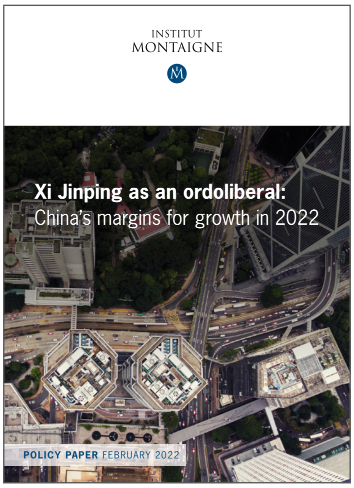
INSTITUT MONTAIGNE

Executive Summary



Since the coronavirus outbreak of early 2020, and even more since early 2021, China has maintained restrictive policies for the public budget, credit and interest rates. There may therefore be more margins for government action and support to the economy than generally recognized. **This note intends to evaluate the reasoning behind this persistent contractionary government policy, and the potential for change in 2022.**

I. 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.** Goldman Sachs has diminished its forecast for 2022 from +4.8% to +4.3%, and the IMF has reduced its growth forecast from 5.5% to 4.8%. GDP growth in China had averaged 9.44% annually between 1978 and 2018. China's consumer price index (CPI) only rose by 0.9% in 2021, suggesting major issues with growth.

Not all trends point in this direction. Since the pandemic started, trade economists have forecasted China's **trade surplus rebound** as a one-off event. Yet, this continues and even accelerates. **FDI and other capital flows to China** are also buoyant, and short-term interest rates remain attractive.

These strengths provide the Chinese ship in 2022 with **a stabilizing keel that prevents it from capsizing.**

II. The available margins in 2022

At what point are we in the current cycle of expansion and contraction? This may provide the answer to what **margins for support are still available at the onset of 2022.**

China has been more conservative than all other large economies since the coronavirus epidemic took hold. Moreover, the general budget had been running behind GDP growth ever since 2014. It has decelerated even more in 2021, with expenditures falling faster than receipts.

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 needs.** Social expenditures related to welfare, health, education and unemployment have had a dwindling share of the budget since 2014.

This is also the consequence of a decision to guard against possible geopolitical shocks. The combination of monetary, fiscal, and credit conservatism with a large export surplus, **provides China's leadership with a feeling of invulnerability.** It therefore focuses on production, while other major economies shoulder the burden of lifting demand.

III. The structure and balance of China's public budget

China's public budget comprises four elements:

- The **"general budget",** itself made of a central budget and local budgets, with transfers in both directions;
- The budget of **government-managed and largely local funds,** – financed by miscellaneous taxes and above all land sales;
- The budget made of **profit transfers from state-owned enterprises** (SOEs);
- The **social security budget,** which involves 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.

This layer cake design, which we have simplified, allows for a lot of obscurities. As often, the fog tends to lift only when a major default happens.

IV. Budgetary policy and the management of the central-local relationship

The skill of China's government in avoiding open default for a sector and to keep in check the resulting gap in local public resources is not only due to **sleight of hand maneuvers,** but also the consequence of **careful management of public budgets and conservative handling of public credit.**

Downward countercyclical policies started as soon as the pandemic receded in mid-2020, resulting in money, credit, and budget running in line at best with expected GDP growth. In fact, the final numbers for 2021 indicate a further overall decline in the general budget expenditures: its GDP expenditure share went 2.67% down compared to 2020.

There is an inescapable conclusion from these trends: **the social downside.**

After a burst of expenditures during the short 2020 pandemic, the curbs on spending have become even more strict, leading to a social shock in all but the wealthiest provinces and cities.

In spite of the celebrated policy of poverty alleviation, **income distribution has become increasingly unequal, and redistribution through public budgets has diminished.** The total unemployment compensation outlay for 2020, is only 0.21% of GDP. The *dibao*, or minimum living standard guarantee, has hardly moved up in the same period and is only 0.19% of GDP.

The reappearance of the Common Prosperity slogan in the summer of 2021 has been seen abroad as an assault on excessive wealth and its displays. However, it may not have been understood that the campaign also serves to counter the impact of negative welfare trends. **There is no sense of a strong redistribution policy, and Xi Jinping has decried "welfarism".**

V. Preserving conservative fiscal and budget policies

In a new phase starting in the fourth quarter of 2021, **officials invoke early but limited easing measures and sectoral rather than across-the-board support, to preempt a downturn, inspire public confidence and foster growth.** Evidently, the choice is also designed to avoid another opening of the flood gates, as had happened with the 2008 global financial crisis. At the time, the government's proactive countercyclical policy resulted in a massive rise in indebtedness.

Since early 2020, there have been debates on the need for more proactive policies, which also apply to monetary policy. But 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. 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.

VI. Monetary and credit policies

Budget policy is not the only resource available to the government for support to the economy. Similar to the budget policy, we have gone through a successive cycle of monetary tightening and light monetary easing. 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. A number of other measures, including lower reserve requirement ratios (RRR) for banks, are a step-by-step loosening. They signal a supportive stance while preserving a cautious stance in the name of stability. **This short overview 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.

Conclusion

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 cautiousness at the center and what passes as profligate spending or borrowing by local governments. But **this time, the pain at local levels is much more intense** 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, but also a function of **Xi Jinping's overall philosophy: minimize the risks from a dependence on the outside world, and stay ready for the possibility of a major geopolitical or geoeconomic crisis.**

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.**