Council on Geostrategy

Explainer
Geopolitics Programme
No. GPE14
April 2023

The Chinese economy after the 'Two Sessions'

By George Magnus

The curtain raiser at last month's National People's Congress (NPC) was, as always, the Government Work Report on the economy, presented for the last time by Li Keqiang, Premier of the State Council, who is stepping down.[1] The report conformed to the normal practice of setting out the Chinese Communist Party's (CCP) main economic targets and priorities in the year ahead, and was accompanied, as usual, by considerable detail and repetition in the annual Budget Report on fiscal policy, and the National Development and Reform Commission's report.[2] In five important respects, however, the Work Report on the economy this year was unusual, posing some interesting questions for the Chinese economic outlook in and after 2023.

[1] Li Keqiang, 'Report on the Work of Government', The State Council of the People's Republic of China, 05/03/2023, http://bit.ly/3msXsic (checked: 14/04/2023).
[2] 'Report on the Execution of the Central and Local Budgets for 2022 and on the Draft Central and Local Budgets for 2023', *Xinhua*, 15/03/2023, http://bit.ly/3MDF5Sn (checked: 14/04/2023) and '关于2022年国民经济和社会发展计划执行情况与2023年国民经济和社会发展计划草案的报告' ['Report on the Implementation of the National Economic and Social Development Plan for 2022 and the Draft National Economic and Social Development Plan for 2023'], 新华社 [*Xinhua*], 15/03/2023, http://bit.ly/3KUBuhi (checked: 14/04/2023).

Things that are different in 2023

First, while the start of the Work Report is always a look back at how the economy performed and the CCP overcame major challenges, most of it tends to be forward-looking. This year, however, only about a fifth of the report was about anticipated developments in the economy and policies the CCP expects to pursue. In 2022 and 2021, about 68% and 64%, respectively, of the Work Report was dedicated to a more forward-looking perspective of economic prospects.

Second, and following on, while this relative 'devaluation' of emphasis on the economic outlook and prospects does not mean the economy is not regarded as important, it does fit with the shift in emphasis away from the economy towards the focus on establishing resilience, stability, and CCP control during uncertain and even risky times.

As Charles Parton notes, the CCP has focused heavily this year on major organisational changes in the administration and supervision of science and technology, data management, discipline and party-building, and finance.[3] Reforms to state institutions, announced at the NPC, were followed afterwards by the announcement of broader plans boosting the CCP's control and influence.

Third, in the wake of the abandonment of zero Covid-19 policies, and notwithstanding the shift in policy emphasis, the CCP is nonetheless eager to get the economy back on its sea legs. This is probably not a Herculean task as the proclivity of people to spend and borrow once pandemic restrictions have gone is now pretty well established. Yet, the CCP seems quite cautious in its expectations and states in the Work Report, for the first time in a few years, that it will be necessary to 'boost market confidence' – an allusion to previous policies, including the 'rectification campaign' against finance, technology and data platforms that did so much to drain trust and confidence among private firms and entrepreneurs.[4] This year there is no mention of the 'disorderly expansion of capital', little on 'common prosperity', and even a reference to the 'rights and interests of entrepreneurs'.[5]

While the softer rhetoric in the Work Report, and other reports and from senior officials, is welcome, it is a moot point whether the change is anything more than skin deep. There has been no let-up in the prioritisation of and reliance on the leading role of state-owned enterprises (SOEs). Private firms are

[3] Charlie Parton, 'After the 'Two Sessions': China in 2023 and beyond', Council on Geostrategy, forthcoming on 20/04/2023.
[4] Li Keqiang, 'Report on the Work of Government', The State Council of the People's Republic of China, 05/03/2023, http://bit.ly/3msXsic (checked: 14/04/2023), p. 32.
[5] *Ibid*, p. 32.

encouraged to contribute to the economy, but are also expected to comply rigidly with the moral, social and political goals and strategies of the CCP. State and CCP entities will continue to take 'golden shares' in private firms in return for board positions. Further, the CCP has taken initiatives to target financiers, and foreign accounting and due diligence firms, reminding people that the Party's determination to 'steer' the private sector is undiminished.

Fourth, the CCP's focus on financial stability in the face of deep-seated problems in the real estate sector and in local governments seems to be firm, and there has been no embrace of large-scale economic stimulus. The Work Report talks about the CCP's intention to 'prevent and defuse' risks.[6] Although the first two months of 2023 have seen a sharp acceleration in credit growth, as measured by total social financing, and local governments are being allowed to borrow about the same as in 2022, the CCP is hoping that it will not prove necessary to pump-prime the economy – though inevitably perhaps, there is no question it would if needs be.

Fifth, several prominent figures from the leading economic and finance team in the government of Xi Jinping, General Secretary of the CCP, have stepped down or been dropped. These include Li Keqiang, who will be replaced by Li Qiang as Premier of the State Council; and Liu He, the Vice Premier, Xi's main economic adviser and head of both the Office of the Central Financial and Economic Affairs Commission, and of the Financial Stability and Development Committee, who will be replaced by He Lifeng, who has headed up the National Reform and Development Commission for the last five years. He is a firm believer in private enterprise, but also in state initiative and is a devout supporter of Xi.

While Yi Gang, the Governor of the People's Bank of China, Liu Kun, the Minister of Finance and Wang Wentao, the Minister of Commerce, will retain their positions for the time being, their power to influence change has diminished, and their longevity beyond 2023 is far from certain. Most of the key positions are being filled by appointees who are confirmed Xi loyalists. This does not necessarily mean that they are ineffective bureaucrats but, by and large, they have excelled in political rather than technocratic posts. This could stand them in good stead when it comes to, say, addressing some of the dysfunctional financial situations of many local governments. However, large-scale administrative reform, greater central control and politicisation, and the replacement of key technocrats by political loyalists suggest that managing the economy in coming years will become more difficult in the face of the rising economic headwinds they will face.

[6] *Ibid*, p. 36.

'About 5%' GDP target, and the cyclical year ahead

Officially, the economy grew by about 3% in 2022, the lowest rate of expansion other than the year of 2020 (when the spread of Covid-19 became truly global), since 1990.[7] The 2023 target of 'about 5%' is the lowest in living memory for those setting it. The CCP's relatively modest guidance target should not be too hard to meet, and there remains a decent chance that it will be overshot. The CCP says in the economic reports repeatedly that it wants to see consumption expand, and income grow especially in rural areas. Local governments will be allowed to issue a comparable volume of bonds to ones issued in 2022, and the CCP's priorities are not just traditional infrastructure but also digital infrastructure, for example, 5G, artificial intelligence, big data, and the internet of things. (Quite how and if these digital goals will be realised, given the semiconductor choke which is now on the PRC, courtesy of the United States, Japan, South Korea, Taiwan and the Netherlands, remains to be seen.)

There should be a decent bounce back in retail spending, hospitality, and transportation and tourism. The scale of the bounce, though, may yet prove to be limited in strength and in duration. Although household deposits in banks – a crude proxy for savings – rose sharply while zero Covid-19 policies were running wild, and have been falling as spending recovers, some household savings may also reflect wealth destruction last year as real estate prices fell. That might then curtail the pick up in consumption in 2023, and cap it in years to come.

If consumption does turn up, then so should private investment. Several factors, Covid-19 aside, have contrived to subdue it, including limited household income growth, the troubles in the property sector, the effects of ageing, the CCP's so-called 'rectification campaign' against some private firms and entrepreneurs, and external risks. Some of these pressures may lessen in 2023 but none of them are really going to change for the better in the next five to ten years.

Even the beleaguered housing sector which slumped badly in 2022 should show a pick-up in sales, if not investment, which the CCP certainly does not want financially stressed developers to undertake. This would still be consistent with a bearish medium-term downtrend. However, property restrictions were eased in over 40 cities last year, and the CCP has eased the constraints on property developers and encouraged banks to lend so that unfinished units can be delivered to households. The NPC reports also say conditions for first time buyers should be improved.[8] To a degree then, real estate sales might increase this year

[7] *Ibid*, p. 2.
[8] *Ibid*, p. 37.

but in the context of a weak medium-term trend, given trends in household formation, first time buyers, and a greater role for the state in providing low cost housing.

Until March of this year, though, the recovery in the PRC was rather more tepid than many forecasters had expected. Automobile and housing sales have picked up but not strongly. The labour market may have stabilised but the CCP's target – to create 12 million jobs – is always hostage to the netting out of other job losses, shrinkage in the work force and other demographic offsets. Admittedly, the offsets in 2023 will be nowhere as harsh as they were under zero Covid-19 policies, but as fewer people join the labour force each year, more leave for age reasons, and graduates find it increasingly hard to find the type of employment and pay they expect, the 'net' figure for new urban jobs will probably be better than in 2022 but fail to get close to the target of 12 million. The key statistic to watch will be youth unemployment, which had been as high as 20% last year but has fallen to a still historically high range of 16-18%.[9]

The Budget Report suggests that the government aims to keep the fiscal deficit from rising too far, but it will be allowed to rise from 2.8% to 3% of GDP.[10] This does not sound like the PRC's budgetary position is especially risky, but it is also not the appropriate way to consider the PRC's fiscal policies. Once allowance is made for the accounting treatment of off-budget funds, the central government's deficit is actually predicted to slip from 4.7% to 4.5% of GDP.[11]

Beyond this, once other government-managed or guided funds, capital investment and social security budgets, and local government entities are included, the so-called 'augmented' deficit is predicted to be broadly stable. The International Monetary Fund estimates that this rose from 13.5% of GDP to 16.8% between 2021 and 2022, and that it would come in at about 16.7% of GDP in 2023.[12] The Budget Report does not include data to aid the re-estimation of these numbers, but from what can be inferred from the report, broad stability is still the most likely outcome. The deficit, in other words, is very high, but does not suggest that any new planned stimulus is being considered.

The economic reports are peppered this year with references to promote self-sufficiency in advanced technologies. Firms are encouraged to allocate funds to research and development, and education and training. Green spending on

[9] Laura He, 'China's economic recovery is on track. But youth unemployment is getting worse', CNN, 15/03/2023, https://bit.ly/3GEdwo9 (checked: 14/04/2023).
[10] 'Report on the Execution of the Central and Local Budgets for 2022 and on the Draft Central and Local Budgets for 2023', *Xinhua*, 15/03/2023, http://bit.ly/3MDF5Sn (checked: 14/04/2023), p. 28.
[11] Julian Evans-Pritchard, Sheana Yue, Zichun Huang and Mark Williams, 'China's economic roadmap for 2023', Capital Economics, 06/03/2023, http://bit.ly/3KTRX5F (checked: 14/04/2023).
[12] 'People's Republic of China: 2022 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China', International Monetary Fund, 03/02/2023, http://bit.ly/412EDBA, p. 3.

electric vehicles and renewables is urged. In the social sphere, the CCP wants to promote more public healthcare in rural areas, to develop further the third pillar (essentially a private, defined contribution arrangement) of the pension system, and to increase the state provision of rental housing, child- and elderly-care, and medical services. The care agendas are important ingredients in the required agenda to address the PRC's ageing demographics and falling population, but there is next to nothing of substance that suggests the CCP is prepared to take on difficult age-related decisions for the time being.

Conclusion: In pursuit of financial stability

To its credit, the CCP cares much about financial stability. Over the years it has attempted to address regulatory weaknesses, poor risk management within financial institutions, and error-prone intervention by either the state or the CCP itself. Yet, recurring bouts of instability suggest other factors are also at work, such as the effect of financial repression and low interest rates leading to the misallocation of capital, the underpricing of risk because of implicit state guarantees, and poor interventions.

Although the People's Bank of China has reported that the number of all small to medium-sized banks considered high risk was 'only 316' at the end of 2021, and expected to decline further over time, there is no question that many banks have much bigger loan losses than are reported, and also have weak funding structures.[13] Ever since the crackdown on egregious forms of risk-taking and shadow banking after the financial crisis of 2015-2016, the PRC has had to contend with the challenge to financial regulation and stability from new finance platforms and innovation; a spate of mostly small and regional bank failures in the last few years; the evolving debt crisis in the property sector; and the increasingly dysfunctional financial state of highly indebted and cash-constrained local governments, many of which have had to cut public spending, delay wage payments to civil servants, and even sell non-core services.

Against this background of recurring financial distress, the CCP has decided this year at the NPC to announce far reaching regulatory reform. The China Banking and Insurance Regulatory Commission will be folded into a new National Financial Regulatory Administration. This body will take on some supervisory functions from the now weakened People's Bank of China, whose regional administrative branches will be replaced by more than 30 political

[13] 'PBOC Predicts Fewer High-Risk Banks as It Cracks Down', Caixin Global, 04/03/2022, http://bit.ly/3oawyMI (checked: 14/04/2023).

entities, and from the China Securities Regulatory Commission. The latter will remain separate, an agent of the State Council, and take on supervisory duties over the bond issuance activities of the PRC's deeply financially stressed local governments.

Yet, reforms to state institutions are only part of a broader plan in which the CCP's role and control will be strengthened. A Central Financial Commission is going to be established to take responsibility for financial policies, along with a Central Financial Work Committee, to oversee CCP-related affairs in the financial system.

What is clear is that in the delicate balancing act between economic efficiency and stability in the financial system, the CCP has decided to carry its centralisation tendencies further into the financial sector and place a big bet on stability. A more centralised system of political control could reduce fragmentation in the system, and lessen the ability of financial intermediaries to indulge in 'regulatory arbitrage' between decentralised regulators and provincial agencies.

On the other hand, it could also turn out to be an agent of still greater financial instability, which is always more likely when the balance sheets of financial institutions are highly correlated. As it is, the PRC's 4,000 or so banks are already under state control and account for the bulk of the financial system since the authorities shrunk shadow banking. Greater uniformity in the system's balance sheet behaviour can amplify fault lines such as bad debt, illiquidity, and other problems including poor decision-making.

The arguments have presumably been had, and the CCP has decided that more centralisation and political control are the way forward to bolster financial stability. It remains to be seen if this proves to be the case. The existence of implicit guarantees covering local government and SOE debt, the bad loan books in the banking system, the diminishing capacity of borrowers to take on more debt, and misallocated capital are all pressing matters which the new regulatory system will have to address, and all contain their own seeds of instability that could undermine the CCP's best laid economic plans.

About the author

George Magnus is a Research Associate at the University of Oxford's China Centre and at SOAS in London, and author of *Red Flags: Why Xi's China is in Jeopardy*. He served as the Chief Economist and later Senior Economic Adviser at UBS during a period spanning over 20 years, having previously worked in an economics capacity at SG Warburg, Bank of America, and Lloyds Bank. He writes, presents, and consults on China in a wide range of media and corporate outlets. All pieces are written in the public domain, and blogs are available at: https://www.georgemagnus.com.

> **Dedicated to making Britain, as well as other free and open nations, more united, stronger and greener.**

ISBN: 978-1-914441-39-4

Address: 14 Old Queen Street, Westminster, London, SW1H 9HP
Phone: 020 3915 5625
Email: info@geostrategy.org.uk