CHINA

A DIFFICULT SPRING TIME

Economic activity contracted in April and May 2022 as a result of severe mobility restrictions imposed in industrial regions such as Shanghai. Since late May, these restrictions have been gradually lifted, and activity has begun to bounce back. However, downside risks to economic growth remain high. The authorities therefore continue to ease their policy mix cautiously. On the fiscal front, support measures remain focused on infrastructure projects and aid to enterprises. On the monetary front, interest rates have been cut since the beginning of the year, and targeted lending programmes have been extended. However, the effectiveness of the central bank's action is reduced by the weak demand for credit. Moreover, the international environment and the risks of capital outflows could limit its room for manoeuvre.

Economic activity contracted in April and May 2022 because of the resurgence of the Covid-19 epidemic and the severe mobility restrictions imposed across major industrial and port regions such as Shanghai. Since late May, these restrictions have been gradually (but not completely) lifted, and activity has begun to recover. Industrial production bounced back (increasing by 0.7% year-on-year in May), thanks in particular to the recovery of exports. Activity in services continued to contract in May (-5.1% y/y), since it was affected more severely by the spring lockdowns, and for a longer period (chart 1). Retail sales volumes also continued to fall in May (-9% y/y). Meanwhile, investment growth accelerated, driven by infrastructure projects.

NUMEROUS CONSTRAINTS ON ECONOMIC GROWTH

Economic growth should recover in the short term, but downside risks remain high. Firstly, the health situation remains uncertain and the authorities are set to maintain a zero-Covid strategy at least until the end of the year (even though local governments were sent directives at the start of June with a view to lowering the risk of excessive restrictions). The threat of further lockdowns should continue to weigh on confidence and demand from households and corporates.

Moreover, private consumption will suffer as a result of the slack in the labour market. The unemployment rate rose from 5.1% at the end of 2021 to 6.1% in April 2022, falling back to 5.9% in May. It is higher for migrant workers (6.2% in May), as well as in the 31 major Chinese cities (6.9% in May). More worryingly, the unemployment rate for young people aged 16 to 24 reached a record high in May, standing at 18.4% vs. 14.3% in December 2021. And the situation could deteriorate further during the summer when new graduates are set to enter the labour market.

Real income growth is likely to be affected by the weak labour market conditions. Meanwhile, the negative effect of rising consumer prices on household purchasing power is expected to be moderate. The CPI only increased by 2.1% y/y in April and May. Core inflation is low (0.9%) owing to sluggish domestic demand, while rises in food and energy prices remain limited despite global tensions, as a result of the continued fall in meat prices and partial controls on grain and energy prices.

Furthermore, the crisis in the property and construction sectors continues, hampering employment, investment and the consumption of durable goods. For example, newly-started projects and property transactions collapsed by 40% and 32% y/y, respectively, in May, and by 31% and 24% over the first five months of 2022 compared to the same period in 2021. Measures have been introduced to encourage transactions and help property developers complete projects already off the ground. Yet, the authorities are maintaining their objectives to bring down housing costs and deleverage developers.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	6.0	2.2	8.1	3.7	5.7
Inflation, CPI, year average, %	2.9	2.5	0.9	2.3	2.7
Official budget balance / GDP, %	-2.8	-3.7	-3.1	-2.8	-3.0
Official general government debt / GDP, %	38.6	45.9	47.0	50.3	52.0
Current account balance / GDP, %	0.7	1.7	1.8	0.8	0.9
External debt / GDP, %	14.5	16.3	15.5	16.5	15.8
Forex reserves, USD bn	3 108	3 217	3 250	3 220	3 240
Forex reserves, in months of imports	14.9	16.2	12.6	10.8	10.0

E: ESTIMATIONS ET PRÉVISIONS

TABLE 1 SOURCE : BNP PARIBAS RECHERCHE ECONOMIQUE GROUPE

CHINA: RESTARTING

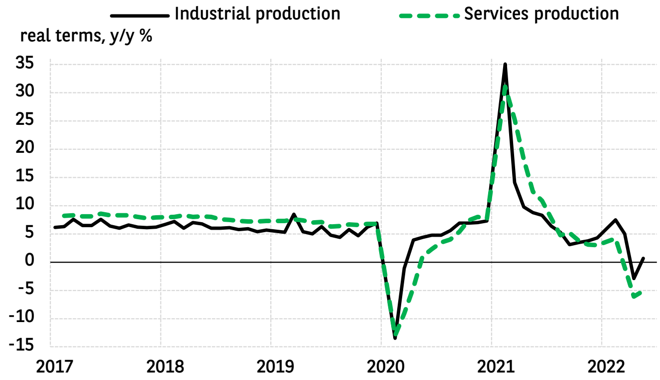

CHART 1 SOURCE: NBS, BNP PARIBAS

Finally, export growth rebounded in May (up 16.8% y/y vs. 3.7% in April) and should strengthen in the short term thanks to a reduction in logistics problems. However, China's export sector is unlikely to be the same powerful driver of growth in 2022 as it was in 2021, given the slowdown in global demand growth. In its April World Economic Outlook, the IMF predicted that global trade volumes will grow by 5% in 2022 and 4.4% in 2023, compared with 10% in 2021.

FISCAL SUPPORT FOCUSED ON ENTERPRISES

In order to counteract the multiple constraints on economic growth, the authorities continue to ease their policy mix. They have maintained a relatively cautious strategy in recent months, supporting the economy through a gradual process of easing and targeted actions, rather than with wide-ranging stimulus packages.

On the fiscal front, support measures have been gradually implemented since the last quarter of 2021. They essentially consist of new investments in infrastructure projects (most often undertaken by local governments) as well as aid to enterprises. In particular, this aid includes measures aimed at supporting SMEs and the manufacturing sector through tax cuts, subsidies and the deferred payment of social security contributions.

One of the few measures designed to support private consumption is the cut in tax on the purchase of private cars, which was included in the new package of measures announced in late May. Some provinces have also made cash payments to households (in digital yuan in some cases such as Shenzhen), but the total amount of these is small.

Local governments may find it increasingly difficult to finance stimulus measures. Since the beginning of this year, they have been faced with a drop in both their tax revenue and land sales proceeds. For the time being, however, China's central government has not increased their authorised bond issuance quotas for 2022[1]. On the contrary, Beijing seems to be putting pressure on local governments to contain their debt growth by better managing their accounts and containing current spending.

« Direct » debt held by local governments (i.e. explicitly budgeted) already increased from 21.6% of GDP at the end of 2019 to 27.6% at the end of Q1 2022 – whereas central government debt stands at just 20% of GDP. Moreover, to this direct debt can also be added the « indirect » debt associated with local government financing vehicles, which the IMF estimates at approximately 45% of GDP. The fragility of local government finances explains the cautious fiscal support policy.

DEMAND FOR CREDIT REMAINS WEAK

Interest rates on loans and money market rates have decreased since December 2021[2]. However, the central bank's scope to reduce rates further is reduced in the current global context, not so much because of local inflationary pressures but because of the risk of capital outflows. In fact, China suffered a loss of investor confidence and large portfolio investment outflows in March 2022, contributing to fall in the yuan's exchange rate after more than 18 months of appreciation (chart 2). In the short term, the central bank should seek to avoid a repetition of such episodes of instability and encourage foreign capital inflows in spite of the tightening of the US Federal Reserve's policy.

In addition, the authorities are making extensive use of credit policy instruments such as loan quotas for banks and targeted lending programmes. These programmes notably aim to support SMEs, rural areas and the sectors that have been hit by the Covid crisis. Moreover, the conditions for mortgage loans and short-term financing of property developers have been slightly eased.

CHINA: EXCHANGE RATE ADJUSTMENT

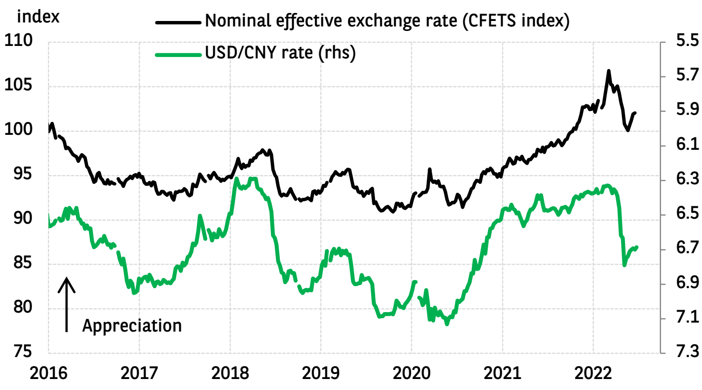

CHART 2

SOURCE: CHINA FOREIGN EXCHANGE TRADING CENTER, CEIC

However, the effectiveness of monetary and credit policy is constrained by the weak demand for loans in the currently uncertain economic environment. Growth in total credit to the economy (social financing) has actually barely recovered in the last six months. It went up from 10.3% y/y in nominal terms in December 2021 to 10.5% in May 2022, mainly driven by the acceleration of bond issues.

Article completed on 27 June 2022

Christine PELTIER
christine.peltier@bnpparibas.com

1 In the 2022 budget, the Ministry of Finance authorised local governments to issue RMB 3,650 bn of new «special» bonds and RMB 720 bn of new «general» bonds. Therefore, the total amount of new bond debt forecast for 2022 is estimated at 3.6% of GDP, a drop from the level in 2020 (4.5% of GDP) and 2021 (3.8%).
2 Since December 2021, the prime rate on 1-year loans has declined from 3.85% to 3.7%, the prime rate on 5-year loans from 4.65% to 4.45%, and the 1-year MLF rate from 2.95% to 2.85%. The 7-day repo rate has fallen faster since March, declining from a monthly average of 2.16% in December to 2.09% in March 2022 and 1.64% in June.