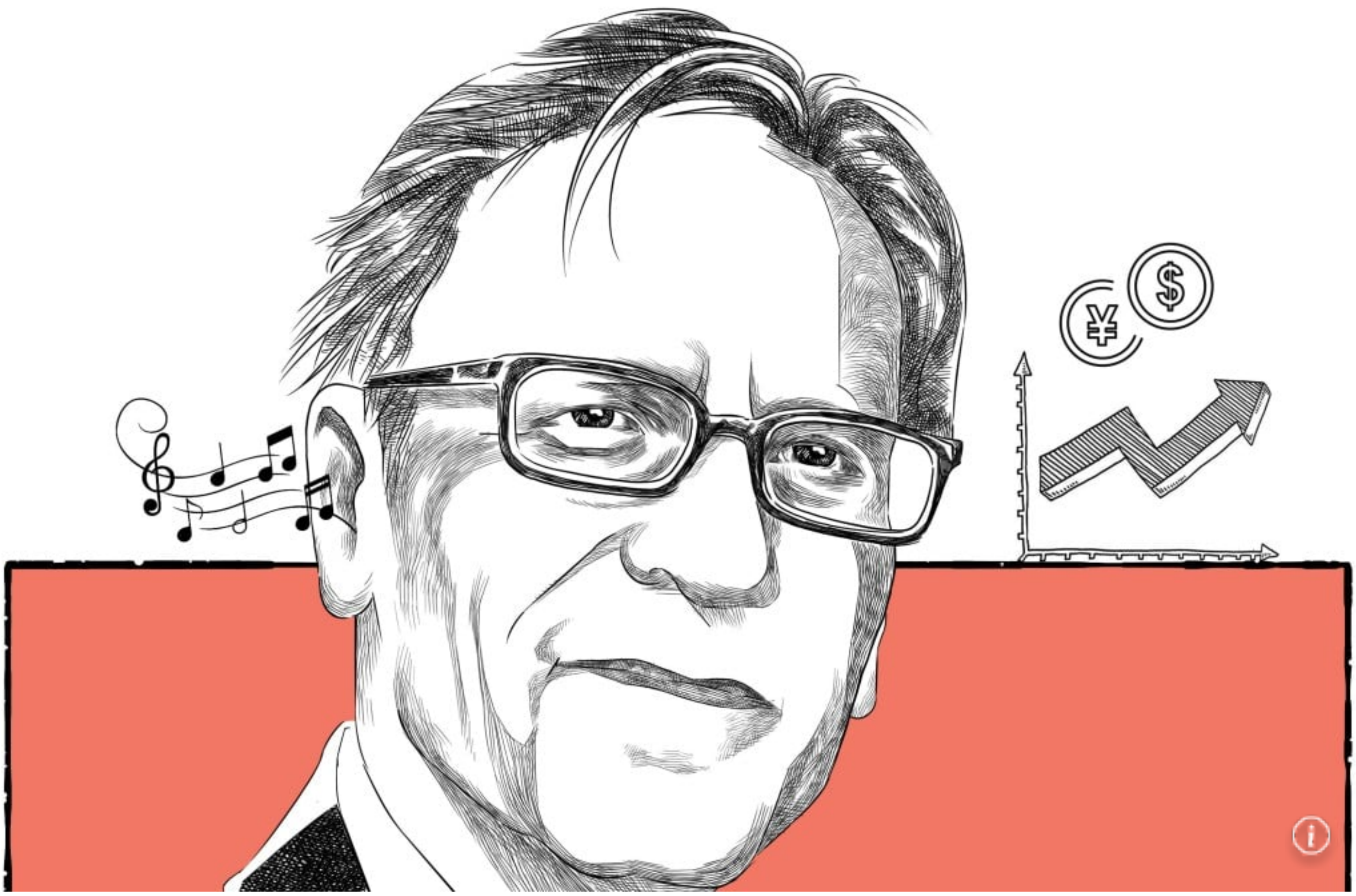
China's economic stimulus *Economy / China Economy*

Open Questions | Economist Michael Pettis on China's consumption paradox and the pitfalls of a trade war

The professor of finance and author talks China's economy and argues the US dollar's monopoly role in trade is an 'unsustainable' anomaly

Reading Time: **14 minutes**



Carol Yang in Beijing

Published: 6:00am, 24 Mar 2025 | Updated: 10:11am, 24 Mar 2025

SCMP Series
Open Questions – SCMP interviews with global opinion leaders
[57 of 57]

After more than two decades in China - including years spent teaching finance at Peking University and Tsinghua University - Michael Pettis has become an oft-cited voice on the challenges faced by the world's second-largest economy. Before moving to Beijing, he also worked on Wall Street as a trader, with stints at JP Morgan and Bear Stearns.

In this interview, Pettis discusses the dichotomy between China's household consumption and its world-leading manufacturing sector, evaluates the new global landscape for trade and reminisces about the glory days of Beijing's arts scene.

This interview first appeared in . For other interviews in the Open Questions series, click .

China's economy has been under scrutiny for its ability to sustain growth, especially with the annual gross domestic product target set at "around 5 per cent". What is the biggest challenge facing the Chinese economy?

I think everybody understands the basic problem of the Chinese economy – very weak domestic demand.

For any economy there are two components of domestic demand – consumption and investment.

Chinese growth has always been extremely investment-oriented. Not only does it have the highest investment share of GDP in history, but even if China were to reduce that share by 10 percentage points, it would still be one of the highest investing countries in the world.

The massive investment made sense in the 1990s and 2000s when China had enormous investment needs: roads, bridges, factories, airports, everything.

The problem is that every country following a high-investment growth model eventually runs out of productive investment opportunities, and because it is too difficult to reverse the growth model, it begins to invest non-productively. It is only when this happens that the debt used to fund investment begins to grow more rapidly than the economy, and we start to see a rapid growth in the country's debt-to-GDP ratio. This has been happening in China now for well over a decade.

When it's hard to rely on investment to drive growth and difficult to boost consumption, the only way China can resolve the imbalance between domestic production and domestic consumption is with large and growing trade surpluses, but of course this can only continue as long as the rest of the world is willing or able to absorb those trade surpluses.

Will China's GDP surpass that of the US someday?

People forget that in the 1960s, everyone believed that the Soviet Union was going to surpass the US in the 1980s. Similarly, in the late 1980s, everybody believed that within 20 years, Japan would be the world's largest economy.

Both the Soviet Union and Japan were growing very quickly with an investment-driven model. However, the problem in each case, including China, is that investment-driven growth is only sustainable up to a certain point.

Once a country reaches that point, continued high levels of investment typically result in misallocated investment. In which case its GDP continues to grow, but that growth is no longer sustainable because much of the economic activity included in the GDP measures do not contribute to real wealth creation. The result is a surge in debt that ultimately limits the ability to keep investing non-productively, and in every case GDP growth has dropped much more sharply than anyone expected.

But ultimately, it doesn't really matter whether China has the biggest GDP in the world or not. What matters is how household standards of living are affected.

Consider the case of Japan. From a GDP perspective, what happened to Japan seemed terrible – at the beginning of the 1990s, Japan accounted for 17 per cent of the global economy, the same as China's share today. Twenty years later, Japan's share had fallen to 7 per cent.

But while the GDP numbers looked terrible, this wasn't the case for Japanese households. During that period household income continued rising, almost as fast as it had before Japan's GDP began its relative decline. In other words, the contraction in the Japanese share of global GDP didn't hurt the Japanese people, whose standards of living continued to rise, which is ultimately all that matters.

For similar reasons, what matters to the Chinese people is how it goes through the adjustment process. Rebalancing means that the consumption share of GDP must rise. This means that even with much slower GDP growth, the income of the Chinese people can rise as fast as it has in the past as long as the economy rebalances. As long as the economy can avoid a very disruptive adjustment as it brings down excessively high investment levels, the vast majority of the Chinese people can be better off every year even as the economy slows.

What will be the impact of the new China-US trade war?

It is a mistake to think of this as a US-China trade war. It is much more generalised than that. In the past five or six years, dozens of countries have imposed tariffs or other trade constraints, and we will see a lot more of this until trade imbalances are finally resolved.

The current trade conflict has been inevitable for years, and I wrote about this in my 2013 book, *The Great Rebalancing*. Joan Robinson, one of the best economists on trade, argued way back in the 1930s that in a globalised system, when a group of countries start running large, persistent surpluses, it's just a question of time before their trade partners begin to retaliate, which is when trade conflict becomes generalised.

They retaliate because trade surpluses are usually created by policies that increase a country's global competitiveness while repressing domestic demand. By running trade surpluses, these countries force the cost of weak domestic demand onto their trade partners. At some point, however, Robinson argued that the trade partners would no longer be willing or able to bear the cost, which typically comes in the form of either higher unemployment or high household or fiscal debt, so they would retaliate with their own trade policies.

At the Bretton Woods conference in 1944, Keynes made the same argument, which is why he proposed a global trading system that penalised countries that ran persistent surpluses. He argued that trade and industrial policies that resulted in persistent trade surpluses put downward pressure on global demand, and this downward pressure would lead to rising unemployment and rising debt. This seems to describe the world of the past four or five decades very well, and in my 2019 book (*Trade Wars are Class Wars*) I showed how it also was likely to worsen income inequality.

The trade conflict we are undergoing, in other words, may represent a major shift in the structure of the global economy – along with a shift in the way we think about economics – a lot like what we saw in the 1970s or in the 1930s.

If that is the case, it means that we are in the midst of a major shift in the structure of the global economy. Our previous experiences in the 1930s and the 1970s suggest that we won't be able to predict what kind of world will emerge in the next decade or so, but we can be very sure that it will be very different from the world of the past several decades. The key for the success of most countries is how quickly they can adjust to the change in conditions. If they can adjust sustainably, they will emerge from this process in relatively good shape. If not, they will find it very difficult.

Will trade and supply chains become more regionalised? What will the US' role be in globalisation?

They probably will, at least in the near term. We live in a world with historically unprecedented levels of trade imbalances, and these are neither normal nor sustainable. In a well-functioning global trading system, countries export to pay for imports, and by specialisation, this increases global output. In our world, many countries export to pass on the costs of weak domestic demand. Trade conflict means that we are returning to a world with smaller imbalances and less subsidising of supply chains, which may mean less trade.

One of the key changes will be a change in the global role of the US dollar. There have been many discussions about which currency could replace the US dollar as the global reserve currency if it no longer holds that position, which is a stupid question.

At no time in history has any currency played the role of the US dollar – this is a complete anomaly and it's unsustainable. If the US dollar reduces its role in global trade – and I hope that happens relatively quickly – it will not be replaced. It is far more likely that we move to a world of multiple trading currencies.

We keep forgetting what we used to know very well – that in a globalised world, every country must choose between more global integration or more control of its domestic economy. A fully integrated global economy can only succeed if all nations retain open trade and capital accounts and refrain from domestic industrial policies that affect the external account.

But if several major economies opt for more control of their domestic economies, and implement policies that lead to large, persistent external imbalances, they force their more open trade partners to absorb those imbalances by changing the structure of their own economies. A country like Brazil, for example, wants to expand its manufacturing sector and reduce its dependence on commodity exports, but given its role in the global trading system, it has seen the opposite happen.

China doubles down on job creation

'Two Sessions': China to focus on gig workers and training to tackle unemployment

These problems have been building through the 1990s and 2000s, but as the consequences of these imbalances have got worse, many countries in the world that once supported globalisation have now decided that they want to regain control of their domestic economies. This means less open trade and capital accounts, whether this comes in the form of tariffs or other kinds of policies.

The role of the US here is particularly important. Since the 1980s, the US chose to play a role – partly for Cold War geopolitical reasons, and partly for the benefit of Wall Street – where it was going to accommodate the imbalances of the rest of the world by leaving its capital account completely open to the needs of countries to acquire foreign assets to balance their surpluses.

The result was half of the excess savings in the world being absorbed by the US for decades, with half of the rest being absorbed by the UK, Canada and Australia, whose financial markets are very similar to that of the US. Of course the flip side of capital inflows is the trade deficit, which is why the US role as global consumer of last resort is simply the flip side of its role of absorber of last resort of excess global savings.

If the US (along with the UK, Canada and Australia) now decide that they are unable or unwilling to continue playing this role, the consequences for global trade are enormous. If the countries accounting for most of the global deficits refuse to continue running deficits, either the surpluses of the large surplus countries collapse or the deficits of the rest of the world explode, or both. Either reaction will be terribly painful.

Does China have what politicians in some countries have described as an excess capacity? If so, what are the causes?

China is overreliant on investment and manufacturing to drive its economy, and this is only sustainable if it is underinvested and if the rest of the world can absorb its manufacturing. But China clearly is no longer underinvested, and the world is finding it increasingly hard to absorb its trade surpluses.

This leaves us with a problem of simple arithmetic. GDP growth in any country is equal to growth in investment, growth in consumption and growth in the trade surplus, with the first two mattering most. If China doesn't want further rapid increases in investment in property or in infrastructure, it must force much more rapid growth in consumption, much more rapid growth in manufacturing, or both.

But Chinese manufacturing is already growing much faster than domestic demand, so further investment in manufacturing is only sustainable if China's trade surplus continues to grow as quickly as it did in the past two years. That seems very unlikely.

That is why there is so much focus on boosting domestic consumption. But we've been talking about boosting the share of consumption for many years, and this is proving very difficult to do.

Why has China's consumption stayed weak? Will spending subsidies help?

Chinese households receive a smaller portion of what they produce – a smaller share of GDP – than households in most of China's trade partners. This very low household share is the cause of the weak consumption. If you are paid a low share of what you produce, then it is not surprising that you will consume a low share of what you produce.

In other words, if I want you to consume more, I have to pay you more. That's the key.

Why is it so difficult to pay people more money? Because a group's gain comes at the losses of others.

There are three groups that share in the distribution of any country's economy: households, businesses and the government. If the household share increases, either the businesses' share must decrease, which can be detrimental to the economy, or the government's share must decrease, which is politically quite difficult.

China's household spending as a share of GDP vs OECD average

	China GDP	Household consumption expenditure share of GDP	Household spending share of GDP (%); OECD

Year	growth (%)	(%); China	average
2024	5	N/A	N/A
2023	5	40	N/A
2022	3	38	59
2021	8	38	58
2020	2	38	58
2019	6	39	60
2018	7	39	60
2017	7	39	60
2016	7	39	60
2015	7	38	60

Note: for mobile user, scroll horizontally for more information

China's household spending as a share of GDP vs OECD average

This is the struggle China faces today. It needs to shift to a new model in which households retain a higher share of what they produce so that China can reduce its reliance on overinvestment and trade surpluses, but its institutions – banking, legal, political, financial and business – have all been built on a very powerful growth model that over 30 to 40 years involved implicit transfers from households to other sectors, including banks, businesses and local governments.

Changing this model is not easy. Consider the various ways that Beijing can force up the household share of GDP. An obvious way is to raise wages much more quickly so they stay in line with increases in productivity. But China's manufacturing competitiveness is largely based on the relatively low share of labour costs, so to fix the problem of consumption means undermining this.

Beijing could also raise interest rates, which allows Chinese households to earn more on their savings, but cheap and plentiful credit is also a major source of China's manufacturing competitiveness.

What about increasing the value of the renminbi? When the renminbi strengthens, imports become cheaper, and because all households are net importers, this would increase the real value of Chinese household incomes. But again, this undermines the competitiveness of Chinese manufacturing.

The key point is that a low consumption share of GDP is not an accident, or an oversight. It is fundamental to China's manufacturing competitiveness. To change one means changing the other.

That is why raising the consumption share is so challenging. Japan faced the same problem in the 1980s. It proposed in 1986, with the Maekawa Commission report, to solve the problem by raising the household share of Japanese GDP.

But for the next five years the consumption share of Japan's GDP declined, after which it took 17 years to raise the consumption share of GDP by 10 percentage points. Of course it is not a coincidence that during this time, the manufacturing share of Japan's GDP declined from 27 per cent to around 20 per cent, even as Japan's share of global GDP declined from 17 per cent to 7 per cent. The point is that weak consumption and a globally competitive manufacturing sector are often different sides of the same coin.

There have been growing concerns about unemployment in China in recent years, particularly among young people. What do you think of this issue? Will artificial intelligence or technological progress worsen the job market?

I would argue that it's the same cause that we just discussed – China is growing, but in manufacturing, which is not labour-intensive, while the services side, where most graduates seek employment, is not expanding.

This shift in China's economy towards more capital-intensive growth rather than labour-intensive growth has been part of what makes it increasingly difficult for people to find jobs.

But it is important to remember that capital-intensive growth doesn't necessarily lead to unemployment. Contrary to what many think, technology that increases the productivity of each worker doesn't replace jobs. In fact, the only way for a country to get rich is to increase productivity, which means fewer workers producing the same amount of goods.

But the key point is what happens to wages. If wages rise in line with productivity, then rising productivity just means that there are fewer workers in manufacturing. But because their income is rising, and they must spend it, they will increasingly spend it on services rather than manufactured goods, which have become relatively cheaper.

That is why automation doesn't lead to rising unemployment. It is only when wages fail to keep pace with rising productivity that we should worry about unemployment.

So even if one day, all cars are made by robots, it doesn't mean there won't be any workers needed in the economy. Higher wages will drive substantial spending in the non-manufacturing sector of the economy.

Is a more equitable wealth distribution the ultimate solution?

It's the only solution. It is mainly distortions in the distribution of wealth and GDP that lead to weak domestic consumption.

If ordinary households retain a large enough share of what they produce, they will consume a large share of what they produce. This is good for businesses, because it is end consumer demand that drives business profits. And it is good for ordinary people because it means their wages are higher.

It is when ordinary households have too low a share of GDP that low consumption becomes a problem. They consume most of their income, unlike the rich, or businesses, or the government. When these other groups retain a disproportionately large share of GDP, because they consume a very low share of their income, total consumption in the economy will be very low.

In that case, they will either need to raise consumption by a surge in household debt – as is the case in the US – or they will need to boost investment. If that investment is increasingly non-productive, as is the case in China, this also means a surge in debt.

In either country – and in many other countries besides – they would be better off returning to the income distributions of the 1970s and 1980s, when ordinary households retained a much larger share of what they produced and growth was more balanced.

Another challenge China faces is the gap in regional development. What's your take?

There is no doubt that China's economy is slowing down, but not everything is affected equally.

The adjustment in China will be very unevenly distributed, with some regions performing poorly while others thrive.

Increasingly, we need to view China as two very different economies. In one case are provinces and municipalities like Guangdong, Fujian, Jiangsu, Shanghai, Zhejiang, Beijing and maybe Shandong. These regions are relatively rich, maybe not as rich as a country like South Korea, but not much poorer.

They have diversified economies, their debt problems are mostly manageable, and very importantly, they have growing working populations thanks to young people coming in from the rest of China.

And then there's the other China, which is much poorer, much less diversified, with unmanageable debt and a rapidly shrinking working population. They will have a very different economic path, and I think those who invest in China or do business in China should recognise these two very different economies.

More generally I would argue that after many years of extraordinarily high growth, in which all parts of the Chinese economy did well, even the ones that performed worst, China has become a more normal country now. And like with any other large economy, some regions and sectors will do well, while some regions and sectors will do badly. That is why I tell investors not to think about China as a whole, but rather to look at specific parts of China they might want to be in.

they might want to be in.

The Chinese government aims to transform the country into a financial superpower. How does this differ from the Western model? What actions should China take?

I think every country, once it reaches a certain status, wants to be a financial power. But I don't think most countries are willing to pay the cost of being a financial power.

In the late 1980s, Japan was a major economy and a capital exporter, and it aspired to become the world's financial centre. However, Japan never became one.

The US and the UK are global financial centres due to their roles in the international flow of capital.

When countries like China run a surplus, they must buy foreign assets with the surplus.

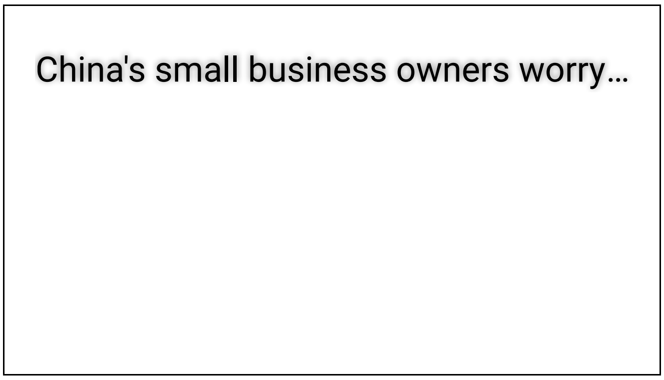
So whose assets do you want to buy? Everyone wants to buy American assets because they offer the deepest market, the best governance and the greatest flexibility.

If they don't buy American assets, they mostly buy English assets or Canadian assets.

The United States makes up half of global deficits. Together, the US, England and Canada make up around 70 per cent of the global deficit, or more. So basically, people are buying assets in those countries. That's good for those countries' financial systems.

But it also means the buyers force up the value of the dollar, and they force the US to run the big deficits that correspond to the surpluses of other countries.

What China wants for its financial system is incompatible with what it wants for its economy. China wants the world to use the renminbi more actively, but they don't want to lose control of the value of the renminbi or to open up their capital account and their financial markets. But global integration is not compatible with domestic economic control. China can choose one or the other, but not both. China won't become a dominant financial centre until it radically transforms its development model and its balance of payments, and so far it doesn't seem to be doing either.



China's small business owners worry about sluggish economy

You founded two popular music clubs and a record label in Beijing, though both clubs have closed. Do you have plans to open a new club? What are your thoughts on the development of China's cultural influence?

I would like to open a new music club if I can find the right space, but it's much more difficult than 10 or 15 years ago. Three years ago I sold my music label, which had become the biggest independent label in China, to a major media company. But last year I joined forces with three of my favourite Chinese composers and musicians – Yan Yulong, Yang Haisong and Zhang Shouwang – to start a new label. And I am always looking around for the right space for a club.

There was a time, 10 or 15 years ago, that Beijing looked like it was on its way to becoming a major global cultural centre, not far behind cities like New York, Tokyo, Berlin or London. There was a real sense among young artists and musicians that Beijing had become one of the most exciting places to be.

And it was not just Chinese artists who believed this – Beijing was attracting musicians from all over the world. The city was full of small underground music clubs, tiny art galleries and shops that sold independent records, comics, fashion, posters. Beijing was filled with spaces where young artists congregated and developed their art.

But those days are over. Chinese artists continue to create crazy and wonderful works. However, rents are higher, it is harder to get permits for small, independent commercial spaces, and there are so many restrictions that all the places that were so important to the creative explosion seem to be gone.

What the authorities seem to want is large performance spaces that book well-known performers and that cater mostly to middle-class tastes. They think cities like New York and London are cultural powerhouses because they have large concert halls, opera houses and mainstream theatre.

And certainly New York and London are wonderful for those things, but these are not what make them cultural powerhouses. What really matters to both cities is that young artists from around the world flock to their underground clubs, galleries and shops to create new ways of making art. We used to have much more of that in Beijing and other Chinese cities, but much less now.

I hope things change. What we learned 10 years ago is that it takes very little for Chinese artists to have a big impact on the global music and art scenes, but right now that doesn't seem to be happening within China.