Atlantic Council
GEOECONOMICS CENTER

Rhodium Group

China Pathfinder: Quarter 2 2024 Update

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AUGUST 2024

China Pathfinder is a multiyear initiative from the Atlantic Council's GeoEconomics Center and Rhodium Group to measure China's economic system relative to advanced market economies in six areas: financial system development, market competition, modern innovation system, trade openness, direct investment openness, and portfolio investment openness. To explore our data visualization and read our 2023 annual report, please visit https://chinapathfinder.org/.

China's leaders insisted that their goal of 5 percent or better economic growth for 2024 was on track in the second quarter, adamantly denying foreign allegations that faltering Chinese demand was causing massive overcapacity and export spillovers. Our reading of high-frequency indicators and assessments from well-regarded Chinese economists (discussed below) are at odds with that assurance. Reluctance to concede the extent of economic weakness has prevented Beijing from speaking with credibility about the steps necessary to address the causes of that weakness, leaving investors and consumers unsure about the outlook. But during that quarter, a potentially crucial meeting was announced: the long-delayed Communist Party Third Plenum to discuss economic priorities, which took place July 15–18. Third Plenum party leadership meetings have occasioned the most significant macroeconomic redirections in China's modern history, such as in 1978, 1993, and—arguably—in 2013 under Xi Jinping himself. Preparatory consultations between leaders and economists thus became an important plank in the macroeconomic story of the second quarter of 2024 (2Q2024). We discuss the context for those second quarter preparations in Part 1 below, explore the details of what policy directions were signaled in Part 2, and look at whether the July 15–18 Third Plenum meeting changed the outlook in Part 3.

Part 1: China's macro story in the second quarter of 2024

Through the second quarter, Beijing insisted that economic growth was strong and on track, but most vital signs of activity were at odds with that assurance. National Bureau of Statistics (NBS) data through May showed decelerating industrial production and investment data. All subcomponents of fixed asset investment (FAI) have slowed year to date, in line with some of the weakest credit indicators in decades, with a new low in total social financing (TSF) growth and with more repayments by nervous borrowers than new credit issued. This lack of new borrowing affected property and infrastructure, weighing on already bad property sales and causing additional price weakness. Infrastructure investment growth slowed through the quarter, despite faster bond issuance. Year-to-date private FAI slowed to 0.1 percent for January–May from 0.3 percent in January–April. Only retail sales data surprised on the high side, at 3.7 percent year-over-year (y/y) growth in May, though this was inflated by frontloaded sales-promotion events.

The singular bright spot for China is export growth, which was up a solid 7.6 percent y/y in May, from 1.5 percent in April. While current data show that export and related manufacturing strength continues, this comes with two important caveats. First, even at their strongest, exports alone cannot deliver the growth rates China wants. Second, Beijing's over-reliance on exports is motivating stepped-up trade protection from across the advanced economy world, and—perhaps more surprisingly—from a host of developing nations in the Global South as well.

The divergence between official pronouncements and market reactions is growing. At its June press conference, the National Bureau of Statistics maintained that, "Judging from the operation of the main economic indicators...transformation and upgrading continue to advance, the national economy continues to pick up and improve, and conditions are generally stable." The research departments of the International Monetary Fund (IMF) and the World Bank upgraded their 2024 gross domestic product (GDP) growth expectations based on these data. But readings from the NBS purchasing managers' index have been in negative territory for nine of the past twelve months, including May and June 2024. China's stock markets have performed poorly, and foreign investor surveys show deteriorating expectations (see the Direct Investment section below).

The most visible expression of the gap between the official narrative and the concerns of other parties was seen in a strident campaign against foreign claims that China had structural

overcapacity. Chinese authorities rejected the premise that China's low-capacity utilization rates and rising exports were a problem, arguing instead that there is nothing wrong with China's supply-side focus, and that the world should embrace this capacity to help battle climate change. This contrasted starkly with a Group of Seven (G7) leaders' summit in Italy that was explicit in calling for Chinese action to address its overcapacity, and the announcement of countervailing duties on Chinese-made electric vehicles entering Europe that would lift tariffs to as high as 48 percent.

Highly regarded Chinese economists have stepped up their calls for out-of-cycle fiscal stimulus to address a shortfall in domestic demand. Yu Yongding—a former adviser to the People's Bank of China (PBOC) and former director of the Institute of World Economics and Politics (IWEP) at the Chinese Academy of Social Science—calculated that China is likely to fall roughly 6.5 trillion renminbi (RMB) short of the investment necessary to reach its 5-percent GDP growth target for 2024. Given the size of China's economy, by implication that would suggest that growth would be around 0 percent if that shortfall were not made up. Yu believes government can expand borrowing to cover this gap, though at the cost of additional future debt-service pressure. But regardless of whether Beijing can finance fiscal support, the point is clear that such a gargantuan stimulus would not be necessary if the economy were on track.

To hear expert points of view, President Xi met with nine businesspeople and economists in late May, in Jinan, Shandong. The details of the gathering were not reported, though it was characterized as a chance to better understand economic challenges. A number of the participants published commentaries or spoke to media just before or after the exchange with Xi, including current IWEP Deputy Director Zhang Bin, National School of Development (Peking University) Professor Zhou Qiren, and head of the Chinese Academy of Macroeconomic Research Huang Hanquan. Each offered frank analyses of current economic conditions. Zhang pointed to the need for additional fiscal infusion to reverse a continuous slide in household demand, as well as rightsizing unproductive government involvement in the marketplace and improving macroeconomic governance generally. Zhou Qiren was prophetic in warning of the risks from failure to implement the Third Plenum promises of 2013 more than a decade ago.

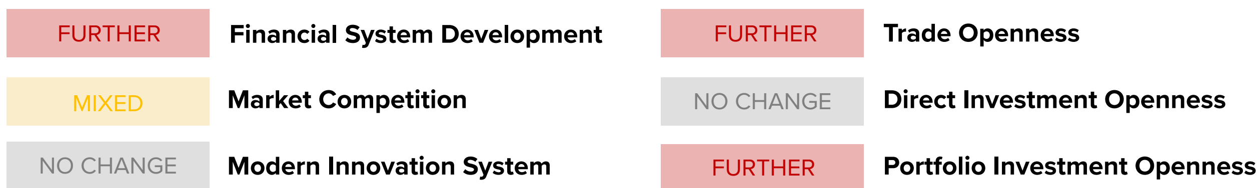
Xi's engagement with these experts in no way, shape, or form assured that the 2024 Third Plenum would move reform expectations in the right direction. The official media report on the session led with Xi giving a speech on the party's "grand blueprint for building a modern socialist country in all respects." Indeed, we now know that the Third Plenum, while pledging to address the challenges experts highlighted, did not show how China intends to do this in practice. Promise fatigue from past implementation disappointments means Beijing has a real messaging challenge. It did, however, show in advance of the July meetings that it was not just foreigners who worried about structural demand conditions, and that Xi and his colleagues were not avoiding that topic with domestic advisers.

A LOOK AT SECOND-QUARTER (Q2) TRENDLINES

Figure 1 summarizes our impressions of movement toward or away from the market economy norms that characterize that outcome in the second quarter of 2024.

FIGURE 1

Q2 2024 policy heatmap: Did China move closer to or farther from market economy norms?



Source: China Pathfinder. A "mixed" evaluation means the cluster has seen significant policies that indicate movement closer to or farther from market economy norms. A "no change" evaluation means the cluster has not seen any policies that significantly impact China's overall movement with respect to market economy norms. For a closer breakdown of each cluster, visit https://chinapathfinder.org/.

FIGURE 1 reflects the direction of China's policy activity in the domestic financial system, market competition, and innovation system, as well as policies that impact trade, direct investment, and portfolio investment openness. This heatmap is derived from in-house policy tracking that weighs and evaluates the impact of Chinese policies in the second quarter (Q2). Actions are evaluated based on their systemic importance to China's development path toward or away from market economy norms. The assessment of a policy's importance incorporates top-level political signaling with regard to the government's priorities, the authority of the issuing and implementing bodies in the Chinese government hierarchy, and the impact of the policy on China's economy.

Part 2: April–June 2024 policy specifics: Signals in six clusters

FINANCIAL SECTOR

The key challenge for China's financial policymakers in 2024, and hence the regulators and firms that depend upon them, has been inconsistent or missing guidance from the political leadership, even as China moves toward more formal party control of the financial system. Trial regulations on party control of financial-sector risk were announced in late May, without details. Reports suggest that this will entail several goals, including small-business promotion, "reasonable" additional finance for the property sector, and a plan to deal with the local-government debt morass that has impaired fiscal policy. Broadly, the announcement suggests that leaders think "strict party governance in the financial field" can lead to a more efficient and stable system. It is highly debatable whether the party's involvement in the financial system is making China more or less stable, and if it is the cause or the cure for the current economic malaise. But for our purposes, decisive political party control of the financial system is an undebatable move away from market economy norms, from the previous impulses of Chinese leadership in the reform era, and from the competing interests of nations that are not prepared to sacrifice systemic efficiency to give political incumbents unlimited control over all financial variables.

The property sector is a linchpin of financial stability, because it is both the people's biggest asset and the nation's worst bad-debt bubble. Thus, the sector's ongoing shrinkage has continued to bedevil the recovery narrative through the middle of 2024. Policymakers announced additional support measures in May covering government purchases of unsold homes and cuts to down-payment requirements and mortgage rates. None of the measures were dramatic or new—mortgage and interest rates had been cut in 2023, and the inventory purchase program was a multi-city pilot. They helped market sentiment marginally, though sales did not show a substantial uptick.

In a major speech in June, PBOC Governor Pan Gongsheng hinted that the bank would purchase Chinese treasury bonds, while insisting this would not constitute quantitative easing (QE) or unconventional monetary policy. Chinese officials have derided Western use of QE in the past, asserting that China was growing well without it, and that Beijing's modest public debt-to-GDP ratio gave it other options. But existing policy levers—both fiscal and monetary—are not working, the current pace of credit expansion is weak given soft demand, and expanding the central bank's balance sheet is one of the only options left to support credit growth. Governor Pan's June speech was followed by the July 8 announcement of new daily open market operations (OMO) in government bond markets (just after the second quarter), using tools not used since 2014. Beijing's "not QE" policies are getting harder to distinguish from the unconventional policies used since 2008 in the West. In reality, greater central bank unconventional intervention in debt markets is a rare case of convergence with market economy norms in current practice, but the PBOC's technocratic monetary policy evolution is likely to be quite different from the "party control" impulse discussed above. At the same time, the PBOC policymaking process—unlike that of its Western counterparts—is not conducted independent of political leadership, so any decisions of this magnitude undoubtedly reflect discussion with and approval from the highest levels of the party.

MARKET COMPETITION

Several policy developments in the quarter offered significant signals for the direction of market competition. While the three highlighted below are nominally market friendly, each of them comes with caveats that, taken together, permit us to score market competition as showing only mixed/no change market economy convergence this quarter.

The State Council finalized a regulation on fair competition review, which becomes effective August 1, 2024. The regulation enshrines fair nationwide competition for domestic firms (including private ones) and foreign firms incorporated in China. It requires authorities at all levels to assure fair competition in reviewing policies, and empowers firms (including registered foreign firms) to petition the central competition regulator, the State Administration for Market Regulation (SAMR), to investigate and challenge local or central government agency rules that impede inter-provincial commerce and competition, or that favor locally protected firms. However, two factors preclude scoring this as a clear move toward market norms. First, other policies have committed to fair competition for many years and have failed to achieve a level playing field (see commentary from law firm Wilmer Hale on the example of the 2020 Foreign Investment Law.) Second, the rules provide exceptions allowing anticompetitive policies to stand that promote national security, scientific and technological progress, innovation, environmental protection, or any other public interest. It's hard to think of anything that doesn't fall under one or more of those grounds for exceptions.

SAMR also announced "Key Measures for Market Supervision Departments to Optimize the Business Environment" in late May, including forty measures across ten categories to clear red tape and standardize administrative processes like business registration. Specifically, the document pledges to take "special action to address disruptive problems of local protectionism and market segmentation" and remove "hidden barriers to market access," acknowledging the distortions and costs of local favoritism.

Private domestic and foreign firms may also welcome measures announced in May to enforce intellectual property online, as well as rules against counterfeit sales and trademark infringement (SAMR's "Interim Provisions on Anti-Unfair Competition on the Internet"). These also ban a range of tech companies' practices and "improper" uses of data, which could impinge some business interests. These include using bots or fake reviews, "abusing data algorithms to gain competition advantages," and other violations. While these measures are helpful, they are

also long overdue, and they potentially come too late for foreign brands to regain market share lost to counterfeits or homegrown competition.

DIRECT INVESTMENT

The Commerce Ministry and ten other major authorities jointly issued "Policy Measures on Further Supporting Overseas Institutions to Invest in Domestic Technology Enterprises." Details remain to be fleshed out, but the focus is on easing foreign exchange requirements, improving local financing options, and making trade sales and initial public offerings (IPOs) less unpredictable as exit options in the future. This "all hands on deck" demonstration of coordinated signaling seems intended to send a strong message that China needs foreign technology investment and will try to attract it. Strident de-risking policies being implemented by the United States and other market economies are the proximate factor motivating this Chinese activism.

The foreign firms at which this is directed will recognize this as a meaningful effort on Beijing's part to induce them to continue investment in China. In addition to the national security issues that complicate their investment decisions, they have grown increasingly wary about the macroeconomic outlook. A majority of respondents to the European Chamber of Commerce in China annual survey, released in May, said the present economic slowdown was a challenge, and that they were cutting investments and jobs in China. China's official foreign direct investment (FDI) statistics reported that FDI inflows continued to decline in the quarter.

In April, the Ministry of Industry and Information Technology (MIIT) announced a pilot program that would allow foreign investors to take majority stakes in data centers and telecom services. While the headlines are positive, caveats apply. Foreigners are still barred from many sectors, like online news and publishing, and are limited to operating in three cities and on Hainan Island. Further, the pilot can be terminated (and foreign licenses rescinded) if officials perceive increased cybersecurity risk. As a practical matter, China's data players have built such a dominant position in the marketplace under protected conditions in the past, so barriers to entry will be difficult to surmount going forward.

The joint measures on foreign investment in domestic technology sectors are a strong signal, but one that is focused on China's industrial upgrading ambitions rather than FDI liberalization per se. Likewise, the pilot program for data center investment is confined to a narrow area of technology competition. Benchmarked against China's past seriousness about cross-border investment liberalization, or against the norms of FDI openness prevailing among advanced market economies, Beijing's direct-investment policy trends this quarter are therefore neutral, rather than convergent with market economy norms.

PORTFOLIO INVESTMENT

With slowing FDI inflows, and domestic credit conditions in the banking system under stress, Beijing released new rules in the second quarter meant to improve the role of capital markets for financing company growth. China's stock markets have generally been highly volatile, with less disciplined retail investors doing the bulk of trading, often with less regard for underlying fundamentals than for speculation on what leaders intend to do next. The State Council issued "Nine-Point Guidelines" in April to improve upon this, with broad sections on strengthening supervision and preventing risks.

A novel element in the guidelines is the focus on encouraging dividends. Issuers will be required to detail their dividend policy plans before listing. The rules provide for naming and shaming of companies that do not pay sufficient dividends over a certain period, and the prospect of investigation by regulators for large shareholders when dividends are not paid out. The rules also make clear that access to capital through equity and debt issuance is something to be governed not by market logic, but by political goals: "We will increase support for equity and debt financing for enterprises that are in line with the national industrial policy orientation and have made breakthroughs in key core technologies." This helps illustrate what Communist Party financial system governance is likely to mean in practice.

Beijing hopes this will encourage investors to move holdings to larger, more stable, and more profitable stocks able to generate steady profits and, hence, to pay dividends. There is debate in more advanced market economies with higher-performing capital markets as to whether greater dividend distribution best serves investor interests. For instance, growth companies—which include much of the cutting-edge innovation—generally reinvest in future earnings and capital gains, rather than distributing profit. Perhaps with that need to also take care of earlier-stage firms, regulators also announced support for the tech-focused STAR market in the form of eight measures to improve firms' ability to obtain capital and issue shares, and to improve trading by facilitating the quotation system and expanding exchange-traded funds (ETFs). The measures are squarely focused on improving China's "hard technology" companies and name-check "technological self-reliance."

Portfolio policy signals also aimed at the cross-border picture this quarter. In June, the head of the China Securities Regulatory Commission (CSRC) announced a loosening of restrictions on overseas IPOs by Chinese firms, though it indicated that Hong Kong would remain Beijing's preferred destination. Lingering issues involving foreign IPOs have weighed on equity funding for the Chinese tech sector. Beijing's rules limiting foreign listings, especially after China's cybersecurity regulators forced Didi to delist from the New York Stock Exchange (NYSE) in 2021, and insistence from US financial regulators to permit auditors unfettered access to Chinese company accounting have made raising capital more difficult.

Authorities clearly sought to improve the flow of portfolio investment in China this quarter. But they are doing it only for politically favored sectors, and in a way that further supplants the role of the market with aspirations for party control that have so far failed to demonstrate a basic grasp of sustainable capital investment dynamics and what produces returns on investment. This is a trend away from market economy norms, which is why foreign investment into China is shifting from long-term capital to more opportunistic and speculative players.

INNOVATION

Beijing is rallying around the concept of "new quality productive forces" as the solution to its economic challenges. This means productivity-based growth flowing from technology deepening. If firms make smart research and development (R&D) decisions, better returns on capital follow, as do profits, competitiveness, and productivity. The workforce gets smarter and more productive in the process, which supports better incomes and stronger consumption. Distinct from market economies, the breadth of Beijing's innovation goals is not limited to a few cutting-edge areas such as those in the so-called "new three industries" getting particular attention today (electric vehicles, renewable energy, and lithium-ion batteries). The more expansive Made in China 2025 campaign better reflects the level of ambition, both in terms of sectoral coverage and the all-of-government effort to promote innovation. This is why reports such as the European report on the extent of distortions to market outcomes in China this quarter covers so many elements of the system and so many sectors, high and low tech alike.

While the extent of distortions is unbounded, we highlight notable actions in support of the innovation model in financing this quarter. In late June, officials announced expanded subsidies for high-tech small and medium enterprises (SMEs), targeting several thousand firms with subsidies of up to RMB 6 million (roughly $825,000) each, totaling more than $800 million. China's infamous "Big Fund" (formally, the China Integrated Circuit Industry Investment Fund) was expanded for a third time this quarter, with approximately RMB 340 billion in newly pledged funds ($47 billion) for development of advanced semiconductors. In the same vein, officials announced new insurance subsidy schemes for firms producing new materials and "major technical equipment," which have not yet established a toehold in the market. Officials are also pledging to guarantee some losses from loans to risky tech startups in an effort to jump-start innovation, as well as to expand preferential tax policies for R&D that are already some of the world's most generous.

This pattern of innovation policy trends is at odds with market economy norms, for three reasons worth highlighting. First, it is inconsistent with the other policy pledges of fairer competition and a level playing field, including for foreign technology firms, analyzed above. Second, it depends on the success of financial system reforms, especially in fiscal policy, if it is to be sustained. Beijing is mandating that almost one-third of the investment support under Big Fund III must be provided by commercial banks, without regard to whether they are the right parties to make such investments or have the resources to do so. Finally, Beijing is developing a grand blueprint for innovation-driven growth heavily indexed to a few industries, which is not likely to be a sound model for other sectors, and the future profits of this model depend on foreign tolerance for trade imbalances that is unlikely to continue. The support directed to innovation policy this quarter, as ample as it is on paper, is not a step toward market economy sustainability.

TRADE

The most important policy signals in the trade domain this quarter were in the rhetorical vein, in a context of foreign trade protection directed at China. The biggest foreign action was the conclusion of the European Union electric vehicle (EV) subsidy investigation in mid-June, but dozens of nations, including many emerging economies, announced trade defense actions against imports from China. G7 leaders meeting in Italy discussed "China's persistent industrial targeting and comprehensive non-market policies and practices that are leading to global spillovers, market distortions and harmful overcapacity in a growing range of sectors." Beijing rejected these claims, arguing that overcapacity allegations were fabricated by the United States and European Union to justify protectionism against competitive products. Reports of Chinese window guidance to analysts not to talk about overcapacity were rampant during the quarter. Nonetheless, a number of Chinese economists released survey data and gave seminar presentations during the quarter that acknowledge overcapacity, while debating whether it was intentional or proper grounds for foreign trade defense. Undisciplined financial policies prevent supply-side rationalization in China, leading to surging exports, and this is a concern. Beijing's insistence that these foreign concerns are not legitimate is a major impediment to moving China and market economies closer together in the trade domain.

As foreign trade defenses mounted, Beijing sharpened retaliatory measures. After the European Union and United States announced measures against Chinese industries with overcapacity, China announced new trade investigations into foreign plastics, EU dairy products and pork, and other products. These measures followed the National People's Congress (NPC) adopting a new law on tariffs in April that provides a legal framework for China to impose retaliatory tariffs (though it does not formally take effect until December). Beijing applied particular pressure on German carmakers in an effort to prevent EU electric vehicle duties from coming into effect.

The Ministry of Commerce introduced some carrots to go along with these sticks. Its trade promotion arm promised that it would aid Chinese firms affected by new foreign tariffs, including legal support for tariff proceedings in the United States. (It will be interesting to see how this program evolves: state aid for these exporters was the grounds for foreign tariffs in the first place.) Finally, China's trade diplomats pursued warmer relations with alternate trade partners, including Australia and New Zealand, to emphasize to those enacting trade defense that they would lose out to their peer competitors. Similarly, state-related media played up divisions within

Europe—for instance, arguing in regard to the EV tariffs that "the G7 itself is divided in its trade policies toward China. For example, Germany is competitive in emerging industries and has many mutual investments with China and is therefore less inclined to impose tariffs on Chinese EVs."

Part 3: Plenum policymaking takeaways

The Third Plenum concluded July 18, and details came out July 21 when the Decisions of the Central Committee of the Communist Party of China on Further Deepening Reform Comprehensively to Advance China's Modernization (2024) were released. Under fifteen headings and in sixty clauses, party leaders described how they will meet China's economic moment, confronting a slowing economy, structural constraints, and rapidly changing foreign sentiment. Read straightforwardly, the decisions are unlikely to restore optimism.

As described above, the hope going into July was that leaders would (after the unusual delay in holding the Plenum) offer concrete enough proposals to change the conversation about short-term financial risks and the longer-term constraints that threaten future growth. Our criteria for success required a clear diagnosis of growth headwinds, concrete recommendations for how to solve them, and internal coherence. The decisions did not meet those tests, suggesting instead that China could simply innovate its way out of malaise without diagnosing the causes of that malaise. Industrial policy to promote "new quality productive forces" was the centerpiece. The document claims that all the structural macro tasks laid out in 2013 were solved, yet it pledges to take on and solve those challenges in the future. It aspires to ensure China has total self-sufficiency and global technological dominance while continuously expanding its international economic linkages, without recognizing the tension between these goals.

To be sure, the decisions contain laudable goals that, in the abstract, would align with the market norms that China Pathfinder tracks. The document pledges to protect property and IPR "regardless of [a company's] form of ownership," building on some of the market competition measures released in Q2. On building a unified national market, the decisions pledge to improve market function and "prevent improper government interference in pricing" while ensuring that "production factors like labor, capital, land...and data are determined by the market"—vague, but at least positive allusions to the role of the market. One clause is dedicated to promoting private enterprise. On trade, we get "safeguard the WTO-based multilateral trading system," "foster a business environment that is market-oriented," "remove all market access restrictions in manufacturing," and "unilaterally open [China's] doors wider to least-developed countries." But with few exceptions, the decisions do not answer how these goals will be accomplished, let alone how the contradictions and tradeoffs among various goals will be resolved.

The 2013 Third Plenum that started the Xi era was built from specific policy actions that could be verified with data. Our read of the 2024 decisions sees them as light on timelines (other than to complete everything by 2029), specifics, or acknowledgement of tradeoffs. They call for SOE reform but vow to them "get stronger, do better, and grow bigger." While acknowledging that a new "fiscal relationship" between the central and local governments is needed, the document simply says that relationship will be "well-defined" and "appropriate." Meanwhile Xi's plan for resolving China's long-term fiscal constraints—tax changes to raise more revenue, and a plan for resolving central-local spending imbalances—remain murky.

Acknowledgements

Written by Daniel Rosen and Matt Mingey.

The authors wish to acknowledge the members of the China Pathfinder Advisory Council: Steven Denning, Gary Rieschel, and Jack Wadsworth, whose partnership has made this project possible.

Sophia Busch, Charles Lichfield, Josh Lipsky, and Jeremy Mark were the principal contributors from the Atlantic Council's GeoEconomics Center.