Section 3
Uncertainty in the Chinese Economy: From "Common Prosperity" to "Zero-COVID"

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1. The Adverse Effects of the Zero-Corona Policy Becoming More Serious

In Shanghai, where the number of people infected with COVID-19 had been increasing since the beginning of 2022, a complete lockdown was implemented for two months from March 28 to the end of May. Through social media, people outside China have become aware that food procurement has become difficult due to logistics disruptions and that many residents have become increasingly stressed due to the uncertainty about the future during the lockdown.

Even if a complete city blockade has not been imposed, many cities have implemented a dynamic zero-corona policy in which even a single infected person within an apartment building results in the whole residents being prohibited from going outside until the number of new cases becomes zero. The Xi Jinping administration's adherence to a zero--corona policy, in which it is unable to break away from its past successes even against the highly infectious and less severe Omicron variant, has been questioned not only overseas but also domestically. In this report, I would like to discuss the future of the Chinese economy, which faces many uncertainties in addition to the zero-corona policy, with a focus on three risks that are confronting it.

The negative effects on the overall economy of the lockdown of major cities brought about by the adherence to the zero-corona policy became apparent in the economic statistics for April 2022, released in mid-May. The largest impact was on consumption, with retail sales in April falling 11.1% year-on-year, the first decline since March 2020 (Figure 1-3-1). On the production side, industrial production in April declined 2.9% year-on-year and the cumulative amount of investment in fixed assets in the period from the beginning of the year until April increased 6.8% year-on-year, a significant drop from a 9.3% increase in the period from the beginning of the year until March. Reflecting these declines in both demand and supply, the nation's surveyed unemployment rate worsened to 6.1% in April, surpassing 6% for the first time in two years since April 2020.

It is assumed that the repeated strict and prolonged blockades of major cities such as Xi'an, Changchun, and Shanghai since the beginning of 2022 have not only depressed production and consumption in those cities but have also

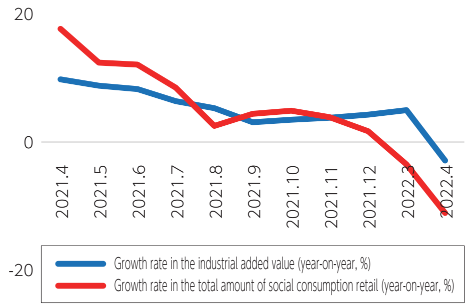

Figure 1-3-1 Trends in the industrial added value and the retail consumption amount

Material)“National database” https://data.stats.gov.cn/easyquery.htm

affected the entire economy through the suspension of logistics.

In a paper published in April this year, Zheng Song and his colleagues at the Chinese University of Hong Kong analyzed the impact of an urban lockdown on economic activity using GPS information records of long-distance trucks from April 2020 to January 2022 (Chen et al, 2022). According to Song and his colleagues, a total blockade of a city for one month reduces truck traffic to and from that city by almost half. If China’s four largest cities (Beijing, Guangzhou, Shanghai, and Shenzhen) were to be completely blockaded for one month, real income in the four blockaded cities would decline by 61%, and the nation’s real gross domestic product (GDP) would decline by 8.6%. 11% of these effects are spillover effects to other regions. The negative effects are even larger when the long-term effects of reduced savings and investment are included.

When Song was interviewed by the economic journal Caixin Weekly (April 18, 2022 Logistics Security), he projected that if any one of the four major cities were to go on lockdown for a month, it would result in a loss of roughly 0.7% of GDP.

Additionally, the lockdown of cities that have the world’s leading container handling capacity, such as Shenzhen and Shanghai, has a direct impact on the global supply chain through the stagnation of cargo transport to overseas destinations. According to a survey conducted by a research firm targeting 1,500 companies engaged in overseas trade, 90% of them stated that they were unable to ship as scheduled and 50% of them stated that their shipments were overdue by 15 days or more (Caixin Weekly May 9, 2022 “Why exports have slowed down”). Additionally, the rising cost of raw materials is also serious, with more than 70% of companies experiencing a 20% or more increase in the costs of raw materials. As a result of these rising logistics costs, more than 90% of companies have been forced to reduce production and almost half of them have halved their production volume.

2. Insufficient Fiscal Stimulus

As noted in the previous section, even though it is evident that the adherence to the zero-corona policy has damaged the entire economy, the government has been unable to come up with an effective macroeconomic policy to counter this, especially an aggressive relief measure through fiscal stimulus. This reluctant attitude of the government undeniably makes the future of the Chinese economy even more uncertain.

In retrospect, in February 2020, when urban blockades were implemented nationwide, starting with the city of Wuhan, the Chinese government quickly initiated bold monetary easing as a post-corona economic policy (Tsuyuguchi, 2020). On the other hand, unlike other major countries, they have rarely provided relief measures through fiscal stimulus, such as the provision of benefits to individuals and companies. Even though measures such as the reduction of social insurance premiums or tax breaks were put in place for companies, most of these measures had ended by 2021, which led to the economic recession that began in the latter half of 2021.

The government has consistently emphasized policies to improve efficiency on the supply side rather than stimulating the demand side, as represented by its aggressive fiscal policies. In March 2020, the Chinese Communist Party issued a document entitled "Opinion on the Establishment of a More Complete Arrangement System and Mechanism for the Production Factor Market." In this opinion, the Chinese government emphasized the direction of (1) developing an efficient arrangement based on the market mechanism and (2) promoting the establishment and development of the factor market by eliminating institutional factors that hinder the smooth movement of production factors regarding the five major production factors, including land, labor, capital, technology, and data; in other words, the direction of reforming the situation in which state-owned companies and local governments have monopolized access to land, capital, and data (China Research Office, Research and Advisory Department, 2020).

As the continuation of this policy, in January 2022, the State Council released the General Bill on Comprehensive Reform Trial Points for Factor Marketization and revealed specific plans for the marketization of production factors, including the efficient use of land resources through markets, the mobilization of labor markets through systems that can evaluate workers' skills and technologies, and the development of rules and systems for the protection of intellectual property rights of new technology and data distribution.

Furthermore, in the Opinion on Accelerating the Construction of a National Unified Great Market released by the Central Party and the State Council on April 10, 2022, the development of the above factor market, along with the creation of unified market systems and rules, as well as the consolidation of the infrastructure supporting the market, is listed as one of the six goals to be pursued in order to construct a national unified market for more efficient resource allocation.

These series of reforms are only aimed at improving the efficiency of the supply side and do not cover the other aspect brought by the thorough implementation of the zero-corona policy of the sharp drop in demand. However, even in 2022, when the zero-corona policy led to subsequent lockdowns in major cities, the government was slow to act to underpin demand. On May 20, the five-year loan prime rate (LPR), which is the benchmark for mortgage rates, was finally lowered from 4.6% to 4.45%, but the one-year LPR, which is practically the base rate for lending, was left unchanged. It seems that the fears of an asset bubble since last year and the continuing depreciation of the yuan in the foreign exchange markets are the main factors behind this decision.

In addition, with regard to fiscal policy, the government revealed a return to its pre-corona balanced budget policy of limiting the budget deficit to 2.8% of GDP (3.6% in 2020) in the Government Activity Report of the National People’s Congress held in March this year. In late May, the State Council announced additional stimulus measures (comprehensive policy measures to firmly stabilize the economy), including a 140 billion yuan increase in the scale of tax refunds, but it has not shown any tolerance for expanding the budget deficit.

3. Excessive Reliance on Monetary Easing and Its Side Effects

As mentioned in the previous section, the fact that the Chinese government consistently failed to implement sufficient fiscal stimulus and instead tended to rely exclusively on monetary easing for the economic recovery from the Corona shock is thought to have subsequently caused various distortions in the Chinese economy. The first issue is the rapid growth of private sector debt, which has exacerbated concerns about corporate bond defaults. According to the statistics on the outstanding debt of each country released by the Bank for International Settlements (BIS) (Figure 1-3-2), the outstanding debt of the corporate sector, which had been kept at a level of 149.3% of GDP as of the end of 2019 through the aforementioned deleveraging policy, has increased to 163.3% of GDP as of the end of September 2020 due to the increased corporate debt, reflecting the monetary easing triggered by the COVID-19 pandemic. This situation has led many to point out that the issue of excessive debt in the corporate sector may be reproduced.

As if to confirm this, the deterioration in the cash flow of major government-affiliated companies has become apparent, as exemplified by the emergence of cash-flow difficulties at Tsinghua Unigroup, a government-affiliated semiconductor giant, in early November 2020 and the reported credit crisis at the China Huarong Asset Management Co., Ltd., a bad debt disposal company in which the Ministry of Finance of China holds a 60% stake, in April 2021. Furthermore, in the summer of 2021, there were widespread concerns that a default on corporate bonds might occur due to the financial instability of the Evergrande Group, China's real estate giant, which sparked speculation that this could lead to global credit instability.

The Evergrande Group has continued its risky management by raising short-term funds in the corporate bond market and making long-term investments in various businesses, including the electric vehicle industry. Therefore, when the government tightened regulations on financing for real estate companies in August 2020, its financial position deteriorated drastically. The restrictions on the total amount of real estate-related loans that were imposed on financial institutions in January 2021 are also believed to have exacerbated the situation.

The increase in outstanding debt as a result of the measures against COVID-19 is a worldwide phenomenon and by itself it is not an immediately pressing issue. But as discussed in the previous section, what characterizes China compared to other countries is that the debt of the government sector has not expanded sufficiently in comparison with the corporate sector.

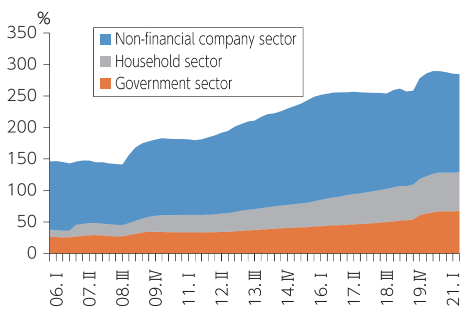

Figure 1-3-2 Change in debt outstanding (vs. GDP)

Material) Source: BIS website (https://www.bis.org/)

The situation in which bold monetary easing is implemented while fiscal spending is restrained is similar to that of the Japanese economy, which relied on monetary easing to overcome the strong yen recession brought about by the Plaza Accord in 1985 and is prone to the emergence of asset bubbles. In fact, when the Chinese economy gradually recovered from the impact of COVID-19, the real estate market showed signs of prosperity at an early stage.

The Xi Jinping administration's stance of emphasizing that housing is for living, not for speculation led to a tightening of the real estate market as represented by the three red lines mentioned above, which caused real estate prices to stagnate in many cities (Figure 1-3-3). In the case of the Evergrande Group, the debt that ballooned as a result of the tightening of the real estate market turned immediately into bad loans, and it is fair to say that many companies have the potential to experience similar problems.

In December 2021, it was reported that the Evergrande Group aims to repay its debt, including foreign currency-denominated debt estimated at about USD 19.5 billion (JPY 2 trillion), under the supervision and guidance of the Guangdong Provincial Government, PBC, and other entities. Prior to this, on October 23, the National People's Congress announced the pilot introduction of a real estate tax, equivalent to a fixed property tax, in some cities. Although the introduction of this real estate tax is a desirable long-term measure to curb skyrocketing real estate prices and correct disparities, its introduction has been actually stalled by the subsequent economic downturn because of its potential to dampen local economies that have been dependent on the enthusiasm for real estate development.

Another issue with the lack of sufficient fiscal stimulus has been the apparent deterioration of the financial situation of some local governments

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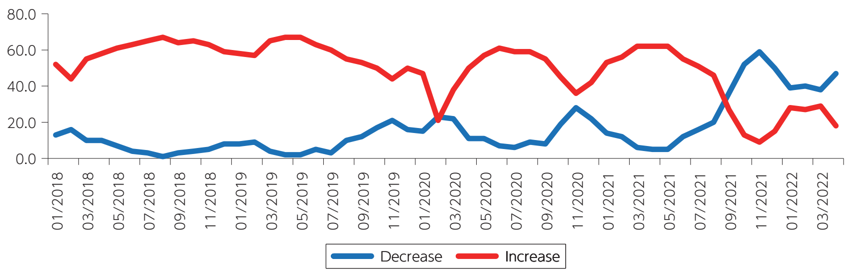

Figure 1-3-3 Changes in real estate prices (70 cities nationwide, compared to the previous month)

Note: The graph shows the number of cities where the price index for new houses increased or decreased from the previous month among 70 cities nationwide.
Material) CEIC Data

(Cheng 2022a). In late December 2021, the municipal government of Hegang, Heilongjiang Province, in the northeast of China, announced that it would cancel its staff recruitment plan and implement a financial restructuring plan, which led to reports that the municipal government had become de facto financially bankrupt (Cheng, 2022b).

It was also reported that in some areas, public officials are experiencing pay cuts due to a lack of financial resources. Originally, a local government's finances depend largely on the proceeds of the sale of land titles, such as agricultural land accommodated by the local government. It is said that the direct reason for the lack of financial resources is that this income has fallen sharply due to the tightening of the real estate market in 2020 (Nakazawa 2021). One of the major backdrops for this shortfall in local government funds is that the main sources of local government revenue, such as the value-added tax and corporate income tax, declined due to tax exemptions and deferrals for companies brought about by the spread of COVID-19, yet such declines were not adequately compensated for by central government finances.

The severe financial situation surrounding local governments is continuing even in 2022. It is said that some local governments have issued strict orders for frugality, such as prohibiting the purchase of new computers and other equipment and requiring the use of cafeterias in government buildings for business entertainment (Nihon Keizai Shimbun, May 26, 2022 "Real estate recession hits China, Strict orders for thrift spreading among local governments"). It is fair to say that the financial difficulties of local governments are a major obstacle to supporting the recovery of the Chinese economy, which is suffering from weakening demand due to the series of lockdowns.

4. Implementation of Forcible Redistribution Policies

Finally, I would like to mention that another cause for concern regarding the future of the Chinese economy is the widening economic disparity and the implementation of forcible redistribution policies as its countermeasure. The Central Finance Committee of the Communist Party held in August 2021 emphasized common prosperity as an essential requirement of socialism and proposed tertiary distribution (redistribution of the means of production is defined as primary distribution, redistribution through fiscal expenditure is defined as secondary distribution, and redistribution through other means is defined as tertiary distribution), in which individuals and organizations voluntarily donate as a means of achieving common prosperity.

In response to this policy, the Alibaba Group and Tencent have successively pledged to contribute the large sums of 100 billion yuan (about JPY 2 trillion) by 2025. The abruptness of this series of policies raised concerns that they might be a return to traditional socialist policies, which were settled by a single word from President Xi. Some experts and China-watchers have viewed this situation as the resurgence of the Cultural Revolution (Cultural Revolution 2.0). However, this view is clearly mistaken. The Cultural Revolution developed into a cultural and political conflict under the guise of promoting further socialism after the thorough public ownership of the means of production through the preceding reforms toward socialism. In contrast, Xi's leadership has not rejected capitalist means of production and has not fundamentally changed the management of the economy. In fact, as mentioned above, his administration is trying to introduce market mechanisms into the production factors, the very foundation of socialism, to promote fluidity and efficiency. As if to confirm this, the term "common prosperity" appeared only once in Premier Li Keqiang's government activity report at the National People's Congress in March 2022.

Rather, it seems that the current administration has recognized that the series of factor market reforms will be inevitably accompanied by a further increase in disparities and has brought common prosperity to the forefront as a preventive measure, or as a kind of vaccine, to prevent criticism from being directed at the administration. To equate the emphasis on common prosperity with a vaccine, a second and third round of vaccinations is necessary. Along with this, it is inevitable that there will be some sorts of side effects, such as the devastating blow to the education industry brought by the ban on the establishment of new tutoring schools, as well as the imposition of non-profit status and delisting of current tutoring schools by the Chinese government's notification.

The successful experience of the anti-corruption campaign is recalled in the implementation of common prosperity. In 2012, at the Second General Conference of the 18th Central Commission for Discipline Inspection, President Xi Jinping announced a large-scale anti-corruption campaign that would strike both "tigers" (high-level cadres) and "flies" (low-level cadres). About 1.34 million party members nationwide, including "big tigers" such as Zhou Yongkang, a former senior leader of the Chinese Communist Party, and Xu Caihou, a former vice-chairman of the Central Military Commission, were punished.

Xi Tian Yang and his colleagues, who examined which government officials were targeted by this anti-corruption campaign, made the interesting point that the anti-corruption campaign conducted by the Xi administration symbolized a shift in China's growth model from the rent model of the Jiang Zemin and Hu Jintao administrations to the loyalty model centered on the Communist Party (Xi=Yao=Zhang, 2018).

According to them, under the rent model of the Jiang Zemin and Hu Jintao administrations, (1) economic growth is the primary goal and (local) governments lead it, (2) local government leaders support the market economy by utilizing local information under a decentralized system, and (3) the Communist Party and central government induce growth competition among local governments through personnel management. In other words, the model is characterized by the combination of high growth in the regions and the expansion of bureaucratic authority.

In 2012 when the Xi Jinping administration began, the widening of economic disparities and criticism from the public about the illicit accumulation of wealth grew, which led to higher costs of maintaining the existing rent model. It seems that because of this, the Xi administration has shifted to the loyalty model that emphasizes trust in the ideological line of the Xi administration party and loyalty to the leaders' policies.

Xi=Yao=Zhang (2018) have verified that the loyalty model is seen in actual corruption detection patterns through empirical research that connects information on the profiles and promotions of city-level administrative division heads, as well as lists of targets of corruption investigations released by the Communist Party Central Technical Committee.

As a result of this research, it became clear that officials who were able to ascend the ladder as competent and at the same time amass considerable financial resources up to the time of the Hu Jintao administration were more likely to be targeted for prosecution. The approach of this anti-corruption campaign to ease the resentment of the general public by penalizing competent, wealthy, and socially prominent local executives is similar to the current approach of targeting successful IT-related companies and their managers in the name of common prosperity.

5. Conclusion

What attitude should the Japanese business community take toward the Chinese economy that is facing such risks? First, we need to reaffirm that the relationship between companies and the government in China is not a simple one. The Alibaba Group, for example, has under its umbrella a public welfare foundation fund to address poverty issues. The large donation of 100 billion yuan is in fact only a promise to give back to the poor through this fund, and the Alibaba Group has the right to decide whether or not to implement it. Looking at this alone, seeing the current situation simply as a return to traditional socialism does not correspond to the actual situation, in which the corporate side readily accepts and implements measures that conform to the government’s grandiose slogan of common prosperity. It is dangerous for Japanese companies doing business with Chinese companies or conducting investment projects to easily accept the major policies of the Chinese government and assume the direction of the country. Nevertheless, it should not be forgotten that doing business in China always carries the risk of being greatly affected by domestic political trends. The Chinese Communist Party is about to hold its Party Congress this fall. In order for the Xi Jinping administration, which is expected to enter its third term, to solidify its power base, it will be difficult to change the zero-corona policy at least until the party congress is successfully completed.

With China’s economic growth entering a downward phase and the current situation in which abuses of the zero-corona policy are having unpredictable downside effects on the economy, it is conceivable that dissatisfaction among the general public is gradually building up, and headwinds against the implementation of the factor market reforms, which were originally supposed to be the centerpiece of a growth strategy, are expected to become stronger. If this situation continues, no matter how much the government stresses the importance of supply chains, foreign companies may inevitably leave China.

Nevertheless, from a long-term perspective, it will be essential for both the public and private sectors in Japan to discuss how far they can cooperate with China in promoting decarbonization policies, sharing data across borders, and creating rules for this purpose. Therefore, I would like to emphasize again that it is more necessary than ever to ascertain the actual situation, which is the premise for discussion.

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