

Evaluating Policy Focus and Recovery Prospects for China's Economy after the Epidemic from the Government Work Report

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In response to the severe challenges arising from the epidemic and the escalating risk of China-US “decoupling”, no specific GDP growth target has been set in the latest Government Work Report. On one hand, the policies focus on the current situation emphasizes bottom-line thinking, switching the priority from ensuring 6% of economic growth to ensuring security in six areas. On the other hand, it pays attention to long-term planning and complement the formulation of Outline of the 14th Five-Year Plan, reflecting the new idea of starting a new chapter amid changing situation. It is expected that with the accelerated implementation of large-scale supporting measures, China's economy is likely to achieve a restorative recovery and a positive growth of about 3% this year.

I. Major challenges for China's economy

1. The impacts of coronavirus epidemic on China's economy have exceeded the global financial crisis of 2008-09. In the future, China will face the risks of imported infection and rebound of domestic infection. At present, China has controlled the epidemic and orderly promoted the resumption of production and businesses. However, from a global perspective, the rare “black swan” event in history has yet to reach the turning point. There have been more than 7 million confirmed cases around the world with great uncertainties ahead. In order to contain the virus and support the economy, China has to coordinate the prevention and control of virus, as well as move forward with economic and social development.

2. China's external trade environment has deteriorated in the post-epidemic era. The epidemic has caused the world economy to fall into the most severe recession since the Great Depression, which would weaken global demand and drag on Chinese exports. The spread of virus and related containment measures, such as lockdown, quarantine, etc., would seriously interfere the stability of industrial and supply chains, affecting China's external trade.

3. The risk of “decoupling” between China and the US is rising. The White House released the report of “US Strategic Approach to the People's Republic of China” on May 20, stating that it will contain China's development through imposing comprehensive pressure. In fact, “decoupling” is a kind of strategic containment. Nevertheless, China and the US are complementary to each other. While “hard decoupling” is unrealistic, “decoupling” in a progressive and selective manner is possible. For example, the US may add sanction on Huawei, include more Chinese high-tech enterprises on the Entity List, and reshape the technology industrial and supply chains, etc. Subsequently, the US could extend the battlefield against China from technology to other areas, such as trade and finance etc., through raising issues of Hong Kong. Therefore, China needs to

prepare and be capable for the situation ahead.

II. Policy focus to promote economic recovery

The latest Government Work Report deployed the strategy to hedge the impacts of epidemic and cope with the “decoupling” between China and the US, and introduced measures on ensuring security in six areas (namely jobs, basic livelihood, market entities, food and energy security, industrial and supply chains, and the normal functioning of lower levels of government), which are proactive measures to stabilize economic fundamentals. Although no specific GDP growth target has been set, the report mentioned that efforts have been made to build a moderately prosperous society in all respects with other economic and social development targets, such as creating more than 9 million jobs in urban areas, achieving a surveyed urban unemployment rate of around 6% and a registered urban unemployment rate of around 5.5%, targeting CPI by around 3.5%, etc.

1. A more proactive fiscal policy needs to be implemented in order to hedge the impact of the epidemic. First, counter-cyclical policy has intensified this year compared with the past, with an increase of RMB 11.01 trillion non-recurring expenditures. The highlights are as follow: The deficit-to-GDP ratio this year is projected at over 3.6%, breaking the 3% threshold for the first time, and fiscal deficit will increase by RMB 1 trillion from the previous year. Meanwhile, there will be issuance of RMB 1 trillion government bonds for controlling the virus. Special government bonds have been issued twice in the past, and the issuance this year will be the third time. The aforementioned RMB 2 trillion will be transferred to local governments, mainly used to supplement the fiscal deficit of prefecture and county governments, and to ensure the normal function of lower levels of government. The quota of the special local government bonds this year will reach RMB 3.75 trillion, up RMB 1.6 trillion from last year. The fiscal expenditure structure will be substantially optimized with increasing expenditure on people’s livelihood, so as to safeguard expenditures in key areas. Second, China’s fiscal policy is still relatively cautious, given that many advanced economies introduced strong stimulus measures with direct cash handouts that led to fiscal deficit rates of over 10% and monetization of fiscal deficits. This not only reserves more policy space for the future to cope with severe challenges, but also constrains the rise of debts.

2. Prudent monetary policy needs to be more flexible and adequate, reflecting policy guidance of “easing credit and cutting interest rates”. The policy aim is to provide liquidity support to those in needs, but not injecting massive liquidity into the market. First, the rising importance of easing credit policy will provide a more accommodative financing environment for market entities. The latest Government Work Report called for using a variety of tools such as required reserve ratio (RRR) reductions, interest rate cuts, and re-lending, etc., in order to facilitate a higher growth of M2 money supply and total social financing (TSF) than that of last year. The report also mentioned the development of new monetary policy instruments that could directly stimulate the real economy and help enterprises to secure loans more easily. The priority of preventing financial risks, once at the top place among three major policy missions, has declined, and will prevent and resolve major financial risks on the basis of supporting the real economy. Judging from the table below, it will be not surprising if the growth rates of M2 and TSF will reach 13% and 14% respectively, and the increment of TSF exceeds RMB 30 trillion this year. In view of this, traditional

economic theory, such as the growth of M2 is almost equivalent to the growth of GDP + CPI, will be challenged. In reality, abundant liquidity may not trigger inflation, and make CPI rise substantially.

Items	2015	2016	2017	2018	2019	Apr 2020
YoY growth of M2	13.3%	11.3%	8.2%	8.1%	8.7%	11.1%
Growth of TSF	12.4%	12.8%	12%	9.8%	10.7%	12%
Increment of TSF (in RMB trillion)	15.41	17.8	19.44	19.26	25.58	Jan-Apr 14.16

Source: People's Bank of China

In terms of the structure of TSF, RMB loans have increased significantly this year. Banks may have higher pressure on rising NPL ratio and disposing non-performing assets in the later period. Second, real loan rates will be reduced. The central bank has cut the RRR three times, implemented targeted RRR cuts, and guided the decline of Loan Prime Rate since this year. In April 2020, the one-year and five-year LPRs dropped to 3.85% and 4.65%, respectively, a decrease of 30 and 15 bps from December 2019. Judging from the current inflation condition, there is room for easing monetary policy further. It is expected that RRR or interest rate cuts are likely within this year, but the magnitude will not be too large. Interest rate cuts will mainly be achieved by deepening LPR reform, improving monetary policy transmission channels, and orderly promoting the convention of benchmark rates for existing loans, etc. Third, the latest Government Work Report mentioned maintaining the RMB exchange rate largely stable. The statement was not significantly different from that in 2019, but its position has been moved forward. Therefore, market participants interpret that policy priority on the RMB's exchange rate will be stability over depreciation.

3. Deploying tasks on ensuring security in six areas with focuses on stabilizing enterprises, jobs, and livelihood. In the post-epidemic era, employment is the biggest livelihood. “Stabilizing jobs” is the only overlap between ensuring “security” and “stability” in six areas. Given micro, small, and medium enterprises (MSMEs) absorb 80% of the aggregate employment population, it is necessary to stabilize enterprises in order to ensure employment. First, tax cuts and fee reductions would be enhanced this year, making it the bright spot for stabilizing enterprises. Tax cuts and fee reductions exceeded RMB 2.3 trillion for 2019, and it is expected that there will be additional savings of more than RMB 2.5 trillion for enterprises this year. Tax and fee reduction policies must be fully implemented for enterprises, so that they can sustain their businesses and assure success for the future. Second, more targeted policies will be implemented in order to strengthen the role of financial support on stabilizing enterprises. The epidemic takes the toll on MSMEs and their difficult problems are: the deterioration of operating cash flow, revenue slump due to the sharp contraction of orders, and increasing burden of rigid expenditure. The financial support aims to solve those problems. The policy of allowing MSMEs to postpone principal and interest repayments on loans will be further extended till the end of March next year. In addition, the coverage of government financing guarantees will be greatly expanded and the fees will be reduced significantly. The government also supports enterprises to expand bond financing, and calls for increasing inclusive finance lending from large commercial banks to micro and small enterprises by more than 40%.

Recently, the China Banking and Insurance Regulatory Commission introduced the “513” measures, which require large-scale banks to increase outstanding manufacturing loans by no less than 5% annually, the proportion of medium-and-long term manufacturing loans at year-end to increase by 1 percentage point from the beginning of the year, and the overall loan outstanding to increase by no less than 3%. Apart from ensuring security in jobs and livelihood via stabilizing enterprises, the government also strengthens employment support for key industries and groups. While paying attention to the development of new forms of employment and work models, the government also promotes “stall economy”.

4. Deploying strategies to expand domestic demand and outline the 14th Five-Year Plan.

Satisfying domestic demand will be the starting point and foothold for the development in the future. As such, the construction of a complete domestic demand system has to be established at a faster pace, transforming sizable market potential into productivity. The first measure is to expand effective investment and guide the funds to new infrastructure, new urbanization, and major projects. Investments in new infrastructure, including next-generation information networks, expanding 5G applications, building battery charging and swapping facilities, and promoting wider use of new-energy automobiles, etc., will enter an accelerated period. New urbanization will leverage the role of leading cities and city clusters in driving the overall development of their surrounding areas, and foster new industries. In order to prevent the funds for speculation and push up property price accordingly, the government insists that property is a place to live and not for speculation. The government will step up efforts to develop major transportation and water conservancy projects, and increase national railway development capital by RMB 100 billion. These investments can not only promote consumption and benefit people’s livelihood, but also adjust economic structure and drive economic growth. The second measure is to promote the recovery of consumption. In recent years, China’s economic structure has changed considerably and consumption has been a major driver for economic growth. The National Bureau of Statistics estimated that at least RMB 1.5 trillion worth of suppressed consumption due to the coronavirus outbreak could be stimulated through a series of measures, including to promote the integration of online and offline consumption, restoring catering and entertainment activities, expanding rural consumption by supporting e-commerce and express delivery services in rural areas. The third measure is to promote technology and innovation. The government initiates to accelerate the promotion of strategic industries such as digital economy, smart manufacturing, healthcare, new material, etc., and enhance the development of public health system, so as to facilitate the “China Standards 2035” strategy. The fourth measure is to speed up the implementation of regional development strategies. Apart from the development of the Guangdong-Hong Kong-Macao Greater Bay Area, we need to pay attention to the development in the western region. On May 17th, the State Council released the guiding opinions on promoting the development in the western region on the new era, clarifying the new position of “re-development” in the western region.

5. Stimulating endogenous development through deepening reform and opening up, in order to enhance the ability to cope with China-US “decoupling”. The first measure is to rely on reforms for stimulating the vitality of market entities, and enhance new momentum for development. The supply-side reform will be the main axle to promote the reform of market-based allocation of factors. Taking the 11 measures recently announced by the Office of the Financial Stability and Development Committee as the starting point, the financial supply-side structural reform will be

further deepened to improve the quality of financial services in the real economy. The reform of decentralization, regulation and optimizing services will deepen in order to maintain fair competition by law, and create a market-oriented, rule-of-law, and international business environment. In accordance with the 14th Five-Year Plan, the CPC Central Committee and the State Council jointly released “Opinions on Speeding Up the Improvement of the Socialist Market Economic System in the New Era” On May 11th. The second measure is to promote a new pattern of high-level nationwide opening up via mutual opening up and co-ordination between the eastern and western regions. The bright spots are: allowing greater freedom of reform and opening up in the Pilot Free Trade Zone, accelerating the development of Hainan Free Trade Port, establishing new Free Trade Zones and Comprehensive Bonded Zones in the central and western regions, significantly reducing the negative list of foreign investment access, and introducing cross-border negative list of trade and services.

III. Recovery prospect of China’s economy

China’s economy is resilient, and the epidemic has not changed the trend of positive outlook amid stability. Following the implementation of large-scale supporting measures in the Government Work Report by the central and local governments, policy advantages will be transformed into development strengths, and the recovery prospect of China’s economy will be prudently optimistic. In general, China’s economy will be in the form of a mild V-shaped recovery.

1. Fundamentals of China’s economy could be stabilized if the work on ensuring security in six areas could be carried out properly in 2020, and China is likely to achieve a positive growth rate of about 3% for this year.

First, the market is confident that the large-scale supporting measures introduced in the Government Work Report could promote economic recovery. Given an increase of RMB 11.01 trillion other than recurrent expenditure in 2020, up RMB 3.8 trillion compared with 2019, some overseas institutions estimated that the growth rate of China’s GDP will be about 2% for this year. However, there are more optimistic views from some domestic institutions. Judging from the fiscal deficit of RMB 3.76 trillion with the deficit rate of more than 3.6%, combined with an increment of 2.2164 million payrolls with GDP growth of 1 percentage point in 2019, it is estimated that the GDP growth rate implied in the latest Government Work Report is about 4%.

Second, although the coronavirus has severely damaged China’s economy, it has also provided many development opportunities. New businesses and models, such as online shopping, non-contact distribution, etc., have developed at faster pace. Moreover, shortcomings of public health and emergency systems exposed during the epidemic need to be improved. It will not only partially offset the negative impacts arising from the epidemic, but also create new room for high-quality economic development.

Third, investments have gradually recovered. The growth rate of fixed assets investment for the first four months has rebounded by 14.2 percentage points, compared with that of the first two months. Guiding investments to new infrastructure, new urbanization and major projects will facilitate the new economic sectors and drivers to maintain rapid development. Although Outline of

the 14th Five-Year Plan is still formulating, many planned investment projects have already started in advance. Investments is likely to play a key role in economic recovery this year.

Fourth, although retaliatory consumption has yet to be seen, restorative consumption has already emerged. Consumption coupons will stimulate the recovery of catering and retail sectors. Spending on automobile and entertainment will significantly rebound, and the spending pattern will be gradually back to normal. In 2019, contribution rate of final consumption expenditure to GDP growth was 57.8%, driving economic growth by 3.5 percentage points. Consumption will continue to be the main driving force for economic growth this year.

Fifth, stabilization of foreign investment and foreign trade efforts are making strides. At present, there is no acceleration or large-scale relocation by foreign enterprises. Japanese enterprises such as Toyota mentioned that they would not relocate. Moreover, Samsung increased investment in its semiconductor factory in Xian. The actual use of foreign capital in April amounted to RMB 70.36 billion, up 11.8% year-on-year, showing that China is still an ideal choice for foreign investment. China and South Korea speed up the development of fast-track entry for business, and economic ties between China, Japan and South Korea are likely to strengthen in the future.

Sixth, China's economy will resume to normal level in the second half of the year given positive policy effects. For many years in the past, a general characteristic of China's economy was that the size of economic aggregate in the second half of the year accounted for 55% of the year, while the first half of the year accounted for 45%. Consequently, it will strongly support a GDP growth rate of about 3% this year.

2. In 2021, China's economy is likely to achieve high speed growth of about 8%. During the 14th Five-Year Plan period, China's economy will return to a reasonable growth range of 5% to 6%. All suppressed economic activities due to the epidemic are likely to be released in 2021. As the strategy of expanding domestic demand make further progress, consumption in China is expected to reach RMB 48 trillion in 2021, becoming the largest consumer market in the world. Along with the low economic base, China's GDP growth is likely to reach 8% in 2021. Looking forward, China will be able to withstand the shocks from deglobalization during the 14th Five-Year Plan period. The development of China's economy will be implemented in accordance with the Outline of the 14th Five-Year Plan, adhere to the new development model, and consolidate and promote high-quality development. A new development pattern will gradually form, which will mainly rely on domestic circulation, coupled with mutual facilitation between domestic and international markets. In view of this, more economic growth points and positions will be generated, supporting China's economy to operate within a reasonable range.