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'New paradigm needed to unlock consumption'

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Many are drawing parallels between China's current economic malaise – a real estate crisis, stagnant consumer prices, a shaky job market – and Japan's "lost decades". How do the situations compare?

The fundamental difference is our stage of development. We are still a middle-income country; Japan was already a fully developed, high-income economy when its bubble burst. China still possesses massive headroom for growth.

And Chinese enterprises exhibit tremendous drive and capacity. Japan was highly innovative too, but it has struggled with commercialisation in recent years – translating that innovation into marketable products. That is exactly what China excels at.

We are a demographic behemoth. Japan is not small, but our population is more than 10 times larger. In a megamarket, innovation yields significantly higher returns and commercialising technology generates greater economies of scale.

Meanwhile, we boast a colossal talent pool, churning out vast numbers of engineers and researchers annually. Relative to our gross domestic product per capita, the quality of China's higher education system is remarkably high.

Critics point out the gap between Chinese and American universities, yet you need to contextualise this against the disparity in per capita income levels. For our current stage of development, our universities are punching well above their weight.

Another important difference is China's financial system, in that overall volume of financing in China is not affected as much by asset price adjustments, especially financing for industrial development.

A vast country means a vast market and abundant talent. Add in our highly comprehensive industrial system, and you have fertile ground for innovation.

Another crucial point: Chinese consumers are not conservative. In my experience, they are remarkably eager to embrace the novel. When a new product launches, people are willing to try it, use it and open their wallets to buy it. This creates a powerful positive feedback loop for innovation.

On the macroeconomic policy front, Japan's prolonged deflation inflicted severe damage – a scenario we wish to avoid. Japan eventually rolled out "Abenomics" with its "three arrows" of fiscal stimulus, monetary easing and structural reform.

The problem was timing: it came too late. For a long time prior, there was a glaring lack of clear directional focus. The lesson for us is that establishing a clear, timely policy framework is paramount.

We should aim to navigate our way out of this predicament much faster than Japan did by designing rational policies, establishing a clear strategic direction early on and ensuring highly coordinated efforts.

To be more specific, what policies should China implement to avoid so-called Japanification?

Fiscal policy, monetary policy and structural reform must work closely together.

Take monetary policy. Easing measures are already being deployed, such as cutting mortgage rates to stabilise the housing market. Yet their impact is limited. Asset prices are ultimately anchored to the real economy: they only truly thrive when underpinned by robust long-term economic growth.

For short-term fiscal stimulus, there is a persistent allocation dilemma. Channel it into investment, and you could exacerbate overcapacity. Direct it into real estate – like state purchases of unsold inventory – and you risk interfering with market-driven price adjustment and crowding out demand from private homebuyers.

Similarly, initiatives like consumer goods trade-in programmes treat the symptoms, not the disease. Genuine consumption is driven by rising employment, income prospects and asset valuations, not one-off subsidies that merely pull future purchases forward.

So, a new paradigm is needed to drive fundamental change. To unlock our consumption potential, we must optimise policies regarding social services, particularly healthcare and pensions. These systems require immense upfront capital investment.

But simply handing out cash risks creating long-term dependency. Welfare spending is also notoriously sticky: raise it today, and it becomes a permanent fiscal burden even after the economy normalises and inflation returns to 2 to 3 per cent.

This is why I recently coined the term "investing in reform". We shouldn't just stimulate consumption; we need to fix the underlying architecture.

Yet structural reform requires a transition period. Given our current environment of weak demand and soft prices, we have a unique window. We should use targeted stimulus to underwrite this transition and foot the bill for reform.

Take our social security system, for example. Currently, it operates on a dual-track system, with disparities between employee and resident schemes. Can we design a blueprint for gradually unifying these tracks?

[Editor's note: In 2024, retired urban workers received an average monthly pension of 3,825 yuan (HK$4,388), whereas rural residents and urban workers not in formal employment received just 246 yuan, according to official data.]

Doing so would require fiscal backing. Forcing residents not in formal employment to pay more is tough. But if we achieve full employment and improve coverage for the informally employed, the vast majority will fall under the employee system anyway. We could also consider expanding that coverage from the individual to the household, which would allow us to broaden its reach significantly.

Executing this immediately would be difficult. The ideal path is to design the blueprint, publish it to anchor public expectations, and use fiscal funds to cover the transition period.

Workers assemble cars at an intelligent factory of electric vehicle enterprise Leapmotor in Jinhua, Zhejiang province. Photos: Getty Images, Xinhua, AFP

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Critics will inevitably point to our elevated debt levels. This is precisely where fiscal and monetary co-ordination is vital.

The government can issue bonds, and the central bank can purchase them on the secondary market. In an environment of deficient demand, expanding the central bank's balance sheet in this manner would not trigger inflation. Instead, it would mobilise idle capacity and labour, generating real economic returns while upgrading our social safety nets.

This is what I mean by addressing immediate demand shortfalls while ensuring long-term fiscal sustainability. When people finally feel secure about their future healthcare and retirement, consumer confidence will organically rebound. Macroeconomic management should serve as the bridge to structural reform.

How large is the technological gap between China and the United States in your view, and in which areas does China have a near-term opportunity to catch up?

Objectively speaking, a definitive gap exists. For one thing, we need to increase our investment in – and continuously provide more support for – basic scientific research.

However, commercial application is where China truly excels. Technological advancement holds intrinsic value, but its true economic weight is felt when it is deployed to drive industrial growth.

Basic research and commercial application are closely linked, yet they are not strictly sequential. You do not necessarily need absolute dominance in the first phase to succeed in the second.

China's distinct advantage lies in this latter stage: commercialisation. We must fully capitalise on this strength while simultaneously ramping up investment in foundational research.

Building foundational prowess does not happen overnight. We cannot expect Chinese universities to become undisputed global leaders by next year. While some already boast impressive international rankings, their underlying research capabilities require continuous fortification. Give our universities and research institutions time, and they will mature.

I work at Tsinghua University and have directly benefited from the state's strong backing. Yet my genuine hope is that China cultivates a far wider array of top-tier universities capable of making fundamental contributions to our technological progress.

In your role at Tsinghua University, you rub shoulders with many world-class entrepreneurs. When do you think China will produce an innovator to rival Elon Musk, and what conditions must exist for that to happen?

China is so vast, and certain issues have deep-seated roots. For example, the *gaokao* [national university entrance examination] is not particularly conducive to innovation – its method of selecting individuals is based on standardised tests.

However, it is exceedingly difficult to find an alternative that suits China's national conditions. The exams sustain social mobility, allowing children from impoverished families to climb the social ladder. They are a vital channel; they carry so much weight in our culture and development that altering the system would be very difficult.

To a certain extent, the *gaokao* shapes primary and secondary education; it acts as the conductor's baton. This system has helped us achieve a commendable average level of education, but the brightest minds – those capable of truly eccentric or brilliant ideas – might be partially stifled in this process.

But they won't be entirely wiped out. There will always be individuals who possess both innovative minds and the ability to ace the *gaokao*, while others could forge a completely different path upwards. This is the intrinsic advantage of having such a massive population base.

What we need to strive for is to make university education – the stage after the *gaokao* – more encouraging of innovation. This is achievable.

Additionally, we must attract talent from around the world. This has been a tremendous advantage for the US, and China ought to harbour the same ambition. Once we attract them, we must employ them effectively and create a relaxed environment that allows them to fully unleash their potential.

We are already working on this. The environment is improving and institutions related to innovation are being refined.

Within this, finance is crucial. If innovation yields no returns, it won't be sustainable. These returns are primarily commercial. Advancing innovation and scaling up production requires resource support, and this is where the capital market can play an excellent role.

We need to put our capital markets onto a better development path, so they provide financial backing for innovation. The same goes for the mergers and acquisitions market. When large corporations spot promising innovative firms, they can acquire them. Alternatively, several innovative start-ups can merge to scale up.

Last year, China's trade surplus reached a record high, reigniting global discussion over terms such as "China shock" and "overcapacity". What is your view on this issue?

China's robust trade performance has been driven by a confluence of factors. Domestically, soft internal demand has led firms to turn to external markets. Globally, however, this surge is fundamentally a response to international needs.

The narrative about "overcapacity" is, in my view, analytically imprecise. Prior to 2019, China's trade surplus as a share of GDP had already declined to a very low level, signalling a structural shift away from export dependence.

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During the pandemic, while global supply chains and logistics networks were paralysed, China's production remained stable. This reliable supply helped the world weather the crisis.

In the post-pandemic era, nations have prioritised supply chain resilience, shifting investment towards localised or regionalised supply chain capacity. China's trade data last year confirmed this trend: export growth was led by capital goods, while consumer product exports declined. This reflects China's role in addressing the substantial global investment demand stemming from a collective push for greater supply chain resilience.

At the same time, the artificial intelligence revolution has catalysed a global infrastructure boom, particularly in electricity supply. This plays directly to China's strengths: our long-term focus on infrastructure has allowed us to develop the very capacity the world now urgently requires.

The green transition is another

Shoppers enjoying the "golden week" Labour Day holiday in Beijing on Saturday. Rising employment and income prospects are essential drivers of consumption.

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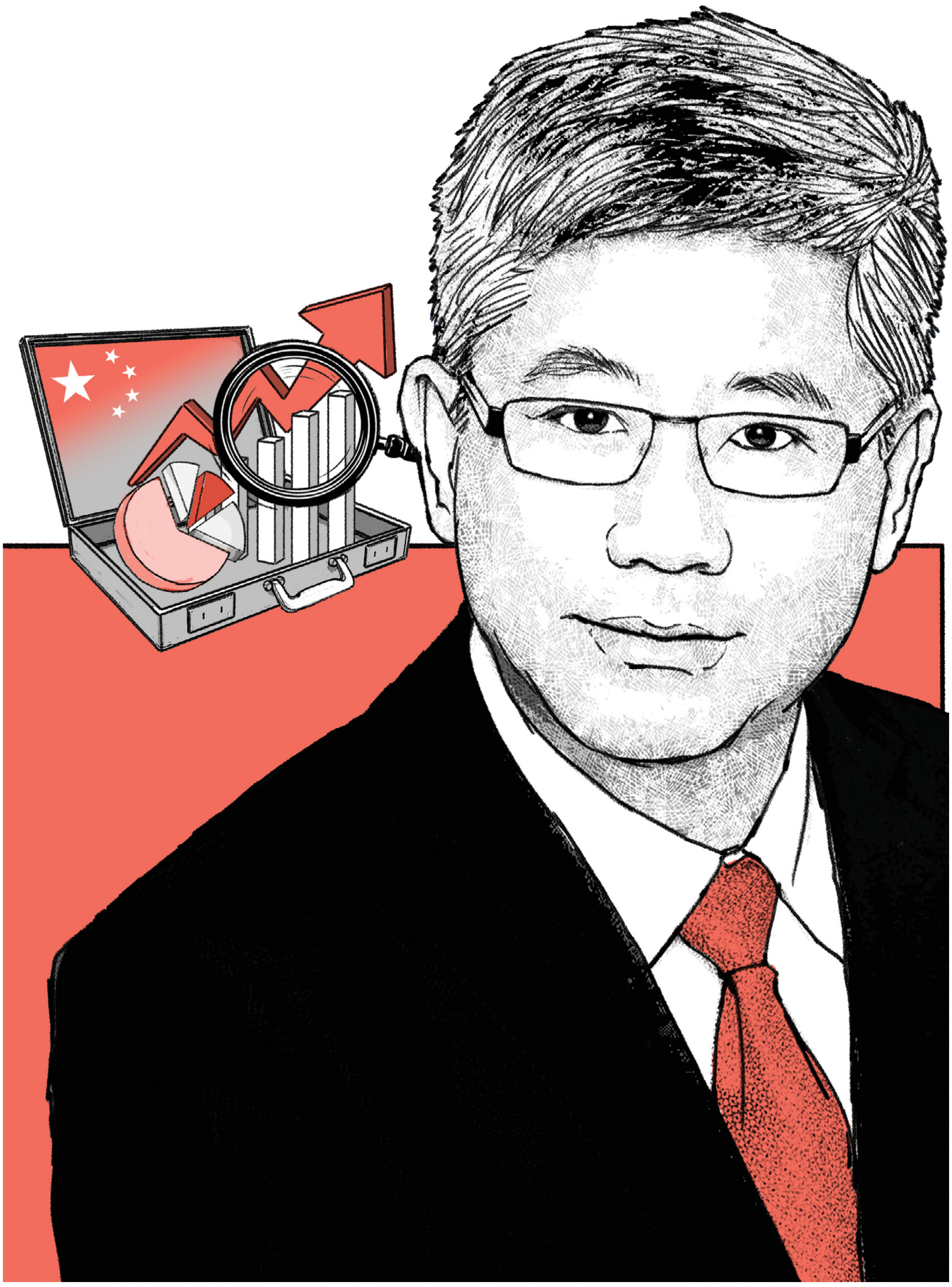

Illustration: Henry Wong

critical driver. While the US has recently wavered on its climate commitments, China remains firm in its belief that an efficient global transition is a necessity. By investing heavily in renewables and electric vehicles, China has built huge competitiveness.

Of course, we understand other countries' desire to protect their own domestic industries. The challenge lies in balancing industrial protection with the global imperative for green energy.

Returning to so-called overcapacity, it is essentially a supply-demand imbalance. But if we perceive both supply and demand as dynamic variables, the situation is different. If nations were to pursue their green transitions more actively, China's current capacity might be exactly what is required to meet global needs.

I also disagree with simplistically elevating all energy issues to the level of national security. There is a fundamental difference between the volatility of natural gas supplies and the stability of installed solar or wind infrastructure. To invoke national security at every turn when discussing energy is, I believe, a form of intellectual laziness.

But on the domestic front, what are the drivers behind this imbalance between supply and demand – and consequent deflationary pressure – and how long is it likely to persist?

If our domestic supply keeps growing while global demand fails to grow as hoped or fails to evolve in a way that benefits global development, then this structural imbalance will inevitably depress prices. This is ultimately detrimental to China's interests.

For our businesses to achieve sustainable, long-term growth, they need healthy profit margins; prices cannot drop too low. Therefore, we must take proactive measures to curb "involution", rebalance supply and demand, and help restore corporate profitability as quickly as possible.

Another vital piece of context is the profound correction taking place in China's property market, where investment and sales are declining. Given its colossal scale, the real estate sector casts a long shadow over the broader economy, impacting entire supply chains. Local government finances have also historically relied heavily on land sales. As the property market shrinks, their fiscal capacity is severely squeezed.

Given the sheer magnitude of this correction, it is no easy task for new sources of demand to rapidly emerge and fill the void left by real estate. Any nation facing a transition of this scale would experience a relatively big economic shock.

This broader price weakness manifests in falling export prices, persistent declines in the producer price index, and sluggish growth in the consumer price index. The government's CPI target for this year remains 2 per cent, but after flatlining last year, reaching that goal remains uncertain, though it should remain our goal.

Looking ahead to the 15th five-year plan period, I particularly hope that we can emerge from this phase of price weakness and secure a mild inflation rate of 2 to 3 per cent. This must be a core policy objective, though much work remains to be done to realise it.

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What does Beijing need to do to boost domestic demand, stimulate consumption and address these structural imbalances?

Fundamentally, it starts with a shift in mindset. We can't consider household consumption as a fallback option or a mere macroeconomic tool to stimulate the economy. Instead, it needs to be viewed as a primary development objective in its own right.

Consumption reflects the real benefits people gain from economic growth – their actual "sense of gain". This is why I've advocated making household consumption a key performance indicator for local governments. The idea is to proactively target consumption as a core goal, rather than scrambling to boost it only when demand falters. This change in perspective would make a difference.

Consumption is a holistic, forward-looking metric. If people are anxious about their future jobs and incomes, they simply won't spend. It takes high-quality investment and genuine innovation to give people the confidence to spend. Therefore, it should really be our guiding metric.

As income levels rise, the growth in demand for manufactured goods naturally slows, but the appetite for services still has massive room to grow. People want better education, healthcare and elderly care, and richer cultural lives.

It's no coincidence that the section on people's livelihoods was the longest in this year's government work report. Much of that focuses on service-based consumption, an area with great growth potential.

The service sector is heavily policy-dependent. Areas like education, healthcare and pensions cannot be left entirely to the free market; they require clear policy frameworks.

For example, the state must ensure basic pension security. When it comes to elderly care – whether at home, in the community or in specialised facilities – who provides it? What are the standards? How are prices regulated? These are all deeply tied to policy. This requires exploration from both central and local governments, which brings me back to my proposal of making consumption a local key performance indicator.

Finally, if we want to improve livelihoods, employment is very important, and services will be our biggest engine for job creation. As automation and artificial intelligence advance, manufacturing will inevitably create fewer jobs. We can only achieve full employment – and by extension, common prosperity – by generating a massive number of service-based roles.

So, returning to your question on how to quickly resolve structural imbalances, we need to push hard to develop consumption with a specific focus on services.

This isn't a zero-sum game: emphasising consumption doesn't mean ignoring investment, just as championing services doesn't mean abandoning manufacturing. It's simply about recognising where greater headroom lies. The service sector clearly has the most room to grow and it demands our full attention.

As you mentioned, the downturn in the property market is currently a major drag on domestic demand and the broader economy. How long do you expect the downturn to last, and how should the government respond?

The correction in the property market was, to some extent, inevitable, stemming from a few fundamental factors. First is demographic change. Many assume these demographic shifts were entirely expected. They actually weren't.

Take the United Nations' World Population Prospects, for example: the projections for China in 2019 versus 2022 are starkly different. The projected population peak was brought forward significantly, and the subsequent rate of decline accelerated. Many of these shifts have only materialised in recent years and weren't fully priced in.

Real estate is essentially an expectations game: if you anticipate mild population growth, you assume ongoing demand; if you expect this kind of demographic trajectory, demand naturally diminishes. People argue that urbanisation is still ongoing, but we cannot ignore the profound, fundamental impact that a shrinking total population has on underlying demand.

Many point to the "three red lines" policy. I view that as the trigger, but it coincided with these demographic shifts – and the demographics remain the root cause.

We economists should also shoulder some of the blame. We failed to clearly articulate the challenges to future growth. Many likely acted out of good intentions, sugar-coating the outlook in the belief that it would bolster confidence. But when forecasts are unrealistic, and people act on them, it backfires.

If you tell me to expect 8 per cent growth, I build for 8 per cent. When actual growth comes in at 5 per cent, we end up with a glut. The property market's current state is partly tied to our shortcomings in helping the industry and the public form objective, rational expectations about future economic growth.

With this in mind, we shouldn't harbour overly optimistic expectations going forward. The demographic trend will not reverse overnight, and growth rates are not returning to 7 or 8 per cent. That is the objective reality – a long-term issue we must confront.

This doesn't mean we sit on our hands, of course. On the policy front, necessary steps like rolling back purchase restrictions must be taken. Red tape should be minimised, and there is ample room to fine-tune the details.

But there is a broader macroeconomic imperative: enabling the wider economy to achieve appropriate price growth, such as a mild inflation rate of 2 to 3 per cent.

Property prices are heavily dictated by nominal prices. The overall price level drives nominal incomes. For instance, if GDP grows by 5 per cent but prices drop, many people don't "feel" it because we report in real terms, while people live their lives in nominal terms – they look at their pay packets and most don't immediately calculate their purchasing power.

Therefore, the psychological impact of nominal prices is immense. With mild inflation, nominal incomes and nominal wealth grow faster, creating a much healthier environment for the real estate sector.

To understand real estate, we need to step back and look at the broader economy. If we can secure mild inflation, solid employment expectations, rising incomes and appreciation in other asset classes, property prices will naturally stabilise. This is perhaps the more critical angle we need to consider.

What value does Hong Kong hold as an international financial centre and the largest offshore yuan market? How should it enhance its competitiveness?

People hold varying perspectives on Hong Kong's development. Some argue it must differentiate itself further from the mainland to develop. It makes some sense: the city must leverage its unique advantages.

However, being different should not be the ultimate goal. Rather, through differentiation, it should build a greater capacity to create value, ultimately coordinating with the mainland to create value together. This is the fundamental logic through which I view Hong Kong's positioning.

> The mainland has its own considerations, whereas Hong Kong can innovate more in terms of regulation

Take financial support for technology, for instance. Hong Kong's capital market differs significantly from the mainland's. It is more internationalised and can act as a pioneer in regulatory trials.

The mainland has its own considerations, whereas Hong Kong can innovate more in terms of regulation, attracting innovative mainland enterprises to list there and providing opportunities for them. This is not about "snatching" enterprises from the mainland, but rather making a contribution to the entire nation and providing financial backing for innovation.

For some enterprises, the listing thresholds on the mainland might be somewhat high. Could Hong Kong make its thresholds more accommodating? With more flexible regulation, it can help incubate, screen and price enterprises. Once conditions mature, they could pursue a dual listing on the mainland, which might yield better results.

Considering the rise of stablecoins, particularly, the city's role is becoming even more prominent.

I believe the world does not wish to rely overly on a single currency – the risks are too big. Could China and other nations or regions, such as Europe, provide more alternatives? As we still have foreign exchange controls, we need the offshore yuan market to provide more global alternatives, which can also assist China in playing a larger role in global development.

Therefore, Hong Kong's role can be immense, making a unique contribution to China's development while simultaneously boosting global development. I do hope for it to become more prosperous.

Visitors to the Digital China Summit in Fuzhou last month. China's highly comprehensive industrial system provides fertile ground for innovation.