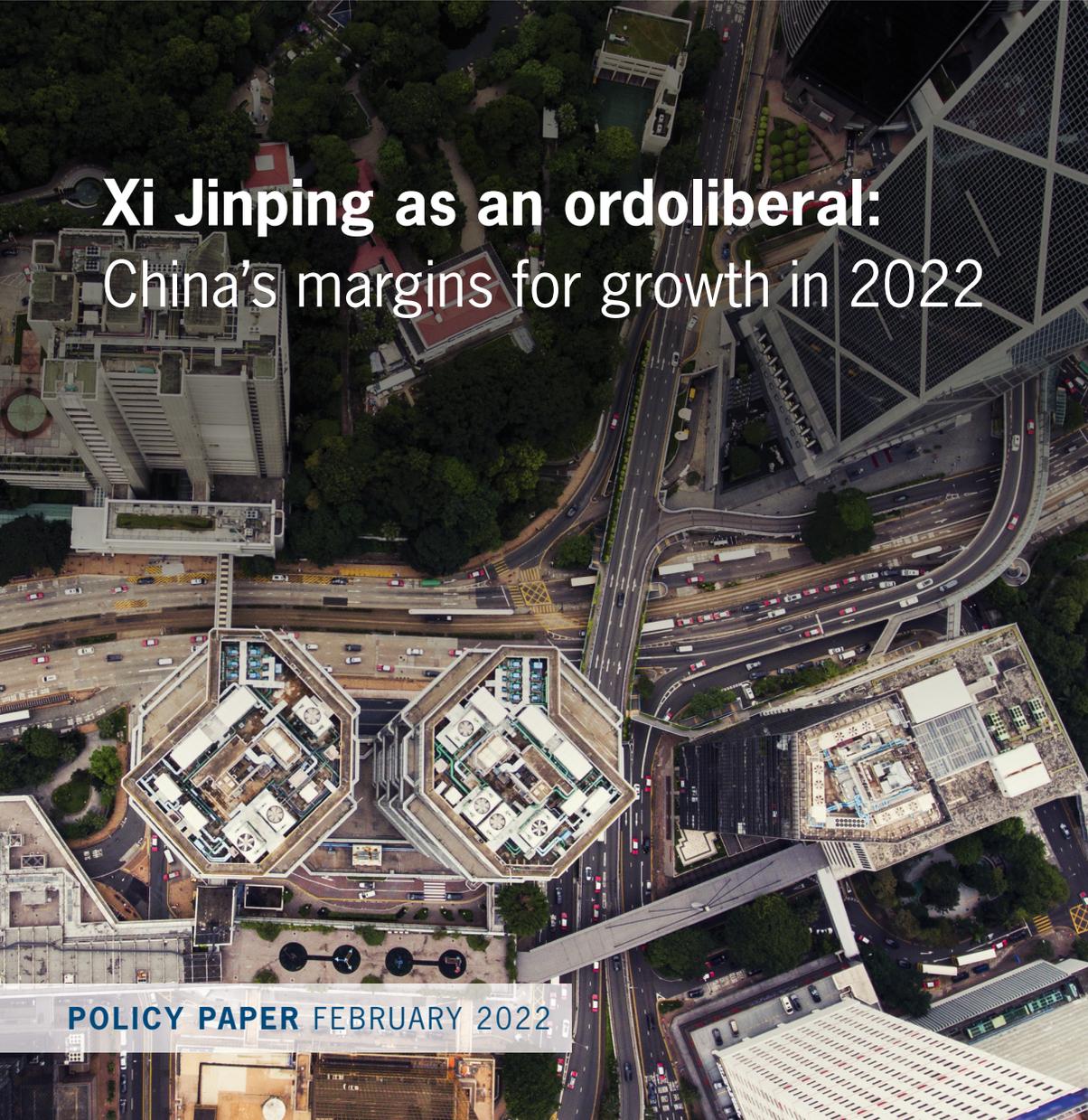


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Xi Jinping as an ordoliberal: China's margins for growth in 2022

POLICY PAPER FEBRUARY 2022

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ABOUT THE AUTHOR

François Godement, Senior Advisor for Asia

François Godement is Senior Advisor for Asia to Institut Montaigne, Paris. He is also a non-resident Senior Associate of the Carnegie Endowment for International Peace in Washington, D.C., and an external consultant for the Policy Planning Staff of the French Ministry of Foreign Affairs. Until December 2018, he was the Director of ECFR's Asia and China Program and a Senior Policy Fellow at ECFR.

A long-time professor at France's National Institute of Oriental Languages and Civilisations and Sciences Po, he created Centre Asie IFRI at the Paris-based Institut Français des Relations Internationales (1985-2005), and in 2005 Asia Centre. He is a graduate of the École Normale Supérieure de la Rue d'Ulm (Paris), where he majored in history, and was a postgraduate student at Harvard University. In 1995 he co-founded the European committee of the Council for Security Cooperation in the Asia-Pacific (CSCAP), which he co-chaired until 2008. His last published book (with Abigaël Vasselier) is *La Chine à nos portes – une stratégie pour l'Europe*, Odile Jacob, 2018.

For Institut Montaigne, he recently authored *Europe and 5G: the Huawei Case* (May 2019, with Mathieu Duchâtel), *Digital Privacy, How Can We Win the Battle?* (December 2019), *Fighting COVID-19: East Asian Responses to the Pandemic* (April 2020, with Mathieu Duchâtel and Viviana Zhu), *Europe's Pushback on China* (June 2020), *Wins and Losses in the EU-China Investment Agreement (CAI)* (January 2021), and *China's Economic Rebound: Views from Beijing* (June 2021).

*There is no desire more natural
than the desire for knowledge*

TABLE OF CONTENTS

Introduction	7
I. The 2021 economic rebound and the trend to a long-term slowdown	8
II. The available margins in 2022	12
III. The structure and balance of China's public budget	15
IV. Budgetary policy and the management of the central-local relationship	18
V. Preserving conservative fiscal and budget policies	23
VI. Monetary and credit policies	26
Conclusion	29
Acknowledgments	31

INTRODUCTION

2022 could be seen as the year when China entered the middle-income trap. In fact, it has likely reached the ceiling of upper-middle-income countries as defined by the World Bank (USD 12,535 per capita GDP in 2021), given the growth performance in 2021 and the reevaluation of the renminbi (6.5% to the USD in 2021, 10% since June 2020).

The arguments for the slowdown include productivity issues, a difficult transition to household consumption and services, a potential bubble economy symbolized by a real estate crash in the summer of 2021, a significantly very reduced birth rate, and an energy transition supply crisis in the same year. **The warnings voiced long ago by former prime minister Wen Jiabao – that China's growth rate was unsustainable without major changes – would become a reality.** The government itself currently acknowledges three pressures: demand contraction, supply shock, and weakening expectations. However, these are circumstantial rather than structural issues.

This slowdown is part of a trend. **China has not seen double-digit growth since 2010, and the country's growth rate has been declining almost every quarter.**¹ Xia Bin, director of the State Council's finance institute at the Development Research Center, notes that in the twenty years since 2003, China's economic growth has been in step-by-step decline every four years.² After 2010, 6% was conventionally seen as the government policy's floor target, narrowly missed only in 2019.

Less obvious, and less commented, is the fact that the government, since the coronavirus outbreak of early 2020, and even more since early 2021, has maintained a restrictive policy for the public budget, credit and interest rates. This was debated among Chinese economists in the past two years, but the overall policy has remained contractionary.

There may therefore also be **more margins for government action and support to the economy than generally recognized. This note intends to evaluate the reasoning behind this persistent government policy, and the potential for change in 2022.**

¹ Yu Yongding, "Fourteen observations on 2022 macroeconomics (关于2022年宏观经济的十四点看法)", China Finance 40 Forum, January 25, 2022, <https://archive.ph/wip/r6RuV>

² Xia Bin, "2022: What should be the key focus of 'stability prioritization'? (2022年: '稳字当头'要重点关注什么?)", Aisixiang, January 9, 2022, <https://archive.fo/13mQ9>

THE 2021 ECONOMIC REBOUND AND THE TREND TO A LONG-TERM SLOWDOWN

The consensus prospect for **China's economy in 2022 points to a growth rate that is significantly under the long-term trend.** GDP growth in China had averaged 9.44% annually between 1978 and 2018. For example, Goldman Sachs, which cannot be not suspected of underplaying China, has diminished its forecast for 2022 from +4.8% to +4.3%,³ and the IMF has reduced its growth forecast from 5.5% to 4.8%.⁴ This is barely half the official figure for 2021 – which was, of course, a recovery year from the 2020 pandemic. The 8.2% 2021 figure is from a low base of 2020 and, therefore, somewhat deceptive. Sequential quarter growth in 2021 was lower than in the last pre-pandemic year: 0.3% in Q1, 1.3% in Q2, 0.7% in Q3, and 1.6% in Q4. Consumer spending and construction activity slowed down: neither retail goods sales nor catering have recovered to their pre-Covid levels, and the government attacks on digital platforms have slowed down the growth of online sales.

There is a further sign that China's growth is running below its potential growth rate, despite its reported figure: while inflation is taking hold in the rest of the world, China's consumer price index (CPI) only rose by 0.9% in 2021. There are circumstantial reasons for this: pork prices, a large component of the CPI, have gone down by 45% since the end of a swine epidemic; reevaluation of the renminbi lowers import prices. The producer price index (PPI), although up by 8.1%, did not recover to its pre-pandemic level and fell in December 2021. Much of this PPI rise is due to the rise in energy prices for producers, and the gap with the CPI indicates that these production costs were not passed on to consumers. While the rest of the world renews with inflation, a consumer price slowdown in China indicates major issues with growth.

³ Tom Hancock, "Goldman Lowers China 2022 Growth Forecast to 4.3% on Omicron", Bloomberg, January 11, 2022, <https://www.bloomberg.com/news/articles/2022-01-11/goldman-lowers-china-2022-growth-forecast-to-4-3-on-omicron>

⁴ IMF, Rising Caseloads, A Disrupted Recovery, and Higher Inflation, January 2022 <https://www.imf.org/en/Publications/WEO/Issues/2022/01/25/world-economic-outlook-update-january-2022>

Graph 1: China's CPI and PPI
(2011 - 2021, YoY)



Source: Statistics published on the website of the National Bureau of Statistics of China.

Not all trends point in the same direction, however. The silver lining remains China's exports. China's export growth has often been described as reaching its limits over the past two years, regarding the share of global exports and its acceptability by the country's trade partners. Yet, the trend continues and is even accelerating. **Once again, history comes to mind: for several years running, former PM Wen Jiabao had also announced in his time a slowdown in exports, which never materialized.** We have a similar situation today. Since the pandemic started, trade economists have forecasted China's trade surplus rebound as a one-off event. It was due to abate soon, under the twin weight of slower international demand and a domestic economic shift towards consumption and, therefore, more imports.

Nevertheless, here we are, with an announced Chinese trade surplus in goods of USD 674 billion for the whole year, or about 4.4% of the expected GDP. This trend is even more pronounced towards the European Union (EU). Although the EU household consumption rate grew much less than in the US (2.5% to 3% vs. 10% at year-end 2021), China's exports to the EU have increased by 57% over 2020, and "only" by 27% to the United States. China's export mix – from medical equipment to house furniture, computer chips, batteries and other alternative energy products as well as

intermediate capital goods – is the basis for this performance. **Overall, external demand has likely contributed over 20% to GDP growth from December 2019 to December 2021**⁵. China still had a deficit for trade in services in 2021 – but at USD 82 billion according to official SAFE figures, it is down by 44% over 2020 figures from OECD data.⁶

The other positive contribution concerns FDI and other capital flows to China.⁷ Official currency reserves “only” increased by USD 146 billion in 2021, standing at USD 3.25 trillion at the end of December. Although China claims to be the first global direct investor, income from investment abroad is still low. Most capital inflows were the work of non-bank companies, including short-term cash-flow deposits by Chinese or foreign companies, which were not reflected fully in central bank reserve numbers. **As was the case in 2020, Chinese banks are reputed to have purchased dollar-denominated or dollar-correlated bonds abroad on behalf of the central bank to reduce the pressure for reevaluation of the renminbi.** This action also explains the large increase in Chinese investments abroad and their current low returns. In 2021, the surplus from cross-border receipts and payments by non-banking sectors was USD 356.4 billion. FDI into China stood at USD 173 billion in 2021, a 20% increase over 2020.⁸ Official statistics from developed economies usually understate FDI and other capital flows to China, mostly because they often transit via tax havens.⁹

China's current account surplus is not, of course, much of an economic surprise. It is largely a consequence of the country's export performance, which was itself the surprise to many economists. **With regards to financial flows and the capital account, it is of course a political surprise to consider how international companies and financial operators have parted ways with the partial decoupling or even diversification concept. It is also worth noting the extent to which opportunity risks from sudden policy changes in Beijing or geopolitical risks are being discounted,** not to mention concerns about due diligence. The main consequence is that it is difficult to see a domestic downturn or a financial crisis turn into an international sell-off of Chinese assets or major turn away from

investment in China. Despite the demise of bonds sold by real estate companies to investors operating from abroad, short-term debt from China, including from the semi-private sector, remains attractive. FDI into China is reportedly less targeted at greenfield and production facilities and more into services, or in research and innovation, which are also classified as services in China. The overall trend is still upwards. It is also reflected in the rise of venture capital investment, reported at USD 129 billion in 2021, largely into sectors that are favored by government policy, such as semiconductors, biotech and IT.¹⁰

This provides the Chinese ship, as it sails into the 2022 waters of the 20th CCP Congress in the fall, with a stabilizing keel that prevents it from capsizing. **China is flush with international currency reserves and short-term cash inflows, and its external debt position is better than that of many developed economies.** These strengths may be enough to prevent an international “grey rhino (灰犀牛),” as Chinese commentators often like to call it, from disrupting China's path in 2022. They may also serve to prevent a major international geopolitical crisis from damaging China. As with the so-called “dual circulation” economy, national security, self-sufficiency in key areas, and capacities are the key components of China's overarching economic strategy. Admittedly, these are short-term priorities: in the longer run, large importer countries carry the most weight in international trade negotiations; the ability and willingness to borrow and increase international debt is the main pathway towards creating an international currency. **China's choices reflect a shorter-term perspective on the risks of geopolitical conflict or an international geoeconomic crisis, an eventuality that officials often cite.**

5 Lu Feng, “An Evaluation of China's Labor Market Recovery and the Outlook for the 2022 Employment Situation”, China Finance 40 Forum, January 11, 2022, <https://archive.fo/JQ9kh>

6 OECD, “Trade in services Exports/Imports indicator”, 2022, <https://data.oecd.org/trade/trade-in-services.htm>

7 “China Trends #11 - China's Selective Opening Up: the Case of Foreign Direct Investment”, Institut Montaigne, December 2021, <https://www.institutmontaigne.org/en/publications/china-trends-11-chinas-selective-opening-case-foreign-direct-investment>

8 “China's FDI inflow up 14.9% to record high in 2021”, Xinhua, January 13, 2022, <https://archive.fo/hN0I5>

9 Antonio Coppola, Matteo Maggiori, Brent Neiman, Jesse Schreger, “Redrawing the map of global capital flows: the role of cross-border financing and tax havens”, NBER, Working Paper 26855, December 2020, pp. 16-18, <http://www.nber.org/papers/w26855>

10 “China's Startups Are Awash With Money as Beijing Shifts Focus to ‘Hard Tech’”, The Wall Street Journal, January 13, 2022, <https://www.wsj.com/articles/chinas-startups-attract-record-funding-despite-tech-clampdown-11642000017>



THE AVAILABLE MARGINS IN 2022

Given these choices and considering the domestic financial liabilities built up in 2021, it is useful to explore the resources presently available to the state at the onset of 2022. They include monetary policy, lending policies and public budgets. These undergo cycles of expansion and contraction in China, which tend to be political cycles of various durations. **So at what point are we in the current cycle? Herein may lie at least part of the answer on the margins still available for the state to nurture GDP growth.**

Strikingly, during the pandemic, China has not engaged in quantitative easing on a scale that would echo the “four trillion” support of 2008 or the policy of other central banks since the beginning of the pandemic. Instead, several trends point to a much more conservative position: monetary creation has become more and more restrictive since June 2020 and is only easing again since December 2021. Moreover, **the general budget has been running behind GDP growth ever since 2014, and has decelerated even more in 2021**, with expenditures falling faster than receipts, resulting in a headline deficit that is much lower than in previous years.

Within this budget, social expenditures related to welfare, health, education and unemployment have had a dwindling share since 2014, and this trend has also accelerated in 2021. The share of local budgets has remained remarkably stable within the general budget. However, since other sources of revenue for local government have decreased with the pandemic in 2020, and even more with the decline in land sales in 2021, **local expenditures have had to be held tight despite growing social needs.**

With regards to credit and monetary policy, China has been more conservative than all other large economies since the coronavirus epidemic took hold. There are structural reasons for this: long-term liabilities such as pensions, extensive local and corporate debt levels, financial and banking inefficiencies that require interest rates much above those of developed economies – including the dollar, with which the renminbi maintains a sliding peg. Xi Jinping has recently warned “major economies” against “a U-turn in their monetary policies, there would be serious negative

spillovers (...). And developing countries would bear the brunt of it”.¹¹ **Even with capital controls in place, China’s trade and financial integration with the world is such that low or zero interest rates in the country would result in capital flight.** The interest rate differential with the US and EU must be maintained to avoid this situation. Monetary policy is therefore quite restrictive, and China’s lending available to the economy, which routinely increased by 15% year on year for decades, stands at 6% at the end of 2021.

Necessity alone does not dictate these restrictive choices. They are also the consequence of a decision to guard against possible geopolitical shocks – including international sanctions or an economic crisis that would harm China’s exports. Under Xi Jinping, China does not want to face such a situation while at the peak of a debt cycle. It has therefore been conservative in its fiscal, monetary, and credit policies. There are no automatic stabilizers to speak of, and countercyclical policies are sometimes discussed even if never applied except downwards to cool the economy. On the flip side, the combination of monetary, fiscal, and credit conservatism with a large export surplus, provides China’s leadership with a feeling of invulnerability. It consequently focuses on production, while other major economies shoulder the burden of lifting demand.

To test this hypothesis, we will not look at long-term liabilities and assets, such as implicit debt linked, for example, to population aging or potential productivity increases through innovation. Instead, we focus on public budgets in the short term and on the margins for action in 2022. **This year will likely see a Party Congress confirm Xi Jinping’s hold on power beyond the terms obtained by his two most recent predecessors. It is also, and not coincidentally, a year when the keyword for economic policy is “stability”,** as expressed multiple times by the December 2021 Central Economic Work Conference. In such a year, what the state can do to alleviate or solve the increasing pressure on local public finances from the real estate crisis, and what it can do to support a flagging growth rate, matter a lot. It may take the form of support for local government budgets in need, through additions to household purchasing power, or through time-honored investment into infrastructures.

Certainly, in the longer term, none of this can replace a large-scale transformation of the economy, such as a shift towards a consumer-based, service-oriented economy, and more market allocation of factors, not to mention a net-zero carbon economy

¹¹ “President Xi Jinping’s message to The Davos Agenda in full”, World Economic Forum - Davos agenda 2022, January 17, 2022, <https://www.weforum.org/agenda/2022/01/address-chinese-president-xi-jinping-2022-world-economic-forum-virtual-session/>

by 2060. But in Xi Jinping's political economy vision, one finds much more on the importance of science and innovation, on coordination and correcting development imbalances than on the role of the market.

Beyond these major transformations, the discussion on potential state support for the economy in 2022 should include the balance between growth and other objectives such as GHG emissions reduction (a very strong theme in the first half of 2021) and "common prosperity" (共同富裕), an old slogan which came again to the fore in the summer of 2021. **Since a one-dimensional and production-based policy to reduce emissions in early 2021 resulted in an energy crunch later in the same year, insistence on a balance between growth and energy transition has come back in the public language.** Officials now criticize the "campaign-style carbon reduction movements" ("运动式减碳") of the first half of 2021.¹² On the overall balance between growth and structural reforms, in noted economist Yu Yongding's words, "if the economy is in the doldrums, it will be very difficult to promote structural reform, technological innovation and common prosperity. It may be perfectly right to advocate 'high-quality growth', but CNY 100 trillion of GDP is CNY 100 trillion of GDP".¹³ On energy, as on more general issues, the direction in early 2022 is to preserve short-term growth from what is now labeled as hasty reforms.

¹² Han Weixiu, "Stabilizing the macroeconomy is not only an economic issue, but also a political issue (稳定宏观经济不仅是经济问题, 更是政治问题)", *Aisixiang*, January 9, 2022, <https://archive.fo/tCuQH>

¹³ Yu Yongding, "Fourteen observations on 2022 macroeconomics (关于2022年宏观经济的十四点看法)", *China Finance 40 Forum*, January 25, 2022, <https://archive.ph/wip/r6RuV>

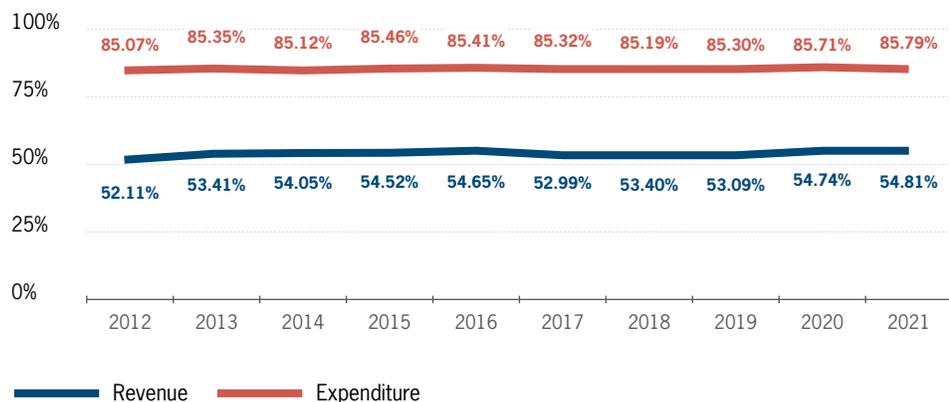
THE STRUCTURE AND BALANCE OF CHINA'S PUBLIC BUDGET

China's public budget comprises four elements, the first of which is the most often cited: **the "general budget,"** itself made of a central budget and local budgets, with transfers in both directions. This general budget represents a relatively low share of the economy – since the 1990s, circa 20% of GDP. The general budget also traditionally exhibits a low deficit (circa 2.3% – 3% of GDP). This figure is reached after net transfers from other revenue available to the state are included.

In the first phase of China's economic reforms after 1978, the share of central revenue and expenditures in the general budget regularly diminished, while local budget revenue and expenditures grew. However, this trend was reversed for revenue by the 1995 reforms, associated with then prime minister Zhu Rongji.¹⁴ **Ever since, the central budget has regained roughly half of revenue – while the local budgets still represent 85% of current expenditures: these are very decentralized.** The situation has had three major consequences: there must be large transfers from the central budget, and/or local governments must acquire additional resources on their own. Therefore, the question of the extent of control by central authorities has come back after 1995, and again today.

¹⁴ "Pourquoi l'Empire pourrait tenir ? Fragmentation de l'autorité et intégration géoéconomique de la Chine postmaoïste", pp 83-99, *Pouvoirs*, n° 81, Paris, April 1997, <https://www.revue-pouvoirs.fr/IMG/pdf/Pouvoirs81.pdf>

Graph 2: Local Government Share of the Total Budget
(2012 - 2021)



Source: Author's calculations based on statistics published on the website of the Ministry of Finance of China.

A second budget consists of **government-managed and largely local funds** – financed by miscellaneous taxes and above all from land sales, or, more appropriately, the sale of long-term leases on land for construction and industries. These land sales are said to represent up to 80% of local budget resources, although the compensation of previous owners of the titles must be factored in. Here, of course, is the key relationship between local governments, supposedly private real estate companies, and promoters of industrial zones.

A third, and far less significant budget, is made of **profit transfers from state-owned enterprises (SOEs)** and is managed by the State-owned Assets Supervision and Administration Commission (SASAC).

A fourth budget, which has grown since the late 1990s, is the **social security budget** involving welfare expenditures (health, retirement, unemployment compensation).

Finally, in the race for local budget resources, there are **extra-budgetary expenses** financed from local government financing vehicles (LGFV), where shadow banking appears. However, if these vehicles are quasi-public, they do not benefit from explicit

state credit backing. Instead, they issue bonds that are purchased by other financial institutions beholden to local authorities – and ultimately resold to the public, including via new wealth management schemes.

This layer cake design, which we have simplified, allows for a lot of obscurities. **Multiple transfers, changes of categories or accounting, numerous side entities mean that statistics are at best approximate, and in some cases guesswork.** As often, the fog tends to lift only when a major default happens. Thus, in a case that is directly related to local public finance, China's largest real estate company, Evergrande, was found in 2021 to have a USD 300 billion debt burden rather than the 80 billion carried in its accounts. The resulting crisis spread to other companies with similar issues, and to a sudden dip in land sales, putting in danger local government budgets.¹⁵

¹⁵ Philippe Aguiñer & François Godement, "Evergrande : quels risques de contagion économique ?", Institut Montaigne, Octobre 12, 2021, <https://www.institutmontaigne.org/blog/evergrande-quels-risques-de-contagion-economique>

IV

BUDGETARY POLICY AND THE MANAGEMENT OF THE CENTRAL-LOCAL RELATIONSHIP

So far, the central government has kept control of the situation, allowing only for slow motion and undeclared defaults in the real estate sector, spreading the debt load around to various categories of creditors and potential rescuers. But **the skill of China's government in avoiding open default for a sector that represents up to 30% of the GDP and to keep in check the resulting gap in local public resources is not only due to sleight of hand maneuvers. It is also the consequence of careful management of public budgets and conservative handling of public credit.** This management has actually anticipated the current debt cycle, curbing the lending that was fueling the bubble. Putting the volume of credit for promoters under control was already much emphasized in 2019, but this may have been insufficient to persuade local authorities and the companies that sought alternative sources. The limits were strongly reaffirmed at the end of 2020 and became a top priority in the spring of 2021. More generally, downward countercyclical policies started as soon as the pandemic receded in mid-2020. They have resulted in money, credit, and budget expansion running in line at best with expected GDP growth – a neutral stand that had, in fact, been official policy since the beginning of 2021.

In fact, **restrictive policies went further in 2021. Actual, as opposed to planned budget outlays, have taken a nosedive, coming in much under announced budget figures for the year.** Even the expected figures for the year had included steep declines for environmental protection (-36.3%), urban and rural community affairs (-27.3%), agriculture, forestry, and water (17.2%). Health spending defied the trend (+19.9%), as one would expect in the context of a pandemic risk and mass vaccination. But the final numbers for 2021 indicate a large overall decline in the general budget expenditures. While the GDP revenue share went 0.33% down (from 18.04% to 17.71%) compared to 2020, the GDP expenditure share went 2.67% down in the space of the same year (from 24.23% to 21.54%).

There is an inescapable conclusion from these trends.

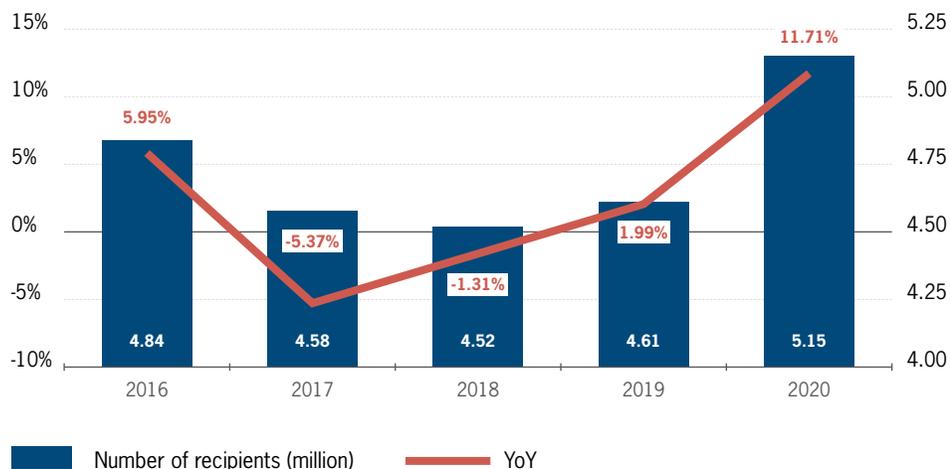
The social downside

First, under Xi Jinping, budget policy at all levels, especially in allocations to local budgets and in social expenditures, has become fiscally conservative, heavily constraining local governments. Were one to forget the rising share of SOEs in the economy, this might justifiably be called a liberal policy shrinking the cost of government. **After a burst of expenditures during the short 2020 pandemic, the curbs on spending have become even more strict.** It happened *before* the government-induced deflation of real estate, although not after the measures taken against large e-commerce platforms. The IMF calls it a “strongly contractionary policy”, prioritizing regulating and deleveraging.¹⁶

Part of this may have unintended consequences. There is an analogy with the other policy move from the top in 2021. **The sudden swing to emissions reduction and decarbonization at the beginning of 2021 contributed to sparking an energy production crisis in the middle of the year.** In a similar way, the strong reconrol of expenditures (along with many investigations into their accounting at the local level) has produced a negative spending and social shock in all but the wealthiest provinces and cities. Anecdotally, this is revealed by reports of deep cuts in local civil servant salaries. **A more ominous sign is the disappearance of many unemployed from the books** – thanks to a massive undercount of migrants who returned to their localities in 2020. Unemployment compensation statistics are hard to interpret. There are figures for the unemployed throughout a given year, but these figures are not broken down according to the duration of unemployment. Overall, the official increase in 2020, the year of the pandemic, was only +11.71% (Graph 3). The total unemployment compensation outlay for the year, while expanding by 50%, is still only 0.21% of GDP (Graph 4). The other major form of social compensation, the *dibao* (低保) or minimum living standard guarantee, a measure directly linked to the poverty alleviation program, slightly increased in 2020 (Graph 5). The number of recipients of *dibao* in cities has receded every year since 2019. The total amount of *dibao* spending in 2020 was only 0.19% of China's GDP.

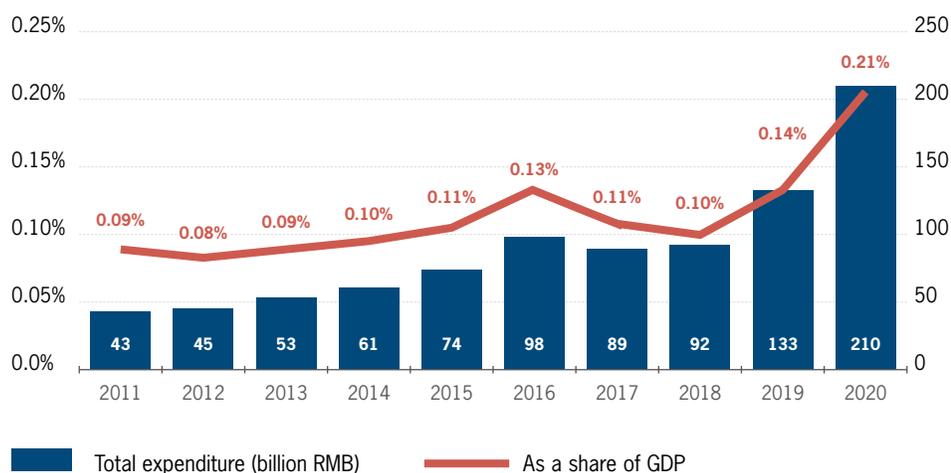
¹⁶ IMF country report, “People's Republic of China: 2021 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China”, January 28, 2022, <https://www.imf.org/en/Publications/CR/Issues/2022/01/26/Peoples-Republic-of-China-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-512248>

Graph 3: China - Number of Recipients of Unemployment Compensation (of different durations) throughout the year (2016 - 2021)



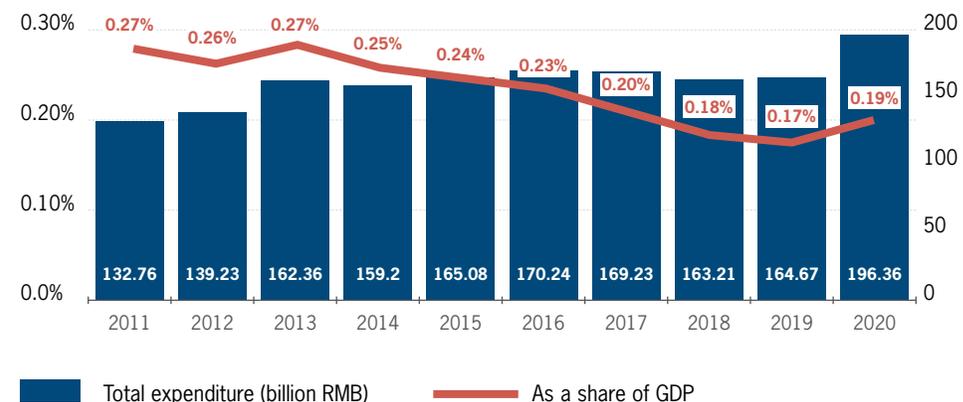
Source: Author's calculations based on statistics published on the website of the National Bureau of Statistics of China.

Graph 4: China - Unemployment Compensation Expenditure (2011 - 2020)



Source: Author's calculations based on statistics published on the website of the National Bureau of Statistics of China.

Graph 5: China - Government Annual Spending on Dibao Program (2011 - 2020)



Source: Author's calculations based on statistics published on the website of the National Bureau of Statistics of China.

The lack of more support for many newly unemployed has been noted both by Chinese economists and by the IMF, which said in its January 2022 Article 4 consultation on China that **“about 230 million migrant workers were left out of urban unemployment insurance benefits”**.¹⁷ China’s executive director at the IMF replied that “in fact, many rural migrant workers have arable lands at home as their backstop, which act as an effective social protection buffer”. A Peking University labor economist writes that the number of new benefit claimants is under the number of the newly unemployed, and suggests that unemployment numbers should take into account changes in migrant flows.¹⁸

Under Xi Jinping, in spite of the celebrated policy of poverty alleviation, which included developmental goals, income distribution has become increasingly unequal, and redistribution through public budgets has diminished. The pandemic and the real estate crisis have accentuated these trends, both for wages and income subsidies.

¹⁷ Ibid.
¹⁸ Lu Feng, “An Evaluation of China’s Labor Market Recovery and the Outlook for the 2022 Employment Situation”, China Finance 40 Forum, January 11, 2022, <https://archive.fo/JQ9kh>

The reappearance of the Common Prosperity slogan in the summer of 2021 has been mostly understood abroad as an assault on excessive wealth and its displays. However, **it may not have been understood that the Common Prosperity campaign also serves to counter the impact of negative welfare trends.** In an August 2021 speech on common prosperity, Xi Jinping mentions the need for better household registration of migrant workers, and pay raises for civil servants, “especially at the local level”: these are indeed key social issues in 2021.

But Xi makes it clear that China should not “go overboard with social security, and steer clear of the idleness-breeding trap of ‘welfarism’.¹⁹” overall emphasis is on hard work and moving up the ladder via better education. Increases in social expenditures have to be gradual, and Xi declares that **“it is inadvisable to quantify targets like we did in the poverty alleviation campaign.” Medical and pension systems must be “refined,” and the emphasis is on coordination and rationalization.** A long-overdue reform such as real estate tax (inexistent except in a few recent pilot cases) is to be pursued in a “prudent” manner. “Unreasonable,” “excessive,” “unlawful” incomes must be put in check, but there is no sense of a strong redistribution policy.

PRESERVING CONSERVATIVE FISCAL AND BUDGET POLICIES

In fact, social expenditures are again secondary to the need to preserve budget balance and fiscal conservatism.

In a new phase, as the real estate crisis takes its bite in the fourth quarter of 2021, officials like to invoke what they call “cross cyclical” (跨周期) policies rather than a countercyclical approach to foster growth. By that, they mean **early but limited easing measures and sectoral rather than across-the-board support, meant to preempt a downturn and to inspire public confidence.** Of course, this light touch presupposes that investors and the public react positively to small signals. Evidently, the choice is also designed to avoid another opening of the flood gates. This had happened in 2008 with the global financial crisis – and the massive rise in indebtedness that followed the government’s proactive countercyclical policy of the time.

This management should not come as a complete surprise. The regulations recentralizing fiscal revenue in 1994 had explicitly obligated local budgets to avoid deficits. Over time, this is what made the transfer of revenue from the center a necessity, in what has been called a “grand bargain” between the central government and local authorities.²⁰ As transfers and new income categories allow local governments to spend more, the public debt grows, and a new cycle of control begins. **China’s public finance and debt have always been cyclical in nature, a fact well known to policymakers.** But, over time, the stakes have grown with the scale of the economy and its financial sophistication.

Since early 2020, there have been debates on the need for more proactive choices which also apply to monetary policy. It was again the case at the end of 2021. However, these debates are low key and, as far as we can see, only among economists. Interestingly, a group such as the Finance 40 Forum published in January

¹⁹ Xi Jinping, “Firmly promote common prosperity (扎实推动共同富裕)”, Qiushi, October 15, 2021, <https://archive.fo/aoKAS>

²⁰ Adam Y. Liu, Jean C. Oi, Yi Zhang, “China’s Local Government Debt: The Grand Bargain”, *China Journal*, December 6, 2021, <https://www.journals.uchicago.edu/doi/10.1086/717256>

2022 a collective, yet anonymous, advocacy of a more proactive budget policy in the current low-interest environment, citing Olivier Blanchard and criticizing the European Union for its restrictive budget policies after the 2008 subprime crisis.²¹ **The piece never refers to China's experience but may be understood as a veiled criticism of China's own conservative budget policy.** Another expert argues that China's export strength and the strong inward foreign direct investment allow for a much more proactive policy, including lower interest rates.²² In his view, preserving flexible exchange rates would be the key to maintaining a differential in returns with the US and avoiding a capital outflow. This interesting idea flies in the face of the political leadership. It not want to over-rely on external markets, nor does it want to trigger accusations of currency manipulation.

In reality, most decisions lean toward preserving restrictive policies and a very minimal loosening of the purse's strings. **The 2019-2021 period delivered a new twist. The government has moved preemptively on several fronts to cool different sectors of the economy:** e-platforms, construction and infrastructure investment, local government expenditures. As a result, much of the 2021 real estate and local finance crash is not the consequence of a speculative market bubble burst, but of a voluntary preemptive move by the government to deflate this bubble before its explosion.

While Xi Jinping's policies are generally considered to favor the state and SOEs, he has not increased public and social expenses in the manner of his predecessors, Hu Jintao and Wen Jiabao, who put in place general social security and pension schemes. Instead, he has relied on regulations and control to improve the governance and the institutions of existing schemes. **In a fascinating account of these different stages of budget reforms, Christine Wong shows the trend under Xi towards micromanagement from the top** – with social expenditures and goals broken down into many categories and with a precise allocation of tasks between the center and the local governments.²³ Control from the top has resulted in increased spending gaps at the local level. Only a few rich provinces have been able to more or less break even: this before the 2021 real estate crisis. In the 2000-2010 decade, local revenue and expenditure grew faster at the local level than at the central level, and net transfers to localities grew even more. The trend continued in 2010-2014,

except for net transfers to localities. After 2015, the trend is reversed, with the growth in local revenue and expenditures under that of the central government's. Net transfers to local budgets have also slowed down. The trends show up less convincingly in results, as per our graph 2 above: but the intent is there.

Graph 6: Change in Revenue, Expenditure and Transfers
(Annual Growth, Price Adjusted)

	Panel A: Revenue			Panel B: Expenditures			Panel C: Net transfers
	Total	Central	Local	Total	Central	Local	
2000-2010	20%	19.8%	20.3%	18.9%	11.2%	21.7%	26.8%
2010-2015	12.9%	10.3%	15.4%	14.4%	9.8%	15.3%	13.1%
2015-2019	5.7%	6.6%	5.0%	8.0%	8.3%	7.9%	5.9%

Source: Christine Wong, "Plus ça Change: Three Decades of Fiscal Policy and Central-Local Relations in China." *China: An International Journal*, vol. 19, no. 4 (2021): 1-31. muse.jhu.edu/article/839228.²⁴

21 "In a low interest rate environment, completely rethinking fiscal policies (全面反思低利率环境下的财政政策)", Finance 40 Forum, January 25, 2022, <https://archive.ph/deBj9>

22 Zhu He, "2021 monetary policy review and outlook on 2022 (2021年货币政策回顾与2022年展望)", Finance 40 Forum, January 18, 2022, <https://archive.fo/30SKO>

23 Christine Wong, "Plus ça Change: Three Decades of Fiscal Policy and Central-Local Relations in China", *China: An International Journal*, vol. 19, no. 4 (2021): 1-31. <https://muse.jhu.edu/article/839228>

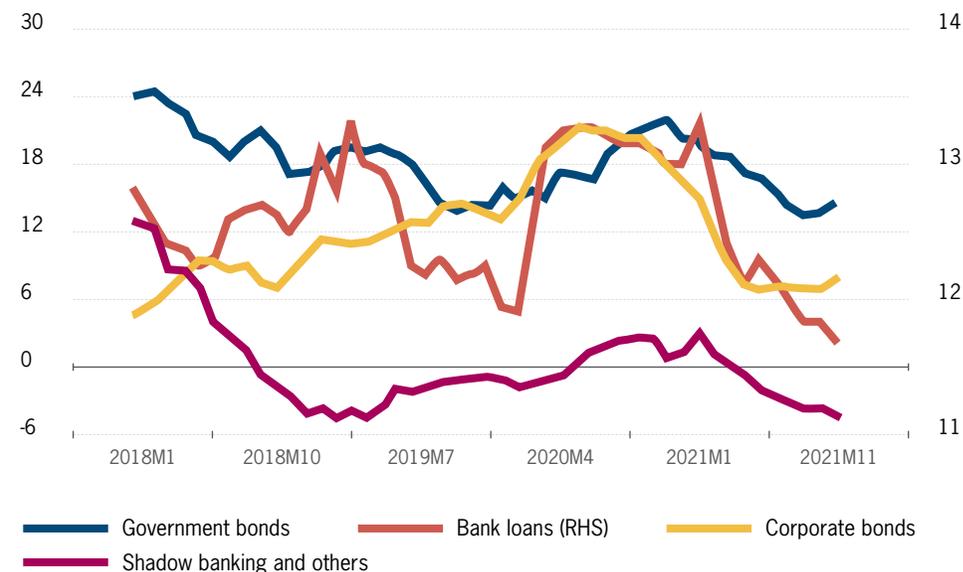
24 Over time, Christine Wong's writings have been a source of inspiration. We have occasionally used her graphs and extended them to include, whenever possible, the entire year 2021.

MONETARY AND CREDIT POLICIES

Budget policy is not the only resource available to the government for support to the economy. Monetary policy enters the picture. The findings there are not very different from those regarding public budgets. **We have gone through a successive cycle of monetary tightening and light monetary easing.** The first started in May-June 2020. The growth rate of M2 slowed down from +11.1% to +8.1% between April 2020 and April 2021. M1 expansion crashed from +14% in February 2021 to +3% in November of the same year. Total social financing available to the economy, a measure of credit expansion, has slowed from +14.5% in February 2021 to 6% in September (Graph 7). The yield of ten-year government bonds increased from 2.5% in April 2020 to 3.3% in December 2020. Again, these trends happened simultaneously with the contraction in budgetary expenditures. They go a long way to explain the economic slowdown of the second half of 2021.

26

Graph 7: TSF Growth Rates by Component
(In percent, YoY)



27

Source: People's Republic of China: 2020 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China", International Monetary Fund, January 28, 2022, <https://www.imf.org/en/Publications/CR/Issues/2022/01/26/Peoples-Republic-of-China-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-512248>.

In the other direction, some loosening started from the July 30, 2021 Politburo meeting. Although in coded language, the meeting reportedly concluded that “the proactive fiscal policy should generate greater effect, while the prudent monetary policy should maintain reasonably ample liquidity and support the continued recovery of small and medium-sized enterprises as well as stressed industries.”²⁵ **Everything was said in a single sentence: fiscal policy is not sufficiently proactive, monetary policy should ease within limits, support to the economy should be sectoral rather than broad-based, and since SMEs and the informal sector lost out to SOEs and large private companies during the pandemic...**

²⁵ “CPC leadership holds meeting to study economic work”, *Xinhua*, July 30, 2021, <https://archive.fo/pp2U1>

²⁶ Special bonds are meant for capital investment in infrastructures.

²⁷ “China front-loads 2022 special bond quota to sustain growth”, *National Development and Reform Commission (NDRC)*, December 27, 2021, <https://archive.fo/WNdhd>

Since that date, reserve requirements ratios (RRR) for banks have been cut twice by 50 basis points, in August and December 2021. The central bank also cut its one-year loan prime rate (LPR) by 10 basis points twice in December 2021 and January 2022. In January, it also announced a more limited 5 basis points cut in the five-year LPR, which often serves as a reference to mortgages. Additionally, reverse repo rates have also slightly fallen.

These measures represent a step-by-step loosening, as much designed **to signal a supportive stance to the economy and to debtors as to preserve a cautious stance in the name of stability.**

Financial institutions may be doing more in practice to support a flagging domestic economy. **The actual issuance of public bonds will go faster in early 2022.** Reportedly, China's Ministry of Finance (MoF) has allowed local governments to issue special bonds²⁶ of CNY 1.46 trillion (USD 229 billion) in the first quarter of the year.²⁷ For a comparative basis, local governments were allowed to issue CNY 3.65 trillion in 2021, a level that was almost reached, but with some catch-up in the 4th quarter of 2021.

Of course, this short overview cannot do justice to the full range of credit policies. But, it makes the point that **the trends in budget policy are not a fluke. Instead, this is an overall coordinated policy – albeit with the usual exaggeration or underperformance at local levels.** As we enter 2022, an obvious question is what actual support will be given to indebted local governments. Another question is how much of this will be subordinated to the goals of the central government – from infrastructure construction to greening, SMEs and high technology projects. And how much will simply be used to unwind quietly the fallout from the real estate crisis.

These questions currently remain unanswered. However, they will be central to judge **whether Xi Jinping and his supporters can continue their targeted support for ambitious sectoral change in the economy while maintaining an overall conservative and cautious budget and financial stance.** Additionally, it will be interesting to assess how much they will need to focus merely on support for the economy – as voiced above by Yu Yongding: “CNY 100 trillion of GDP is CNY 100 trillion of GDP”.

²⁶ Special bonds are meant for capital investment in infrastructures.

²⁷ “China front-loads 2022 special bond quota to sustain growth”, *National Development and Reform Commission (NDRC)*, December 27, 2021, <https://archive.fo/WNdhd>

There are more margins for government action and support to the economy than generally recognized. But the prevailing policy is to use these margins very selectively and only as they become necessary to prevent a contraction of the economy. There was always a contrast between central cautiousness at the center and what passes as profligate spending or borrowing by local governments. In fact, this is often a consequence of tasks pushed down at the local government level. In previous phases, the central government has made up the gap, and/or allowed local governments to find new sources of revenue.

Nevertheless, this time is different. After two decades of *de facto* decentralization following the recentralisation of 1995, the center has called the game of local governments with budget cuts followed by credit cuts and finally a hands-off attitude in the first phase of a real estate crisis that it seems to have initiated. In this phase, Xi Jinping appears to be a fiscal and financial hawk, and his government seems preoccupied with the moral hazard implicit in coming to the rescue of local governments. In a second phase, it is beginning to release some support, but this will also imply a centralized control of resources. **The pain at local levels is much more intense than in 1995 because there has been no *quid pro quo* between central and local authorities until the end of 2021.**

Relief is now on the way, but on the central government – and Xi Jinping's – terms and in a limited fashion. It is not only an issue of the perpetual struggle for control between central and local levels in China. **It is also a function of Xi Jinping's overall philosophy: minimize the risks from a dependence on the outside world that more central indebtedness would bring, stay ready for the possibility of a major geopolitical or geoeconomic crisis on the world stage.** Other policies, such as the accent on food security, go in the same direction. Simultaneously, the state is to keep its focus on critical transformations, such as technological upgrading, energy transition, digital governance, and connectivity.

Should an accident happen – and the most likely black swan at this moment is a surge of Omicron, which the authorities are adamant to avoid at any cost – the previous conservative stand described above, and the margins of action that have been preserved, would come in useful.

The other accident, of course, would be a failure to control this highly complex and contradictory policy. **Support but within limits, prevent moral hazard but**

avoid a meltdown, work towards common prosperity but avoid “welfarism”:

on the receiving end of these policies, there are people, and in an ever-increasing authoritarian atmosphere, failures will be the Party's and singularly Xi Jinping's. This will also play out in the long term. But for the time being, the man with the visionary policies focuses on “stability” for this year, and he has given his apparatus the means to preserve it.

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THERE IS NO DESIRE MORE NATURAL THAN THE DESIRE FOR KNOWLEDGE

Xi Jinping as an ordoliberal: China's margins for growth in 2022

Since the Covid outbreak of early 2020, and even more since early 2021, China has maintained **restrictive policies for the public budget, credit, and interest rates**. This is a striking divergence with all other large economies engaged in large-scale quantitative easing, and is also in contrast with China's long-term slowdown in growth.

However, China's **export growth** continues and even accelerates, defying the judgment that it was a consequence of **China's niche positioning during the pandemic**. Some Chinese economists argue that this provides safety for a more supportive budget, credit and monetary policy. This opinion is clearly not followed by the government. The note explains the reasoning behind this **persistent contractionary government policy and the potential for change in 2022**.

Within this restrictive policy, certain social expenditures have taken the brunt of budget austerity since 2014. The central government has initiated in **2020-2021 a credit crunch** that has led to a real estate crisis and threatens the revenue of local governments. There is clearly a **coordinated policy** on budget, monetary and credit issues. This policy has gone through a cycle of tightening, now followed by very limited easing.

There are more **margins for government action and support** to the economy than generally recognized. But the prevailing policy is to use these margins **very selectively and only as they become necessary to prevent a contraction of the economy**. Support is also intended to further the central government's goals – from energy transition to innovation.

Chinese officials mention the risk of a geopolitical or a geoeconomic event on the international scene. Should this happen, the conservative stand and the margins of action that have been preserved would come in useful, **providing China's leadership with a feeling of invulnerability**.

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Institut Montaigne

59, rue La Boétie - 75008 Paris
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