ARTICLE FOR THE EDGE

CAN CHINA TURN AROUND ITS ECONOMY?

China is facing one of its most difficult domestic and international situations in decades. This has compelled its leaders to adjust policies but, because they face domestic challenges that require sometimes conflicting policy measures, policy actions have been cautious and contradictory. This raises questions as to whether their measures can successfully avert a damaging slowdown.

As a result, the rest of the world should prepare itself for more fallout from China's economic travails: global economic growth could slow; emerging market currencies could come under pressure if the Chinese Yuan were to depreciate further; and depressed investor and business confidence could undermine investment which is already faltering because of tightening monetary policies and the geo-political uncertainties caused by the Ukraine crisis.

Government policies had weakened the domestic economy even before the current covid wave

China's economy had already been slowing since late 2021 because of well-intentioned policies meant to tackle underlying structural problems. The authorities had pressed banks and other financial institutions to be more cautious in lending so as to reduce China's high leverage. They had also tried to cool the real estate sector by imposing restrictions on developers because they were worried about the imbalances in this sector. In pursuit of President Xi Jinping's desire for a fairer society which practised "common prosperity", government agencies had also cracked down on private firms citing the need to prevent dominant business groups from misusing their market power, especially Big Tech. All these measures resulted in weaker investment and slower economic growth. Xi and his colleagues were prepared to tolerate this so long as employment and the incomes of ordinary folks were largely protected.

Xi's calculations were upset, however, by the increasingly hostile external environment. Russia's invasion of Ukraine caused energy and food prices to soar and created political and supply chains dislocations which undermined global economic activity. Nervous global investors pulled capital out of China and other emerging markets, causing China's Yuan to weaken. To top it all, China now faced a menacing challenge from rising covid-19 infections which have prompted local authorities in economic hubs to impose stringent restrictions on activities, severely disrupting production and consumption. Even production zones unaffected by the new infection waves have suffered because components sourced from affected areas are unavailable and because cargo traffic by road, rail and sea have been retarded.

Thus, economic output in the second quarter of this year will almost certainly contract from the level in the first quarter. The latest purchasing manager surveys for April make for grim reading. The manufacturing sector has lost momentum while the services and construction sectors have almost certainly contracted. The lead indicators such as new orders are down, suggesting no relief in coming months. Job losses are also a growing concern.

Appreciating the magnitude of downside risks, the political leadership has now signalled a more forceful commitment to boosting the economy.

- Last week, President Xi Jinping personally recommitted his government to large-scale infrastructure spending. From the press releases, it looks like the infrastructure push could be a big one, although there are few details.

- Prime Minister Li Keqiang has also outlined wide-ranging measures to support distressed segments of the economy. Temporary subsidies will be given to migrant workers and fresh college graduates. Small-medium firms will be allowed to delay pension and other compulsory government payments as many of them are struggling. Rural folks will be helped by government projects in farming, water conservation and rural road building schemes.

- Xi and other policy makers have also reassured big tech companies that the crackdown will be eased. A symposium involving the major tech players will be convened after the Labour Day holiday to provide these important companies with more details.

- An even greater sense of urgency was evident in last Friday's Chinese Communist Party Politburo statement which called on the government to accelerate the implementation of policies, implement tax rebates, tax and fee cuts and other policies, and make good use of all kinds of monetary policy tools.

These announcements follow a steady drumbeat of smaller-scale policy commitments in recent weeks and signal a shift towards more expansionary policies. But it is important to note that this policy shift is not akin to the gargantuan stimulus package in late 2008 to tackle the global financial crisis. This revised policy direction is primarily meant to ensure political stability by targeting aid to parts of the populace where distress might stir dissent. It is not targeting economic growth *per se*. Hence the very selective nature of the measures and their focus on urban migrants, fresh graduates and farmers.

Five factors will impede policy effectiveness and coherence

The measures that have been announced so far should help prevent a downward spiral in the economy but the result will still be a mediocre economy beset with difficulties.

First, covid hot spots are unlikely to be quickly contained: Shanghai has struggled to bring the covid infection surge under control. While the number of new infections is declining, new covid cases in unguarded zones have remained at levels which worry the local government – cases in these areas indicate the prevalence of the virus in general areas, which means that new outbreaks would still remain likely. Moreover, hot spots are emerging in other parts of the country. Beijing is imposing progressively harsher measures to get its spike in infections under control. Other economically significant areas are also beginning to impose restrictions on activity as new infections emerge – Zhengzhou being the latest.

Second, consumers remain nervous and unwilling to spend: The central bank's recent survey showed that households' propensity to save rose to an all-time high in the first quarter of this year. It strikes us that consumer psychology has been so damaged by recent developments that great caution prevails. In particular, consumers are wary of taking on more loans – this is why the government's measures to encourage banks to extend short-term consumption loans probably will not work well. Other measures such as giving tax cuts to firms in the hope that they hire more workers and so indirectly boost consumption are also not likely to be effective. This is why local governments are now dishing out consumption vouchers to households, so as to more directly boost spending. This will help but, given the weak consumer psychology, we do not expect a significant boost to consumer spending.

Less confident consumers are also going to be less inclined to buy homes. Thus, existing stresses in the real estate sector could be amplified. Note that the central bank survey mentioned above also showed that homebuyers' expectations for home price appreciation had declined to levels last seen in 2015.

Third, local government officials and bank credit officers are not incentivised to support stimulus. Infrastructure spending will only jump-start the economy if local officials move expeditiously to implement projects. But, they have been extremely hesitant to do so – despite substantial increases in funding availability in January and February, other indicators of construction activity have remained in the doldrums, such as sales of excavators and heavy trucks, which have remained well below normal levels.

It is not difficult to see why this is the case. Local government officials know that this is the season for promotions and demotions. Why would they take risks by issuing contracts or awarding tenders that might not sit well with the rigorous guidelines on the commercial viability of infrastructure projects imposed on them? The best course of action for a risk-averse official is to do nothing. The increasing frequency of crackdowns on corruption, with the financial sector being the latest target, also suggests that credit officers at banks will be leery of stepping up lending to firms despite exhortations from the central leadership.

Moreover, the sacking of local officials over their inadequate responses to COVID-19 suggests that officials will continue to overreact to localised Omicron outbreaks by instituting harsh, growth-crushing lockdowns, making the policymakers' desired finetuning of their dynamic zero-COVID strategy harder to achieve. We expect rolling lockdowns and mobility restrictions to worsen labour and raw material shortages, impeding the ramp-up of infrastructure activities and continuing to depress consumer psychology and business sentiment.

Fourth, private businesses are unlikely to regain confidence so quickly: Mixed signals from the leadership will keep private entrepreneurs unconvinced of the shift in the government's attitude towards the private sector. Even as the technocrats were reassuring entrepreneurs that the crackdown would be eased, President Xi was calling for stronger antimonopoly action against platform companies. His strictures against the "disorderly expansion of capital", code word for allowing private firms to operate freely, would have sent a shudder down the spines of big businessmen. Xi's comments reflected a suspicion of private enterprise – he insisted that "By its nature, capital pursues profits, and if it is not regulated and restrained, it will bring immeasurable harm to economic and social development,…".

Fifth, policy differences and challenging trade-offs also limit policy effectiveness: The lack of details on additional stimulus is probably due to policy differences between different groups in government: For instance, Liu He, China's top economic and financial official, has supported moves to ease pressure on the real estate sector – concerned that mounting financial stresses could tip the entire economy into a crisis. However, vice-premiers Han Zheng and Hu Chunhua are reportedly wary of his support for easing restrictions on the real estate sector. Liu He and central bank governor Yi Gang are also said to be wary of the debt binges that typically accompany infrastructure largesse.

Conclusion: implications for the rest of the world

In short, it does not look as if the shift to more expansionary policies in the past week will suffice to turn the economy around. The key economic agents – consumers, home buyers, private businesses, local government officials, and financial institutions – are unlikely to repurpose themselves to sizably raise domestic demand. China can probably eke out *true* growth of about 3-3.5%, but the economy will continue to suffer from a range of stresses ranging from rising corporate defaults to supply chain dislocations to failing SMEs and a downbeat consumer.

China's global footprint is large today. It represents around 18% of world output and 10-11% of global imports. China's slowdown will hurt everyone as a result:

- Weaker demand will translate into slower growth in export demand for economies that are deeply connected to China, such as east and southeast Asia as well as export powerhouses such as Germany and a whole range of commodity exporters. In addition, there will be more supply chain dislocations by late May or June as the current port congestion and disrupted transportation in China feeds through to supplies of key components.

- Unless there are geo-political shocks such as a European ban on importing Russian oil and gas, China's slowdown could mean lower prices for oil and other raw materials. That would offer some respite to energy importing countries. But exporters of other commodities may suffer lower revenues.

- Growing concerns about China could lead to more capital outflows from China and further Yuan weakness. That would put pressure on currencies of other emerging economies, especially those in Asia.

In other words, the rest of the world must hope desperately that the Beijing authorities will cast aside their hesitancy and move more vigorously to boost their economy.

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