Goldman Sachs Exchanges

Will China's policy stimulus be enough?

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Date of recording: December 2, 4, and 13, 2024

Allison Nathan: China is grappling with domestic economic challenges at the same time that external risks from US trade threats are rising. In response, Chinese policymakers have announced a raft of stimulus measures which they doubled down on just last week, but will the stimulus be enough?

Michael Pettis: In the short term, we're probably going to see an expansion of fiscal support. Much greater than we've seen already. Probably in the first quarter, we will finally start to see, real attempts to stimulate the demand side of the economy and that will be very positive in the short term. But ultimately, it's only a short term solution.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges. Each month, I speak with investors, policymakers, and academics about the most pressing market-moving issues for our Top of Mind report from Goldman Sachs Research. This month, I spoke with China watchers Hui Shan, chief China economist at Goldman Sachs, and Michael Pettis, professor at Peking University's Guanghua School of Management. We discussed China's economic challenges and just how effective the policy stimulus could be in addressing them. I started off by asking my colleague Hui to level set on how China's growth has evolved in recent years.

Hui Shan: There were quite a few surprises in the Chinese economy over the past couple years. If you think back to the early 2023 reopening, if China had followed any other economy's experience, there should be a very strong rebound but 2023 growth was only 5.2% after 3% in 2022. So that was a disappointment given reopening boosted services activity.

And then coming 2024, we had this surprise of very strong exports, but domestic demand continued to weaken, especially in the middle part of the year. I think that was a clear downsize surprise. GDP growth quarter after quarter in year on year terms was decelerating, which explains why end of September policymakers announced the stimulus. But overall, how much pain policymakers seem to be willing to tolerate was surprising just given investors' previous perception that, when things get bad, Chinese policymakers will come out with a stimulus package.

In a sense, that still was happening, that things got really bad in the third quarter and we have this stimulus package. But the magnitude and the delay in policymakers' reaction function, those are all surprises.

Allison Nathan: And so obviously as you began to discuss, we have seen a slew of policy measures announced in the last couple of months. How effective do you think what they have announced so far will be?

Hui Shan: The biggest policy change so far is the local government debt swap plan. And that's the 10 billion RMB package approved by the National People's Congress standing committee meeting early November. That's the most important piece of all the easing measures announced so far. This is trying to put out the fire and address the most urgent risk in the economy.

Now, is it effective? It's too early to tell. We think that this is important and underappreciated because, in a typical debt swap, it's just changing one form of debt to another, doesn't do that much. It doesn't really change your fundamental balance sheet. But in reality, without this, the local governments are taking whatever they can take. And when they have the revenue, they are not spending on the schools and hospitals; they are spending on paying back debt. So that's hugely contractionary. And now you don't cut your spending on schools and hospitals. So it's very important to have this newly allotted quota.

Allison Nathan: But is that quota allotment, that increase of new debt, is that big enough relative to the size of the outstanding debt? And it's my understanding that they can issue that debt over five years, so is it too little too late?

Hui Shan: Is it enough? Is it perfect? Probably not in the grand scheme of things, in the sense that overall local government financing vehicle, totally interest-bearing liabilities are over 60 trillion. And in that context, if you give them two-plus trillion a year doesn't seem to be that important. But I think of it as two things.

One is we estimated this year's fiscal shortfall is a little over 2 trillion RMB. So in that sense, central government now give them 2.8 trillion per year of additional quota seems to be enough to just cover the hole. So the central government did the math and giving enough to make sure that the deleveraging versus operating the government are separate. They don't want to pursue deleveraging and endangering the local government running the daily lives and daily activity for their citizens. If you don't give them this breathing room, this extra quota, they're going to use the taxed revenue and all the other financing sources to pay back debt and prioritize deleveraging efforts. And that means everything else is secondary. Your civil servants' salaries, your school lunches, your hospital bills, and all that stuff is secondary, and that would be very disastrous in my view.

Allison Nathan: Are there any other policy developments that can move the needle?

Hui Shan: I would emphasize two. One is the new measures on the equity market. That's new compared to previous cycles. We don't know the exact motive whether this is trying to generate some wealth effect for households, whether it's purely trying to generate more inflation because we have this deflationary pressure throughout the industrial sector, or whether this is purely just for confidence. But the intention and focus on the stock market is notable.

The other thing notable about this stimulus package is that the government seems to recognize that property infrastructure investment, that alone, that used to be the main driver or main lever for China stimulus, no longer applies. So they're talking more about consumption. They haven't figured out how, but they are talking more about consumption. They have this goods-trading program. A lot of people we know are taking advantage of it. There are sizable subsidies. It's a bit like a US cash for klunkers. You're trading your old stuff, and they give you a subsidy and you buy a new one. That's been working very well in the past couple months, so I think that's important in the sense that you can tell policymakers are also shifting very gradually that they need to think about consumption.

Property, that's the past. Infrastructure, can't find profitable projects anymore. We need to think about consumption.

Allison Nathan: So then we get to November. We have an election in the US, and we have Donald Trump being reelected and the accompanying threats of increased China tariffs. So talk to us a little bit about how much risk that poses to China's economy, especially since exports have been the bright spot this year.

Hui Shan: Yeah. So I think it's very important to differentiate the Chinese exports to the US, per se, which is targeted by Trump tariffs and other impact of Trump tariffs as a second round of effects as in uncertainty impact because, if you do the math, Chinese exports are about 20% of GDP. 15% of Chinese exports go to US, and in the extreme scenario, let's say the Trump tariff is so high that nothing coming from China will go to the US, that's 15% of Chinese exports. But exports total is only 20% of GDP. I mean, that's three percentage points of GDP. It's about 4 trillion RMB.

I think given China's own central bank and relatively low central government debt-to-GDP ratio, is that really end of the world with 4 trillion RMB? If I just print 4 trillion RMB, nothing has happened. So from that point of view, it's not that big of a deal. Domestic issues are much more important than the tariff, per se.

But I think the problem is all these uncertainties, you don't know where to invest, you don't invest. So all these second-round effects will be much more impactful.

Allison Nathan: But in the case of China, it seems like we've been talking about this shift from export-led growth to consumption-led growth for a long time now, but we haven't seen them successfully do that. Do you think they're now finally moving in the right direction?

Hui Shan: We're relatively confident on the direction. You have to think about Chinese policymakers as human beings, right? Like, you don't make change until you have to, right? And I look back, I think, because they pressed on the property stimulus or infrastructure stimulus, they do something easier and more immediate and they have other instruments to deploy in previous cycles. They didn't have to undertake this very difficult task of stimulating consumption, so that's the direction of travel. I just don't know how much they are able to do and how fast.

Allison Nathan: Next, I spoke to Michael Pettis. I actually interviewed him a decade ago in 2014 about his views on China growth, so I began by asking him what surprised him most about China's growth since we last spoke.

Michael Pettis: The last time we spoke, I had argued that the very high GDP growth targets that China set were much higher than the real economy could deliver. And so the only way to be able to achieve the GDP growth targets involved significant increases in investment, mostly in the property sector but also in infrastructure. And what I argued back then was, because so much of this was nonproductive, it meant that there would be very rapid growth in the Chinese overall debt burden. And I thought that policymakers would probably stop this process well before debt had reached current levels, but clearly they haven't. And so China's debt-to-GDP ratio, which officially is around 300% of GDP, is much higher than I thought they would have been willing to tolerate. The problem with that, of course, is that the ultimate adjustment is going to be that much more difficult because there's a lot more bad investment that has to be written down.

Allison Nathan: When you talk about China's debt load, who holds that debt? Who's actually on the hook for it?

Hui Shan: The distinction between central government debt, local government debt, and even corporate and household debt doesn't make as much sense in the case of China as it does in many other countries because, ultimately, the local government debt was generated because of GDP targets set by Beijing. And local governments were only able to raise these levels of debt because of an implicit guarantee by the central government. There is a widespread perception that local government debt is not the obligation of local governments. If they are unable to pay, ultimately, the central government has to step in.

And this extends not just to local government debt but also to SOE debt, a lot of corporate debt, and even household debt. And the reason there is because the way Beijing looked at debt creation was as a way of generating these higher levels of growth than the economy could otherwise manage. So what that really tells you is that the central government, directly or indirectly, is on the hook for all of the debt within the system because all of the or almost all of it is extended by commercial banks. And commercial banks all need to be recapitalized, and they are very unlikely to default on depositors. And so ultimately, they have to be recapitalized by the central government.

Allison Nathan: What is your view on how willing the central government really is to service that debt?

Michael Pettis: Yeah, they're in a very tough position because, on the one hand, they want to keep the central government balance sheet as clean a possible. But on the other hand, they create very high GDP growth targets, and it's the responsibility of local governments to achieve those growth targets. And because the local governments are unable to achieve those growth targets with organic growth, with real growth by the private sector businesses, etc., the only way they can achieve that target is by borrowing and investing in infrastructure projects that ultimately generate less growth than they cost. So these are loss-making activities, right?

So as long as the local governments are required to do this -- and they are -- they have no choice but to let their debt burdens rise very, very rapidly. So they've argued that the reason they are so highly indebted is because they're following Beijing policies. So what does it mean?

I suspect that what it really represents is a politically contentious struggle between the central government and the local governments about allocating the costs of all of this bad investment. Many people will tell you that local governments are bankrupt; they simply can't pay their debt. That's technically not true. Local governments are bankrupt from a cash flow point of view. Their revenues are way down and their expenses are up and they're not allowed to borrow. But they own an awful lot of assets.

So ultimately, my guess is that this is the way Beijing is trying to put pressure on local governments to liquidate their assets in order to pay for the debt so that Beijing doesn't have to pay for the debt. Now, this is a very political process. In China, I think there's a popular misperception that the central government is so powerful that it snaps its fingers and everybody in China jumps. That's not true. There has always been a real division of power between the central government and the local government, and I think what's happening is that there is a fight between the two over how the losses are going to get allocated.

If you are Beijing and you want to see any increasing centralization of power, one of the ways to achieve that is to weaken the economic power, which means also the political power, of local governments. So to the extent that you can force the allocation of losses to local governments, who will then pay for it by liquidating assets, then you're able to kill two birds with one stone. Address the debt problem and further centralize power within Beijing.

Allison Nathan: Let me just move on and ask a bit about the policies that have been announced. So far, there has been this increased ceiling for local government debt to be able to issue more debt, new debt, to deal with their existing debt. How effective do you think that policy is?

Michael Pettis: Not effective at all because what it really represents is moving debt from one pocket to another. So the pocket where it's hidden off balance sheet into the pocket where it's on balance sheet. Some people say that this is very good for local governments because the off balance sheet debt has a higher interest charge than the on balance sheet debt. The on balance sheet debt is pretty close to being sovereign debt, so the required coupons are much lower.

The argument is that this frees up cash flows for local governments that they can spend on services and transfers, etc. It's a very popular argument here, but there are two important problems with the argument. The first problem is that, when you look at the actual savings, they're really tiny. We're talking about 50 billion a year or 70 billion a year. And at 123 trillion economy, this is really not going to change anything.

Secondly, if you lower interest rates, that doesn't come for free. That just means the lender gets less revenue, and the lender is the banking system. So by lowering the debt servicing costs of local governments, you are also lowering the revenues of the banking system. Now, if the banks were independent and independently capitalized, you could argue that there's a real transfer from the banking system to local governments. But even the top banks in China need to be recapitalized, so that leaves them in a bit of a quandary.

If you restructure debt in such a way that you are paying less interest to the banks, on the one hand, you're saving money because you're paying less interest. But on the other hand, that's matched almost dollar for dollar by the increase in the amount of recapitalization of the banking system. So once again, you're really shifting money from one pocket to another. You're not changing anything fundamental in the system.

Allison Nathan: Okay, understood. That's not the only type of policy that the government has begun to roll out to help support growth. Are there other policies that you think will be effective at supporting the economy from here?

Michael Pettis: There are four other policies, all of them problematic. One is to continue subsidizing manufacturing. In fact, I was at a presentation with a very prominent Chinese economist who's actually quite influential in policymaking circles, and he made what I felt was a rather astonishing statement. He said, "We all agree we need to boost consumption, but there is a good way and a bad way. The bad way is to transfer income to the household sector. The good way is to transfer income to businesses so that they expand and hire more workers and raise wages and that will drive consumption up."

Now, the problem is that China doesn't just need more consumption, it needs more consumption relative to production. It's got a huge imbalance. So the idea that the good why to drive up consumption is by driving up production and having part of that flow into consumption gets it completely backwards. But at any rate, that's one of their policies. We have to continue subsidizing the supply-side of the economy. That, I would argue, makes the imbalances worse.

Another one of their policies is the big problem in China is lack of confidence in the household sector because of the decline in housing prices, so we need to stabilize the housing market. Well, I don't need to tell you that so far there's been a lot of talk about doing that, but it hasn't happened. Real estate prices continue to decline. Real estate transactions continue to decline. I'm not sure that there are policies that can prevent the decline in housing prices because the problem in China is we have way too much housing for a declining population.

And let me do a quick digression here. We should never talk about China's housing problem. There are two very separate Chinas. There is the China of the southeast, you know, provinces like Zhejiang, Jiangsu, Guangdong, Fujian, Shandong, Shanghai, Beijing, where you have a problem of excess property, excess housing, but it's not too bad. And those all have growing working populations, thanks to immigration.

And then you have the rest of China which has a real problem where most of the excess housing is built up, and they all have very rapidly declining working populations. But at any rate, Beijing's strategy is, if we can stabilize property pries, we will raise consumer confidence and that will cause consumption to go up. Maybe it'll work, maybe it won't.

The third strategy is related, and that is that, if we can get a boost in the stock market, that also will raise consumer confidence and, through a wealth effect, may cause consumption to go up. I'm very skeptical. The float within the stock market is quite small. Most speculators are pretty rich, so it's not clear there's a big wealth effect. And the market is so volatile that I'm not sure that, even if you made money on Tuesday, you'll go out and spend it on Wednesday.

And then finally, the last strategy is to boost consumption directly through transfers. But the only way they're doing that really is through consumer coupons. There's a few other things they're doing. They are trying to spend more money on students, spend more money on very poor retirees, and issue lots of consumer coupons, in the hopes that that stimulates consumption. The problem there is that, when you add up all of these numbers, they're really tiny. And the reason they're really tiny is because all of this spending doesn't occur at the Beijing level. It's not national spending. It all occurs at the provincial and municipal level. And provinces and municipalities have real cash flow constraints.

So they're promoting a lot of these programs, but when you actually add them up, the numbers are really tiny.

Allison Nathan: Right. Interesting. And then of course you now have the reelection of Donald Trump and the threat and likelihood of more tariffs. How problematic will that be for China?

Michael Pettis: I think China is very worried about that. And I think the rest of the world is very worried about that. China is about 17% of global GDP, but it accounts for about 30% of global manufacturing. And the Chinese strategy in the last two to three years -- and longer than that but especially in the last two to three years -- has been to double down on manufacturing growth, which means that ultimately China's share of global manufacturing must grow twice as quickly as China's share of global GDP, right?

The problem is that, in the past, the US absorbed most of that. And you can see in the US the manufacturing share has declined pretty steadily since the beginning of the century. The US is about 23% of global GDP and only 17% of global manufacturing, to reverse that trend and to try to increase the US manufacturing share to something closer to its GDP share.

Here is the problem. It's just a problem of arithmetic. And that is China and the US together account for nearly 50% of global manufacturing. And if they both try to increase their manufacturing shares of GDP then, by definition, the rest of the world has to accommodate by reducing its manufacturing share. But who wants to do that? Nobody.

Europe is extremely worried about this and putting into place very strong trade policies that prevent a further erosion of its manufacturing share. So much of that has moved over to developing countries who have seen their own manufacturing badly hurt by this struggle between the two titans.

So the problem is that China's solution is the kind of solution that would work 20 or 30 years ago when they were too small to matter. Now that they account for nearly one third of global manufacturing, the solution cannot work without significant accommodation by a very reluctant rest of the world.

Allison Nathan: Right, okay. So is there any policy that you think is likely to be implemented that is going to improve the current situation?

Michael Pettis: In the short term, we're probably going to see an expansion of fiscal support. Much greater than we've seen already. Probably in the first quarter, we will finally start to see real attempts to stimulate the demand side of the economy, and that will be very positive in the short term. But ultimately, it's only a short-term solution.

The only sustainable way to rebalance the economy, to increase the consumption share of GDP so that they can reduce the investment share and the trade surplus, involves increasing the share of GDP distributed to the household sector, which is easy to say. But the flip side of that is you have to reduce the share of GDP retained by either governments or businesses, and that's the very hard part to do.

Allison Nathan: So what I'm hearing from both Michael and Hui is that, when it comes to the Chinese economy, the problems are much clearer than solutions at this point. So ultimately, the question of just how effective policy stimulus will be in addressing China's economic issues remains an open one. Let's leave it there. Thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan.

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