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Beijing to Embark on New Round of Stimulus in 2022

Bill Campbell | December 2021

Since its acceptance into the World Trade Organization on Dec. 11, 2001, China has become an ever-more dominant player on the stage of global trade and growth. Today, the Chinese wield influence in many countries through trade and financial linkages, in some cases outweighing the clout of the U.S. Emerging markets have become interlinked with China, and the trajectory of their growth often follows the lead of Chinese growth. In March 2020, COVID-19 caused a severe global growth shock around the globe, but China managed to quickly power out of the epidemic's economic grip. Following this dramatic rebound, Beijing decided to slow stimulus and focus on deleveraging in 2021, a policy shift that has formed a headwind to many countries this year. In 2022, I expect China to change course back to a more stimulative stance, which could have a large positive impact on many countries' economies and global financial markets.

However, internal politics rather than international considerations will dictate the timing of China's resumption of stimulus. Beijing will attempt to sequence and calibrate fiscal and monetary policy to the economic upside to culminate shortly before or by the opening of the 20th National Congress of the Chinese Communist Party next October. At this event, China President Xi Jinping is expected to be appointed to an unprecedented third term – in modern China, leaders have not served longer than two five-year terms. In March 2018, Chinese lawmakers, under Xi's direction, amended the country's constitution, abolishing the presidential two-term limit. This cleared the way for Xi to continue to rule for as long as he has his party's support. Such support is a given, as evidenced by the nearly unanimous vote in favor of the constitutional change (2,958 for, two against).

Notwithstanding its economic, diplomatic and military might, China faces challenges abroad and at home. On the global stage, the COVID-19 pandemic has greatly disrupted the Chinese economy as the country has taken a zero-tolerance approach, resorting to dramatic lockdowns that have sporadically curbed domestic economic activity. Luckily for the Chinese, their country is one of the world's largest goods manufacturers; increased demand for goods helped the Chinese economy rebound strongly from the initial COVID-19 shock while the rest of the world remained moribund. We need to pay attention to the more recent outbreaks, as we have previously seen curbs implemented on economic activity due to new outbreaks of COVID-19, potentially risking future growth.

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Figure 1
Source: Bloomberg, DoubleLine, as of September 30, 2021

To address the initial collapse in economic activity caused by lockdowns in 2020, Chinese authorities unleashed a massive credit stimulus to support economic growth, and it worked. The combination of policy stimulus and the increased global demand for Chinese goods helped the Chinese economy recover quickly. *(Figure 1)*

At the turn of the year from 2020 to 2021, Chinese authorities saw the need to pull back on credit stimulus. With economic activity healed, Beijing refocused on financial stability and dealing with a large stock of leverage in the economy. China's economy is highly dependent on leverage, which has supported robust growth, but recently the Bank for International Settlements estimated that China's total credit to the non-financial sector was over 285% of GDP. *(Figure 2)*

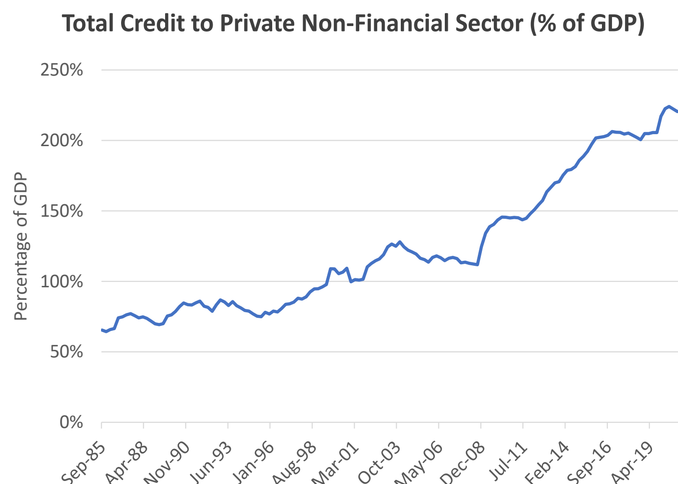


Figure 2
Source: Bank for International Settlements, Federal Reserve Economic Data, as of December 31, 2021

Although Chinese government debt remains very low, Chinese corporations, households and banks combined with the government to push this total debt calculation to a level that Chinese authorities felt the need to address.

In addition to the more recent credit tightening, China has been on a regulatory reset since earlier this summer. The aim of the regulation is "common prosperity," an idea introduced by Xi in the summer of 2021 when he signaled a shift in the development of the Chinese economic system to allow citizens more broadly to share in the opportunity to become wealthy.[1] What was implied by this speech is that there would be a focus on deleveraging, more state control of large companies, more worker protections and more wealth distribution, to cite just a few of the changing policy priorities under Xi. The net result of these policy shifts has been a dramatic slowdown in several sectors of the economy.

Some of the sectors that have been at the forefront of the new regulatory reset have been property, technology, consumption, carbon reduction and education. In the property sector, there was a lot of concern about the amount of leverage, the large level of speculation and the lack of affordable housing development compared to high-end speculative housing. Making housing more widely affordable is a long-term goal, and heavy regulatory compulsion to achieve it, will not abate for many years to come. The focus on making the economy perform more for the working class rather than the wealthy is a big factor underpinning the new regulations coming out of Beijing. The new real estate regulations bear watching, as real property accounts for about 71% of family wealth in urban areas.[2] In the past, the real property market has been an effective transmission channel for stimulative policy. However, the new regulations as they currently stand will make the quick transmission we saw in the past more difficult.

Another homegrown issue has been a ban on importing coal from Australia as part of the focus on reducing carbon emissions. This policy has impacted the domestic power sector by causing coal shortages and subsequent rolling blackouts. These blackouts have impacted the industrial sectors' ability to operate at full capacity. The Chinese authorities have recognized this issue and have started to focus on imports of coal from other countries and to increase production at domestic coal mines, particularly in Mongolia. Coal supplies have picked up recently, but the headwind to growth has already been felt.

These headwinds, global and domestic, have been starting to take their toll on growth, with GDP in the third quarter of 2021 surprising to the downside: 4.9% year-over-year, slightly below a market expectation of 5%. This has caused Chinese policymakers to start to turn from the very strict regulations they enacted. Authorities are starting to allow some state-owned enterprises

to move away from strict adherence to the "three red lines," a policy meant to rein in the ability of Chinese property developers to increase their leverage. Moreover, several state-owned developers received approval to sell local bonds in the interbank market. Finally, Premier Li Keqiang told local governments to pick up construction projects at the beginning of 2022 when he chaired the State Council meeting in November.

The recent changes toward looser policy are the first signs that China might shift its all-important credit impulse in 2022. China's credit impulse, defined as the ratio of the increase in credit relative to GDP, has global implications, as it leads Chinese import demand. *(Figure 3)* A change in the credit impulse is a good measure of stimulus in the Chinese economy, as it effectively aggregates the many measures authorities implement in China's complex economic and financial system. We can see that the credit impulse works with a lag as credit wends through the banking system and find its way into increased domestic demand in the Chinese economy. Since the beginning of 2021, the credit impulse has been falling and putting downward pressure on the Chinese economy and global growth.

China Credit Impulse (CHBGREVO Index) vs. China Imports Year-Over-Year (CNFRIMPY Index)

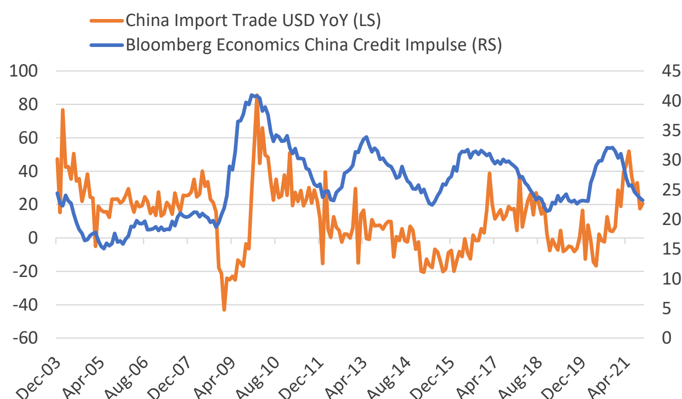


Figure 3
Source: Bloomberg, DoubleLine, as of October 31, 2021

An important factor underpinning the political influence of China's policy outside of its borders is China having become a large and growing player in the global economy. According to calculations by the International Monetary Fund, China accounted for 18.3% of global GDP in 2020 (on a purchasing-power-parity basis), and that number is estimated to grow to over 20% by 2026. *(Figure 4)* This factor will continue to underpin the importance that Chinese growth and credit will have on global economies and financial markets. Investors need to closely watch the trajectory of Chinese policies, especially regarding credit.

China GDP as % of World

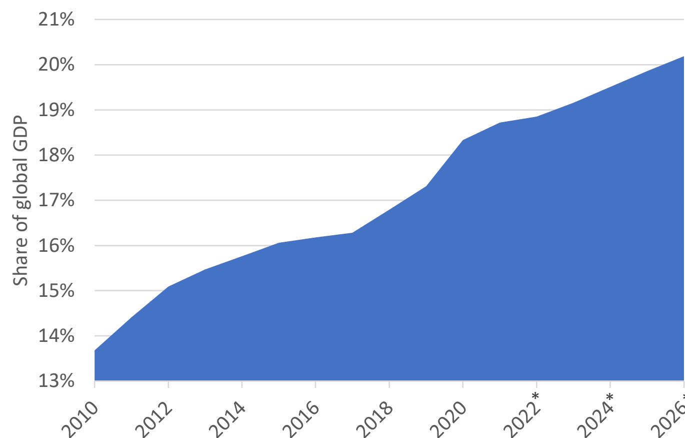
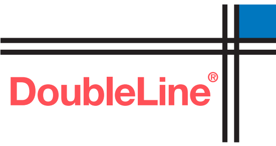


Figure 4
Source: International Monetary Fund, Statista
*2021-2026 IMF estimate

As we move into the new year, I expect that Chinese policymakers' attention will focus on the October Communist Party Congress meetings. This will result in a much less restrictive policy on the regulatory and credit fronts. Beijing has already started to thaw its icy policy stance. The People's Bank of China reduced the required reserve ratio for banks by 0.5%, effective on December 15, 2021. The reduction of this ratio had the impact of increasing liquidity by an estimated 1.2 trillion Chinese yuan (equivalent to $188 billion in U.S. dollar terms). To be sure, Chinese authorities will try to prevent excessive speculation, and the trajectory of regulation will remain on a tighter path than we have seen in previous years. That said, loosening China's overly tight stance today and an increase in the credit impulse will benefit the Chinese economy and by extension the global economy in mid-2022. If I am right on this, the impact on global markets will be supportive as well. Many developed and emerging market economies will benefit given their export links to China. Watching the turns in the credit spigot in China very closely will serve as a meaningful guidepost for investors in 2022. ■



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Citations

[1] "China's 'common prosperity' goal to evenly distribute wealth as Xi Jinping sets out stall for development," Orange Wang and Su-Lin Tan, China Macro Economy, Aug. 18, 2021. https://www.scmp.com/economy/china-economy/article/3145439/chinas-wealthy-urged-xi-jinping-give-back-society-ensure

[2] "Housing wealth inequality in urban China: the transition from welfare allocation to market differentiation," Chunling Li and Yiming Fan, The Journal of Chinese Sociology, Sept. 11, 2020. https://journalofchinesesociology.springeropen.com/articles/10.1186/s40711-020-00129-4#Fn1

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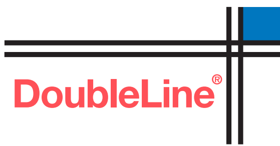

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