How to Consolidate the Upward Trend of China's Economic Recovery[1]

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Abstract: While China's economy is back on track toward recovery, three potential risks in the second half of 2022 should be watched closely: first, the lingering COVID-19 pandemic; second, the risk of consumption, real estate and export plunging into recession all at the same time; third, regional and sectoral financial risks. In response, China should step up efforts to boost domestic demand as soon as possible so as to consolidate the trend of economic recovery.

I. CHINA'S ECONOMY IS BACK ON TRACK TOWARD RECOVERY; MORE EFFORTS ARE NEEDED TO PUSH ECONOMIC GROWTH CLOSER TO POTENTIAL GROWTH ASAP

In the first half of 2022, China's economy was hit by a new round of Covid-19 outbreak and the government immediately rolled out a package of measures to stabilize growth. A 2.5% year-on-year GDP growth in the first half of 2022 is a hard-won result, reflecting the solid economic fundamentals and the timeliness of the stabilization policy. Since May, many macro indicators have started to improve, indicating that the economy is back on track toward recovery.

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[1]The article is the summary of discussions at a recent CF40 seminar on China's Q2 economic performance. It was first published in CF40's WeChat Blog on August 2, 2022. It is translated by CF40and has not been reviewed by the author.

Some experts pointed out that during the recovery in Q2, infrastructure investment led by government departments played a key role in stabilizing the macroeconomy. But due to the pandemic-induced shocks, investment demand in the private sector in Q2 remained weak. The manifestations are: the recovery of household consumption was sluggish; the real estate market was still bottoming out, with no substantial improvement in land purchase, investment or new constructions; against the backdrop of mounting downward pressure on export, manufacturing investment has also started to decelerate. Meanwhile, general public budgetary expenditure and government-managed fund expenditure maintained a high-speed growth in Q2, and infrastructure investment clearly ramped up. Increased fiscal spending has offset some of the downward pressure on the economy caused by the pandemic, stabilized growth and credit expansion, and made up for insufficient social demand.

However, employment and inflation data show that China’s economic growth is still significantly lower than the potential growth rate. **More efforts are needed to consolidate the upward trend of economic recovery and push economic growth closer to the potential rate.** In particular, youth employment is facing greater pressure, with unemployment rate in June significantly higher than the previous level. In addition, certain service sectors are under higher employment pressure. The outbreaks of Covid-19 cases in multiple regions have made a huge impact on the labor-intensive consumer service sector, causing uncertainty in its hiring demand and reducing its capacity to absorb labor force, which has exacerbated the employment pressure. The core CPI, which excludes food and energy prices, tends to be a more realistic reflection of inflationary pressure. Over the past 30 months, the core CPI has risen by a cumulative 1.8%, showing no significant inflationary pressure. These data suggest that **weak demand remains the key constraint on economic recovery.**

II. THREE MAJOR RISKS IN THE SECOND HALF OF THE YEAR

Three potential risks face the Chinese economy in the second half of 2022 while it’s expected to remain well on track toward recovery.

First, the biggest uncertainty is still the lingering COVID-19 pandemic. The highly contagious Omicron spreads faster than previous variants, putting heightened pressure on pandemic control across the country, especially amid mounting risks of imported infection as other countries open up. Covid will batter not only consumption, but also logistics, production, supply chains and exports.

Second, the risk of consumption, real estate and export plunging into recession all at the same time deserves special attention. The global economy has been going down since the start of 2022 as developed economies tighten monetary policies to control inflation. The weakened external demand as a result will pare down China’s export growth and drag its manufacturing investment. At the same time, household consumption demand may well remain slack given restricted income; automobile sales have climbed back up but have yet to recover the level back in 1H21. The real estate sector is still heavily indebted, and it’s still uncertain whether it can stabilize and pick up in the second half of the year. Hence, there is the risk of consumption, real estate and export dropping at the same time and thus taking yet another a bite out of the already sluggish total demand.

Third, China should guard against regional and sectoral financial risks. The cash flows of some of the local governments and sectors in China are becoming so strained that their normal functioning and contract implementation have been affected. Experts at the seminar stressed that what is facing China’s real estate sector is no longer a liquidity crisis, but a debt crisis. Whether the real estate market can pick up rapidly in 2H22 will be critical to China’s macroeconomic stability and prevention of systemic risks.

In addition, corporate governance and bad loan risks have been accumulating in some of the small- and medium-sized financial institutions. The interwoven risks are posing severe challenges to local governments.

III. POLICY RECOMMENDATIONS

In summary, China's economy is back on track toward recovery, but the economic recovery in the second half of the year still faces many challenges and uncertainties. It must pay more attention to the above-mentioned risks and step up efforts to boost domestic demand as soon as possible so as to consolidate the trend of economic recovery.

First, policymakers should heed more attention to conventional monetary policy tools while trying to increase credit supply. Conventional policy tools, including RRR cuts and interest rate cuts, should be adopted in a timely manner to boost aggregate demand. This requires the central bank to provide a clear benchmark policy interest rate as soon as possible to stabilize market expectations, and guide market players to actively adjust their behavior.

Second, the fiscal authorities must ensure that fiscal expenditure growth in the second half of the year meets the budget target set at the beginning of the year, and use more sustainable financing methods to promote infrastructure investment. The sharp drop in local government land sales revenue has made the budget revenue of local government funds significantly lower than the target put forward at the beginning of the year. Local governments must supplement fiscal resources through all possible channels as soon as possible to meet future spending need. Local governments must not rely on the high-cost financing from focal government financing vehicles (LGFVs). Special government bonds, subsidized bonds and policy loans should be considered to support infrastructure investment, which can greatly reduce financing costs, and enable more rational project planning.

Third, there is a need to immediately roll out a policy package to promote the long-term healthy development of the real estate industry, and leverage the joint efforts of local governments, financial institutions and real estate enterprises. Broader relief plans should be provided to resolve the current liquidity difficulties faced by real estate companies, such as deferral of repayment of domestic debts, to avoid further spread of liquidity risks. Moreover, while emphasizing the responsibilities of local governments, efforts should be made to promote debt restructuring. Debt disposal measures should support efforts thatturn existing housing stock into rental homes, so as to increase housing supply in the metropolitan areas.