AS ECONOMIC RECOVERY WEAKENS, CHINA BRACES FOR STRONGER HEADWINDS

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EAI Background Brief No. 1630

Date of Publication: 18 February 2022

Executive Summary

1. China's economy grew strongly in the first half of 2021, with 18.1% year-on-year growth in the first quarter and 7.9% in the second. However, growth had decelerated considerably to 4.9% and 4.0% in the third and fourth quarters, respectively (Figure 1).

2. Part of the slowdown was due to the base effect as the economy in the first half of 2020 was badly affected by the COVID-19 pandemic and the various COVID restrictive measures. Weaknesses in recovery were also evident in the quarter-on-quarter growth. Varying between 0.3% and 1.6%, growth was not only below that of the second half of 2020, but also on average lower than that in 2019.

3. Investment and the secondary sector led the slowdown in growth. Investment's contribution to growth was negative in the second half of 2021 (Figure 2) and the 1.1 percentage points for the year have been the lowest since 1990. The secondary sector's (i.e. industry and construction) contribution to growth dropped to 1.4 percentage points in the third quarter, the second-lowest since 1993 when the statistic was first reported (the lowest being the first quarter of 2020).

4. Investment and the secondary sector were marred by slow credit growth. Growth in aggregate social financing slowed over the first nine months of 2021, stabilising only in the last quarter, as economic recovery had not taken firm root. By the end of 2021, the increase in aggregate social financing amounted to RMB31 trillion, 10% less than that in 2020. New RMB (renminbi) loans even declined in the last two quarters of 2021 year-on-year.

5. The slow credit and loan growth could be attributed to first, the government's renewed deleveraging efforts in 2021. In 2020, debt levels rose sharply as the government sought to counter the impact of COVID-19, and the overall debt to GDP ratio rose from 247% at end-2019 to 270% at end-2020. The new round of deleveraging emphasised controlling hidden local government debt and reining in debt of the real estate sector through "the three red lines" policy.

6. Second, fiscal policies were a drag on growth for most of 2021, despite the formal "proactive" fiscal policy in place. Central government policy was key to the slowdown in government spending (down by 1.1%) despite government revenue expansion (more than 14.7%) in the first three quarters of 2021. Central to local fiscal transfers were lower than that in 2020 and government's measures on real estate firms led to slower growth in land revenues. The issuance of local bonds also lagged due to concerns about debt levels. Spending was constrained for most of the year, only to finally turn around in the last quarter.

7. Third, investment was also impacted by tighter government regulations, such as new regulations to promote "quality growth". These ranged from regulatory crackdown in the internet economy to the banning of after-school tutoring businesses. Despite the laudable objectives, they affected the economy both directly and indirectly. Growth in fixed asset investment slowed in the second half of 2021 (Figure 3), particularly in the real estate sector, a key driver for growth.

8. While investment growth had weakened and consumption was unable to make up for the slack, China's exports contributed more than one-fifth of the year's GDP growth in 2021 despite a stronger RMB. Exports in both goods and services were particularly robust, registering a record-high trade surplus in the last quarter of 2021 (Figure 4). At the same time, foreign direct investment in China continued to increase while direct investment outflows had stabilised.

9. By end 2021, policies started to turn more supportive, including the decision by the People's Bank of China to cut the reserve requirement ratio from mid-December and accelerate the issuing of local special bonds. The "clarification" of the three red lines policy also brought some relief to the real estate sector.

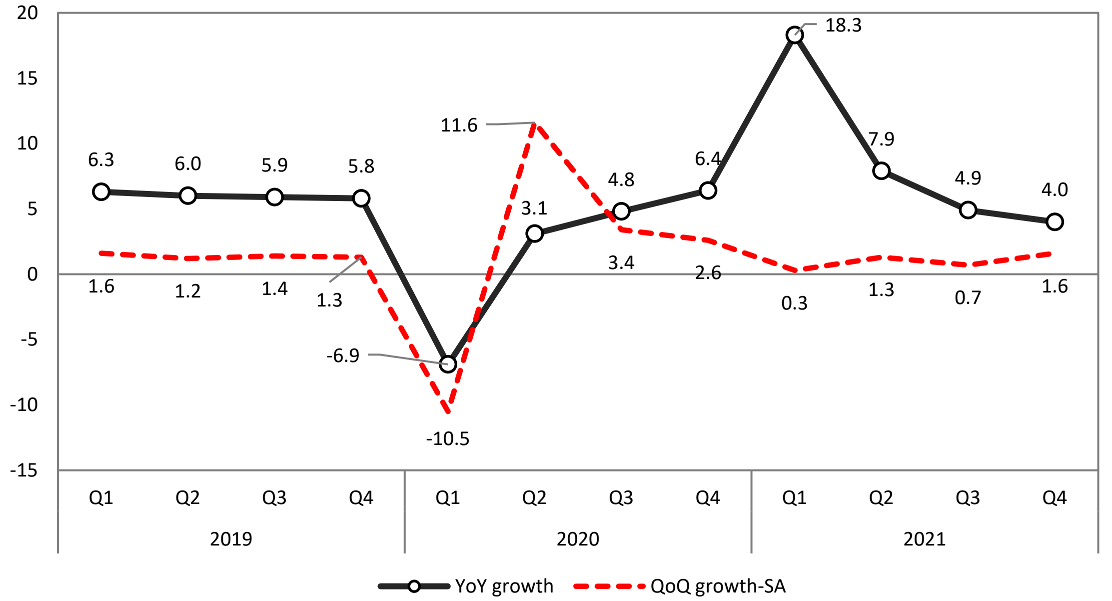
10. China's policymakers have promised more support for the economy in 2022. The December 2021 Central Economic Work Conference clearly signalled concerns for growth due to the "three pressures" faced by the Chinese economy: "demand contraction, supply shock and weakening expectations". The "stability" of the economy is now considered top priority, with an emphasis on "prudent and flexible" monetary policy and "proactive and efficient" fiscal policies.

11. Despite more supportive policies, this year’s GDP growth forecast is modest. The current consensus forecast puts 2022 growth at 5.2%. The International Monetary Fund puts growth at 4.8%. While the central government has yet to issue any 2022 growth targets, all provincial-level governments announced growth targets ranging from 5% (Beijing) to 9% (Hainan), or a simple average of 6.3%, 1.5 percentage points lower than the average self-reported rate of 7.7% in 2021.

12. These projections are subject to considerable risks, including new COVID-19 outbreaks. China’s dynamic clearing policy has worked well in the past, but with the highly contagious Omicron variant, its policies may cause considerable supply disruptions locally and globally. In the medium term, China needs to rapidly cultivate new sources of growth as it had depended too heavily on real estate and infrastructure in the past. Investment in “new” infrastructure—such as clean energy, transmission and 5G telecoms—holds promise in that respect.

13. China’s fiscal system, including central-local fiscal relations, need a major revamp to strengthen the automatic stabilisers and accommodate more social spending. Such major reform is unlikely to happen in 2022 as the Communist Party of China will hold its 20th Party Congress in the later part of the year. The central government could, however, increase transfers to local government and individuals to stimulate consumption and support local investments in the “new” infrastructure.

FIGURE 1 GDP GROWTH, 2019-2021 (Quarterly YoY and QoQ, per cent)



Source for all figures: CEIC Data, unless otherwise stated.

FIGURE 2 GDP GROWTH BY DEMAND
(Contribution to growth, percentage points)

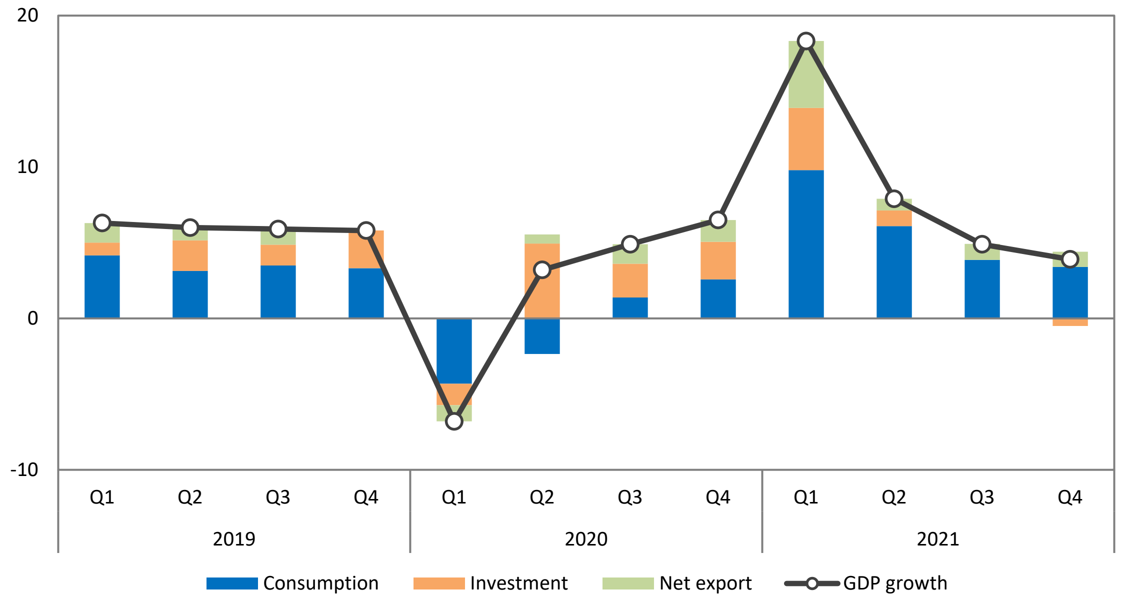
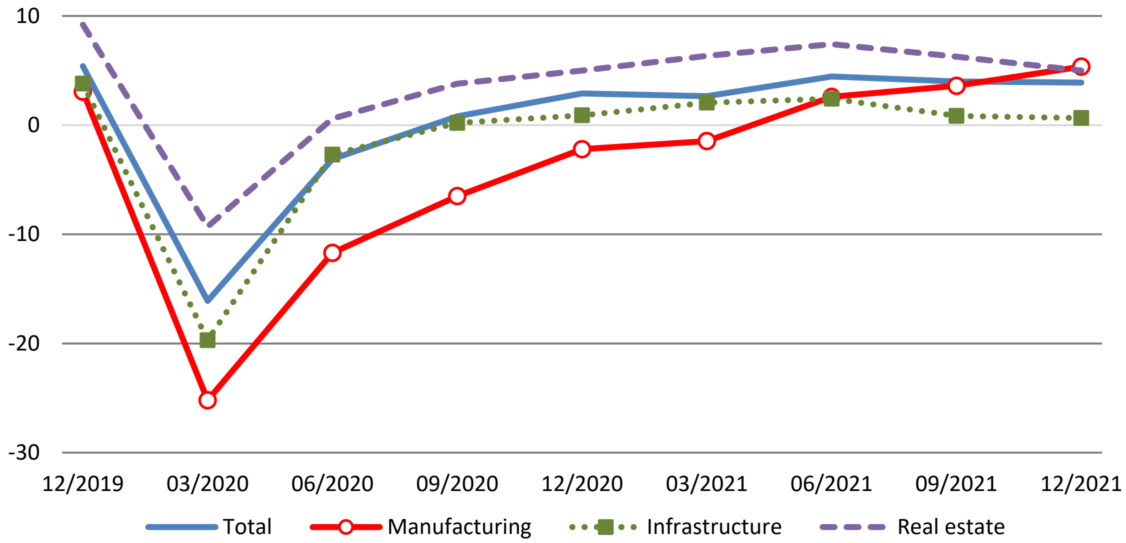


FIGURE 3 FIXED ASSET INVESTMENT BY SECTORS
(YoY growth, YTD, percentage)



Note: Year on year (YoY) growth rates for 2021 are two-year average figures.

FIGURE 4 TRADE IN GOODS AND SERVICES
(Amount and YoY growth, RMB billion and per cent)