
China's Economy: Dragon in Turbulence



By Pushan Dutt , INSEAD

Anaemic growth and a crippling economic war with the United States weigh on Xi Jinping even as he cements his position as China's most powerful leader since Mao.

China's President Xi Jinping has been confirmed for an unprecedented third five-year term as the leader of both the Chinese Communist Party (CCP) and the country's military. While the appointment of Xi and his new leadership team went relatively smoothly during a week-long meeting of 2,300 CCP delegates in Beijing, the same could hardly be said for China's economy: The once high-flying dragon is entering a period of turbulence. And, when the dust has settled, the global trade and political order may look very different.

A rash of flashing-red economic indicators reflect the depth of China's woes. The economy grew by 0.4 percent in the second quarter of 2022, the slowest pace since its rapid ascent in the early 1990s save for Q1 2020, when Covid-19 first emerged. The third quarter saw more robust growth of 3.9 percent, but it merely took average growth for the year to date to a mere 3.0 percent, far below the 5.5 percent targeted by Xi's administration and

the 3.2 percent forecast by the International Monetary Fund.

The medium-term outlook is similarly bleak. The IMF expects China's economy to grow by 4.4 percent in 2023, well off the >5 percent rate needed to meet Xi's goal of doubling GDP by 2035. Forecasts by the World Bank are even more gloomy.

Three forces are to blame for bringing the dragon down to earth: the zero-Covid policy that is hobbling the economy, a **meltdown in the property sector**, which accounts for 30 percent of China's GDP, and a sweeping **crackdown on Big Tech**. Remarkably, all are self-inflicted wounds. If advanced economies enter a recession, China will see additional drag on growth.

For now, Beijing has something else to grapple with: Washington's **new sweeping export controls on advanced semiconductors**, the "brains" of electronic devices used in everything from healthcare to military systems.

Bargaining chip

In October, US President Joe Biden's administration announced a ban on the sale of high-end chips to China by both American firms and foreign ones that use American machines or knowhow. The control also prohibits US citizens and green card holders from working in China's semiconductor industry. Hundreds of executives and engineers, among them employees at the elite Dutch manufacturer ASML, resigned within days, paralysing semiconductor operations. A single shot fired by Biden has done more damage to China than four years of performative "decoupling" under his predecessor Donald Trump.

The chip industry depends on a highly complex and interconnected global supply chain that draws expertise from different regions: design in the US, manufacturing in Taiwan and South Korea, equipment from the Netherlands and assembly, packaging and testing in China. Today, China remains limited to the low value-added parts of the ecosystem.

Biden's ban will motivate Beijing to accelerate its push towards self-sufficiency, not just in semiconductors but advanced manufacturing as a whole, as it did in nuclear and hydrogen bombs and satellite technology under the "Two Bombs, One Satellite" project in the 1960s.

But many believe it would take the Chinese 30 years to achieve chip self-sufficiency. Even in this difficult race, the Chinese government may be shooting itself in the foot. It has opened **corruption investigations** against senior executives of a state-run investment fund that is the central plank in its efforts to achieve "semiconductor independence". The probes, of which the authorities have provided scant detail, sent chills through the sector and put the brakes on China's progress in chip development.

Trouble from within

Biden's economic war on China will have seismic consequences for the international trade order. In the near term, expect China to retaliate with their own controls on critical exports like rare earth to the US. For certain imports it may switch from the US to other countries, like Brazil for corn. Beijing may even go after American multinationals like Apple and Tesla with significant operations in China.

In the longer term, the two countries will pursue self-serving trade arrangements outside of the World Trade Organization system, using a mix of carrots and sticks. The global political order will also be reshaped as both Beijing and Washington will intensify their tussle for allies, especially in South-east Asia, and lock horns over **Taiwan**. Unfortunately, pragmatism and economic interests will take a back seat while ideology and antagonistic nationalism move to the forefront.

Even without external threats, China will have its work cut out managing internal challenges. The population of 1.4 billion is on the brink of **shrinking for the first time** in 60 years. On the current trajectory nearly half of them will disappear by the year 2100. Fewer working-age people means fewer workers and fewer consumers, posing a drag on GDP growth.

Already the demographic dividend that has enabled China to become an economic powerhouse on the back of cheap labour is nearly spent, with productivity growth slowing to an average of 5.7 percent from 2014 to 2018, compared to 15.5 percent from 1995 to 2013.

But the bigger worry may be the CCP itself. The party's heavy-handed – if well-intentioned – attempts to eradicate the pandemic, achieve **“common prosperity”** (including by reining in the previously freewheeling and lucrative tech sector) and start-stop policies in taming the housing bubble have had disastrous consequences, with ripple effects on the world

economy.

What China needs, for a start, is more moderate governance and a refocus on economic policies that work. Even Xi, whose authority will remain unchallenged for years, needs a team that is competent and unafraid to give independent advice. Otherwise, brace for more turbulence ahead.

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About the author(s)

Pushan Dutt is a Professor of Economics and the Shell Fellow of Economic Transformation at INSEAD. He teaches in the MBA programme and the **INSEAD Leadership Programme for Senior Executives**.