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GUEST ESSAY

The Problems With China's Economy Start at the Top

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This is a perilous moment for China. The numbers portray a stalling economy, but there is a far more profound concern. Chinese consumers and businesses are losing confidence that their government has the ability to recognize and fix the economy's deep-seated problems. If President Xi Jinping's government doesn't tackle this fundamental issue, any other measures will have little impact in arresting the downward spiral.

Mr. Xi's government has prioritized state enterprises, which hew closely to the Chinese Communist Party line and are under direct government control, over the private sector. Technology companies, including highflying fintech businesses like Ant Group, that were seen as having grown too big and powerful have been forced to break up into smaller units and are now subject to more state control. The crackdown, which intensified after Mr. Xi tightened his grip on power late last year when the legislature amended the Constitution, allowing him to extend his reign, has also enveloped private companies in education and other sectors. In addition, the government's apparent hostility toward foreign businesses amid rising geopolitical and economic tensions with the United States and other Western countries — which could affect China's ability to maintain access to global markets and technology — are worsening the loss of confidence.

The government's unwillingness to modify its increasingly untenable "zero Covid" policy, followed by the abrupt reversal of that policy last December, further undercut confidence in the policymaking process. This confidence problem is apparent in the tepid private investment and weak household consumption over the past year. Reflecting their concerns about economic prospects, households are saving more and spending less on big-ticket items like cars. China's currency, the renminbi, is depreciating in value as capital flows out of the country and foreigners become less willing to invest in China.

The worrying cognitive dissonance between the government and entrepreneurs became apparent during a recent trip I took to China. It was striking how officials in Beijing seemed relatively sanguine about the economy and argued that, in recent months, enough had been done to reassure entrepreneurs that they were seen as making important contributions to the economy. Entrepreneurs, on the other hand, thought that the government's actions spoke louder than its words and that actions taken to cut successful businesses down to size were clear indications of its hostility toward private enterprise.

The reality, which Beijing seems to acknowledge only grudgingly, is that the private sector is crucial to keep the economy chugging. The labor force is shrinking, which leaves productivity as the key driver of growth. Private enterprises, which made the country a global leader in digital payments for instance, have tended to be far more innovative and productive than doddering state enterprises. The government's desire to encourage domestic innovation and shift the economy toward higher-tech and green technologies cannot rely just on large state enterprises.

Small- and medium-size companies, particularly in the more labor-intensive services sector, are important for employment as well. Despite rapid growth in gross domestic product in recent decades, the Chinese economy has not been able to generate many new jobs, because much of that growth has come from manufacturing investment, and the government has been trying to cut jobs from bloated state enterprises. At a time of slowing growth this becomes a particular concern, as evidenced by the surging youth unemployment rate, which poses risks to social stability.

The increasingly centralized and often wayward nature of policymaking under Mr. Xi has also hurt confidence. One example comes from the property sector, which Beijing has long relied on as a pivotal source of growth — and which had become marked by speculative activity, in part because of government policies that increased the availability of mortgage financing. The Chinese government has rightly let some air out of this bubble, including by limiting financing for multiple home purchases and by tightening eligibility restrictions.

Some property developers told me that they understood the rationale behind the government's actions but not the abrupt way in which some policy changes were introduced, leaving them little time to adjust. This has reportedly led to a sharp fall in housing prices and construction activity, which the government has now tried to compensate for by reversing some of the restrictions. Such abrupt policy shifts hardly inspire confidence. One view is that officials in Beijing "live above the clouds," lacking a full understanding of how their attitudes and policies affect businesses.

Private enterprises see worrying signs of rhetoric that could have practical consequences. Mr. Xi's "common prosperity" initiative, introduced in 2021 and officially described as an effort to quell public disquiet about rising income and wealth inequality, has been interpreted by successful entrepreneurs as being directed squarely at them. The initiative, which has spurred regulatory and anti-corruption crackdowns, has served as a cudgel against private businesses as well as banks and even government officials straying from the party line.

The government's response to the drumbeat of concerns about rising youth unemployment was to scrub the release of those data. In doing so, it seems to believe that the spread of bad news is behind the loss of confidence. Similarly, even as it becomes apparent that prices for goods and services are falling because of weak demand and excess capacity in some industries, the government has pushed back against talk of deflation. Investors and analysts outside China have said that they have recently been denied access to some of the services provided by Wind Information, a private database with corporate and financial data that had been used to flag concerns about China's financial markets.

While it has not publicly acknowledged the severity of the economic situation, there are signs that the Chinese government is aware that the confluence of domestic and external difficulties is creating a deflationary spiral that will become increasingly challenging to reverse.

The central bank recently cut interest rates, but cheaper and more plentiful credit will not get households or private businesses to spend more if they are anxious about the future. The move could also worsen currency depreciation and capital flight. Measures to cut income taxes and strengthen spending on health and education could help marginally bolster household consumption. Still, such measures might not amount to more than Band-Aids.

The real challenge is for the government to explicitly recognize that without a strong relationship with its private sector, its hopes of transforming the economy into a high-tech one capable of generating more productivity and employment growth are unrealistic. It needs to back this recognition up with concrete measures to support the private sector, including financial-sector liberalization that will help direct more resources to private businesses rather than state-owned ones. Transparency about information and about its policymaking process will help the government a lot more.

President Xi might favor a command and control system, but he is learning that private-sector confidence is the hardest thing to control. And yet it is vital for realizing his visions for the Chinese economy.

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