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China

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*Cheap lending to lowquality borrowers renders one of Beijing's prime policy tools less efficient.*



## POLITICAL ECONOMICS

### The Credit Engine Behind China's Economy Is Sputtering

China's economy is off to a strong start this year, if you believe data released this week. Although, of course, you shouldn't entirely. Industrial production grew at a faster pace in the first two months of this year than in December, and at 6.3% year-on-year was much faster than the 5% many economists had expected. Ditto retail sales, whose 2.8% growth far exceeded an anemic December (0.9%) and economists' 2.5% prediction. The retail number has become one of the most important measures of China's economic performance given the imperative to move toward greater domestic consumption.

Six years into a major property market correction intended to reshape China's economy entirely, economists watch keenly for any signs China may finally be emerging into a new, more stable normal. Are these it?

Alas, note at the outset that Beijing itself doesn't believe the economy is improving. Officials this month promulgated a series of economic plans centered on a GDP growth target of 4.5% to 5%, the lowest since 1991. In part that target sends a signal from the senior Communist Party leadership to other officials that Beijing will tolerate some of the pain of an economic adjustment. Local cadres shouldn't rush to juice the stats with excessive lending and white-elephant public-works projects. All to the good.

But the official GDP target also in part reflects officials' perception of reality. It's widely understood that the government economic data concerning GDP growth are a lie intended to flatter the party. Any good lie, however, aspires to a measure of credibility. The GDP target reflects the fastest growth rate President Xi Jinping thinks he can plausibly pretend to have achieved. It's a bad sign when even the party is dialing back the ambition of its deception.

Look closer, meanwhile, and a new and more serious economic dilemma is emerging.

During the first few years of China's real-estate rebalancing, one had the sense that Beijing believed it *could* continue with its old economic-growth model if it wanted to but knew that it *shouldn't*.

Since Mr. Xi embarked on the property correction in August 2020, Beijing has tried to steer the economic rebalancing carefully—sometimes allowing fate to run its course by bankrupting some companies or stressing some local governments overexposed to off-balance-sheet real-estate lending,

other times arresting the decline with old-style policy hacks such as credit subsidies.

Increasingly, however, the question is whether Beijing *can* deploy its old policy tools even if it wants to. Evidence is accumulating that Beijing's firepower is running down, as Logan Wright of the Rhodium Group consultancy noted in a recent report.

The tell is credit, the rapid expansion of which for decades has been Beijing's primary means of achieving economic growth. Despite robust new bank lending of around \$680 billion, the total rate of credit growth is slowing dramatically: to 6.1% year-on-year in January, compared with an average of 9% a year in 2017-24 and 18.1% in 2007-16.

This by itself wouldn't be a terrible thing, given that an overreliance on wasteful lending contributed to the imbalances China now must resolve. An ideal scenario would involve less but better lending: significantly less wasteful credit to state-owned enterprises and government entities, partly offset by judicious lending to productive private firms.

Instead, the efficiency of credit at generating economic growth may be declining even as the pace of credit creation slows. Some 58% of loans in December were made at interest rates at or below the official benchmark lending rate of 3%, Mr. Wright notes, and that proportion has risen steadily over the past couple years.

This suggests banks are struggling to find borrowers (read: in the private sector) that could generate returns above 3%, which is remarkable in a developing economy with enormous potential for catch-up growth if nothing else. Instead banks are lending to inefficient state-owned enterprises and investment pools linked to local governments. Cheap lending to low-quality borrowers then weighs on bank profits, hindering future productive lending. This hints at the declining efficacy of one of Beijing's prime policy tools.

Mr. Wright suggests this is less a "crisis" or a "collapse" than a "prolonged decay," which is apt. Beijing's great advantage, if you can call it that, is that its relatively closed financial system is immune to the market pressures that normally would trigger a crash amid slowing economic growth and deteriorating credit quality and bank profitability. It's always been more likely that China would simply lose one decade after another to chronic economic anemia, as Japan has since the 1990s.

An extended gradual decay also might sometimes allow for modestly positive news such as the data that garnered so much excitement this week. Just don't mistake the absence of a crisis for the presence of a recovery.

*By Joseph C. Sternberg*

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