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# LAW AND ECONOMICS YEARLY REVIEW

ISSUES ON FINANCIAL MARKET REGULATION, BUSINESS DEVELOPMENT AND GOVERNMENT'S POLICIES ON GLOBALIZATION



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# THE CHALLENGES FOR
# THE POST-PANDEMIC CHINESE ECONOMY

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ABSTRACT: *After decades of an impressive economic boom, China has to deal with the imbalances and contradictions that made this mighty expansion possible. Since the global financial crisis, foreign trade – the main growth engine – has experienced a structural downsizing of its relevance for the Chinese economy in a climate of growing distrust from the rest of the world towards the Asian giant. At the same time, domestic demand shows signs of weakening, signaling the difficulties encountered by the authorities in pursuing an effective upgrading of spending and investment needs and capacities to the typical levels of a middle-income economy. The non-financial sector is burdened by heavy overleveraging and the recent initiatives undertaken by policymakers to curb speculation in the real estate sector and limit the indebtedness of local governments have not produced the desired results. The government had to back down and promise new stimuli to the economy. Meanwhile, the challenge of «common prosperity» remains open.*



1. In the year of the 20$^{th}$ National Congress of the Chinese Communist

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Party, China is fully committed in promoting a stable and healthy economic environment. The anniversary is of great significance and, for the occasion, Xi Jinping will have to prove that he has what it takes to obtain his third term as President of the People's Republic.

The last two years have been closed with great success. In 2020 – a year of recession for almost all countries worldwide – China grew by an enviable 2.3% and in 2021 its GDP increased by 8.1%, well above the pre-pandemic average.

The seeds of the Chinese unprecedented economic boom during the 21st century had appeared during the last decades of the previous century marked by an epochal season of reforms unleashed by Deng Xiaoping. The annual GDP – which has never experienced a negative rate of change since 1977 onwards – has gone from $ 191 billion in 1980 to $ 360 billion in 1990, and reached $ 1211 billion in 2000.

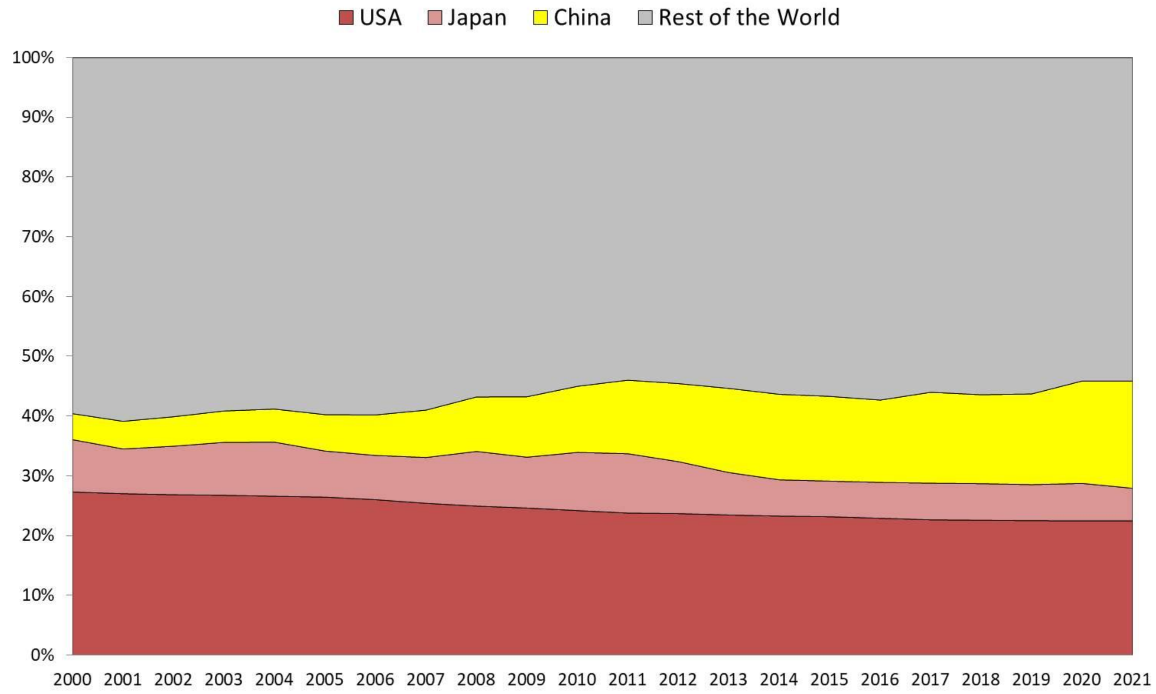
This extraordinary economic performance continued into the 2000s, with an average annual growth of 10.35% over the period 2000-2009, which allowed China to capture an increasingly large chunk (currently about 18%) of global GDP at the expense of powers such as the United States and Japan (see Figure 1). The decade 2010-2019 saw a progressive slowdown in the growth rate of Chinese GDP (on average + 7.67% per year), which must however be contextualized in light of the negative consequences of the global financial crisis not only for the Chinese economy but for the entire world economy.

The main driver of Chinese growth has undoubtedly been the strong expansion of foreign trade, which has been blessed by the country's accession to the World Trade Organization in 2001 [Yu and Hamid, 2008]. Within a few years (2004-2008), China's trade surplus has skyrocketed from $ 32.8 billion to $ 297 billion, posting an increase of over 800%.

Foreign trade has confirmed itself as the main engine of Chinese economic growth also in the period 2020-2021. In particular, the over 8% output growth posted in 2021 is largely the result of a rebound in global economic activity – especially on the demand side – that China has been able to skilfully ride with its trade expansion strategy, as evidenced by the record trade surplus of $ 676.4 billion.

However, a slowdown is expected for 2022. The signs can be seen in the downward trend of last year's quarterly growth data: + 18.3% per annum in the first quarter, + 7.9% in the second, + 4.9% in the third and + 4% in the fourth. For 2022, the consensus of analysts stands at around 5%, with the International Monetary Fund which in January revised its estimates downwards, bringing them to + 4.8% against the + 5.6% expected in October 2021.

*Figure 1* – Percentage contribution to World GDP



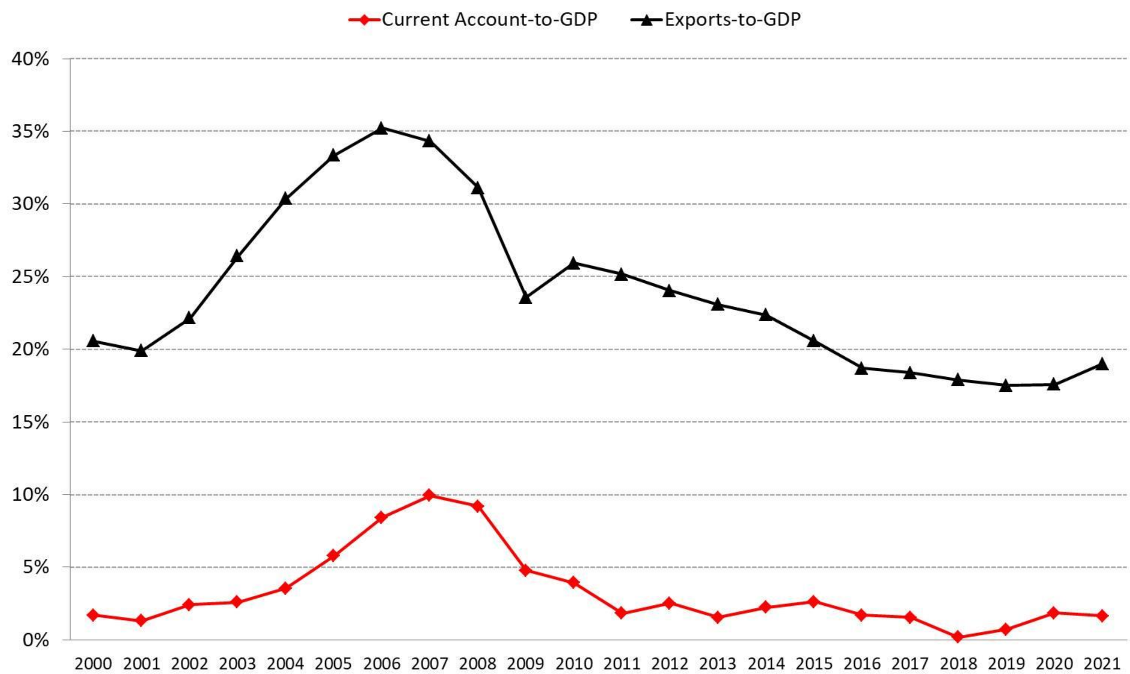

Source: IMF

Among the causes of the expected economic slowdown there is an almost inevitable deceleration in trade. As early as December 2021, top representatives of the Chinese Ministry of Commerce began to declare they expected a decline in exports for 2022 due to the contraction in foreign demand, problems in supply chains, persistent uncertainties about the evolution of the pandemic and geo-political tensions.

However, deeper dynamics are also at work, which raise uncertainties about the Asian giant's performance [Dollar, 2022]. Among them, two deserve particular attention: the structural reduction in the relevance of trade for the Chinese economy after the global financial crisis and the enormous leverage of the non-financial sector.

2. After the global financial crisis, the weight of trade in the Chinese economy has been structurally downsized. The phenomenon is evident by examining the trend of the current account balance and exports as a percentage of GDP since the beginning of the century (see Figure 2). The current account balance, which in 2007 had reached 10% of GDP, underwent a major decline in 2008-2009; since then it has fluctuated below 5% following an essentially downward path, with the exception of the rebound that occurred in the last two years due to the extraordinary conditions created by the pandemic.

*Figure 2* – Chinese current account surplus and exports in GDP terms



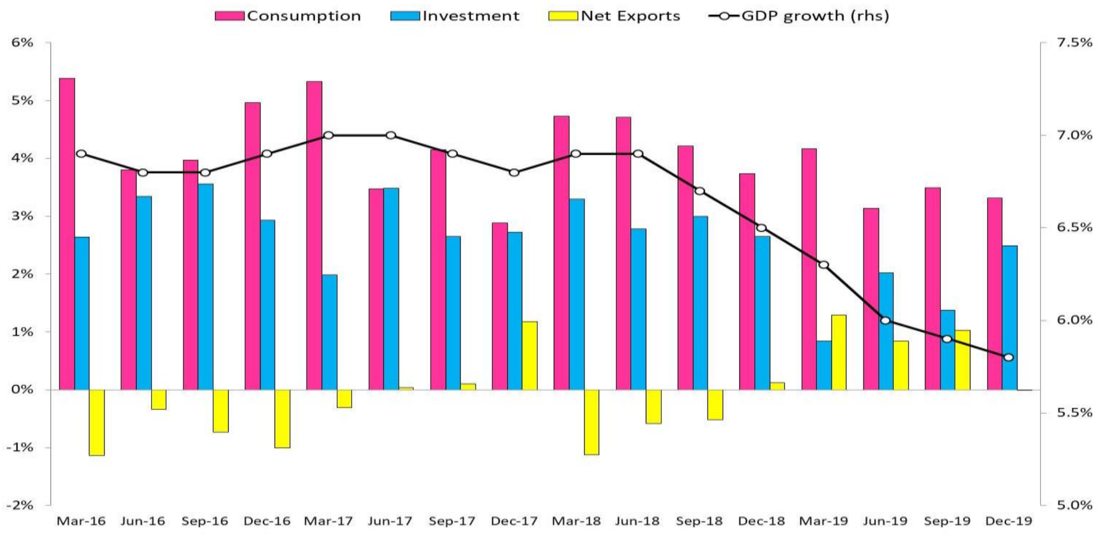

Source: IMF and Bloomberg

The same goes for exports: in the period 2000-2008, Chinese exports were on average equal to 28% of GDP, with peaks of 35% in the years immediately before the international financial crisis. After the sharp slowdown in 2009 and the (physiological) rebound the following year, the exports-to- GDP ratio has embarked on a path of decrease that has brought it steadily below 20%. Even in 2021 – despite a 1.6% recovery compared to the first year of the pandemic – it remained below this value.

These dynamics come from a mixture of factors, among which: a narrowing in Chinese competitiveness as global exporter related to rising labour costs (especially in labour-intensive production processes, [Nicita and Razo, 2021]), and increased importance of domestic demand as driver of growth (even if not able to fully compensate for the decline in the component represented by foreign trade).

To assess this latter point, it is useful to take a look at the contribution of the three main demand-side items to China's GDP growth in the run-up of the pandemic (see Figure 3). In the four-year period 2016-2019 internal demand has been pivotal to Chinese growth. Consumption, in particular, had a strong role, experiencing an average growth above 4%, albeit in what looks like a downward trend. Even more amazing is the poor performance of net exports, whose contribution to the economic growth averaged close to zero during the period at stake.

*Figure 3* – Contribution of the three main demand components to China's GDP growth: 2016-2019
(YoY growth rate)

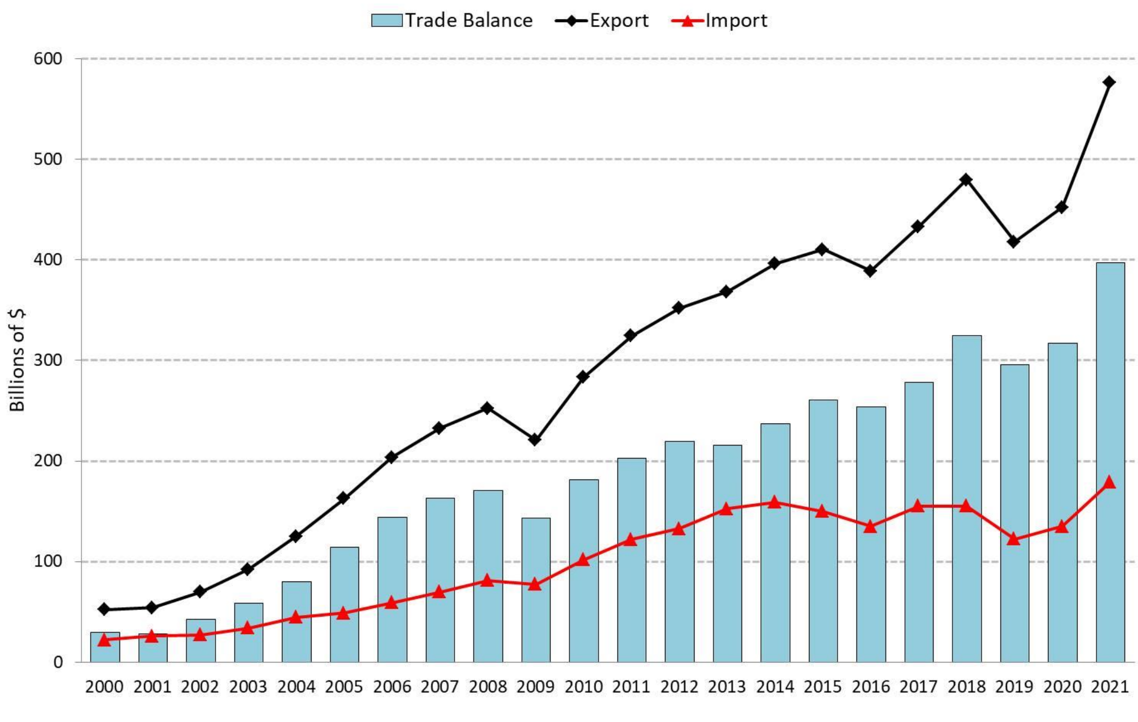



Source: National Bureau of Statistics of China

3. A third element that has weighted considerably on the downsizing of trade within the Chinese economy is the changed attitude of the United States and other countries towards the Chinese production and commercial machinery after 2010.

The US – as well known – is the leading market for Chinese exports, with a trade deficit towards the Asian giant of almost $ 400 billion in 2021 (see Figure 4). Washington recently announced that the Beijing government has not respected the purchase commitments made under Phase 1 of the Sino-US trade agreement signed in early 2020, when Trump decided to shelve the tariff war.

*Figure 4* – China's trade with the US




Source: Bloomberg

Those commitments envisaged that in the two-year period 2020-2021, Chinese imports of certain US products and services (including agricultural goods, manufactured goods and energy products) should have exceeded the base levels reported in 2017 by at least $ 200 billion, for a total of $ 502.4 billion. Instead, actual Chinese imports of the goods and services identified by the agreement would have been equal to 57% of what was promised, with peaks of 80% for agricultural goods.

A resumption of the tariff war appears unlikely. Some sectors of the American economy have strongly benefited from the increase in Chinese demand and Trump's tariffs have hit American consumers and investors much more than Chinese exporters [Amiti *et al*., 2020; Fajgelbaum *et al.*, 2020]. Yet, there is a mounting economic and political pressure on the White House to pretend from China new purchase commitments of US goods and services for the coming years.

Apart from its bilateral trade relations with Beijing, Washington is also actively engaged in curbing the expansion of Chinese power in the international arena, not only from an economic and financial point of view, but also from a political, military and ideological one. In February 2022, the Biden Administration published its *Indo-Pacific Strategy* [US White House, 2022], which reveals an unequivocal shift of the US attention towards a region that is considered *vital* to its security and prosperity. Since inception the document makes it clear the US position with a sharply defined statement: «*The United States is an Indo-Pacific Power*» and explains that the intensified American focus on the region is partly due to the mounting challenges faced by the Indo-Pacific, particularly from the People's Republic of China.

The US is also a frequent presence in the long list on initiatives taken over the last years to contain the enlargement of the Chinese sphere of influence. Underlying these initiatives [Beckley, 2022] is a sentiment of distrust towards China shared by an increasing numbers of countries. According to a survey carried out in 2020 by the Centre for Strategic and International Studies, about 75% of foreign policy elites in Asia, the US and Europe consider China as a national security problem and believe that the best way to address it is to form coalitions of like-minded countries.

There is not only a growing annoyance with China's mighty economic expansion, but there are also concerns over security and defence issues and a growing embarrassment of many countries in willingly accepting the official position and the concrete decisions of the Beijing government on respecting and safeguarding human rights[1].

International cooperation against the perceived Chinese threat already includes several partnerships and agreements. In 2021 the United States, the United Kingdom and Australia have signed a security pact (*AUKUS*), by which the US and the UK commit to help Australia in the acquisition of nuclear-powered submarines. Last year the US have also entered into a partnership with Japan for competitiveness and resilience that fosters innovation in digital technologies, research and investment in biotechnology, the identification of reliable suppliers and collaboration on sensitive supply chains, such as that of semiconductors. Meanwhile, Japan has signed an agreement on supply chains with Australia and India that offers incentives to companies that move their activities outside of China [Beckley, 2022].

To these measures on a voluntary basis add others that are somehow "stimulated" by the US. This is the case of the restrictions placed by numerous countries against Huawei, the Chinese 5G telecommunications giant, but also of the moves aimed at slowing China's progress in the production of cutting-edge chips by inhibiting its access to the equipment of the United States and their allies. For example, in 2020 the United States *de facto* forced the Dutch ASML, the only company in the world to produce the components necessary for the manufacture of the most advanced chips, to block the sale of a machine to the Chinese SMIC.

4. For its part, China keeps striving to consolidate its power through strategic agreements and ambitious outward investment projects. Over the last years it has exploited its huge economic and trade leverage to sign important partnerships with historical US allies. In 2022 it has entered into force the *Regional*

[1] In May 2021 the European Union froze the ratification of the Comprehensive Agreement on Investment (CAI) with China in response to the sanctions adopted by the latter against the EU institutions and deputies who had condemned violations of human rights by part of the Beijing government. Later on (September 2021) the European Parliament approved a Report on a new EU-China strategy which affirms the strategic importance of EU-China relations but clarifies that until China removes the aforementioned sanctions, the CAI approval process will not will be resumed.

*Comprehensive Economic Partnership* (RCEP), a free trade agreement among 15 Asia-Pacific countries – including China, Japan, South Korea, Indonesia, Australia and New Zealand – which account for almost one third of global population and GDP.

Meanwhile, the *Belt and Road Initiative* (BRI) and the growing stakes cultivated in Africa aim to ensure a reliable network of commercial partners (possibly geographically close or in any case easily reachable using infrastructures financed by Chinese capital) towards which to direct Chinese exports and from which to procure the resources and goods needed to the functioning of the Chinese locomotive.

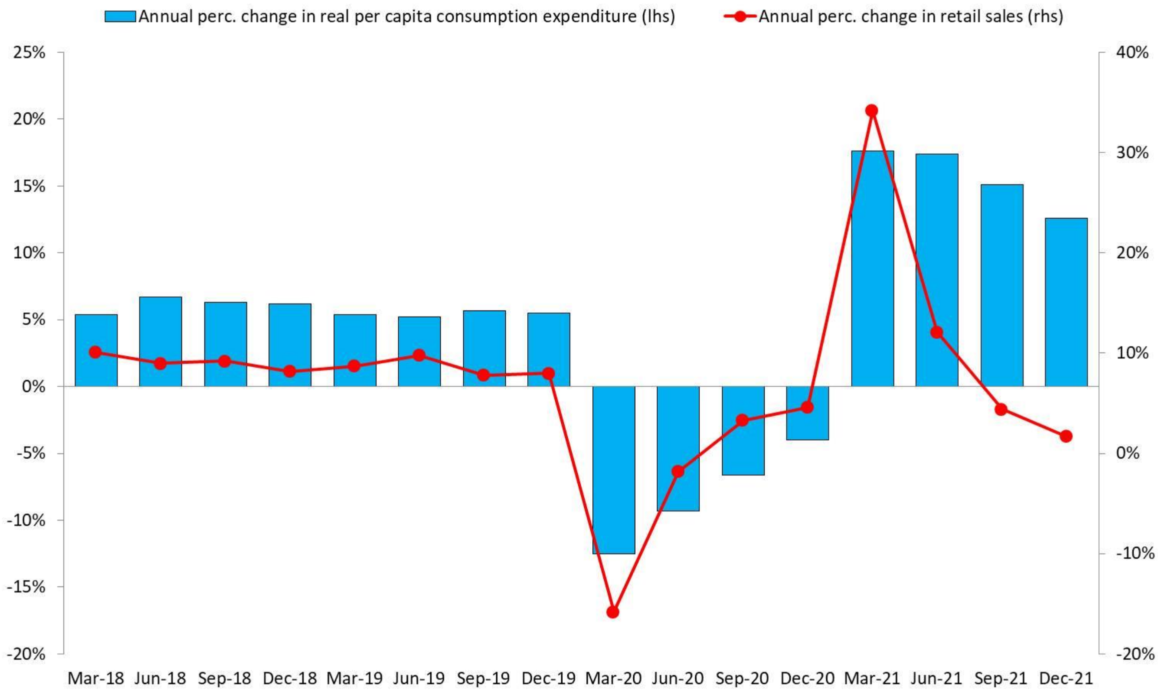
Other initiatives are instead aimed at strengthening the internal market, as in the case of the mega-project of the *Great Bay Area* which intends to connect Hong Kong, Macao and the Guangdong province (the most profitable in mainland China) with a 36 km bridge to create a single market that is at the forefront of innovation and development on a global scale [Mauldin, 2018].

These projects are part of the broader *dual circulation strategy* with which China – taken note of an increasingly less favourable external climate – intends to reorient its economy inwards (*internal circulation*) without however renouncing investments and international trade (*external circulation*) [Lin and Wang, 2021]. Formalized by the Politburo of the Communist Party in April 2020, after the Covid experience had forced China to turn its gaze to the domestic market, the *dual circulation strategy* should prioritize domestic consumption as a growth driver with the dual purpose of increasing the self-reliance of the country and achieving the «*common prosperity*» of its people.

However, almost two years after the announcement of the new strategy, there has been little concrete progress towards *internal circulation*. After the blaze recorded in the first part of 2021, the recovery in private consumption has lost its tone as indicated by the slowdown in the growth of real per capita expenditure in the last quarters of 2021 (see Figure 5). The retail sales figure is also disappointing, which last December had increased by just 1.7% compared to the same period in

2020.

*Figure 5* – Evolution of Chinese private consumption from 2018 to 2021

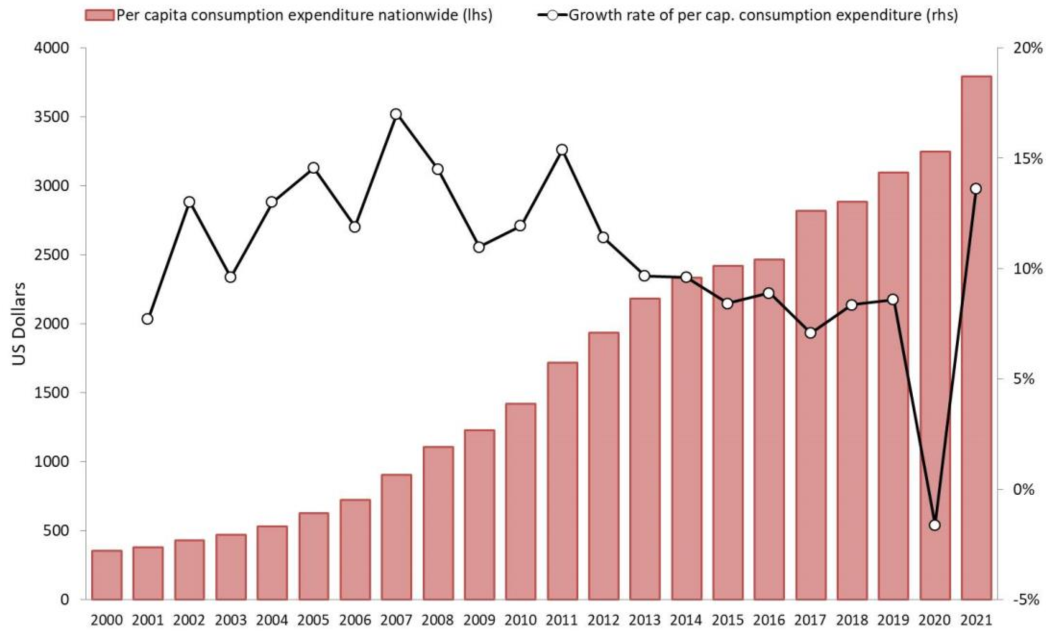



Source: National Bureau of Statistics of China

The slowdown in private consumptions was influenced by the problems on the global supply side (for example in the automotive sector) that emerged during 2021 as well as by the reduction of the credit stimulus by the Chinese monetary authorities. But it is also symptomatic of the difficulty of achieving – at least in a short time – a stable boost in consumption by a population that continues to receive relatively low wages and is still far from having the typical spending needs of a mature economy. In 2020, Prime Minister Li Keqiang said the annual disposable income per capita is $ 4,200 and that 600 million people live on a monthly income of just $ 140.

An analysis over a longer time horizon reveals that, since the global financial crisis, both consumption and wages have experienced a slowdown in growth rates. The phenomenon is particularly evident when observing the trend in per capita consumption expenditure (see Figure 6): in the period 2000-2011 it posted an average annual growth rate of 12.7%, while in the period 2012-2021 the average annual growth rate fell to 8.4%.

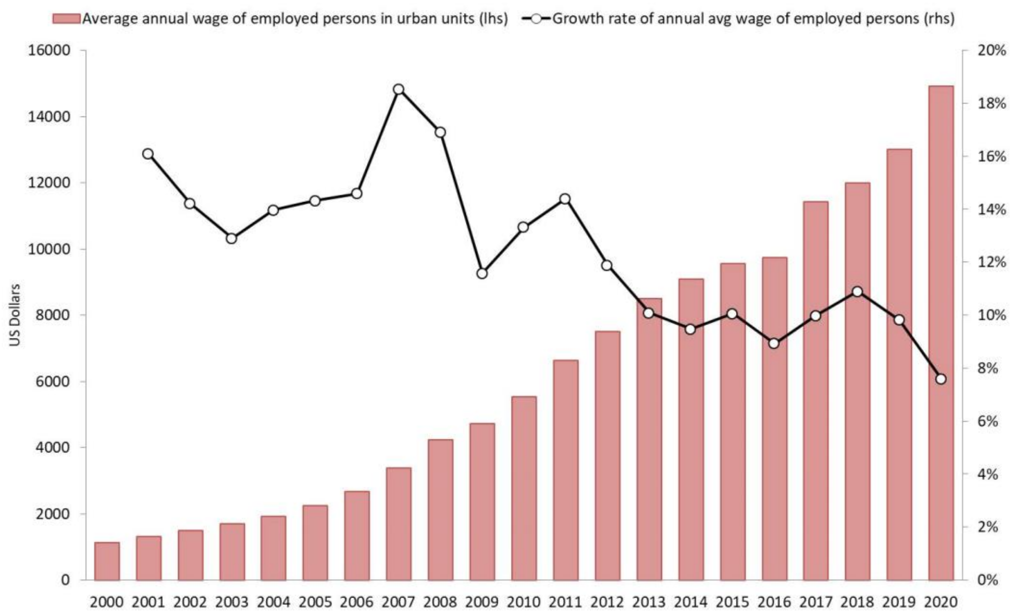
*Figure 6* – Chinese per capital consumption expenditure: 2000-2021




Source: National Bureau of Statistics of China

Average wages share a similar pattern (see Figure 7). Today, the average annual remuneration of urban workers has increased by more than 1200% compared to the beginning of the century, but in the decade 2011-2020 its average annual growth rate has dropped by more than 4 percentage points (from 14.6% to 10.3%) compared to the previous decade.

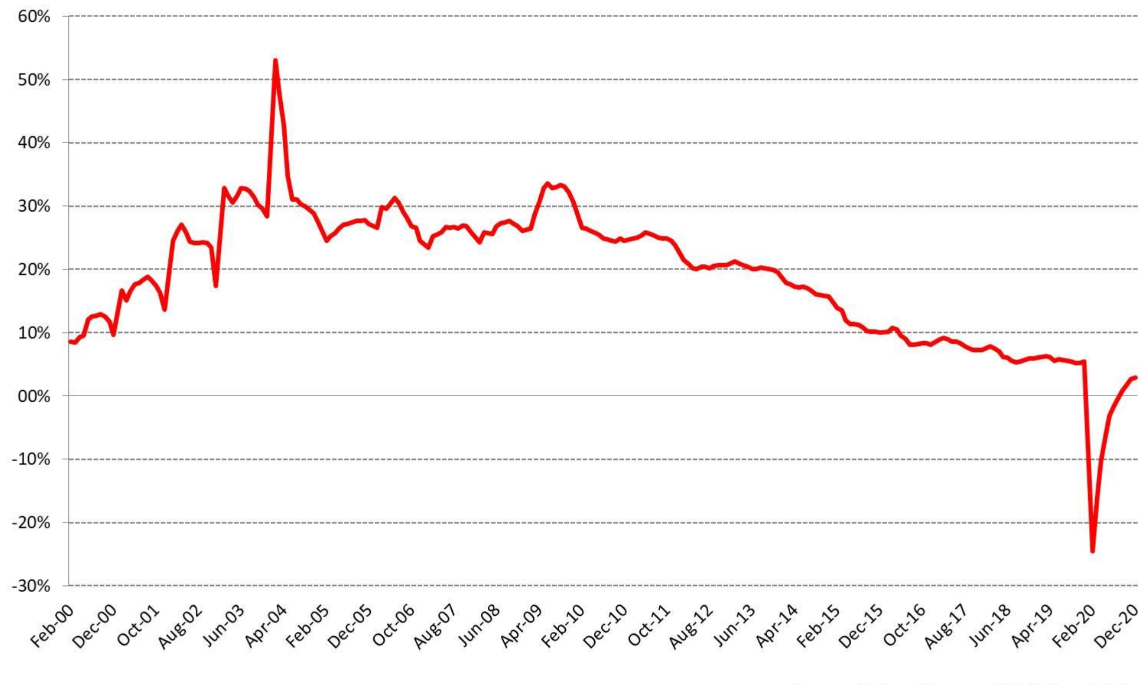
*Figure 7* – Chinese average annual wages: 2000-2020




Source: National Bureau of Statistics of China

The weakness of consumption is accompanied by a (only partially physiological) decline in growth rate of investments. Indeed, provided that in absolute terms investment spending remains high in both the public and private sectors, a look at the long-term trend reveals a descending pattern. Infrastructure investments fell from 12 to 6 per cent of GDP between 2007 and 2020 and over the same period their annual growth rate fell from 13.6 to 5.8 per cent. More generally, starting from the global financial crisis, the growth rate of expenditure on fixed-asset investment – on average equal to 25% in the period 2000-2007 – began to decline (see Figure 8) and ended 2019 just above 5%. A further slowdown occurred in 2020, which clearly suffered from the pandemic shock. However, even for 2021 the data show an at least controversial picture.

*Figure 8* – China fixed-asset investment YoY: 2000-2020
(excl. rural households)

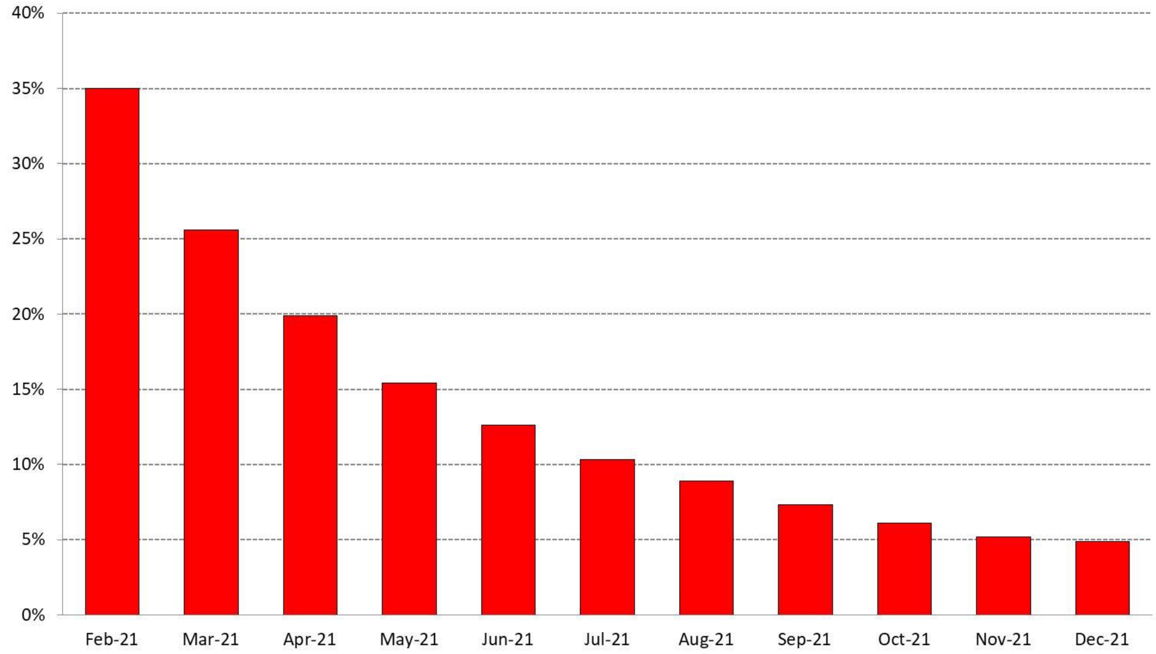



Source: National Bureau of Statistics of China

Last year investments in fixed assets grew by 4.9% (by 7% those of the private sector), but the focus on monthly data (see Figure 9) reveals a clear downward trend that from 35% at the beginning of the year continuously drops, falling below 5%.

In fact, in the first half of 2021 there was a rebound effect from the pandemic shock which in the second half was followed by a gradual slowdown linked to the reduction of the credit stimulus and the outbreak of the real estate crisis triggered by Beijing's attempt to stop speculation in a sector that represents 29% of GDP.

*Figure 9* – China: fixed-asset investment YoY in 2021
(excl. rural households)



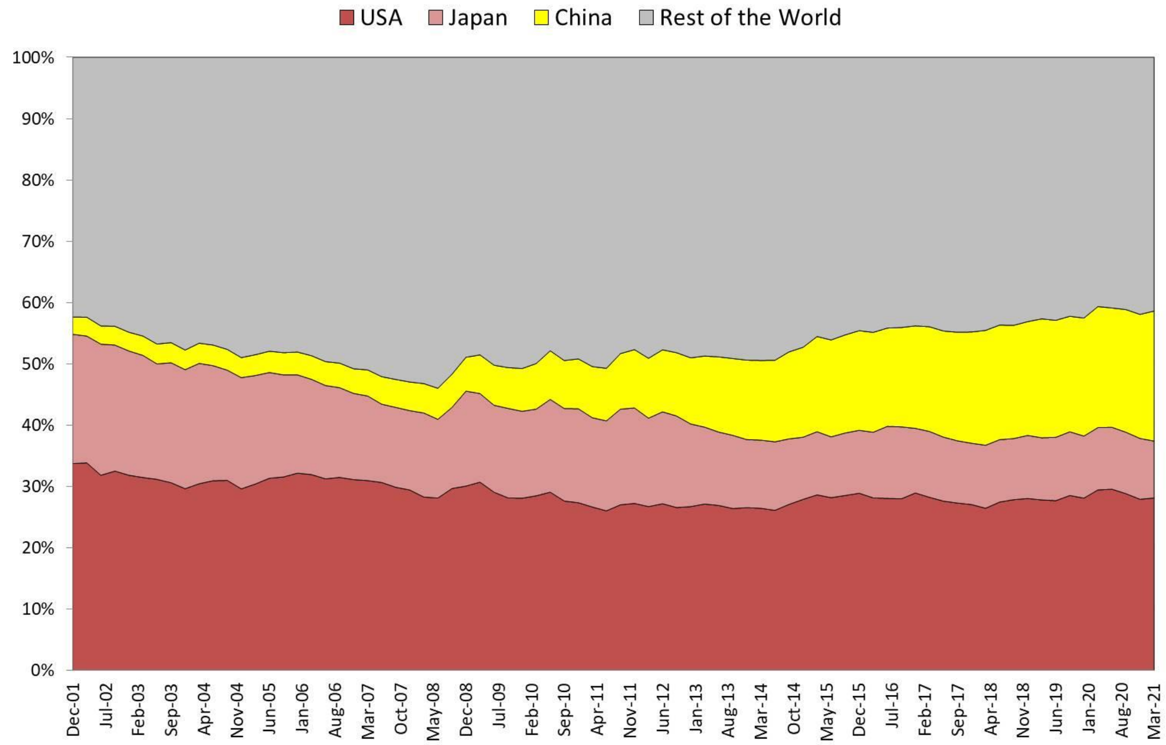

Source: National Bureau of Statistics of China

5. Huge leverage is the other big weak link in the Chinese economy, recently brought to the fore by the real estate giant Evergrande crisis.

The data of the Bank for International Settlements on credit to the non-financial sector allow to immediately frame the exceptional dimensions of the phenomenon. In March 2021, the aggregate debt of households, businesses and the public sector exceeded $ 46 trillion, equal to 287% of China's GDP. Growth rates are impressive, with an average annual increase of 18% over the last two decades.

As a consequence, if at the beginning of the century China represented a fairly small share (less than 3%) of the global non-financial sector debt (public and private), currently its weight is 21%, second only to that of the United States (28%, see Figure 10).

*Figure 10* – World non-financial sector debt (public and private) in GDP terms: main contributors by reference economic area

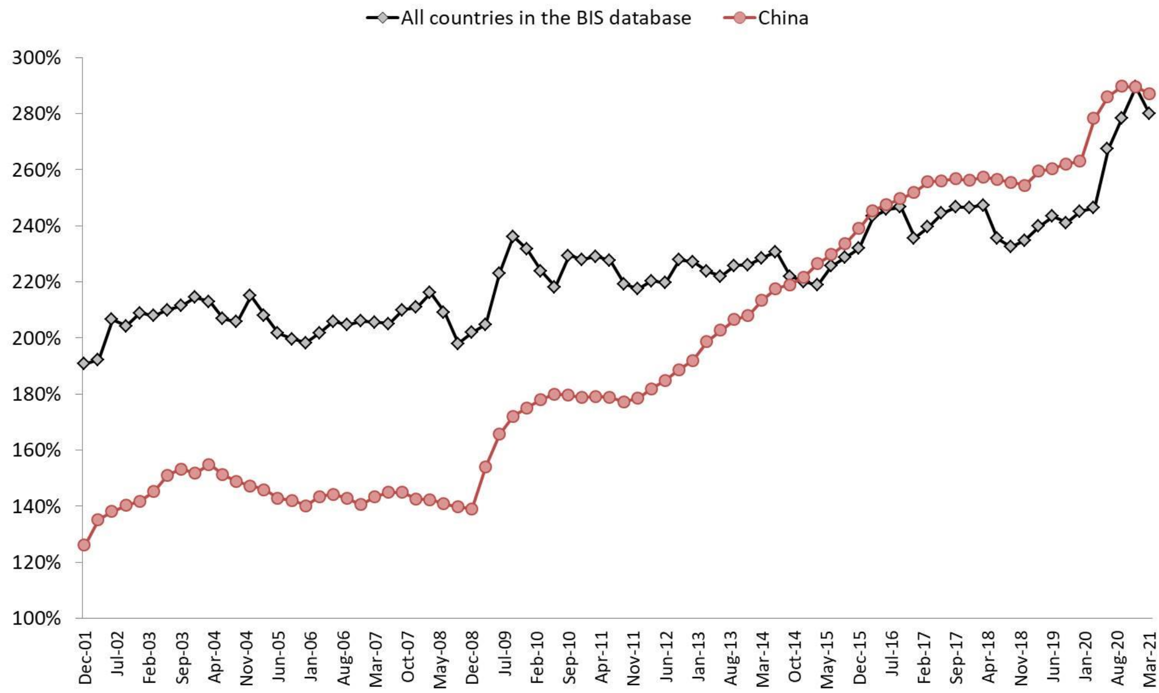



Source: Bank for International Settlements

Note the similarity between the dynamic of Figure 10 and that of Figure 1 of Section 1: the comparison between the two Figures makes it immediately clear how the resort to indebtedness was fundamental to stoke China's economic growth over the past two decades.

Once again, however, the global financial crisis marks a watershed between two distinct phases. Until 2008, debt growth went substantially in step with that of the economy, so the leverage of non-financial operators represented a fairly stable percentage of GDP. The picture changed radically since 2009: that year the leverage of the non-financial sector posted a big leap upwards increasing by about $ 2,400 billion (that is over 36 percentage points of GDP) driven by an extraordinary credit stimulus. Under pressure from the authorities concerned to react adequately to the global financial crisis, the banking system more than doubled new loans to the economy compared to the previous year (from 4178 to 9622 billion Yuan). Since then, China's debt/GDP ratio has continued to grow at a rapid pace until 2015, surpassing the global one by the end of 2014 (see Figure 11).

*Figure 11* – Non-financial debt in GDP terms

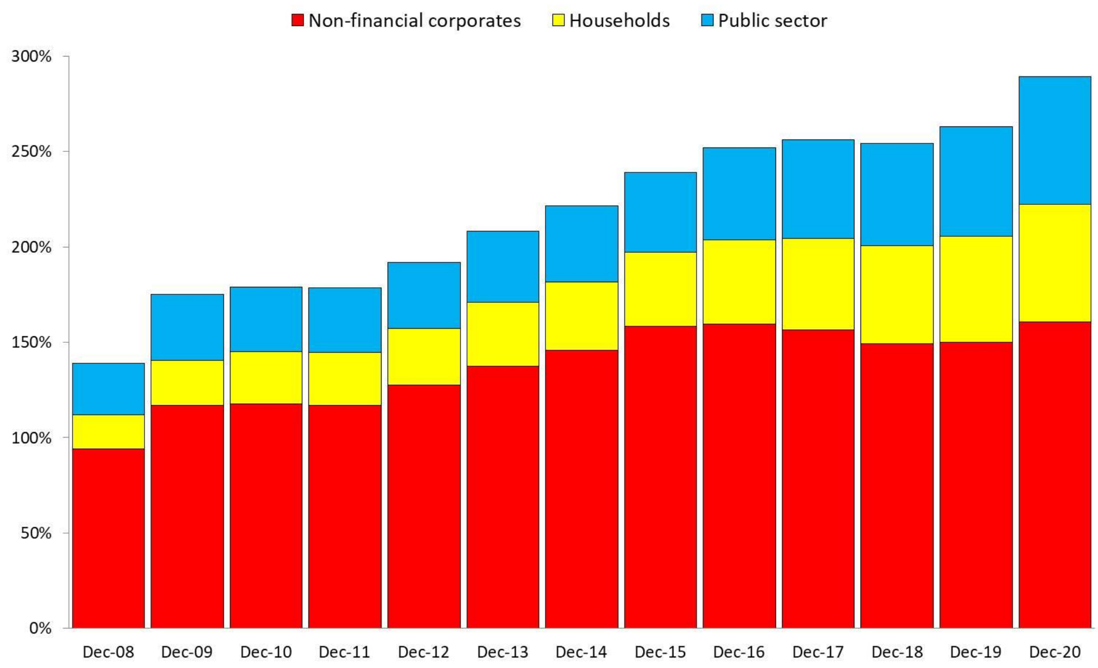



Source: Bank for International Settlements

The undisputed protagonists of this expansion were non-financial companies, whose total debt at the end of 2015 was equal to 1.6 times the entire gross domestic product of China (see Figure 12). In the case of state-owned companies, this exploit was mainly favoured by public banks' lending, while for private ones, resources also came in abundance from unregulated credit channels, the famous shadow banking.

The uncontrolled growth of shadow banking (+ 660% between December 2008 and December 2015) and the significant credit exposure achieved by state banks prompted the Beijing government to start a policy of deleveraging the economy between the end of 2014 and 2015. The effect of this policy was to halt the advance of corporate debt which remained at around 150% of GDP in subsequent years. The following years (up to the end of 2019) were characterized by a significant increase in household debt, which went from 48% to 55.5% of GDP, with a significant incidence of real estate loans. Finally, in 2020, a new expansion of credit to the economy to quickly emerge from the pandemic emergency led to another considerable increase in leverage in all three sub-sectors that are part of the non-financial economy.

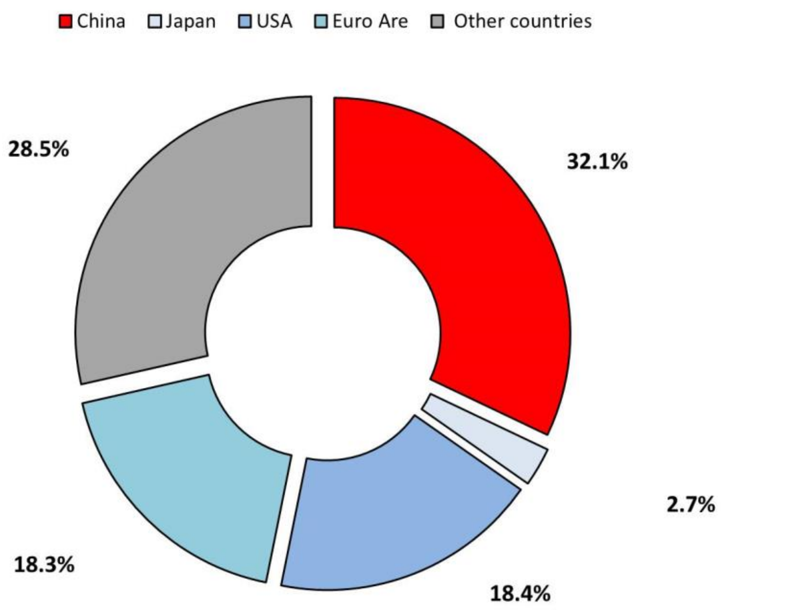
*Figura 12* – China: non-financial debt in GDP terms - breakdown by sub-sectors




Source: Bank for International Settlements

Between March 2020 and March 2021, the overall leverage of the non-financial sector increased by 22% compared to + 8.5% in the United States and + 14% in the euro area. In terms of contribution to the increase in global non-financial debt in the time interval considered (over $ 26 trillion), China outperformed the other economic macro-areas, with a weight equal to almost 1/3 of the total (see Figure 13).

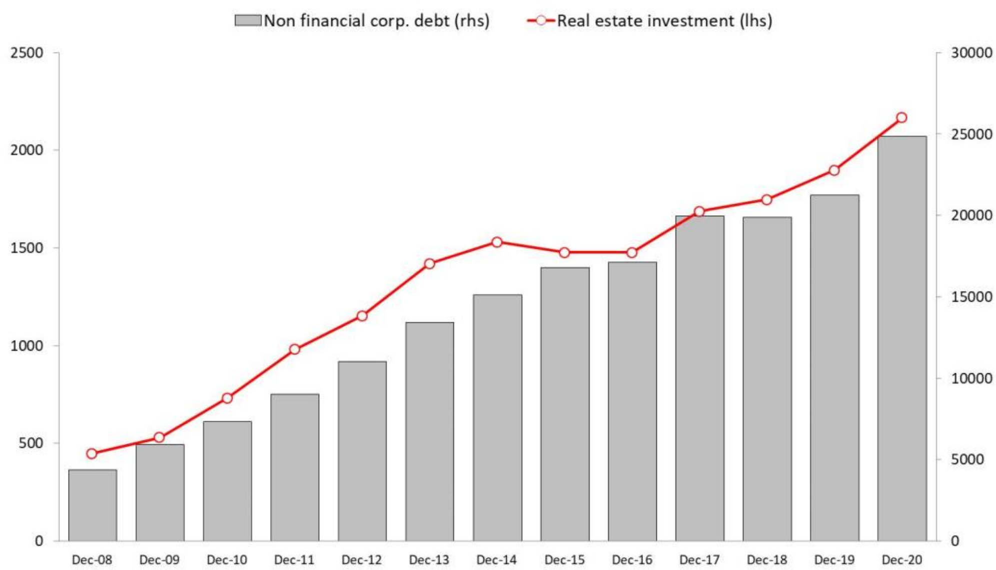
*Figure 13* – Increase in global non-financial debt global from March 2020: contribution of the main economic macro-areas




Elaborations on Bank for International Settlements' data

6. The real estate sector is among those that have benefited most from the rapid accumulation of debt in the Chinese economy. The connection between real estate boom and corporate credit expansion is evident by comparing the latter with data from the National Bureau of Statistics of China on real estate investments in the country (see Figure 14). The dynamics of the two quantities are largely superimposable.

*Figure 14* – Real estate boom and corporate debt in China
(data in billions of $)



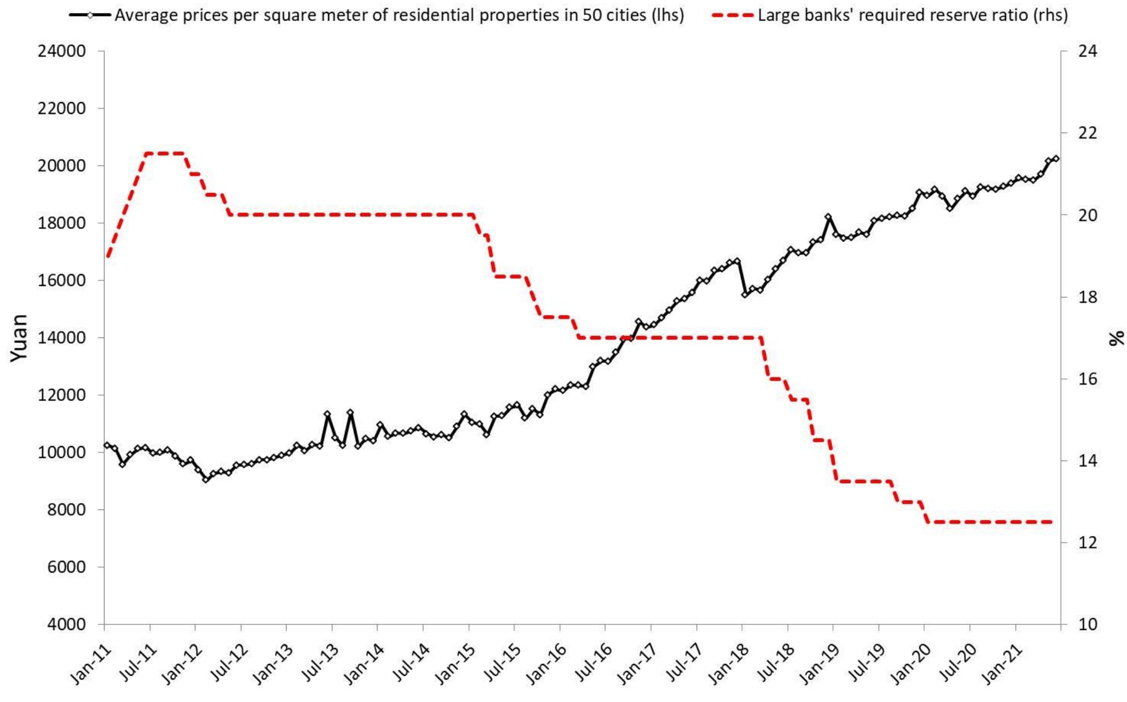

Source: Bank for International Settlements and National Bureau of Statistics of China

Real estate investments, which amounted to $ 471 billion at the end of 2008, in 2014 had exceeded $ 1500 billion; after a modest slowdown in the two-year period 2015-2016, they resumed growth as early as 2017 and reached $ 2166 billion in December 2020.

At the base of these astronomical figures there are several factors, starting from the strong demand for housing, especially in cities. The urbanization process has resulted in an exceptional flow of individuals from rural to metropolitan areas. In 2000, 64% of the Chinese population lived in rural areas; in 2015 this percentage had dropped to around 50% and today it is around 38%. This phenomenon intersected with another peculiar feature of the Chinese reality: the high rate of home ownership. Among the large economies, China is in fact the one with the highest percentage of owner-occupied dwellings (about 90%) and over 20% of households own more than one house, a figure higher than the one of many developed countries. These habits of life and investment have consolidated over time and reflect the preference of the Chinese for investments perceived as not risky (the safety of the "brick") compared to those considered more risky, such as in the stock market.

These socio-cultural dynamics have been favoured by the large inflows of liquidity from abroad in return for China's commercial success in the international arena. But the abundance of credit to the economy by the domestic financial system also played a decisive role, favoured by years of support by the monetary authorities. When the real estate sector, which is extremely important to economic growth, showed signs of slowing, the People's Bank of China intervened by cutting banks' required reserve ratios to guarantee a copious credit supply both to companies in the sector and to households, with the effect of supporting house prices (see Figure 15).

*Figure 15* – China: real estate prices *versus* required bank reserve ratios




Source: Bloomberg

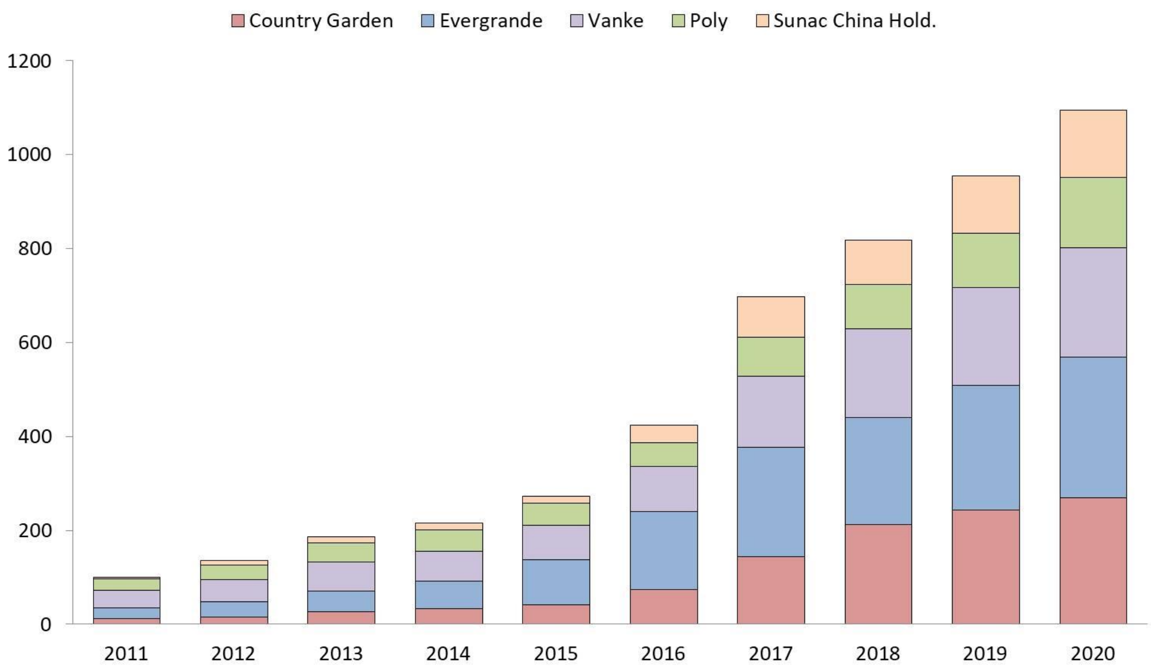
In the long run, these artificial support mechanisms have fuelled a de-anchoring of property prices from household income, witnessed by abnormal values in the house price-to-income ratio. In Hong Kong the ratio is 45, in Beijing it is close to 50, meaning that the price of a house in the capital is about 50 times the annual income. Such high figures have not even been seen in Japan during the bubble of the early 90s. Not to mention that these are average values on all homes, but home prices are significantly higher in the most renowned cities (*tier 1*). For example, in June 2021 the average price per square meter of residential properties was $ 3,240 calculated on a sample of 50 cities of various levels, while that of housing in *tier 1* cities was $ 8,140.

The overheating of the sector has unleashed speculation and moral hazard on the part of developers, favouring an excessive building proliferation, certified by the high share of empty homes. According to a nationwide survey, nearly 22% of China's urban housing stock was unoccupied in 2017, which equated to more than 50 million empty homes.

To fund their projects, developers have accumulated a monstrous debt not only towards banks and other intermediaries but also towards non-financial counterparties. Very often builders collect large advances or security deposits from customers on properties that have not yet been completed or even started. The payment of suppliers through commercial papers (i.e. short-term credit notes) is also widespread, so much so that in July 2021 the Chinese regulators began asking developers to include information on the issuance of these forms of debt in their periodical reports.

To get an idea of the enormous leverage of the sector, it is enough to consider that at the end of 2020 the top 5 real estate companies (Country Garden, Poly, Evergrande, Vanke and Sunac) had total liabilities of over $ 1,000 billion, about 10 times more than levels of 2011 (see Figure 16). And this figure does not include off balance sheet liabilities.

*Figure 16* – Total liabilities of the top 5 Chinese real estate developers
(data in billions of $)




Elaborations on Bloomberg data

7. Since August 2020, the Beijing government has announced its intention to limit the debt of developers with the aim of halting the growth in property

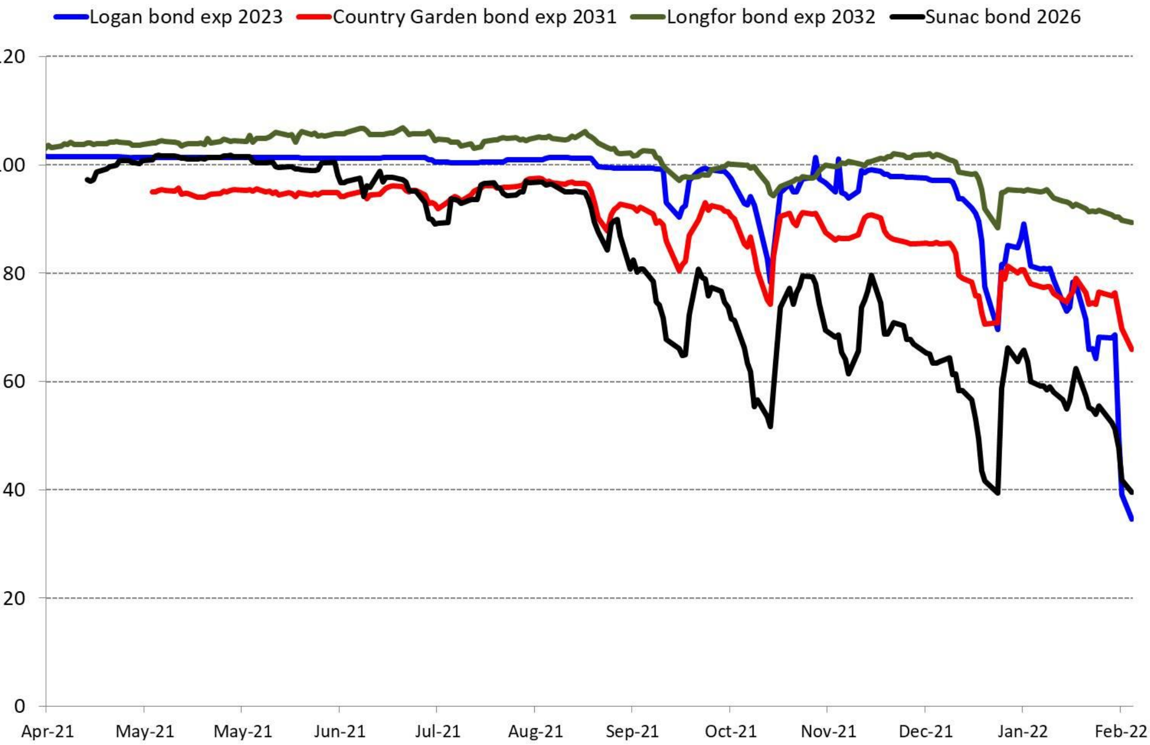
prices, diverting credit to other strategic sectors (such as technology) and curbing the speculation. The squeeze came in 2021 with the «*three red lines*» policy, which introduces thresholds for three financial ratios of some large real estate companies: liabilities on total assets, net debt on equity and cash on short term debt. According to what was established by the central bank together with the Ministry of Housing, the first two ratios must be below 70% and 100% respectively, while the third must be above 100%. If a company does not comply with any of the three thresholds, the following year it will not be able to increase its debt by more than 15%. As a comparison, it is worth noting that some large companies such as Country Garden and Evergrande have reached peaks of increases in total liabilities of 95% and 75%, respectively, in the last decade.

The new rules have made the financial climate more hostile for real estate companies, not only because of the limits on leverage but also because – together with the first defaults of small public companies – they have contributed to questioning the implicit guarantee of the state on the corporate debt.

In February 2021, the China Fortune Land Development company did not honour some payments and in the meantime other developers have also started to have liquidity problems. In the case of Evergrande (which, needless to say, did not respect any of the three red lines) this scenario aggravated a situation that had deteriorated since the third quarter of 2020. The first rumours that if strategic investors had asked for their money back, Evergrande would have had a liquidity crisis date back to that period. Since then things have plummeted. Banks have begun to reduce their exposure, regulators have put the company under pressure and the management has begun to sell company branches to raise cash and pay off debts. In a short time, the downgrades from the main rating agencies arrived and the prices of the bonds issued by Evergrande collapsed. Lack of cash and the impossibility of funding did the rest [Minenna, 2021].

The contagion to the entire real estate sector and to other strategic areas of the Chinese economy revealed how unrealistic Beijing's intentions were [Pettis, 2021]. Within a few months, financial markets repriced the credit risk of the property sector: many of the biggest names in Chinese real estate (such as Country Garden, Sunac or Logan, see Figure 17) have burned billions of dollars in market capitalization and the value of their bonds has plummeted, in some cases reaching default prices.

*Figure 17* – Market value of a sample of bonds issued by top Chinese developers: Apr. 2021-Feb. 2022



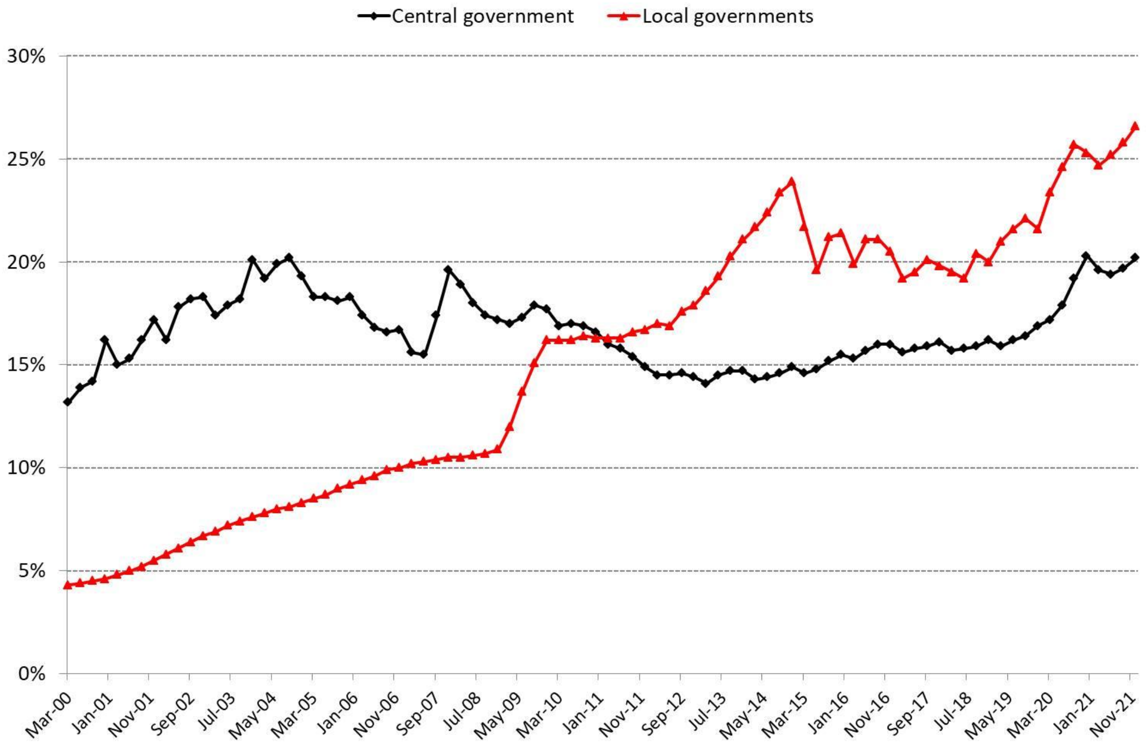

Source: Bloomberg

8. Problems quickly spread from real estate to the finances of local governments who rely heavily on proceeds from land auctions to replenish their coffers. In China, the land belongs to the people (that is, it is public) and the auctions concern the temporary allocation of land for relatively long periods. Between June and September 2021, the percentage of unsold lots in local government auctions almost tripled (from 10 to 27 percent) and the situation did not improve in the following months. A research on a sample of 300 cities revealed that in 2021 the land revenues of local governments fell by 7%, the lowest value since 2014, creating budget problems for local governments, which

are the main source of financing of public spending[2] and which are also burdened with a mountain of debt.

From 2010 onwards, local public debt has systematically overtaken that of the central government (see Figure 18) and has now exceeded 25% of GDP, with a value of nearly $ 5 trillion.

*Figure 18* – China: central government and local governments debt in GDP terms




Source: Center for National Balance Sheets

Moreover, this is only the explicit debt of local governments, to which must be added the more abundant implicit (or hidden) debt, which was mainly ignited by financial vehicles (so-called Local Government Financing Vehicles or LGFVs) created specifically to circumvent the restrictions on local government loans and proliferated after the global financial crisis. Nomura's estimates for 2020 indicate that the total implicit debt of China's local governments would be $ 7 trillion. This means that the total liabilities of local governments (implicit + explicit) are around $ 12 trillion; adding up the additional $ 3.6 trillion in central government debt, it

[2] In 2018 the IMF observed: «*China is the most decentralized country in the world in terms of expenditures shares, with subnational governments responsible for 85 percent of government spending*» [Wingender, 2018].

comes to $ 15.6 trillion in total public debt, roughly equal to 87% of GDP [Minenna, 2022].

The government has repeatedly tried (unsuccessfully) to rein in local government debt. In the summer of 2014, it passed a package of fiscal reforms which should have improved the discipline and transparency of public finances and tightened budgetary constraints for local governments to push them to a more careful selection of investments to be financed. The “braking” effect of these reforms did not last long: already in 2018 the ratio between local government debt and GDP was back on a growing path and with the further surge in 2020 it exceeded for the first time the 25% threshold.

A new attempt took place in July 2021, when the China Banking and Insurance Regulatory Commission and the Ministry of Finance issued a document titled «*Guiding Opinions for Banking and Insurance Institutions to Further Do a Good Job in Preventing and Resolving Hidden Debt Risks of Local Governments*» [Hsu, 2021].

The document (also known as *Circular No. 15*) urged banks and insurance companies not to increase the hidden debt of local governments and to carefully assess their financial conditions and spending commitments before disbursing new funds. However, it seems that, within a few weeks, *Circular No. 15* disappeared, along with most of the references to it in the state media [The Economist, 2021].

Perhaps it was a preliminary version, destined for further filing, or perhaps Chinese authorities have decided not to give too much prominence to the news. A plausible alternative is also that the crisis that was already brewing in the real estate sector has required an afterthought. Indeed, as property auction revenues declined, local governments faced increasing difficulties in placing their bonds on the market due to the gradual deterioration of domestic investor confidence and the reduction of monetary stimulus from the central bank.

9. Faced with the real risk of a chasm in local government budgets and

persistent problems in the real estate sector, the Chinese government has had to reverse the credit tightening. Since autumn 2021, money supply has resumed growing at a faster pace and, with it, the credit impulse to the economy (see Figure 19).

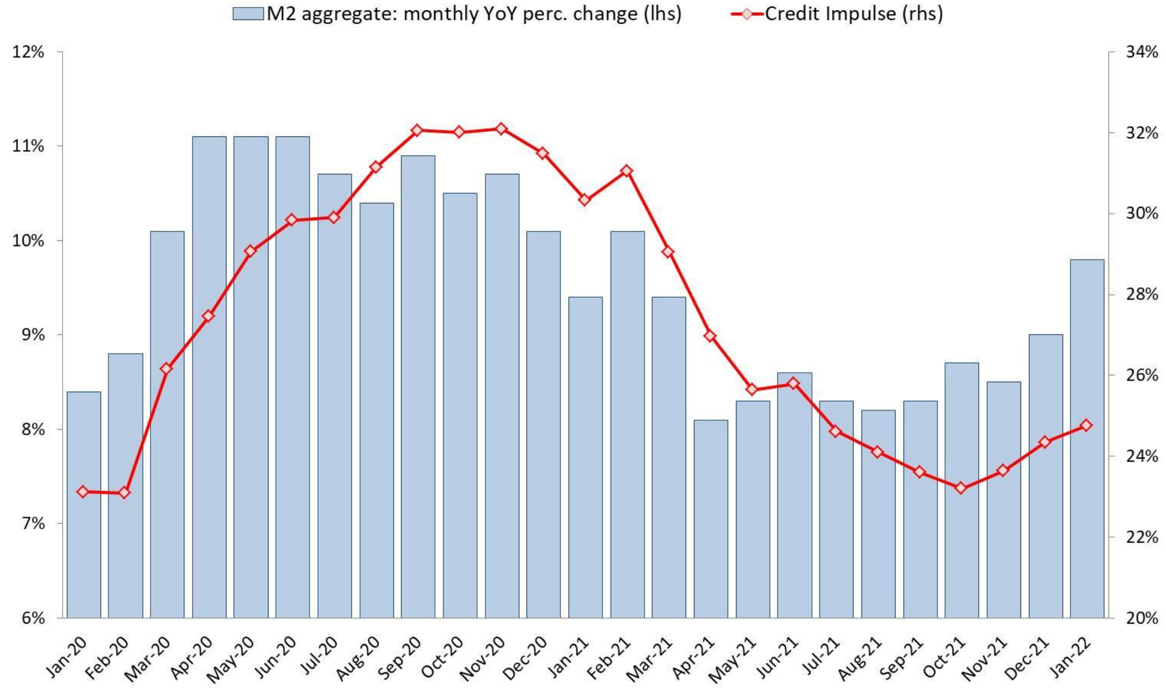
In the meantime, new measures to support domestic demand have been announced both through a relaxation of regulatory constraints on debt and in the form of a reduction in the tax levy on companies, especially small and medium enterprises.

In March 2022, strong reassurances also came from the government about its commitment to support the financial markets and the interests of private investors. In the two-year period 2020-2021, Beijing embarked on an important regulatory and sanctioning campaign to stem the monopolistic and anti-competitive conduct of tech companies such as Alibaba and Tencent[3]. The squeeze on internet giants – such as the one on the property sector – was part of President Xi Jinping's broader plan to turn China towards a «*genuine growth*». To this aim, it was essential to disconnect the country's economic development from the credit stimulus and to pursue «*common prosperity*». However, the deterioration in investors' confidence prompted by the Russian-Ukrainian conflict and the resumption of Covid-19 infections in China[4] and Hong Kong triggered a sell-off in the Chinese stock market in early March 2022, which hit especially the tech sector. Faced with the choice of continuing with the reforms or supporting the economy in a hard moment, the government opted for the second alternative and decided to put the reforms on hold to focus on its growth objectives.

[3] The crackdown on technological companies also included actions to counter the listing of large Chinese companies in the US market.

[4] Since the beginning of the pandemic, China has adopted a zero-Covid policy which has led the government to order tight lockdowns even on large and densely populated areas as soon as the risk of new outbreaks became apparent. This policy penalized the country's economic and commercial activity, and only in March 2022 the policymakers declared the intention to adopt a more flexible attitude in the action to counter the pandemic. However, in the same month, the authorities ordered the lockdown of the Shenzhen technology hub and, subsequently, of the city of Shanghai (the latter organized in two subsequent stages to dampen the impact on population and economy).

*Figure 19* – China: money supply and credit to the economy




Source: Bloomberg

10. After decades of impressive expansion, Chinese economy is facing multiple challenges associated with the difficult transition to a middle-income economy. Since the global financial crisis domestic demand has weakened, with consumption and wages experiencing a clear slowdown in their growth rates. Investment in fixed assets also exhibits a descending pattern in the long-term. A reversal occurred in early 2021 but proved to be temporary as it manifestly cooled down in the second part of the year. On the other hand, foreign trade – which has been the main growth engine since over two decades – has undertaken a structural decline in its relevance for the Chinese economy. China's formidable trade performance – initially welcomed by neighbouring countries and the West – from 2010 onwards has been perceived with growing concern by the rest of the world, favouring the proliferation of anti-Chinese agreements and partnerships.

A further criticality arises from the enormous leverage of the Chinese economy. Non-financial sector debt is worth about 280% of GDP and was accumulated with the help of strong credit stimuli launched in response to the international financial crisis. Addiction to over-leveraging is particularly evident in the real estate sector and in the public sector, and explains the crackdown that the government has tried to give on both sectors through regulatory and credit tightening in 2021.

The crisis of the real estate giant Evergrande and its rapid spread to the entire property sector and to the finances of local governments, however, made it necessary to take a sharp retrofit to protect China's ambitious growth objectives in an international environment threatened by the economic consequences of the war in Ukraine and persistent problems in global supply chains. The credit impulse to the economy has been resumed, another round of regulatory and fiscal easing has also been announced together with the promise of market-friendly policies to support the domestic stock market.

Once again, Beijing was forced to backtrack on reforms. As observed by Daniel H. Rosen [Rosen, 2021], China's economic and monetary policy over the past decade has been characterized by numerous attempts to bring financial speculation and over-indebtedness under control, especially by subnational governments and state enterprises. In 2013, the People's Bank of China cut banks' access to short-term funding: the manoeuvre sent short-term debt rates skyrocketing, causing a crisis in the interbank market that forced the central bank to quickly revoke its decision. The same fate has struck the attempt – undertaken between 2013 and 2014 – to deleverage the public sector through the involvement of private investors on the equity markets. The relaxation of listing rules and the related boom in IPOs triggered the euphoria on the stock markets which soon turned into the bubble that burst in middle 2015.

In March 2022, the government has renewed its commitment to deliver economic growth, maintain a stable macroeconomic performance, pursue high-quality and innovation-driven development, and achieve supply-side structural reforms [Li Keqiang, 2022]. Yet, such ambitious goals will have to confront with difficulties and obstacles both inside and outside the country.

Internally, the decision to go ahead with measures to support the economy is tantamount to postponing again the solution of the problem represented by the huge debt of the non-financial sector. Thus, at least in the short term, China will not come out of what increasingly looks like a debt trap. The government's wager, in the year of the 20th anniversary of the National Congress of the Communist Party, is that the response of domestic consumption and investment to the new wave of stimuli will be such as to ensure the economic performance will catch up and possibly outperform, in the end, the growth of debt. But slowing factors productivity, shrinking population and low Covid tolerance will hardly allow for such an outcome.

On the external front, the climate of distrust on the part of the United States and many other key trading partners, the withdrawal of monetary accommodation in many advanced economies, the surge in the prices of energy, agricultural and food commodities and the numerous unknowns related to the Russian-Ukrainian conflict pose a heavy burden on the fate of China's foreign trade.

According to some observers [Pozsar 2022; Munchau 2022; Escobar 2022], the Russian-Ukrainian conflict, however, could also represent a huge opportunity for China in the medium to long term. Indeed, the conflict could accelerate the establishment of a multi-polar order in which China appears destined to play a leading role in the opposing bloc to the Western one. A first step in this direction could be the consolidation of the Yuan among the main currencies at the international level, with a simultaneous downsizing of the dollar's importance. Yet, for such a scenario to really materialize, it would be necessary for the Beijing government to permanently put aside capital controls, which it never really seemed willing to do.

In any case it is clear that the economic relevance, innovation capacity and determination of its people will continue to guarantee China a central role in the global economic and financial landscape. But it will be also very interesting to understand how the Asian giant will face the internal and external challenges that separate it from the full transition to an advanced economy and with fewer imbalances.

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