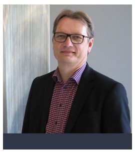
BLOG

The difficult path to recovery in China

6 Apr 2020 – Chinese economy



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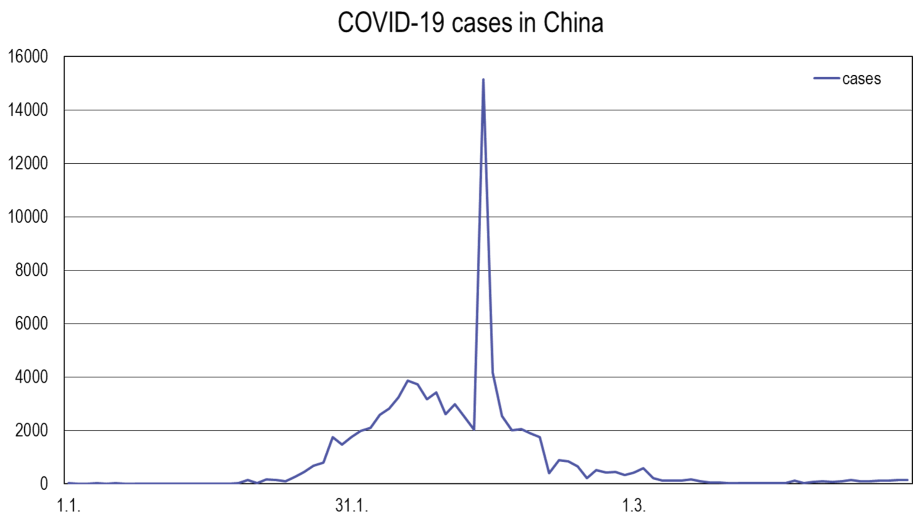
The epidemic has subsided in China…for now (Chart 1). The impressively speedy suppression of the coronavirus epidemic in China reflects a tight regime of containment measures, including a lockdown of Hubei province, social distancing, travel restrictions, and a quarantine for incoming travelers. Even though recent cases mainly originate from abroad, domestic pockets of COVID-19 infection likely remain undetected. Since most of the population has yet to develop immunity to the virus, the potential for significant flareups or a new wave of cases will persist in China until a vaccine is developed or "herd immunity" is otherwise achieved.

Chart 1



Source: European Centre for Disease Prevention and Control.
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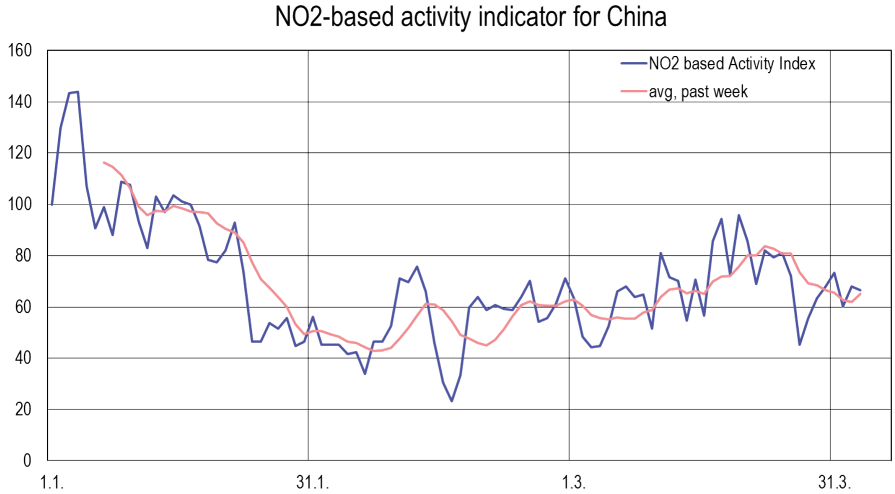
Chart 2



Source: Air quality historical data platform; author's calculations. The Index for China is the normalized (Jan 1 =100) average over 9 large cities.
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After a sharp decline in January and even sharper decline in February, the Chinese economy started to recover in March (Chart 2). The drop in Chinese economic activity is unprecedented in recent history. While March purchasing manager indices show only a muted recovery in manufacturing, high-frequency indicators such as travel flow and traffic congestion data indicate that economic activity is quickly rising, albeit unevenly, in many Chinese cities. While shops, restaurants, and schools have been re-opening even in the worst-affected regions, there is a long way to go to full normalization.

Further economic hardship in the cards. A large economic aftershock is expected as external demand falls due to the global spread of the virus. As the two-month lockdown has already hurt businesses on a broad front, particularly small and medium-sized firms in the service sector, soaring bankruptcies and layoffs are a concern. The government is addressing these issues with a combination of monetary policy, macroprudential and fiscal policy instruments, but the accommodation has been relatively modest, possibly indicating that the policy focus remains on containment rather than recovery.

Monetary policy reaction addresses bottlenecks in access to finance. While the 7-day reverse repo rate was lowered to 2.2 percent, it is some ways above the zero lower bound. After a general cut in reserve requirements of 0.5 percentage points towards the 10-percent mark in early January, the People's Bank of China (PBoC) implemented a further cut in mid-March that selectively targeted banks engaged in small business lending. Prime lending rates have been cut marginally and the PBoC has been using its “window guidance” superpowers to channel liquidity to the worst-hit parts of the economy. The deposit reference rate has thus far stayed put.

Monetary policy balances between accommodation and financial stability. While improved access to finance can help in maintaining activity during the crisis, the private-debt-to-GDP ratio in China stands at 250 percent, which is quite high by international standards. Any further increase in enterprise sector debt would exacerbate already considerable financial stability risks.

Positive expectations key to recovery. While the central bank can increase the credit supply through the various instruments at its disposal, the demand for credit and speed of recovery will depend on expectations regarding the ability of the government to manage the difficult economic path ahead. It remains to be seen whether the Chinese government's strong track record in this regard can convince the public to spend. There is also the risk that a wide-scale second-wave epidemic could hit China. Governments in many other Asian countries have already had to re-tighten restrictions in the recent days.

Health of the banking system already an issue before the epidemic. The official non-performing loan (NPL) ratios of banks remain at around 2 percent of total assets, but, as noted in by IMF's latest Financial Sector Assessment Program review of the Chinese financial system in 2017, the number lacks credibility due to China's widespread use of creative accounting practices. Such practices are likely to be a problem, especially for the myriad of small to mid-tier banks. Our own research confirms these concerns relating to the NPL numbers of Chinese banks (Karlo Kauko: The vanishing interest income of Chinese banks, BOFIT Discussion Papers 2/2020).

Still room for further fiscal accommodation. Based on the latest IMF Article IV assessment, public debt was at around 80 percent of GDP in 2019. While this figure is quite high by developing country standards, it is well below the US and euro area levels. Given that China's debt is mainly held domestically, there likely remains room for further fiscal expansion. However, general government net borrowing even before the crisis was estimated to exceed 10 percent of GDP. Further fiscal stimulus needed to manage the crisis fallout would likely exacerbate the significant structural issues related to China's economy.

China's economic model at the crossroads. The Chinese economic model until recently has been characterized by an approach in which state-owned enterprises and other government-connected companies get preferential treatment in such areas as access to finance, licensing, and land use. While the Chinese can rightly be proud of their rapid suppression of the coronavirus, this discrepancy in access to resources could generate social tensions with those who now face significant hardships. China's vast government deficits even before the crisis suggest that the model was not working as intended. Simultaneous managing of these rising tensions and a second round of pandemic poses significant challenges for the Chinese leadership.

Tags

COVID-19, China, COVID-19, BOFIT, monetary policy, COVID-19 virus pandemic, fiscal policy