissions chaired by Xi. This is where the over-arching "dual circulation" policies are sourced and where the key low carbon energy innovation, advanced manufacturing and urbanisation strategies obtain their direction.

Allowing for the brake on growth imposed by the deleveraging and by strict COVID policy, China is also re-orienting capital. Its remarkably high savings ratio (recently over 50 percent) is a great strength which has allowed China to avoid reliance on foreign capital. But it also reflects low levels of consumption, a basic hurdle in the transition to an economy more balanced between external trade and domestic consumption.

While China has wrestled with the property deleveraging, with COVID and with the impacts of global disruption, its investments in new industry – especially that related to energy security/renewables – has developed a substantial momentum. At least one province is now committed to a large scale, fully firmed renewable energy transition that is at least partially based on supplying energy to eastern and central China, where land use options are fewer. A key enabler of that strategy is the incipient reform of national electricity markets, which have been largely parochial up to now.

In summary, China under Xi is pursuing a rational policy that requires fundamental change in some elements of China's economic and political essentials. The property/construction driver of growth had become redundant at about the time of his appointment and is demonstrating in its deleveraging how hard it is to break that habit. The related issue of provincial government authority is being tested as those agencies are forced to manage the consequences of a debt bubble largely created by their own efforts.

While political issues, both domestic and international, quite rightly command much attention, there is no mistaking the scale of the challenge China has taken on in shifting to a more sustainable basis for its domestic economy. As it often does, economic strategy might well resolve the questions of both politics and national security that dominate discussions concerning China.


Cities Where LGFVs Dominate Land Purchases
LGFV land purchases as a share of total land sales in first half of 2022 (%)
Value of land purchases (million yuan)
88.8%
81.8
70.7
58.7
58.1
51.1
49.5
46.3
43.4
42.3
1,731
4,113
800
600
400
200
0
Jiayuguan Gansu
Tianmen Hubei
Huangshi Hubei
Jingdezhen Jiangxi
Loudi Hunan
Tongliao Inner Mongolia
Bayingol Xinjiang
Suining Sichuan
Sanya Hainan
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Source: Zhongtai Securities
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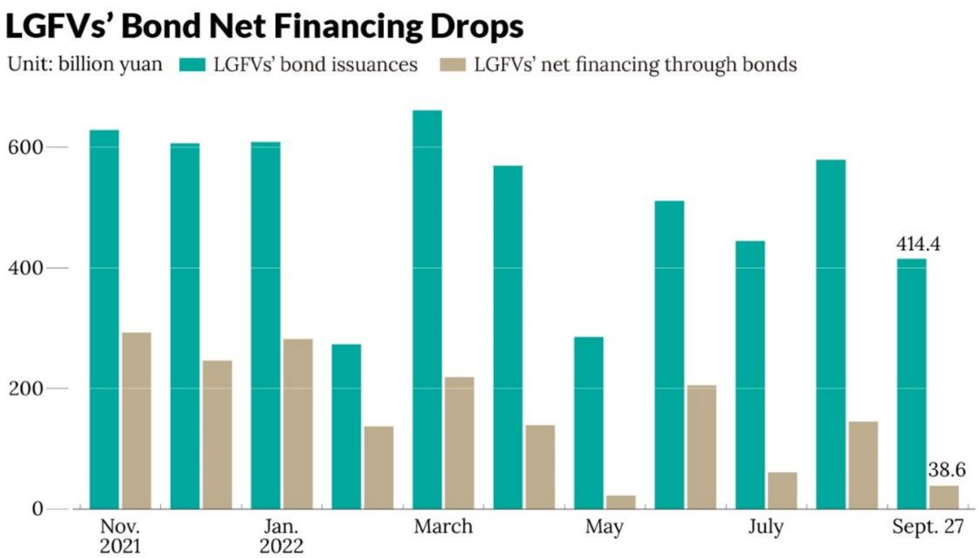
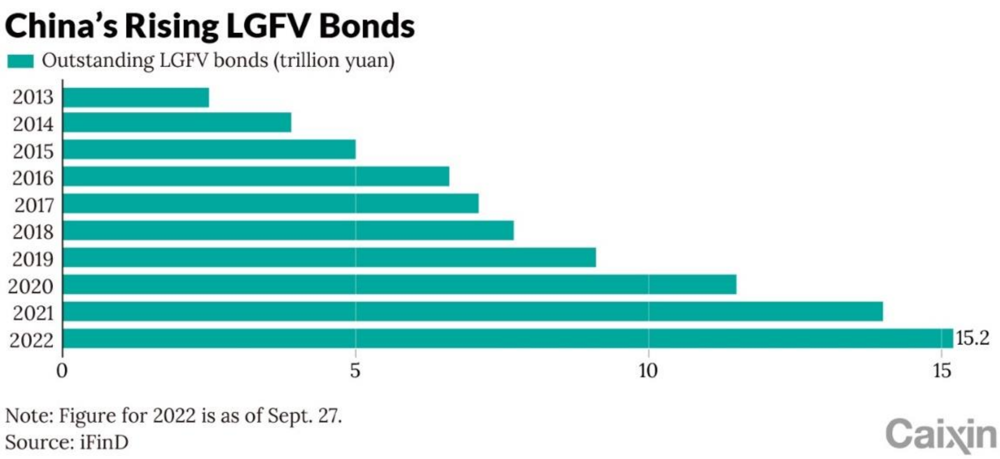

LGFVs' Bond Net Financing Drops
Unit: billion yuan
LGFVs' bond issuances
LGFVs' net financing through bonds
600
400
200
0
414.4
38.6
Nov. 2021
Jan. 2022
March
May
July
Sept. 27


China's Rising LGFV Bonds
Outstanding LGFV bonds (trillion yuan)
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
15.2
0
5
10
15
Note: Figure for 2022 is as of Sept. 27.
Source: iFinD
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