China Briefing

What comes next in 2022 for China?

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Executive summary

- *China's plans, which we discussed last month, outline how its leaders think the next year will progress.*
- *China thinks that 2022 will be a hard year: it will put significant pressure on local governments, large companies (be they state or privately owned), and banks to try and keep growth alive and at the promised 5.5% rate. There will be broad tax cuts aimed at micro-enterprises.*
- *China cares much more about the real economy than the financial economy; it is willing to trade loss of value on capital markets for improvements in regulating the real economy and addressing its deep inequality divide between rural and urban areas, and the "Common Prosperity" agenda. This will drive further volatility in equity markets.*
- *COVID-19 will remain a deep issue. There will be some improvements in treatment, but China will not open up for the inflow of international travellers and will instead focus on keeping supply chains moving and using more selective lockdowns.*
- *China's focus with the rest of the world will be on avoiding taking sides on Ukraine, and trying to improve relations with countries that are not sanctioning Russia. Capital and know-how will be warmly welcomed.*

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China remains enigmatic. Last year, its economy grew by just over 5%. China alone was responsible for a third of world economic growth, more than the US, Europe and Japan combined. Yet if one reads highlights of last year's economic news, the story was far more about a destruction of capital market value in a regulatory crackdown. One can only read that as a story of outsiders trying to figure out what is going on in China.

In this Briefing, which builds on the last Briefing on China's plans, we try and take what the Chinese government has told us and deduce what's coming in the year ahead.

As the loss of value discussed above shows, China remains laser focused on its own plans and often ignores capital holders. It wants to remake what it sees as the real economy, proactively. Long-term gain is to trump capital holders' pain. (This does not mean that China doesn't want capital. We will write further on Chinese capital markets soon, but for now, they simply do not have the depth of liquidity needed. Rather, it means that China's leaders see capital market development as one goal among many).

So, one may rightly ask, what is their goal? In this Briefing, I will outline what they've said about perhaps the three biggest challenges they face (the economy, COVID-19, and the international environment), and comment upon what that might mean for investors.

Tax cuts and how China sees business

China projects economic growth to be 5.5% for the year ahead. Where will this growth come from?

> "China will draw on the savings that we did not tap into over the past two years, meaning we will use the surplus profits from state-owned financial institutions and state monopolies, and there will also be some surplus from the fiscal funds."
>
> — Li Keqiang, Chinese premier

But any fund the Chinese premier alludes to will alone not be enough. There is clearly an expectation of local governments and enterprises contributing more to economic growth. Specifically, they have been told to use tax refunds, probably because they can be more easily targeted at small and medium enterprises (SMEs), who *"support a massive amount of job opportunities. Currently, many of them are financially strapped and are in great difficulty."* The tax refunds will need to be provided by local governments. To chivvy them on, Li will increase transfer payments by 18% to nearly RMB 10tn. That's roughly five times as much as the centre is spending on tax refunds. But in both cases it is, on paper anyway, a shift away from the more traditional models of stimulating growth.

This gets to the question of who Beijing plans will lose in this year ahead. The first group is undoubtedly local governments, who will be given more transfers and less tax revenue but still have to provide more services. (Li made a specific point about cutting yet more red tape, perhaps his greatest policy obsession, and that is going to keep local leaders busy).

But China has a need for greater demand-side reform. Exports and the trade surplus are soaring even as domestic consumption and related business investment lag. For China to change from investment and supply-side measures to higher wages, fiscal redistribution and other demand-side measures are easier at the central level and in speeches. It's easy to recommend building fewer bridges and paying more benefits, but when you get down to the lower levels who have to do the heavy lifting, their muscle memory is of building more things and reclassifying land.

So, although we are not claiming causality, China is working to skip local governments and go directly to micro-enterprises. As Li stated in his final press conference: *"By improving the business climate, in recent years, we have seen that the number of market entities in China has reached 150mn, an increase of 100mn from over ten years ago. Most of these market entities are privately held firms. There is some 100mn self-employed households who must not be*

underestimated because they support the livelihoods of many families, and they also help to meet consumer demand. In my discussions with business leaders, they told me that it is those very micro and small firms and self-employed households are playing a significant role in supporting the circulation of the economy. Otherwise, without them, even big companies, even state-owned enterprises will be hamstrung."

What does this mean for investors? These micro firms and self-employed households mainly exist today due to the development of a flourishing tech ecosystem. Without the marketplaces of Alibaba, Pinduoduo, etc. they could not help China's economy grow.

But, even more bizarrely, they are supported by China's infamous "common prosperity" policy, which is usually seen as being anti-big tech and an attempt to bring China back to Maoist-style communism.

To examine this, we look at China's own guide to common prosperity.[1] Contrary to what is usually argued, common prosperity is not anti-market or anti-growth. The goal is to double GDP per capita by 2035 and become a middle-developed country. They state that China's GDP per capita is just 16% of the US GDP in 2019, and domestic consumption per capita similarly lags behind (although it exceeds that of Japan). Urbanisation was 61% in 2019 but still far behind the >80% of that in developed countries. Hence, China must continue the role of "the market" in resource allocation, and also improve the role of the government to create more equal opportunities for competition and decrease inequality.

But, and this is critical, common prosperity is based on tech firms. China's pilot for the national rollout of common prosperity is Zhejiang province, home of Alibaba. It has a high GDP per capita, urbanisation, and disposable income, and has lower urban-rural income disparity than the rest of the country (1.96 vs. 2.56x nationally). It is also very market-oriented, with 76% of the population employed in private enterprise. And above all, it was picked because it was best able to use digital methods.

How do China's leaders believe common prosperity can prosper? First, through tax reforms. Second, through greater spending on education and healthcare.

And finally, the government is to "establish scientific and effective antitrust rules, maintain market competitiveness, and weaken wage premiums in monopolistic industries and the disruptions of monopolistic capital on market mechanisms." This part of anti-monopoly measures is hitting investors hard. One must presume that China's leaders have their reasons as to why they are pursuing them.

One way of characterising it is that China is pro-small business, but not pro-big business. It wants the middle-income small business owner to thrive, and it is very suspicious of big business and their monopolistic tendencies, including state-owned enterprises. This, in part, accounts for some of the poorly-communicated and over-zealous regulatory actions. Beijing is also dealing with irresponsible corporate stewardship and governance, more akin to 1980s Japan than the US. Whether it was HNA Group's aggressive acquisitions overseas, the real estate firms' relentless expansion domestically, or Ant's use of local banks to skirt central regulators, Beijing thinks that big business is often trying to get around it.

There are also some structural reasons. Emulating the US development model has left China facing the same challenges of deindustrialisation that plague large parts of the US. Somewhat counterintuitively, China has seen the largest decline in manufacturing as a share of GDP among major economies over the past decade, not unlike the US experience.

Country	% of GDP
China	-5.2
US	-4.1
Japan	-1.8
Germany	-1.4

Table 1: Change in manufacturing as a percentage of GDP since the early 2000s[2]

There are some onerous implications of this on doing business in China. It is to service underserved customers on the fringe, and improve employment outcomes for rural residents by helping with agriculture, tourism, ecommerce, food processing, and other useful areas. It is also to focus on training technical talent. This is a probable explanation for the massive welfare funds started by the tech giants: they

[1] "读懂共同富裕" published by Liu Yuanchun on 1 January 2022
[2] The World Bank

know that this will be popular with the top leaders. The goal is to move rural workers into China's middle class. Technical workers and SME/solopreneurs will be crucial here, so lower taxes, improved business environment, and more market-oriented financial services are needed. Middle-income earners should pay less taxes. The government's role here is clear: to encourage entrepreneurship. But also, to cut down any fat cats. The government is to change personal tax rates and capital taxes, institute property and consumption tax, and encourage high earners to contribute to society. Tech giants are seen as useful as they increase employment, but they are also seen as causing greater income inequality. Thus, they will have to suffer oversight.

COVID-19

The next elephant in the room is the COVID pandemic. China's economic growth last year could be seen as due in part to the relatively lower impact of COVID-19. 2022 will see China's government relax some of its policies. They have already stated in public that "COVID will not interfere with global supply chains." The "zero-COVID" strategy, however, will be far harder under Omicron. Already there are cases in 28 of China's 34 provinces. Xi Jinping on 29 March described it as "the critical moment of the epidemic".[3]

China's playbook is becoming clearer. It will no longer require citywide COVID-19 testing in most cases, marking a change to its epidemic control playbook, as the country looks to implement faster and more targeted methods of tackling rising omicron outbreaks. It will save blanket testing for situations where the virus has spread widely for some time, to avoid infections being missed, as with what has just happened in Shanghai.

There have been two reforms put in place. The new guidelines changed "territory-wide testing" to "area testing," placing more emphasis on scientifically and precisely defining where COVID-19 testing should take place.[4] So for Chinese bureaucrats, the plan is that "we will keep adjusting and narrowing the area for nucleic acid testing according to the result of each round of tests and the source of infections."[5] Using insurance, they are also making testing free. All of these measures show how China is moving to a new idea of "dynamic zero", one where the goal is finding cases as quickly as possible rather than stop the pandemic altogether.[6]

This does not mean that China will drop its "zero-COVID" rhetoric. Liang Wannian, head of the COVID-19 response expert panel, said strongly that China will not "lie flat"[7] (i.e. it won't give up). But rather it means the pressure on how to solve COVID will fall on local governments. Orders were dispatched to the provincial working groups to continue to guide the epidemic prevention work in the epidemic areas and block community transmission as soon as possible.[8] All local working groups are encouraged to take precise prevention and control measures according to local conditions.

With these arrangements local governments take the heat for failings and not the centre. These changes grant an advantage for China's economy, which is that it stops blanket bans and full zero-COVID policies. It gives more freedom to locals. It is very hard for the centre to check up on everyone, which gives more room for sensible local policies.[9] But lower levels will take the blame — the criticisms of local government have already started.[10] In return, they get some cash. The two sessions established a regular mechanism to directly allocate budgetary funds to prefecture- and county-level governments. They placed RMB 2.8tn of central government funding under this mechanism, and gave plenty of room for local governments to issue and use special-purpose bonds.

Moreover, no matter the concerns, it is very hard to move supply chains. According to a recent US-China

[3] "始终坚持人民至上、生命至上" published by People's Daily on 29 March 2022
[4] "关于印发区域新型冠状病毒核酸检测组织实施指南（第三版）的通知" published by the National Health Commission of the People's Republic of China on 22 March 2022
[5] Jiao Yahui, Director of the Bureau of Medical Administration of the National Health Commission (NHC), press conference on 22 March 2022
[6] Ma Xiaowei, Director of the National Health Commission, said that the essence of "dynamic clearing" is speed and accuracy. "Dynamic" means not pursuing absolute zero infections and "clearing to zero" means finding together, putting out together, and keeping the bottom line that there is no large-scale rebound of the epidemic.
[7] "中国为什么不能像国外一样"躺平"?梁万年解答" by 凤凰网 on 22 March 2022
[8] "战疫最吃劲时精准防控如何做?" by Xinhua Daily Telegraph on 23 March 2022
[9] "On March 21, the joint prevention and control mechanism of the State Council sent inspection teams to 10 provinces to carry out inspection work, or in other words, to make sure everyone was doing a good job.
[10] "常态化防控举措落实要有刚性" by Xinhua Daily Telegraph on 24 March 2022

Business Council survey, over 80% of members report not moving any segment of their supply chains from China in the last 12 months and 85% have not paused investments in China in the same period.[11] And the survey reports that this data is basically consistent over the last decade. While wages and costs may be increasing rapidly in China, there are still very few cases of reshoring. So it is hard to see China moving away from anything that is not consistent with Xi's recent public orders to "strive to achieve the maximum prevention and control effect at the least cost, and minimise the impact of the epidemic on economic and social development".[12] This won't be good for outsiders being allowed in, but it should be better for the economy than current expectations might predict.

International environment

Despite strong criticism by the US and allies, China appears not to be changing and instead to be continuing with its existing domestic policies. Critical self-sufficiency in domestic industry has been a long-term goal since 2014.

This doesn't mean that China is not welcoming capital (with the proviso noted above, that it is subservient to economic goals). In recent weeks, leaders have redoubled the official push for investment and engagement with international finance. There have been no signs of China changing any of its domestic policies to make them more anti-American. Anything but, based on the encouragement given to American financial services firms. But leaders are allowing an anti-US line of reporting in official media, perhaps to stop allegations that they are becoming soft.

What China has done post-Russian invasion of Ukraine shifted its foreign policy. There have been a number of reports of China improving its foreign relations within the Middle East. This includes paying for oil in RMB rather than USD, and a recent joint statement of Saudi Arabia and China on not meddling in other countries' affairs: *[Regarding Ukraine] "The two sides agreed that all countries' sovereignty and territorial integrity should be respected and their reasonable security concerns should be taken seriously. It is imperative to prevent any humanitarian crisis, maintain the peace talk process, and resolve conflicts through dialogue and negotiation. Both sides emphasised that all countries have the right to make independent judgements, withstand external pressure, and disagree with the simple logic of 'black or white' and 'friend or foe'. The two sides also exchanged views on the Yemen issue. Faisal briefed on the current situation in Yemen. Wang Yi said that China understands Saudi Arabia's reasonable and legitimate concerns and stands ready to play a constructive role in addressing the Yemen issue by political means."*

This does not read like a push to replace the US dollar or overturn the strategic system. Rather, it is opportunistic; an ability to improve one's relations with other important nations while one can. Saudi Arabia's desire to be left alone over its activities in Yemen means that it is more aligned with China, rhetorically at least.

In a similar vein, China is pushing to weaken the US Indo-Pacific strategy. Foreign ministry officials spoke most bluntly in a recent academic forum, reported on by Chinese media, stating that Asia should avoid *"small blocs based on a Cold War mentality and group confrontation"* and that *"to pursue the Indo-Pacific strategy, provoke trouble, put together closed and exclusive small circles or groups, and take the region off course toward fragmentation. Bloc-based division is as dangerous as the NATO strategy of eastward expansion in Europe...If allowed to go on unchecked, it would bring unimaginable consequences, and ultimately push the Asia-Pacific over the edge of an abyss."*

China even went as far as to make a failed attempt to woo India, which has conspicuously supported Russia. China's foreign minister recently visited New Delhi for their first meeting since deadly border clashes two years ago. He said, *"China and India should put the border issue in its proper place in bilateral relations and should not apply the border issue to define or even affect the overall development"* and that *"China does not pursue a so-called 'unipolar Asia', and respects*

[11] "Member Survey 2021" by The US-China Business Council
[12] "始终坚持人民至上、生命至上" published by People's Daily on 29 March 2022

India's traditional role in the region." China has in this way leapt into the global breech, building coalitions with the many countries that are not condemning Russia for its actions. Even when it fails, as with India above (whose foreign ministers responded to Chinese entreaties by referring to the border), China is able to go out to areas that may be concerned about being ignored and give them a viable alternative to Western nations. What's next for China's foreign policy? It does not appear China will take a side, although it is very unlikely to take an anti-Russia stance. Expect diplomatic outreach, especially with countries who have their own internal security concerns.

This all sounds very ominous for US markets and good for China's relations with emerging markets. Yet one must take a pause. It is characteristic of China's approach to matters to be that of pushing different lines at different times. The foreign ministry's role is to push as hard as it can for what it sees as China's foreign interests. Very little of this is considered in what the economic and financial ministries do, as their role is only to improve China's economy and financial situation. There is a strong incentive to continue the status quo: bad news for those who want China to step up more on the international stage, but good for predictability.

Implications

There are a number of implications for investors based on this analysis. One is that China's focus on tax relief may not light a fire under its economic growth as well as its old method of massive infrastructure and land spending as domestic stimulus, but is more likely to keep inflation lower.

Premier Li himself sees the macroeconomic levers as controlling the money supply and keeping inflation down, also jabbing at the US economy by commenting, *"We refused to resort to flooding the economy with massive stimulus or excessive money supply. Hence, we saw that last year China's CPI rose less than 1% despite the high inflation worldwide. I think that very much has to do with our reasonable macroeconomic policies. We formulate China's macroeconomic policies based on China's own national conditions, and I have no intention to make comments on the policies formulated by other countries here."*

Beijing's antitrust regulation against rising corporate power is likely to create a golden era for SMEs. On 27 July 2021, Vice Premier Liu He publicly announced Beijing's strategic pivot to supporting technologically advanced SMEs, which have been dubbed as the "little giants". According to the Ministry of Industry and Information Technology, "little giant" companies refer to leading SMEs that specialise in niche sectors, command a high market share, boast strong innovative capacity, and focus on core technologies. As long as they are high-tech, they should do well.

Who is likely to fall prey to greater antitrust powers? The main regulatory risk is on delivery companies such as Meituan; they are likely to fall foul of an order that *"the government will ... continue to improve policies related to providing social protection for these people [gig economy workers]".* This continues to be a Xi Jinping policy from April last year. But while the Party is likely to continue to squeeze these companies to follow diktat, it also really needs them. Applying technology is hard without your main technology firms.

Finally, expect more bumps in the Sino-US relationship in 2022. The regular sniping of officials at one other will just harden each nation's negative impressions of each other, and that naturally makes commerce harder. This is particularly the case with the US, which has midterm elections coming up at the end of this year and has what appears to be growing levels of anti-Chinese sentiment. The regular editorials in Chinese official media calling the US hypocrites will exacerbate this.[13]

[13] "美国对危机负有不可推卸的责任（钟声）" by People's Daily on 29 March 2022

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