Beijing's Silence is Deafening

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China's economic policymaking process appears broken, or at the very least impaired. The recent liquidation of Evergrande and the uncertainty over measures to support the equity market merely add to a growing list of pressing economic problems where Beijing has either punted, or is refusing to announce any actions they are actually taking. The fact that there has been no Third Plenum meeting on economic reform held, or even announced, marks another meaningful change from past practice. This is not normal, for China or for any government struggling with a burgeoning crisis of confidence, at home and abroad.

Two recent events offer insights into the state of China's economic policymaking at present. This week's decision by a Hong Kong court to force Evergrande, China's largest property developer into liquidation, ended some uncertainty about the legal outcome of creditors' claims but created even more uncertainty about Beijing's intentions in managing the fallout in China's property sector. Mainland courts may or may not recognize the Hong Kong court's instructions to liquidate Evergrande's onshore assets, including unfinished construction projects in which homes have already been sold. Completing those unfinished houses is supposedly Beijing's top priority related to the property sector. Presumably it will be easier to complete construction if the corporate entity responsible is intact, rather than embarking upon the painstaking work of distributing those projects to already indebted local governments or other state-owned developers to finish. But it still remains unclear what Beijing wants to do, or who within China's leadership is coordinating this policy response. Evergrande is unlikely to be only one of the major developers to eventually face liquidation after defaulting on its debt, unless Beijing has a more concrete plan for restructurings.

Second, last week's saga related to a stabilization fund for the equity market revealed the limits of Beijing's capacity to credibly communicate with financial markets. After a Monday State Council meeting in which support for the flagging stock market was clearly the major topic, Bloomberg reported on Tuesday some details of a 2 trillion yuan stabilization fund, involving the repatriation of offshore assets held by state-owned firms in order to channel more funding into onshore equities. Amidst initial market euphoria and further speculation concerning the Bloomberg report, the China Securities Regulatory Commission (CSRC) neither confirmed nor denied the story, but issued a statement reaffirming policymakers' focus on financial market stability, including a pledge to increase "flows of medium and long-term funds" into the market. Then on Thursday, rumors that this plan had been rejected caused a rapid correction in equity markets. The CSRC then released another statement following a work meeting on Thursday and Friday pledging even more support for the equity market, but stopping short of promising a stabilization fund.

Investors were already very skeptical of the stabilization fund, fearing it was yet another case in which promises of policy support would fall empty. The CSRC's silence strengthened such skepticism—if the Bloomberg report was accurate, why wouldn't Beijing announce it and boost confidence? When markets were looking for clear messaging, Beijing maintained a deafening silence.

In the end, the equity market has now started to focus more on the prospect of policy support than the improvement in economic fundamentals, and as a result has continued to fall, with most

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onshore indices weakening by around 2% today. Even if such a stabilization fund is eventually approved, this would simply repeat one of Beijing's most significant missteps from the stock market bailout of 2015, when government entities similarly spent hundreds of billions of dollars to unsuccessfully stem a market decline. This would also move China's capital markets even further away from the long-term objective of providing an alternative source of capital to the banking system, or improving the allocation of capital in the broader economy.

And besides the events of the past two weeks, China's leadership has yet to announce the date of a Third Plenum meeting on Party's goals for economic reform and restructuring over the next five years (or longer). Usually, this meeting would be held in October or November of the year following a major Party Congress, but mum's now the word on whether it will take place at all. At the very least, this is a missed opportunity, as it would provide China's leadership with a venue to provide a countervailing narrative to the pessimism surrounding China's economy, and the promise of a down payment on long-delayed economic reforms. But the silence is now the story. Economic growth has officially met targeted rates, but virtually no one is paying attention to Beijing's preferred headlines.

This is not normal. It is also far from Beijing's own past practices. Even the haphazard interventions into the equity and currency markets in 2015 were policies that were formally announced, for better or worse. In the late 1990s, in response to the Asian financial crisis, China's government under Premier Zhu Rongji outlined several concrete policy actions to recapitalize China's banks and prepare its financial system for greater integration into the global economy. But now as China confronts its most significant crisis of market confidence, there is only official silence, along with the tedium of multi-pronged proposals for initiatives that are never completed. Instead, economic policymaking is starting to resemble the period of zero COVID, complete with denials, unrealistic messaging, and then finally a mad scramble to adjust to reality.

Hello Darkness, My Old Friend

The list of economic problems in which markets are waiting for concrete technocratic plans from Beijing is long, and growing. In addition to the flagging equity market, the following issues beg for some form of policy clarity from Beijing.

Unfinished property construction. The Evergrande liquidation naturally raises a question of whether or not Beijing was interested in proposing a more constructive solution that would unlock new sources of funding to complete unfinished properties. After all, one liquidation likely makes others among major developers more probable, if Beijing is not seen as supporting alternative restructuring plans. It still remains unclear how many people who bought homes from Evergrande will see their properties completed, and presumably this will be more difficult if the developers themselves are no longer functioning corporate entities. Whether or not Beijing will instruct Chinese courts to honor the Hong Kong courts' liquidation orders is the key question for now, but there is a broader question of how Beijing actually plans to fulfill its most important political objective, which is to ensure that incomplete houses are actually finished around the country.

Local government debt. China's local government debt issues are obvious to all, including Beijing, and the Central Financial Work Conference was supposed to address proposals for restructuring the stock of existing debt (which could be as high as 100 percent of GDP) while also proposing new financing mechanisms for local government infrastructure investment in the future. But after the conference itself was delayed for over a year, and then longer into late October 2023, absolutely no concrete measures for debt restructuring were publicly announced. Media reports leaked the existence of a reported Circular 35 designating twelve provinces as high-risk, and other reports discussed PBOC liquidity support for defaulted LGFV bonds. But none of this was officially announced. If there is a refinancing plan for troubled LGFVs, the size and scope of it is still unclear.

Fiscal capacity. Similarly, China's local government debt problem has its roots in China's system of revenue sharing between central and local government. Tax revenue continues to decline relative to the size of the economy because most taxes derive from China's investment-led growth model, not consumption-led growth or services activity. But there has been no plan announced to resolve or improve these imbalances in favor of local governments, nor to unveil new taxes to raise revenue. The promise of "tax reform" for the first time in almost a decade in the Central Economic Work Conference is the only hint of potential changes.

Household consumption. China has seen a very modest recovery in consumer spending after the end of COVID restrictions, as there was no concrete policy support from Beijing for household incomes, while employment prospects weakened throughout the pandemic years. Based on Premier Li Qiang's speech at Davos this year, that lack of policy support was a point of pride, as China still supposedly hit its growth target without aggressive stimulus. Instead of unveiling new measures to shift China's economy toward consumption-led growth, there have been vague reports that Xi Jinping views transfer payments as "welfarism" and continued extensions of older rural subsidy programs. The question of when China's long-overdue transition to consumption-led growth will finally occur remains unanswered, even when the limits to investment-led growth are apparent.

AMCs and managing bad debt. Earlier this week, there was a Xinhua report released claiming that ownership in three of China's asset management companies for disposing of bad debt would be transferred to the China Investment Corporation, which is still the holding company for China's state-owned commercial banks as well. Essentially, this would mean that the AMCs were no longer separate from the entities whose loans they were supposed to buy at market prices, underlying that these would be state-directed asset transfers in the future. Then the report was deleted from Xinhua, and the sudden change became the story. If there is a plan to eventually manage the growing pool of non-performing assets within China's financial system, no one seems clear on what it is.

Capital outflows and exchange rate management. As US interest rates are likely to stay above Chinese interest rates for several years, China will face long-term outflows of capital from its financial system, as Chinese households and corporates will diversify savings into foreign assets. This will create depreciation pressure on China's exchange rate, and will eventually exhaust the PBOC's capacity for intervention (although this could be many years in the future). Capital controls may slow or manage this flow, but will not ultimately reverse these trends. Investors need both short-term and long-term reasons to buy RMB-denominated assets, and to have confidence in the regulation and operations of China's equity and bond markets. But other than defending against rapid capital outflows by selling US dollars and instructing state banks to do the same, the PBOC is no longer defending a long-term vision for its exchange rate management, unlike the stated objective of eventually moving toward market flexibility after the July 2005 exchange rate reforms.

People Talking Without Speaking: Potential Explanations for Inaction

China's leaders are frequently making public remarks attempting to shore up confidence in the economy in general, but they are repeating the same messages and failing to respond to investors' specific policy concerns. All of the areas detailed above are policy issues where in the past, economic technocrats have formulated concrete plans to manage China's economic challenges, but they are not doing so now, or are acting only quietly. The key question is why conditions have changed. Below are some potential explanations for this inaction among economic officials in China.

The centralization of authority under Xi Jinping. Policymaking may no longer occur unless it is dictated from the top. If Xi says the economy faces no problems, then there will be no solutions needed from technocrats below. This is of course overly simplistic, but a lighter version of the argument would hold that there is simply limited bandwidth at the top to address complex financial issues, in contrast to past administrations, and there is therefore limited urgency to address them unless there is an active crisis to manage. Alternatively, greater Party control of key financial ministries may be effectively stifling past centers of economic policymaking and limiting top leaders' access to technocrats' ideas.

An anti-corruption campaign in the financial industry and among regulators has killed policy initiative among officials. This is more plausible than it might seem at first glance, as several financial regulators and employees at major institutions have recently been charged or investigated with corruption-related offenses. It may now appear far riskier for anyone else in the system to stand out or take a risk on behalf of a new idea that might add to costs or create financial instability.

There are no good or easy ideas, so we are doing nothing. This is a plausible explanation, as these are structural economic problems in China. Solutions are costly, and involve trade-offs which may sacrifice China's short-term economic growth. And it's easier to avoid blame for a decision if you don't make one at all. Some officials may feel this way, but for top leaders, inaction is also a policy choice, and it will lead to much weaker investment growth and eventually defaults and financial stress if current debt problems are unaddressed.

An inexperienced new economic team. Another possibility is that the relatively new economic team under Vice-Premier He Lifeng does not feel informed about the best options to take, and will need more time to get up to speed on China's problems. We doubt this explanation, as all officials are clearly responding to the confidence crisis in the economy in press conferences right now, but it may be partially true that the new team is unclear where the relevant areas of technocratic expertise are to be found within the bureaucracy.

Bureaucratic roadblocks. This would suggest that financial technocrats are arguing with one another about the best course of action to take to solve these problems. If different bureaucracies have different ideas, the results may be both inaction and silence about the problem. This is not particularly compelling in our view because usually these policy debates between bureaucracies over technocratic issues would play out within domestic media, and that does not appear to be occurring.

This is the plan. Cover up the problems and pretend nothing is wrong. Brezhnevism in Beijing is one potential explanation. While some in the Propaganda Department may believe that they can continue to publish positive news and economic data *ad infinitum*, China's headlines are already running aground on the rocky shoals of economic reality. Technocrats know this, and opinions among this group are far from monolithic, so this explanation is not particularly compelling.

Silence Like a Cancer Grows

Beijing's silence may be explicable for any one of the reasons above, or some other reason we have not considered. Foreign investors are not owed an explanation of Chinese policymaking or the reasoning behind it. But in the past, Beijing has tried to publicly provide the rationale for economic policy changes in order to encourage inbound investment flows. The consequences of policy ambiguity are therefore likely to be revealed via changes in the capital and financial account.

But most importantly, silence itself is a policy choice, and it will lead to more reactive economic policymaking in the future, with Beijing waiting for episodes of financial stress to finally respond.

Leaving local government debt risks and fiscal constraints unresolved will simply slow local government investment (and economic growth) further. Leaving other non-performing loan issues unaddressed will contribute to zombified banks unable to finance more productive private sector activity in China's economy. We have already written extensively about Beijing's inability to use its traditional credit and fiscal policy levers to shore up economic growth in the future. More surprising is the fact that Beijing is not actively trying to repair those policy tools.

These problems will not disappear on their own, even if Beijing would prefer to change the subject of global conversations about China's economy. Economic growth has already slowed significantly over the past two years, and even though we expect a modest cyclical improvement this year, the economy is unlikely to grow at rates close to those over the previous decade. But as policymakers delay or obscure critical decisions concerning fiscal matters and the financial system in China, a few indicators will be useful markers of the extent of both foreign and domestic concern about the future.

The exchange rate. The capital outflows from China are inevitable, given the country's $40.6 trillion money supply that is still growing at around $3.5-4.0 trillion per year in domestic currency, and rising incentives to diversify into foreign assets. Beijing will be increasingly tempted to offset some of the economic impact of Western de-risking and disinvestment from China by softening its defense of the currency. As capital outflows pick up, Beijing will be under pressure to generate new incentives for foreign capital inflows as well. New capital controls or rapid depreciation of the currency will be signs that Beijing is once again losing control of the narrative.

The central bank's balance sheet. As it is increasingly difficult to generate faster real credit growth in a financial system clogged with non-performing assets, the PBOC has turned to expanding its balance sheet with structural liquidity tools such as the medium-term lending facility (MLF) and pledged supplementary lending (PSL) to generate new lending. The PBOC will try to define these unconventional monetary policy tools as within the scope of its previous actions, but the size of the central bank's balance sheet will reflect the level of financial stress requiring a response.

LGFV defaults and local fiscal health. Highly indebted local governments cannot survive on ambiguous promises of liquidity support. They will continue to cut back on services and infrastructure spending if Beijing does not provide alternative sources of revenue or new financing channels. And a few defaults by LGFVs may lead to a wave of local governments following suit, to pressure Beijing to provide assistance. Fiscal revenue levels will highlight the extent of the stress Beijing and localities are facing.

Disclosure Appendix