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BANK OF CHINA Hong Kong Financial Research Institute

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Multiple Challenges and Policy Focus of China's Economy

Dr. E Zhihuan, Chief Economist, Bank of China (Hong Kong)

China's economic growth has been facing multiple challenges since 2022. From external perspectives, the evolution of the pandemic and the divergence in epidemic prevention and control measures between countries and regions have continued to exacerbate the divergence of global economic growth. The high inflation has accelerated the pace of the United States' interest rate hikes and balance sheet reductions. The protracted Russia-Ukraine conflict has led to the cross-transmission of economic and financial risks. From the internal point of view, the epidemic outbreaks have reappeared among multiple cities and pressed the pause button of the economy, affecting the lives and consumption of residents. The 2022 Government Work Report proposes an annual economic growth target of 5.5%, reflecting the policy considerations of stabilizing growth and the employment priority principle. Facing internal and external difficulties, it is necessary to strengthen macro-policy support and enhance confidence and expectations on economic growth.

1. Global economic growth divergence intensifies cyclical differences

Recently, some countries have tried to coexist with the virus. The real economy's sensitivity and panic to the epidemic have decreased. The output gap has gradually narrowed, and economic growth has normalized within a range higher than the long-term average. In general, the differences between countries in terms of economic structure, fiscal and monetary policy space, social development level, government governance capacity, and the pace of epidemic prevention and control have become increasingly prominent. Some advanced economies have recovered quickly, and the global recovery trend will be differentiated further.

Before the outbreak of the Russia-Ukraine conflict, the International Monetary Fund lowered global economic growth from 5.9% in 2021 to 4.4% in 2022, the U.S. GDP growth rate from 5.6% to 4%, Eurozone economic growth from 5.2% to 3.9%. The divergence of major economies' growth momentum has intensified. The U.S. economic growth in 2022 is likely to be revised down to around 4%, but still above its average of the past decade and significantly above the trend growth rate.

China's economy has begun to decelerate since the second half of 2021, and it will continue to face downward pressure in 2022. The 5.5% annual economic growth target is close to the upper limit of market consensus, showing a certain degree of aggressiveness and continuity of the long-term goal of doubling GDP in 2035. The Chinese and U.S. economies are in different growth cycles and may present significant macro-policy differences, and the comprehensive impact needs to be assessed in details.

2. Major economies accelerate policy shifts, leading to new risks

The divergence of economic growth increases the differences in the direction of macro-policy among countries. The U.S. labor market is moving toward full employment as jobs lost during the pandemic has gradually recovered. The service sector is recovering faster, supported by higher vaccination rates and progress in drug research and development. The supply chain bottleneck pressure caused by the epidemic has not been fundamentally relieved. Factors such as population aging and de-globalization trends have shown long-term impacts on inflation. In the following period of time, suppressing inflation is a significant challenge that needs to be addressed urgently. A monetary policy shift has become the primary choice to ease the upward pressure on prices.

The Fed announced 25 basis points increase in the federal funds rate, which was limited, and real interest rates are still at historically low levels and will not have a severe impact on financial markets. At the same time, the global financial market has full expectations for the US Federal Reserve to raise interest rates. The Fed continues to convey to the market that the expansionary monetary policy is about to exit, to guide market expectations.

This rate hike is the beginning of a series of tightening actions for a more extended period, meaning a turning point in monetary policy. The Russia-Ukraine conflict intensified the rise in commodity prices. The epidemic and supply bottlenecks also led to persistently high inflation pressures, prompting the Fed to accelerate the pace of monetary policy normalization. The normalization sequence of US monetary policy is to slow the pace of asset purchases first, then stop asset purchases, raise interest rates moderately, and finally shrink the balance sheet. The Fed's latest dot-plot shows that the market generally expects more than seven interest rate hikes this year and may even raise interest rates by 0.50% at one time, thereby accelerating the pace of returning to long-term interest rates.

For a long time, the U.S. Fed's monetary policy orientation has mainly focused on domestic economic data without considering its international spillover effects. At present, the United States is facing severe inflationary pressure. The PCE has been raised to 4.3%. The inflation level will significantly exceed the target range in the next two years, and the core inflation rate will also show the same trend. Long-term upward inflation is an essential basis for raising interest rates. The market is also worried about the superposition of inflation and economic stagnation, leading to the stagflation risk. From the labor market perspective, the unemployment rate will reach 3.5% by the end of this year, close to the full employment, which may form a new cycle of rising wages and inflationary pressures. Therefore, both significant indicators of inflation and employment support the Fed to further accelerate the process of exiting the easing policy.

3. The Russia-Ukraine conflict increases the risk of international capital flows

Judging by the current situation, the conflict between Russia and Ukraine first hit major European member states, leading to multiple difficulties and adverse challenges to the economic growth of the Eurozone. The Russia-Ukraine conflict affected the global supply chain and pushed up energy prices. The inflation in the Eurozone accelerated to a record high. According to Eurostat's latest data, the harmonized index of consumer prices (HICP) in the Eurozone rose by 7.5% in March. The core HICP rose by 3.0% year-on-year, up 160 and 30 basis points respectively from February. The continued rise in energy prices will affect the process of regional economic recovery, with rising pessimistic expectations of producers and consumers on the economic outlook, investment, and consumption. Eurozone manufacturing PMI in March was revised lower to 56.5, a drop of 1.7 from February, hitting a 14-month low, which means that the economic growth rate of the Eurozone may continue to decline.

The Russia-Ukraine conflict directly affects the trend of commodity prices and triggers risk aversion in the global financial market. International capital has fled to safe-haven assets such as the US dollar, US bonds, and gold, which intensified the volatility of the international financial market.

The Russia-Ukraine conflict has led to secondary disasters. The United States and European countries have imposed a new round of financial and economic sanctions on Russia, restricting Russia's use of foreign exchange reserves and excluding some Russian banks from the SWIFT system. In the past few years, Russia has gradually reduced its holdings of US treasuries in its foreign exchange reserves and implemented de-dollarization in the currency denomination of imported commodities. The denomination of export commodities is still mainly in US dollars to balance the demand for US dollars.

The US and European financial sanctions restrict Russia's foreign exchange reserves, which shakes the confidence of relevant countries in the US dollar. This may provide a new opportunity for reforming the international monetary system and promoting the process of diversification of reserves.

4. Fiscal policy will be more effective and proactive, and monetary policy will be more forward-looking and precise

China's macro policy options are adjusted against global macro policy adjustments. In the short term, three external factors will pose challenges to China's economy and need to be cautiously and adequately addressed. From the perspective of the external environment, it is necessary to pay attention to the impact of the normalization of US monetary policy. From the internal point of view, the epidemic outbreaks have reappeared among multiple cities and pressed the pause button of the economy, affecting the lives and consumption of residents. Achieving the 5.5% growth target will be tough. The Chinese economy continued to decelerate in last year's third and fourth quarters. The trend of economic deceleration in the first quarter of this year has not been fundamentally reversed. To achieve the growth target, it is necessary to increase the coordination and support of macroeconomic policies for the whole year. China's economic growth rate is likely to show a trend of slowing down and then stabilizing this year.

First, the fiscal policy reflects the requirements of prioritizing stability while pursuing progress, emphasizing that reasonable efforts should be put forward. It is necessary to continue strengthening fiscal policy support for the real economy. Fiscal revenue continues to grow, coupled with the fact that certain state-owned financial and other institutions have turned over profits from recent years and transferred them into budget stabilization funds. The scale of expenditure will expand by more than 2 trillion yuan compared with 2021. The transfer payments from central to local will increase by about 1.5 trillion yuan, the most significant increase in years. Also, the government will seek to improve the effectiveness of the fiscal policy, further drive effective investment, and advance infrastructure investment to leverage private investment. Government investment funds will also further drive effective investment. The 3.65 trillion yuan of local government special bonds, coupled with the support of bond issuance funds later last year, is expected to be moderately advanced in infrastructure investment, to expand government investment and leverage the private sector. Infrastructure investment will become one of the critical pillars of stable growth.

Second, the monetary policy focuses on inter-cycle adjustment, emphasizing flexibility, precision, reasonableness, moderation, and self-centeredness. It grasps the strength and pace of the policy, handles the relationship between economic development and risk prevention, makes good use of the space for RRR cuts, maintains the overall financial stability, and enhances the resilience of economic growth.

Third, while increasing the intensity of the cross-cyclical approach, giving full play to the dual functions of aggregate and structure of monetary policy tools, and focusing on precise and advanced efforts to meet the real economy's practical and effective financing needs. Also, it is essential to comprehensively use monetary policy tools, such as medium-term lending facilities and open market operations, etc., and maintain reasonable and sufficient liquidity. In addition, it is necessary to focus on increasing financial support for critical and weak areas such as small and micro enterprises, technological innovation, and green development, etc.

Fourth, it is necessary to continue to improve the formation and transmission mechanism of market-oriented interest rates and promote the reduction of the comprehensive financing costs of small and micro enterprises. It is also essential to make good use of re-lending for rural and county entities and guide financial institutions to increase support for SMEs. The Two Sessions proposed implementing new tax and fee reduction and credit support policies, strengthening support for SMEs and individual industrial and commercial businesses, providing more credit support for SMEs through inclusive loans, and guiding large platform companies to reduce fees to ease the burden on SMEs.

Fifth, the difference in economic cycles between China and the United States determines the differentiation of macro policy trends, reflected in the narrowing of the China-US interest rate spreads and changes in the DXY. The DXY rose by 6.4% in 2021, and the increase was concentrated after June 2021. The interest rate hikes and the increased demand for safe-haven of the new variant virus will further push the dollar higher in 2022. For the RMB exchange rate trend, the RMB against the USD maintained a stable and moderate-to-strong trend in 2021, with a rise of 2.6% throughout the year, benefiting from the strong performance of China's foreign trade, the rollout of vaccination, and the cooling down of risk aversion, etc. Multiple factors will continue to support the performance of the RMB exchange rate in 2022, such as the potential in China's economic strength, the high level of current account surplus, the uncertainties of the global economic growth and the epidemic, the steady progress of the opening-up of the mainland's financial market, and the certain attractiveness of RMB-denominated financial assets to international investors, etc.

5. Implementing structural policies that focus on balancing short-term impacts and expected shocks

China's economy faces triple pressures of demand contraction, supply shocks, and weaker expectations. Among them, the adverse effects of weaker expectations cannot be ignored. As the internal and external environment becomes more complex, the promotion of structural reform policies should emphasize process management and secondary risk control to avoid adverse effects on expectations.

Long-term structural reform is the key to achieving high-quality economic development in China, and there will never be perfect timing. Therefore, in the current structural policy reform, we should pay special attention to the pace, control risks, and make it work as its intended function.

On the one hand, the management of relevant policy expectations should be strengthened. When functional departments launch structural policies, including the reform of the factor market, they should conduct scenario planning, fully consider the impact of industry-specific measures on the financial market, consider the different perspectives of the domestic market and the international market on policy interpretation, and fully communicate with market players.

On the other hand, the cooperation between relevant functional departments should be strengthened. For example, there is room for further improvement in the standardized management of some Internet platforms and the collaboration between financial management departments.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2020**	**2021**	**2021/Q3**	**2021/Q4**
總量 (億元) GDP($100 Million)	26,716	28,426	7,205	7,692
升幅 (%) Change(%)	-6.1	6.4	5.5	4.8
二. 對外貿易 External Trade			**2022/02**	**2022/01-02**
外貿總值 (億元) Total trade($100 Million)				
總出口 Total exports	39,275	49,607	3,138	7,733
進　口 Total imports	42,698	53,078	3,459	7,987
貿易差額 Trade balance	-3,422	-3,471	-321	-255
年增長率 (%) YOY Growth(%)				
總出口 Total exports	-1.5	26.3	0.9	10.6
進　口 Imports	-3.3	24.3	6.2	8.1
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	0.3	1.6	1.6	1.4
四. 樓宇買賣 Sale & Purchase of Building Units			**2022/03**	**2022/01-03**
合約宗數 (宗) No. of agreements	73,322	96,133	3,828	13,737
年升幅 (%) Change(%)	-2.0	31.1	-57.7	-39.9
五. 勞動就業 Employment			**2021/11-2022/01**	**2021/12-2022/02**
失業人數 (萬人) Unemployed(ten thousands)	259.1	250.9	13.5	15.8
失業率 (%) Unemployment rate(%)	5.5	5.5	3.9	4.5
就業不足率 (%) Underemployment rate(%)	3.1	2.7	1.8	2.3
六. 零售市場 Retail Market			**2022/02**	**2022/01-02**
零售額升幅 (%) Change in value of total sales(%)	-24.3	8.1	-14.6	-4.9
零售量升幅 (%) Change in volume of total sales(%)	-25.5	6.5	-17.6	-7.6
七. 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	356.9	9.1	0.3	1.0
年升幅 (%) Change(%)	-93.6	-97.4	-52.2	-1.8
八. 金融市場 Financial Market			**2022/01**	**2022/02**
港幣匯價 (US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.2	779.8	779.4	780.8
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	30.1	8.0	-20.1	2.3
M2	5.8	4.3	-2.0	3.6
M3	5.8	4.3	-2.0	3.5
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	5.4	4.6	-2.3	3.9
港元存款 In HK$	6.2	1.4	-13.4	-1.4
外幣存款 In foreign currency	4.6	7.9	11.0	9.5
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	1.2	3.8	-6.4	1.6
當地放款 use in HK	1.7	4.7	-9.8	1.3
海外放款 use outside HK	0.1	1.7	2.7	2.1
貿易有關放款 Trade financing	-6.2	14.2	14.0	16.0
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	27,231	23,398	23,802	22,713