As China's Economy Falters, Be Careful What You Wish For

Clark Packard

May 31, 2022

It is becoming increasingly clear that China's economy is facing significant headwinds. Most of this is Beijing's own doing. A draconian zero-COVID-19 policy has locked down swaths of the economy, severely hit consumer spending, and curtailed factory output. Aggressive regulation of the technology sector, driven by Chinese President Xi Jinping's retreat from private enterprise and embrace of Maoist socialism, has paralyzed a once-dynamic industry. A debt bubble in the country's overinflated real estate sector has led to spectacular crashes, including the default of Evergrande, a gigantic property developer. Meanwhile, Russia's invasion of Ukraine is pushing up global prices of food, energy, and other commodities imported by China. For all these reasons, the International Monetary Fund recently lowered its forecast for China's economic growth to 4.4 percent this year—anemic by past Chinese standards. Bloomberg Economics predicts as little as 2 percent and expects the United States to grow faster than China for the first time since 1976.

Couple these recent trends with longer-term headwinds such as slowing productivity growth, demographic decline, and a continued brain drain among technology workers and entrepreneurs, and it becomes clearer that China is not the economic juggernaut many in the West believe it to be. In the context of heightened geopolitical competition, that's led to a lot of schadenfreude, cheer, and outright triumphalism in the West. Now, "the United States can shape the collapse of China just as it did the Soviet Union," Robert Wilkie, secretary of veterans affairs during the Trump administration, argued late last year.

Nonetheless, hoping for an economic collapse in China would be very unwise.

First, recessions hurt a lot of average people. Although the Chinese Communist Party is becoming increasingly totalitarian at home and revisionist abroad, there are more than 1.3 billion Chinese who have no connection to the party. They will bear the brunt of China's economic tumult, as will lower-income Americans and less well-off people around the world. All of them will be caught in the fallout when the world's second-largest economy falters.

Since the beginning of Beijing's economic liberalization in the late 1970s, it is estimated that about 800 million Chinese have been lifted out of grinding poverty. Despite Beijing's troubling turn toward illiberalism, the mass reduction of poverty in China remains one of the world's most important humanitarian success stories. A recession—whether from Xi and the party seizing control of the economy or other causes—will hurt average Chinese citizens. In an attempt to soften the blow, China is already planning to pump $5.3 trillion into its economy—about a third the size of its overall economy—through fiscal and monetary measures this year. These include increased lending to small businesses, cuts in taxes and administrative fees, and subsidized consumer purchases.

In the United States, average Americans are at risk given the high degree of economic integration between the two countries. Americans continue to consume goods from China at a record pace, despite higher tariffs imposed as part of the U.S.-Chinese trade war. With U.S. inflation soaring and China continuing to be crucial in U.S. companies' supply chains, the slowdown in Chinese manufacturing due to Beijing's pandemic policies will put even more upward pressure on prices in the United States, hitting American consumers and companies that are already struggling to deal with the reemergence of inflation. Meanwhile, the U.S. economy shrank in the first quarter of 2022, and economists increasingly predict a U.S. recession within the next year or so—even without the additional blow of a Chinese implosion.

China is also a significant foreign market for U.S. goods and services, exceeded only by Canada and Mexico. A slowing Chinese economy means a decline in demand for U.S. products—including cars, electrical machinery, medical equipment, and fuel—hurting American businesses and workers reliant on exporting to China.

Finally, the Chinese Communist Party derives much of its legitimacy from continuing to grow the economy and raise the country's standard of living. If a significant economic downturn thus threatens to weaken the party's hold on power, one likely result would be an even more aggressive, nationalist foreign policy. There's nothing like a little jingoism and war to draw attention away from domestic troubles. Yes, an economically weaker China would face tougher trade-offs between military spending and other objectives. But there is no guarantee Beijing wouldn't double down on its aggressive foreign stance and tighten elsewhere instead.

With a major land war raging in Europe, the U.S. economy softening, and China's ever more visible problems, the risk of a global recession is increasing. As Harvard University economist Kenneth Rogoff recently reminded us, "a collapse in one region will raise the odds of collapse in the others."

To be clear, Beijing's economic practices pose significant challenges that must be addressed—whether it's unfair competition with market-oriented Western economies or China's systematic undermining of the rules-based trading system. But the way to force China to play a more constructive role in the global economy is to deal with these issues head-on—not by hoping for its economy to collapse. A significant downturn in China could have grave and unforeseen consequences for the rest of the world—so be careful what you wish for.

***Clark Packard** is a research fellow at the Cato Institute.*