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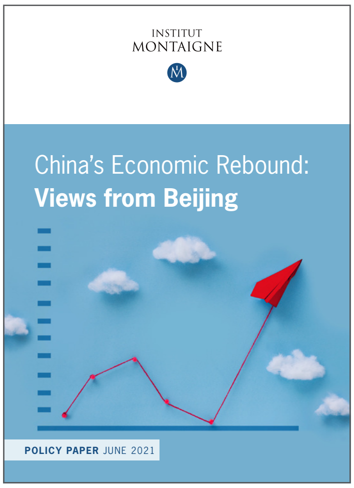
Executive Summary



After an intense but short phase of pandemic and lockdown, **China had the fastest and strongest economic rebound in the world.** The recovery was largely based on support for production and the supply side, including exports. **China's economists question whether this is sustainable, or is a spike.** China's policy path diverges from all other major economies, where monetary easing and economic policies have been designed to support demand and consumption during a protracted pandemic.

This policy paper looks into the **Chinese views and debates on China's macroeconomic policies** in recent months, including the implications of **decarbonation pledges** and the recent **demographic findings.** These views are mostly about the domestic Chinese economy and its fiscal and monetary policies. The international angle is usually viewed with primary attention at present and future U.S. policies. Other economies seem to deserve much less attention.

One overhanging sentiment is uncertainty. This is also reflected in China's official statements on the international economy and China in 2021. But the debate also reveals that at least some Chinese experts wish for more proactive policies, whether state-led or based on monetary expansion, implying more support for market incentives for growth.

The views presented here are not this writer's, even if some comments are included. Several key aspects that international experts would likely have mentioned are not present.

What the Numbers Say

The official doctrine is that China remains a developing economy. But our sources assess Chinese forecasts in light of those of OECD countries – rather than comparing China to emerging or developing economies.

At first sight, all signals are green: **China's Q1 2021 economic recovery has extended the recovery of the second half of 2020.** There are nuances: Chinese analysts suggest a stronger recovery in supply than in demand, and in housing and construction than in manufacturing or even infrastructure. The picture they paint also suggests a widening gap between coastal and central regions and between the north and south of the country.

Foreign direct investment and financial capital flows into China picked up. They are hailed as "a vote of confidence by international capital" in the official media. China has become the world's leading destination for investment in 2020, ahead of the United States, and continues to break records in Q1 2021.

Chinese exports also reached historic heights in 2020 with a trade surplus of USD 535 billion. The trend remains explosive in Q1 2021. However, **March 2021 also saw a strong rebound in imports,** a 38.1% YoY increase compared to the 30.6% of exports, breaking with the trend for the past year. **This import rebound may be linked to Chinese fears of a global rise of inflation as well as expected political difficulties,** leading to preemptive purchases of primary products and the stockpiling of IT components.

Behind these overall figures and a dynamic foreign trade picture, other aspects of the economy appear much more sluggish – or stable, depending on one's viewpoint. **There is a gradual reduction in public support for the economy,** both in the central budget and in credit operations. "Total social financing" (i.e., credits made available to private actors by the financial system) is also down considerably.

Risk Assessment as a Benchmark for Fiscal and Monetary Policy

China, which did not practice quantitative easing, is also **the only major economy to normalize both its fiscal and monetary policies.** Others drive global growth by subsidizing demand. **China freerides these efforts and boosts its supply side economy.** The Politburo has emphasized international uncertainties, justifying cautious economic policies.

Chinese economists have divergent views on risk assessment and the effectiveness of fiscal and credit policies. Some justify **neutral monetary and fiscal policies.** Money creation and "social financing" should essentially follow nominal GDP growth, and priority should be given to the economy's "endogenous dynamics".

Others advocate for **a more proactive monetary policy** based on different assumptions: an expanding demand will boost growth and reduce debt; China's finances and currency reserves can well afford this policy; and finally, an open door to imports is in support of China's plans to move up the innovation and technology chain. One People's Bank of China (PBoC) official has gone farther, advocating a reevaluation of the renminbi vs. the US dollar to stem imported price inflation.

Regardless of these interesting and active debates, the government's objectives for 2021 all point in the same direction: a significant reduction in support for the economy, possibly resulting in a slowdown of growth. **Maintaining an export dynamic, which was an essential pillar of growth in 2020, remains a priority,** and China's public finances keep room for maneuver in case of unforeseen developments.

The Economic Stakes of Decarbonation

In expert Chinese macroeconomic debates, decarbonation policies often do not have a place. But Xi Jinping's pledges at the UN in September 2020 (carbon emission peak in 2030, carbon neutrality in 2060) opened the way for a revision of energy policies that goes beyond changes in the shares of different primary energy sources. **If there is any chance of achieving the targets set, China will need to change the content of growth itself, unless it accepts a much slower rate of growth.** This is hardly a pleasant scenario for the Chinese government, which has defended its right to "catch up" with the past amount of CO_2 emissions of industrialized countries. **Curbing these emissions should not become "an excuse for trade barriers",** emphasized Xi Jinping during a video summit with his French and German counterparts.

Some key experts underline that actual levels of CO_2 emissions are unknown outside of the largest companies: **what yardstick will be used to assess the changes? Three observations** can be made about the recent past (since 2013) and the trend in 2020:

- Coal consumption has returned to its 2013 peak (4.2 billion tons).
- Electricity savings are not encouraged: the average price of power is about half what it is in other industrialized economies.
- In the spring of 2020, Premier Li Keqiang's annual government report speech continued to place economic profitability first and emphasized "clean coal".

The solutions, should the government be looking for them, are difficult to find and carry substantial economic implications. In 2020, the recovery was achieved through supply-side economics and support for traditional sectors.

In the face of this dilemma, a number of policies are being implemented or considered. They are introduced sector by sector and area by area. In the very short term, the government decided in 2021 to reduce production in the most energy-intensive sectors. A vast and complementary range of measures are also being introduced – but often without a national plan or overall quantitative objective. The policies are pledged province by province, city by city, company by company. **They are largely responses to top-down pressure filtering through the bureaucracy.**

One essential issue is that of market incentives, i.e., not only a carbon tax mechanism, and a mechanism for setting carbon emission trading prices. A national carbon pricing system has been long delayed, following several pilot projects since 2011. **One interesting analysis suggests a coordinated but differentiated combination of a carbon tax and an emissions trading scheme (ETS) carbon price market.** However, this proposal largely ignores the socio-political context of consumers and employment. An authoritarian regime which restricts political freedom must stay attentive to socio-economic needs.

The Demographic Shock: How Soon?

To these themes, one can add a new debate on demography and the economy, following the surprising results of the 2020 census – **a sharp drop of total fertility to 1.3.** The consequences for the trend may not be immediate or even short-term. Nonetheless, **the trend changes perceptions of the future Chinese economy, its human resources and social burden, and points to a reduced growth potential in the future.**

China follows the demographic transition found in other societies – as income and education improve and urbanization becomes predominant, birth rates go down. There is an important difference with predecessors in the transition: **the birth rate in China has actually gone down earlier and faster than it has in other societies,** including in East Asia.

The number of women of childbearing age is low and the number of women aged between 22 and 35 is expected to fall by 30% in the next decade. This implies that even if the total fertility rate was to improve, the yearly birth rate relative to the population would still not rise. The consequences are clear: **China's population will enter an absolute decline earlier than 2025** (which was the official prediction), and perhaps as early as 2021. Proposals to counter the trend are making the rounds of China's official media.

Take-aways for Europe

What are the main take-aways for Europe and the countries which view China as a partner in cooperation, an economic competitor and a systemic rival?

1. **Maintaining the dynamic** in foreign direct investment, capital inflows and Chinese exports is a priority. China is not likely to concede on these grounds under Xi Jinping's watch.
2. China's economic decisions are largely shaped by domestic factors, to which one can add risks from U.S. policies. **One does not sense a perception of a risk from Europe,** even in the area of trade and investment.
3. State capitalism, supply side policy support, industrial policies and innovation remain **China's prevailing choice to foster growth.**
4. **Most changes in China remain driven by the party-state – and are therefore reversible. Any international agreement must still insist on implementation and verification.**
5. In broad economic terms, **China remains a free-rider,** achieving its economic rebound on the basis of a support for global demand by other central banks. Are China's new climate targets the exception? They will be hard to achieve in any case, and these developments bear watching.

In bilateral relations with China, at fora such as the G7 and G20, partners should **question China on its willingness to support the global economy** as befits its status as the world's second economic power. At climate conferences, they should also **put an accent on the concrete steps,** including international verification, that China intends to take to achieve ambitious but distant goals.

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