Section 3
Challenges Facing China's Economy: From Real Estate Recession to Excess Supply Capacity in Emerging Industries

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1. The Continued Real Estate Market Slump

The prolonged slump in real estate prices has decreased consumer demand, and the uncertainty surrounding it has attracted attention to the outlook for China's economy. At the National People's Congress of the People's Republic of China in March 2024, Premier Li Qiang set the target for real economic growth rate at around 5% for the year, similar to the level in 2023. The government activity report prioritizes the construction of a modern industrial system and the acceleration of the development of "productive forces of new quality" as the primary goals for achieving this target. At the same time, the report emphasized the government's flexibility in pursuing aggressive fiscal policies and stressed that the budget deficit in 2024 should be maintained at 3% of gross domestic product (GDP), adhering to the principle of a balanced budget.

The Government Activity Report's emphasis on innovation in high-tech industries and avoiding further expansion of the budget deficit indicate that the Xi Jinping administration is more determined than ever to achieve "innovation-driven economic growth," as symbolized by "China Manufacturing 2025" through supply-side efficiency improvements. The government's stance is now stronger than ever.

On the other hand, the current real estate market remains sluggish. In response to the situation where the construction of already sold condominiums has been halted, the "Notice on the Implementation of Financial Support for the Stable and Complete Development of the Foothold Real Estate Market" (referred to as "Financial Article 16") was announced in November 2022. Simultaneously, comprehensive policy under the slogan "*baojiaolou* (to guarantee the delivery of purchased condominiums)" was implemented to support housing construction and prevent further declines in prices. In February 2023, the policy rate remained unchanged, but the government implemented easing measures, supplying RMB 199 billion to the interbank market through the Medium-Term Lending Facility. As a result, mortgage rates fell, and new condominium prices in 70 major cities began to rise slightly. However, this increase was short-lived, and starting in June of the same year, housing prices began to decline again in many cities.

In June and August 2023, the government reduced both 1-year and 5-year loan prime rates (LPR) by 0.1%. Furthermore, in February 2024, the government decreased the 5-year LPR by 0.25%. Despite these interest rate reductions, real estate prices declined sharply in the first quarter of 2024, with home sales prices and floor area also falling in line with this trend (as shown in Figure 1-3-1). On May 17 of the same year, the local government initiated a series of policies, including purchasing condominium inventories to convert them into affordable housing, providing incentives for condominium owners to sell their existing homes in exchange for new ones (trading an old house for a new one), and eliminating the minimum mortgage rate. However, doubts remain about the effectiveness of these measures in halting the decline in housing prices. Critics argue that further interest rate reductions could squeeze banks' margins, delay the disposal of non-performing loans, and potentially lead to depreciation of the yuan.

This stagnation in the real estate market is believed to hinder the recovery of domestic consumption demand. The first-quarter economic statistics released in April 2024 showed that real GDP growth was 5.3% a year on year (YoY), exceeding expenditure. In particular, the increase in industrial production (in value-added terms) was 6.1% YoY, which drove growth. In contrast, consumption (total retail value of social goods) only increased by 4.7% YoY, with goods consumption rising by just 4.0%. This highlights the continued demand to fully absorb the growth in industrial production.

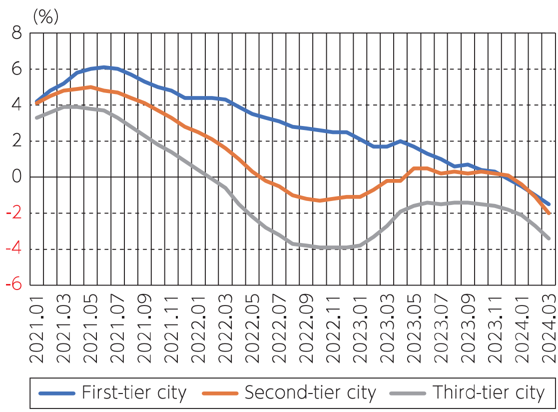

Figure 1-3-1 Trends in the housing price index (YoY)

Source: National Statistics Bureau website (https://www.stats.gov.cn/)

2. Overcapacity Problems in Emerging Industries

Western governments, wary of an export surge from China, view the Chinese government's further expansion of supply capacity in emerging industries, including green tech industries such as new energy vehicles (NEVs) and solar panels, as leading to further excess supply capacity.

This is highlighted by U.S. Treasury Secretary Janet Yellen's visit to Guangzhou and Beijing from April 3 to 9, 2024, where she met with top officials. During these discussions, she expressed frank concerns about China's overcapacity problem, often referred to as "the second China shock."

Ms. Yellen also expressed that China's overcapacity problem is not a short-term issue caused by the U.S.-China conflict, but a medium- to long-term challenge for the Chinese economy, driven by structural problems such as a high savings rate and a tendency toward sluggish consumption.

According to a report in the economic media magazine *Cai Xin Zhou Kan* (Yu, 2024), China's industrial capacity utilization rate, which indicates the state of supply capacity, has continued to decline. The utilization rate was 75.1% in 2023, however, in the first quarter of 2024, and fell to 73.6% which is decreased 0.5% YoY. China's current overcapacity problem is characterized not only by heavy industries such as steel, whose oversupply has long been a problem, but also by emerging industries such as electric vehicles (EVs), solar panels, and lithium-ion batteries, which have supported China's overseas exports since the Corona pandemic and have been called the "Three New Divine Devices" (*Xin-san-yao*), namely electric vehicles (EVs), solar panels, and lithium-ion batteries.

The magazine mentioned above introduces the fact that, as a result of a survey conducted by a major automotive parts manufacturer, the utilization rate of all Chinese automobile manufacturers fell from 62% in 2017 to 48% in 2023. Of these, only 20 companies had an operating rate of over 60%, and 36 companies had a similar rate of less than 30%. In addition, the utilization rate for lithium-ion batteries is still around 50%, and the supply capacity for solar panels is 2.5 times that of global demand.

According to the same article, China exported 1.324 million vehicles in the first quarter of 2024, increasing 33.2% YoY. Of these, 307,000 were NEVs. In addition, exports of solar panels and lithium-ion batteries increased by 36.6% and 69.4%, respectively, on a volume basis.[1] This export composition is perceived as a threat by Western governments.

Traditional industries are dominated by state-owned enterprises, and the

1) In the case of solar panels, total exports fell 4.9% YoY due to falling prices.

government has been effective in solving the overcapacity problem by issuing orders to reduce the scale of production or to expel inefficient state-owned enterprises. However, many of the emerging industries that are currently facing overcapacity problems are private enterprises, which are difficult for the government to control. Furthermore, there is a possibility that demand for these emerging industries will increase significantly worldwide, especially in emerging and developing countries, and it is not easy to determine whether the current "excess supply capacity" situation will persist over the long term. In light of such a situation, it is an urgent issue to establish a flexible system for adjusting production capacity that can respond to criticism from the international community.

3. The Policy of Subsidizing the New Energy Vehicle (NEV) Industry

Western countries' view of China's "excess supply capacity" in emerging industries stems from the perception that the Chinese government has, in recent years, implemented aggressive industrial policies, leading to rapid production expansion[2].

The industrial policy for the NEV industry is a typical example. The following is a brief review of the policies and results of the subsidy policy for the NEV industry.

A distinctive feature of the subsidies for the promotion of NEVs provided by the Chinese government since 2013 is that although the payments are made to companies, their purpose is to subsidize sales to consumers, with the payments being tied to the number of NEVs sold (Figure 1-3-2, Yu, 2021). This type of subsidy mechanism does not favor any particular company and is very different from the intra-regional protectionism that local governments in China have been practicing with local automobile companies in the past.

In addition, the local government has implemented a policy to build charging stations as infrastructure in each city as the policy supports NEVs

2) At present, industrial policies are being revived and practiced in many countries. This is clearly shown in the study by Juhász, Lane, and Rodrik (2023), which estimates the change in the total number of industrial policies from 2010 to 2022 and the number of industrial policies by region. The authors used natural language processing to select and count the number of policy documents classified as industrial policies from the information on policy documents obtained from the Global Trade Alert (GTA) database. According to the paper, the number of industrial policy cases was only 34 per year in 2010, but it began to increase gradually around 2013, reaching 1,568 cases in 2022. By region, Western Europe and OECD countries had the largest number of industrial policies, with 13,514 in total from 2010 to 2022.

combining with price subsidies. According to the National Development and Reform Commission, by the end of May 2023, the cumulative number of charging infrastructure in China will be 6.36 million[3]. It is important to note that the government's industrial policy for the NEV industry has not been to subsidize specific manufacturers, but rather to expand the consumption of, and demand for, NEVs. The market's rapid expansion has contributed to the increase in their productivity, combining with the dynamism that encourages new revenues to complete vehicle manufacturers and intermediate goods[4]. The rapid growth of automotive battery manufacturers, including the global battery manufacturer Contemporary Amperex Technology (CATL)[5], should be understood as an increase in the sophistication of the division of labor driven by expanding final

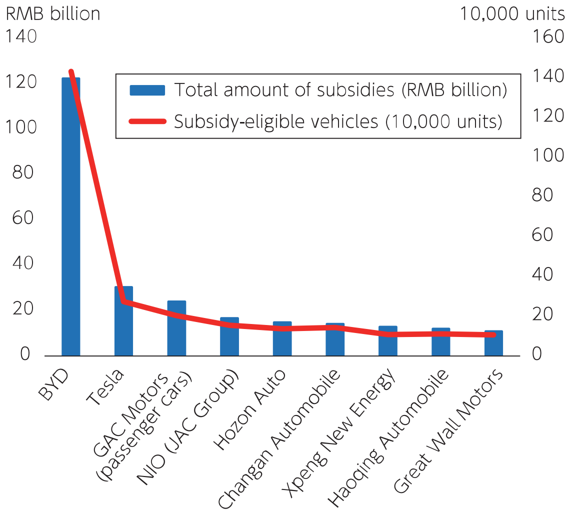

Figure 1-3-2 Total direct subsidies by NEV manufacturer and number of eligible vehicles

Source: Ministry of Industry and Information Technology, 'Announcement on the Preliminary Review of the Clearing and Audit of Subsidy Funds for the Promotion and Application of New Energy Vehicles in 2022 and Prior Years', 17 August 2023, (https://www.miit.gov.cn/jgsj/zbys/qcgy/art/2023/art_90fc1b40d8d1436f80e7aeb48ac21ac8.html)

3) These include AC slow charging, DC fast charging, high power charging, and wireless charging (Inoshita, 2023).
4) Kajitani (2024) calls this process "Smith-Marshall-like growth."
5) In 2023, CATL and BYD rank first and second, respectively, in the global EV battery market (Inoshita, 2023).

demand[6].

On the other hand, government subsidies for NEV purchases were significantly reduced in 2019 in response to domestic and international criticism of an excess of NEV production. This has led to an export offensive by NEV manufacturers in search of their markets abroad (Inoshita, 2023).

This phenomenon is similar to the situation in the early 2000s, when so-called *shanzhai phones* (fake-brand cell phones) produced mainly in Shenzhen boomed in China and were eventually exported to other countries in Asia and Africa. In any case, it is difficult to believe that government subsidies and industrial policies alone can explain the expansion of production scale and decline in prices. The subsidies for consumers ended at the end of 2022, and the NEV production ratio regulations mandated for manufacturers have not been effectively functioning, as most manufacturers have already met them. It is precisely the large number of "companies rushing into the boom" that has led to overproduction and price declines and is also the reason for the recent surge in exports.

Observers of the Chinese economy have long referred to the sudden expansion of production capacity, driven by a combination of market growth and "companies rushing into the boom" as a "rush economy" or "high output and high death rate." The major difference, of course, is that the *shanzhai phones* boom of some 20 years ago occurred essentially in the absence of government intervention, whereas NEVs are strongly supported by the government. What these phenomena have in common, however, is that the rapid expansion of demand spontaneously generates a new division of labor in the industry, which in turn generates the entry of new industries and increases productivity. In other words, the Chinese economy, which has continued to grow through a combination of rapid market expansion and a "rush economy," is prone to a situation of excess supply capacity in certain industries.

4. Is the Expansion of Consumption Demand Feasible?

Can China's economy, facing both a drop in demand due to the real estate slump and an excess supply capacity as a result, weather this difficult situation?

6) However, the traditional logic of domestic industry protection has also been at work in the development of key component industries such as automotive batteries. For example, according to Tang (2021), an expert on China's automotive industry, the entry of foreign firms into the automotive battery industry has been severely restricted. In 2015, the Ministry of Industry and Information Technology (MIIT) announced the "Standard Conditions for the Automotive Power Storage Battery Industry," which specifies the use of batteries from government-approved manufacturers as a condition for receiving subsidies for the sale of NEVs.

It is important to note that the Chinese government has not entirely ignored the need for demand expansion measures. In the Government Activities Report for the National People's Congress, the issuance limit for local government special bonds, primarily used for local government special bonds, was raised to RMB 3.9 trillion. Additionally, it was announced that RMB 1 trillion in long-term special government bonds would be issued over several years. Some have pointed out that the size of the budget deficit in the general budget is actually much larger. For example, Huang Tianlei, Research Fellow at The Institute for International Economics, estimates that the real Balance of Payments deficit in 2024 will be 7.7% of GDP, after taking into account fiscal balances other than the general budget, such as the Governmental Fund Account and the State-owned Capital Management Account, and the reversal of the Budget Stability Adjustment Fund, which is a pool of annual carryover of fiscal balances (Huang, 2024). The real budget deficit in 2024 is expected to be 7.2% of GDP, 1.4 percentage points higher than in 2023.

In other words, there is a strong possibility that the Xi Jinping administration recognizes that one of the causes of the current economic slump is a lack of demand, and that aggressive fiscal policies must be implemented to address this problem. However, for several reasons, the author believes that it will be quite difficult for these demand-stimulating measures to actually produce results under the current conditions.

The first reason is that the Chinese government's aggressive fiscal policy has not been conveyed as a clear message both domestically and internationally.

For example, the issuance of very long-term special government bonds is not counted as a budget deficit in the general budget but is included in the budget of the Governmental Fund, which is a special account. The special government bonds included in the fund budget are to be repaid with the government's own project revenues, as was the RMB 1 trillion Anti-Quarantine Special Government Bond issued in 2020. At this point, we should recall Rickard's neutrality proposition. This proposition suggests that when fiscal expenditures are covered by the issuance of government bonds, rational economic agents will anticipate future tax hikes and increase their savings rather than spending, so that effective demand will be neutralized. If this holds, then special bonds issued under the firm stance of allowing budget deficit increase should be economically neutral, or at least that is the government's intention. However, if the goal is to boost domestic consumption, this stance may send a counterproductive signal to the market[7].

The second reason is that, even if the government recognizes the need for demand stimulus, it aims to achieve this not by boosting consumption demand but through capital investments to realize its ambition of surpassing the West in manufacturing, as seen in the focus on a "new quality of productive capacity" mentioned above. However, such investment in manufacturing will not fundamentally solve the problem of insufficient demand in that it may further increase domestic supply capacity and further widen the receiving gap.

In addition, the recent aggressive capital investment in the manufacturing sector has been induced by a policy to compensate for the slump in real estate prices. This is clearly demonstrated by the sharp shift in bank lending from the real estate sector to the industrial sector in recent years, as shown in Figure 1-3-3. New real estate lending peaked between 2018 and 2019 and then declined rapidly after 2021, when the Covid-19 pandemic continued. This has been offset by a large increase in bank lending to the industrial and green industries.

The surge in real estate prices that has continued for the past two decades

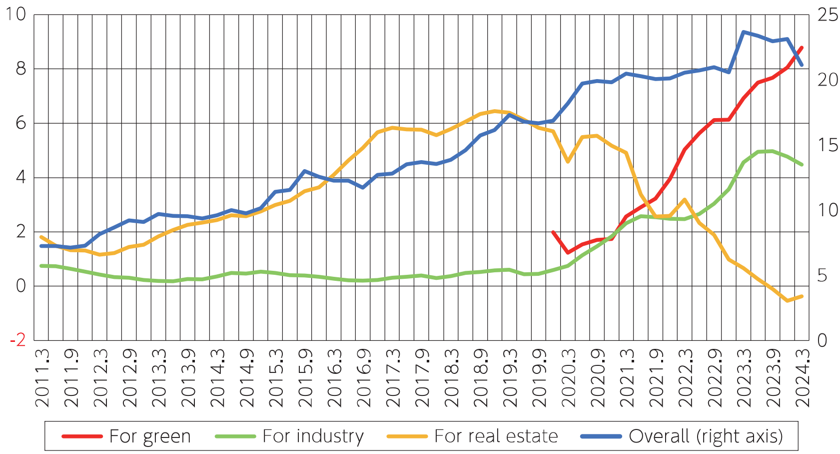

Figure 1-3-3 Trends in new financial institution loans (RMB trillion)

Source: Caixin Data, CEIC
Note 1: The amount of new loans was calculated as the difference between the various loan balances for each year.
Note 2: There is some overlap between 'green investment' and industrial investment.

7) The 30-year and 20-year special ultra-long-term government bonds were issued on May 17 and May 27, 2024, respectively, each with a maturity of 40 billion RMB. When the bonds were first issued, speculative trading by retail investors caused the prices to fluctuate wildly, causing the Shenzhen Stock Exchange to temporarily suspend trading of the bonds on the morning of May 23, 2024.

has been a product of excessive domestic investment, in the sense that surplus funds generated by the high domestic savings rate and sluggish consumer demand have been channeled into the real estate market. However, this structure is no longer the case, and in recent years, policies such as the “One Belt, One Road” concept, which calls for developing countries and emerging economies to provide an outlet for excess supply capacity, have been toned down. Under these circumstances, an export offensive by manufacturing firms targeting the markets of developed countries is now seen as an alternative.

However, if the Chinese government aims to achieve a soft landing in the real estate market, it will need to maintain the immediate rate of economic growth through aggressive fiscal and monetary policies and, in the meantime, support domestic consumption demand by expanding and improving the social security system to prepare for the spread of social unrest that will accompany the decline in real estate prices. In her remarks during her visit to China, Ms. Yellen also clearly recognized that China’s excess supply capacity problem is a medium- to long-term challenge for the Chinese economy, which has structural problems such as a high savings rate and a tendency for consumption to stagnate. In order to address these issues, it is necessary to shift the policy direction from one that focuses on improving production capacity on the supply side to one that raises the level of consumption demand. The author believes that these proposals are generally applicable, and also believes that these recommendations are generally appropriate.

Given these circumstances, the direction that the Chinese government should take with regard to economic policy is clear. In other words, the Xi Jinping administration should make a clearer commitment to increasing domestic consumption demand, rather than taking the current, confusing stance, in order to ease economic friction with the United States and other Western countries, and to realize sustained economic growth for the Chinese economy in the future. Will the Chinese government be able to solve the longstanding problem of insufficient consumer demand and put the sluggish economy on the road to recovery? The success or failure of such a move will depend on whether or not the government shows a serious attitude toward this issue.

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