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CHINA: PUTTING THE TIGER ON A STRONGER FOOTING IN 2022

9 February 2022

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Executive Summary

- *The Chinese economy is experiencing a difficult start to 2022, driven by renewed Covid-19 outbreaks. Even if the sanitary context eases, private consumption is likely to remain below the pre-pandemic trend level in 2022 (-2.8% or -USD170bn).*
- *Going forward, the flailing domestic leg should be supported by further policy rate cuts, public investment in infrastructure (c.3% of 2022E GDP) and temporarily laxer regulation. The external leg should remain robust, in the context of modest depreciation of the CNY, regional trade integration and US-China trade tensions being on hold.*
- *All this should bring the Chinese economy to a stronger footing in H2 2022. Beyond that, achieving "common prosperity" could imply a volatile medium-term growth pattern, depending on how policies are implemented and communicated.*

The ongoing slowdown of the Chinese economy highlights the tug of war authorities face between short-term growth and long-term economic prosperity. Since the second half of 2020, China has reemphasized the goal of creating a more sustainable growth model in the long run through "dual circulation"[1] and "common prosperity". But the ensuing tight regulation sparked adverse consequences for private sector confidence and domestic demand in the second half of 2021[2]. In the short-term, the "common" effort appears to be putting "prosperity" at risk, and "domestic circulation" is under pressure while "international circulation" is the bright spot – the inverse of the "dual circulation" strategy.

To add to this, the economy is facing a bumpy start to 2022, given the stringent zero-Covid strategy applied to renewed Covid-19 outbreaks, as well as temporary factors such as factory closures ahead of the Chinese New Year holiday, and the implementation of several production limits to reduce air pollution during the Winter Olympics. January data show activity growth moderated: almost all major indices in the PMI surveys declined, suggesting that the manufacturing, services and construction sectors were all hit by a mix of sanitary and seasonal factors.

Even if the Covid-19 situation eases, domestic demand, and in particular private consumption, are likely to remain volatile and below the pre-

[1] See our report *Dual circulation : China's way of reshoring?*
[2] See our report *China's great crunch : Causes and consequences, at home and abroad*

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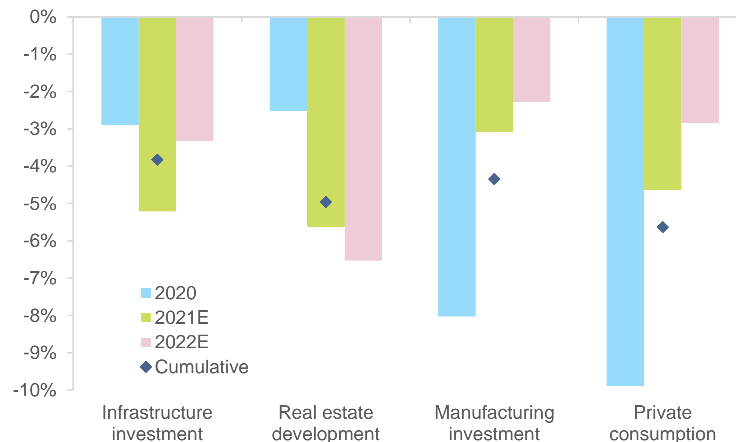
pandemic trend level this year – by -2.8% or -RMB1090bn (-USD170bn), according to our estimates (see Figure 1). This comes in a context of household spending facing other headwinds this year: We estimate that the household savings rate already returned to pre-Covid levels in Q2 2021. In addition, the slowing macroeconomic environment could threaten household income growth. Indeed, even though still in line with the pre-pandemic level, China's unemployment rate ticked up for the second consecutive time in December 2021.

As a result, we expect a tough first quarter (+1.1% q/q) for the Chinese economy.

Figure 1 – Distance of domestic demand to pre-pandemic trend level (%)



Source: National Bureau of Statistics of China, Euler Hermes, Allianz Research

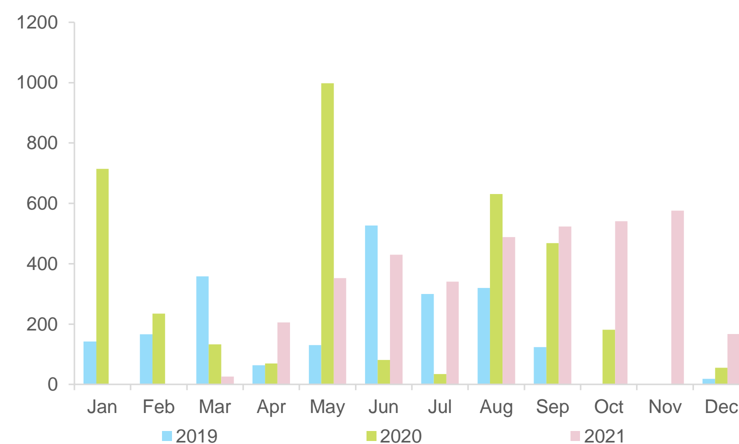
In this context, policy easing needs to be sufficiently stepped up and efficient to stabilize the economy. We expect another 10bp policy rate cut and a 50bp RRR cut in H1 this year, with more in H2 if needed. Additional public debt directed towards infrastructure investment should amount to RMB3,750bn (c.3% of 2022E nominal GDP). After tightening sharply and quickly for nearly a year, China's policy mix started to ease in H2 2021, with liquidity interventions and interest rate cuts by the PBOC and calls to accelerate government spending. The shift in policy stance has become increasingly apparent in the past few months, but more is needed to shore up confidence and stabilize the economy.

On the fiscal side, policy support seems slow to show effect for now, probably due to conflicting short- and long-term priorities. The latest data show that fiscal revenue and expenditure continued to decline in December (in y/y terms) despite the government's call for a more proactive fiscal policy. This is probably because local governments are also asked to take care of long-term debt sustainability. Going forward, fiscal revenue is likely to remain soft in H1 2022 (due to Covid-19 outbreaks and the struggling property sector), but fiscal spending should accelerate, thanks to clearer guidance in terms of government funding e.g. through special bonds issuance. The annual quota for these bonds will be defined in early-March (during the Two Sessions parliamentary meetings), but the central government has already instructed local governments to start front-loading issuances (see Figure 2) to support fiscal spending and infrastructure investment.

We expect the 2022 target for local government special bonds to stand at

RMB3,750bn (c.3% of 2022E nominal GDP), compared with RMB3,650bn in 2021 (and RMB3,750bn in 2020). RMB480bn worth of special bonds were likely already issued in January 2022. Such public spending will be directed towards funding "new infrastructure" projects aimed at facilitating the green transition and advanced manufacturing and digitalization targets rather than "brown" network infrastructure, such as highways, railways and airports that were the focus of previous easing cycles. As such, the short-term demand effects of the ongoing fiscal easing could be more significant than in the past due to a higher fiscal multiplier[3]. The long run impact on potential growth could be even more significant[4]. That said, the actual effectiveness of the planned fiscal stimulus should be put in the context of local governments' willingness to follow through, fiscal sustainability and financial conditions. Public investment supported by monetary easing tends to be most powerful.

Figure 2 – New local government special bond issuance (RMB bn)



Source: Ministry of Finance of China, Euler Hermes, Allianz Research

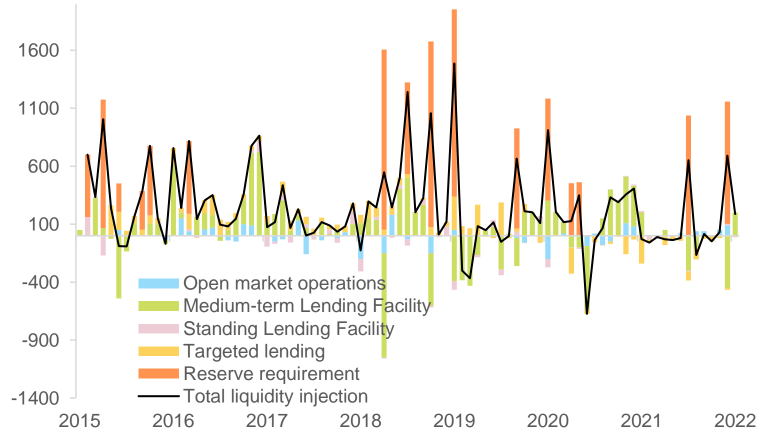
On the monetary side, though, the policy reaction has been faster, with two cuts to the reserve requirement ratio in the second half of 2021. This was followed by a 10bp cut in the policy rate (one-year medium-term lending facility interest rate) in January 2022, which led to a 10bp cut in the one-year loan prime rate (LPR), along with a 5bp cut in the five-year LPR. The PBOC has also been active with open-market operations to provide liquidity (see Figure 3).

We expect another 10bp policy rate cut and a 50bp RRR cut in H1 this year, with more possible in H2 if needed (though this is not our baseline scenario). At a press conference in mid-January, the PBOC's communication tone clearly turned more dovish and pro-growth, highlighting the need to push for faster credit growth. Indeed, China's overall debt-to-GDP level had been declining for five quarters up until Q4 2021. Coming back to the previous peak means that credit growth could reach 10.8% in 2022, compared with +10.3% in 2021 and +13.3% in 2020. To see credit growth actually rebound, the PBOC also needs to guide banks to expand credit allocation to households and firms.

[3] See our report *Public infrastructure investment: Enough bang for the buck?*

[4] According to our analysis of the recent infrastructure stimulus packages in Europe and the US as well as a recent analysis by the IMF, climate-smart infrastructure tends to generate a higher output elasticity of public capital, i.e., investing in clean energy and transport ends up producing more GDP than it initially demands. Given that the public capital stock to GDP in China is still lower than in Europe and the US, it can be assumed that the return on capital might be even higher.

Figure 3 – PBOC net liquidity injection (RMB bn)

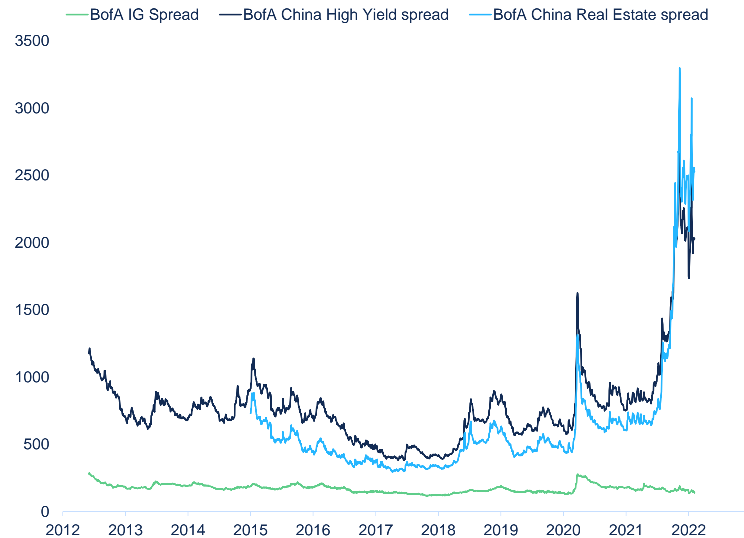


Source: PBOC, Euler Hermes, Allianz Research

Interventions from policymakers and regulators helped to ring-fence the credit issues that emerged in autumn 2021 in the real estate sector to the more vulnerable firms. The corporate credit spread for the real estate sector seems to have reached a plateau since the turn of the year (see Figure 4). Several housing activity data also narrowed their declines in November-December compared to October (e.g. new starts, completions, property sales), a trend extended until the end of January, as shown by high-frequency property transaction volume data (see Figure 5).

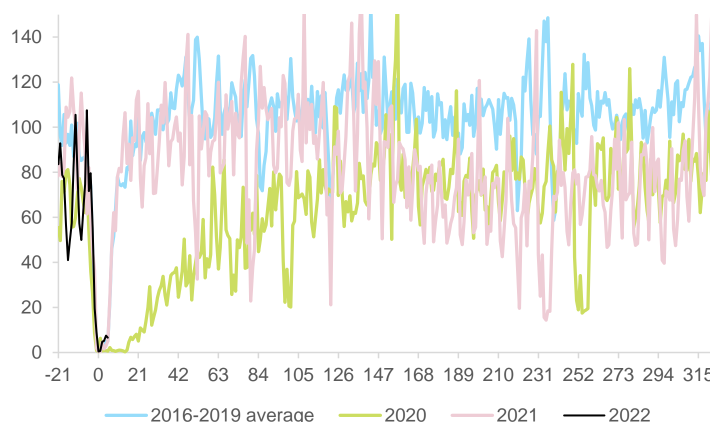
While concerns of a multi-year drag in the property sector hit corporate and household confidence, continued policy intervention should help avoid fears of a systemic crisis in the property sector and provide a floor to housing prices.

Figure 4 – Corporate credit spreads in China (bp)



Source: Refinitiv, Euler Hermes, Allianz Research

Figure 5 – Daily property transaction volume in 30 largest cities (30 days preceding Chinese New Year = 100)



Source: National Bureau of Statistics, Euler Hermes, Allianz Research

However, front-loaded policy support needs to be coordinated with laxer regulation to allow for efficient monetary and fiscal policy transmission. This is likely to happen temporarily, before a likely return of regulatory risks from 2023. In order for the policy easing to be efficient in supporting growth, China's regulatory environment needs to go in the same direction and (temporarily) ease. More precisely:

- Real estate sector: Macroprudential rules dictating how banks finance the sector and housing purchase rules and funding conditions for households could be temporarily eased to help credit growth recover and put a floor on the drop in real estate activity.
- Energy sector: Measures already put in place in October 2021 to support coal mining activity and funding show policymakers' resolve to ensure smooth energy supply against environmental targets. This temporary rebalancing of priorities, increased flexibility and better coordination will help avoid the risk of electricity rationing in 2022.
- Public spending: Clarifying the policy priorities for local governments would improve the efficiency of fiscal easing. This would mean, for example, emphasizing infrastructure investment rather than debt sustainability or other concerns in the political turnover year that is 2022.

Such measures and announcements, along with fiscal and monetary easing, would send a coordinated and clear signal from policymakers that could help shore up confidence in the private sector in 2022.

The external environment for exports should remain supportive, with a modest depreciation in the CNY likely, regional trade integration and US-China trade tensions on hold in 2022. Exports were a bright spot for the Chinese economy in 2020 and 2021, in turn supporting manufacturing activity and investment in that sector. Though global demand is likely to have peaked in 2021[5], it should remain above potential, thus providing continuous support for China's external activity. Furthermore, we estimate that stronger regional trade integration through the full ratification of the Regional Comprehensive Economic Partnership at the beginning of this

[5] See our *Global Trade Report*.

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year could bring at least USD28bn worth of additional export gains for China in 2022.

The main risks to China's external context come from its relationship with the US, with a number of political triggers that could worsen China's export environment, including:

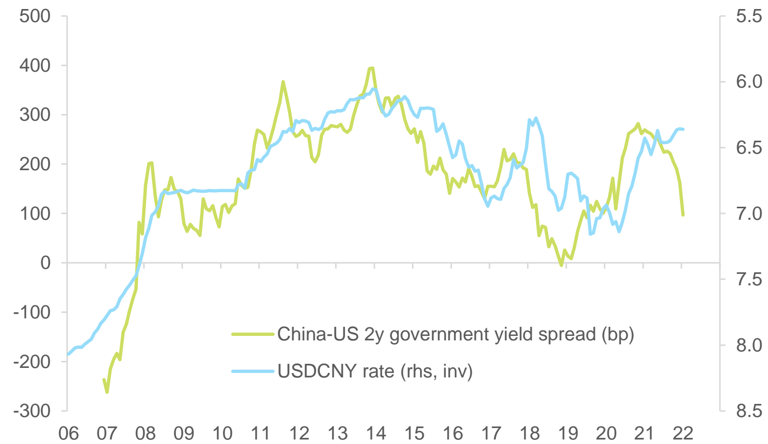
- The US reacting with tariff hikes against China for not complying with the Phase One Deal's import targets.
- Economic sanctions by the US as a reaction to increased military incursions by China in the Taiwan Strait.
- Regulation on both sides affecting companies in targeted (strategic) sectors.
- The sharp depreciation of the CNY leading to the US labeling China a currency manipulator.

While all these potential decisions would be largely politically driven as they have limited economic rationale, we look into more details at the risk of a negative feedback loop between a depreciating CNY and capital outflows, though such a scenario is unlikely in our opinion. Indeed, even if the US-China monetary policy divergence is likely to widen further, the impact on the USDCNY rate should be relatively limited – as already observed in the past few months (see Figure 6). This comes in a context where capital inflows into China remained robust through the end of 2021 (+USD27bn in Q3 and +USD28bn in Q4), while outflows were observed for other emerging economies as a whole (+USD25bn in Q3 and –USD8bn in Q4 for EM excl. China). Capital inflows into China are likely to continue in the medium run as global investors consider China structurally attractive[6], while China's capital outflows rules remain tight and the PBOC continues to increase its FX reserves. Indeed, in the event sentiment shifts and capital outflow and depreciation pressures start to materialize, they would likely be countered by China's sufficient FX reserves, which even increased over the past two years (by +USD142bn to USD3,250bn between end-2021 and end-2019), thanks to large trade surpluses. The 2015-16 currency scares in China tell us that a sharp depreciation of the currency would have an impact more through a confidence shock than a financial conditions shock. Indeed, China's reliance on external funding is relatively low (external debt at 16% of GDP in 2020, compared with 33% for emerging countries as a whole).

As such, we expect a modest depreciation in the CNY in 2022, with the USDCNY exchange rate reaching around 6.5 at year-end. Such a scenario is unlikely to be the cause for heightened US-China tensions nor to trigger significant capital outflows.

[6] See our report *China´s corporate debt: Triaging in progress*

Figure 6 – US-China monetary policy divergence vs. USDCNY rate



Source: Refinitiv, Euler Hermes, Allianz Research

Taken together, support to the domestic leg with a robust external leg should bring the Chinese economy to a stronger footing in H2 2022. However, once the ongoing cyclical headwinds fade away, authorities may turn their focus back on the long-term target of establishing a sustainable and fairer growth model. In an aim to converge toward "common prosperity", the regulatory risk could thus return from 2023, depending on how policies are implemented and communicated. This could imply a volatile medium-term growth pattern, though lessons learnt from past experience and the 20th Party Congress in autumn this year could lay the ground for better coordination and communication in policymaking.

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