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Four Questions Regarding the Chinese Economy

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China's economy decelerated sharply toward the end of 2021 and at the start of the new year it was growing at about 4 percent. But some easing of monetary policy and real estate regulations could move it closer to 5 percent. With the all-important Party Congress scheduled for the end of the year, the leaders want steady growth but also stability. The main headwinds are in COVID, real estate, policies toward the private sector, and trade. The situation with the pandemic could become better (mRNAs boosters for the Chinese population) or worse (new variants resistant to Chinese vaccines). On the one hand, in real estate, too much tightening could lead to a collapse in prices that results in panic selling and weakened household wealth and confidence. On the other hand, Too much easing could reignite the bubble and lay a foundation for a larger financial crisis. The regulatory crackdown could reach new sectors or leave most of the private economy untouched. In trade, the risk is a re-acceleration of the U.S. trade war, and too weak of a global economy to make up for the re-acceleration by trade with other partners. All in all, it makes for a year of dangerous growth.

It has been a roller-coaster ride for the Chinese economy since the emergence of COVID-19 in late 2019. There was a brief recession in the face of the initial lockdown of the economy in early 2020. But China bounced back very quickly – more quickly than the other major economies. In the first half of 2021, the economy grew at a blistering 12.7 percent rate. Naturally, it was going to slow down from that rate, but the drop to 4.9 percent year-on-year in the third quarter of 2021 was surprisingly sharp. The economy decelerated further to 4 percent in the last quarter.[1]

China faces quite a few headwinds that explain this slowdown -- headwinds that are likely to persist in 2022 and that will probably make this a disappointing year for growth and related economic variables. First, COVID-19 has not gone away. It has morphed into new variants, most recently omicron – highly transmissible though less deadly than earlier variants. Periodic outbreaks will lead to local lockdowns, affecting both demand, especially for services that require person-to-person exchange and many supply chains.

Real estate is one sector that performed well during the early stages of the pandemic. Households had pent up savings and demand for more space. But the extent of real estate expansion was worrisome in that it involved very large expansions of constructed space, prices rising to bubble territory, and highly leveraged property developers. To prevent a more serious bubble, the regulators tightened financing requirements for developers, throwing some large

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[1] 中国国家统计局 (National Bureau of Statistics of China), 2021年四季度和全年国内生产总值（GDP）初步核算结果(Preliminary Accounting Statistics of National GDP in 2021), January 2022, at 2021年四季度和全年国内生产总值（GDP）初步核算结果

private developers into financial distress and even bankruptcy. But the authorities got what they wanted – price declines in many cities and a contraction of property development. However, this inevitably has taken a lot of wind out of the economy's sails.

A third headwind is that over the past year and a half the authorities have engineered a regulatory crackdown on the digital economy – notably big-tech firms such as Ant Financial, Didi Ridesharing, Meituan online shopping and delivery, and online tutoring firms. Some in the West have interpreted this as a wholesale turning away from the private sector and the market economy. But the actual targets are online firms that have grown up in a lightly regulated environment and have expanded enormously. Clearly the top leadership is not comfortable with their size, internationalism, and independence. Also, there may be some lingering Stalinist attitude that services are not as important as manufacturing, and a desire to bring Chinese talent to bear on making semiconductors and machinery, rather than improving pizza delivery. Whatever the motivation, the actual target of the regulatory crackdown is certain types of digital firms, whose valuations have dropped and which, in many cases, are laying off workers and reducing contracting.

But the idea that this is a general crackdown on the private sector is belied by the fact that other sectors of the economy have continued to be liberalized – most notably automobiles and financial services. China received a historically high amount of foreign direct investment in 2021, suggesting that private investors can still find niches in the Chinese economy where they are welcome and can make money. But even if the regulatory crackdown is targeted to only part of the economy, it is still a headwind that reduces some economic activity and cools enthusiasm for investment and entrepreneurship.

Balancing these various headwinds in 2021 there was one important positive development for the Chinese economy: trade. The government stimulus in the U.S. and Europe focused on maintaining household income and demand. Not only was demand high in the aggregate but its composition shifted away from services toward goods such as laptops, smart phones, and exercise equipment—all major exports from China. China's production bounced back well enough, especially in the first half of 2021, to meet this demand. Despite some supply chain snarls, China managed to export a historically high volume of goods, an important plus for the overall economy.

Based on these recent developments, China's economy is entering 2022 quite weak, facing growth around 4 percent, or perhaps a bit higher with some modest stimulus. Whether it accelerates or decelerates from this current level depends on four key questions: Is zero tolerance for COVID sustainable? Can real estate development be reined in without a financial crisis? Will the tech crackdown spill over to the entire private sector? And can China maintain its export boom and trade truce with the U.S.?

Is Zero Tolerance for COVID Sustainable?

The biggest risk facing the Chinese economy is the same as everywhere else: how disruptive will be the spread of the omicron variant of COVID, and will there be further significant variants? China's initial lockdown in 2020 was very severe and the hit to the economy was very large. But by the first half of 2021 China's economy was recovering nicely. Many aspects of normal life

were returning. Domestic air travel by the three biggest carriers, for example, reached 115 percent of the pre-COVID level in April.[2]

More recently, however, sporadic outbursts of the virus have resulted in cautious behavior by consumers.   According to Variflight, in November domestic air-passenger traffic stood at about 40 percent of the pre-COVID levels. Beijing restricted entry of travelers from any Chinese city that had reported even a single case of COVID during the past fourteen days.[3]

This extreme caution was prompted by a desire to keep COVID under control in advance of the Beijing Winter Olympics. For the Chinese government, a lot is at stake. Beijing's zero-tolerance approach relies on mass testing, stringent border controls, expansive surveillance, contact tracing, extensive quarantines, and lockdowns to tame sporadic outbreaks. Even with China's formidable contact-tracing capacity and high vaccination rates, Omicron could prove especially elusive, given the short window in which positive cases can be detected. Studies have also suggested that the two major Chinese vaccines, made by Sinovac and Sinopharm, are not as effective in preventing infection by the omicron variant. (So far the Chinese authorities have only approved the Chinese vaccines.)[4]

The arrival of the omicron variant complicates the zero tolerance approach. China has managed to keep infection numbers very low by international standards, but doing so is requiring strong measures. The city of Xi'an, with 13 million people in its administrative district, reported 1200 domestically transmitted cases during December 9–30. The response was a two-week lockdown for all households and a massive testing campaign.[5]

Similarly, twenty-three cases in a district of Ningbo, home to the world's busiest port in Zhejiang province, led to a partial lockdown early in the new year that disrupted port operations.[6] So far these disruptions are minor in the context of China's overall economy. As of mid-January, 20 million people were confined to their homes in five Chinese cities. But it is impossible to predict how households will respond to the ongoing, periodic outbreaks; or, how extensive the outbreaks will be now that the more transmittable omicron variant is the dominant strain.

An additional factor is that early evidence shows that the Chinese vaccines provide little protection against omicron. The main travel season, *chunyun* or Spring Festival travel, got

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[2] Stella Qiu and Jamie Freed, *China's Domestic Air Traffic Recovery Faltering Due to Zero-Covid Policy*, Reuters, December 9, 2021, at https://www.reuters.com/world/china/chinas-domestic-air-traffic-recovery-faltering-due-zero-covid-policy-2021-12-10/
[3] Ibid.

[4] Paul Mozur and John Liu, "Hong Kong Researchers Find that Two Doses of China's Sinovac Vaccine Are Inadequate Against Omicron," *The New York Times*, December 15, 2021, at https://www.nytimes.com/2021/12/15/world/asia/omicron-hong-kong-study.html

[5] Xinhua News, "China Focus: Xi'an Youth Fight COVID-19 Resurgence with Tech, Togetherness," December 29, 2021, at
http://www.xinhuanet.com/english/20211229/307dd6a86c04439da1f9e02822ca4bc9/c.html
http://www.xinhuanet.com/english/20220104/50d255bf8b9041e9815a7e7591e258c9/c.html

[6] Xinhua News, "East China City Reports 23 COVID-19 Cases, January 4, 2022, at http://www.xinhuanet.com/english/20220104/50d255bf8b9041e9815a7e7591e258c9/c.html

underway in late January. A number of provinces and cities discouraged people from traveling, and numbers will almost certainly be down from normal. This is the time of year that consumption of services, in particular, is high: transportation, hotel stays, restaurant meals, entertainment, movies, and amusement parks. These mainstays of middle-class consumption are all likely to be down. Many special activities planned for January 1 were canceled in response to this reality, as were some Spring Festival activities on February 1.

Meanwhile, China is rushing to develop a messenger RNA vaccine. Chinese pharmaceutical companies initially focused on traditional inactivated vaccines because the existing technology was easily available. Furthermore, Chinese regulators have not approved any of the foreign vaccines in order to protect the domestic industry. But the inactivated vaccines produce a weaker immune response than mRNA vaccines, which induce a targeted response to the virus's spike protein as it enters human cells. China has administered 2.8 billion doses of Sinopharm and Sinovac's inactivated virus vaccines to 1.2 billion people.[7] But the Xi'an lockdown underscores the official lack of confidence in domestic jabs. China has never authorized mRNA products for therapeutic use, putting domestic drug companies at a disadvantage.

Hence key questions for 2022 are: How far will the omicron variant spread? What will be its effect on consumer behavior? How quickly can China develop mRNA vaccines and make such boosters widespread? Will new variants emerge and spread?

Can Real Estate Be Reined in without a Financial Crisis?

Real estate has come to play a critical role in the Chinese economy. Its contribution to GDP has grown steadily, from less than 10 percent at the beginning of the housing reform in 1997 to over 30 percent in the past few years. As reference, the share in the U.S. reached 20 percent on the eve of the housing crisis in 2005, and in Spain it hit 30 percent before its bubble burst.[8] There are a number of indicators that signal the potential for a housing bubble in China that will burst. Most importantly, prices have gotten out of line with incomes. The ratio of house prices to income is above 40:1 in Beijing and 30:1 in Shanghai, compared, for example, to less than 20:1 in London and closer to 10:1 in New York and San Francisco.[9] China's demographics are such that growth of the urban population will slow, and, as GDP growth moderates, growth of household income will likely slow as well. Hence, the sustainability of the housing bubble in China is very much in question.

On the financing side, real estate developers have relied on a high degree of leverage to fund their activities. This has been one of the main contributors to the overall rise in leverage in the Chinese economy. Worried about growing financial risks, regulators tightened financing conditions for real estate developers starting in late 2020 and they accelerated the tightening in 2021. In particular, regulators introduced three red lines: in financing metrics that should not be

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[7] Our World in Data, *Coronavirus (COVID-19) Vaccinations*, University of Oxford, January 2022, at https://ourworldindata.org/covid-vaccinations

[8] World Bank, *China Economic Update,* December 2021, at https://www.worldbank.org/en/country/china/publication/china-economic-update-december-2021

[9] Ibid.

crossed. These are: (1) a debt-to-equity ratio of 100 percent; (2) a liability-to-asset ratio of 70 percent; and (3) a cash to short-term debt ratio of 1.[10]

The logic of the red lines is straightforward. If cash cannot cover short-term debt, then a developer is susceptible to a funding squeeze that will call in short-term debt and leave the firm insolvent. For the longer term, the debt-to-equity and liability-to-asset ratios ensure that developers have a significant amount of their own equity at risk, which tends to rein in speculative excesses and also makes resolutions less painful if a firm does go into default. It should be possible to sell off the equity to repay all or most of the debt with a ratio of around 100 percent. The ability of real estate developers to take on new debt depends on where they stand with respect to the red lines. If a firm has crossed all three lines, it cannot take on new debt; if it has crossed two, its increase in debt must be below 5 percent; if it crossed one, its increase in debt must be below 10 percent; and if it is within all three guidelines, it can take on new debt up to 15 percent.[11] In this way China is trying to steer loans to the most financially stable firms in the sector.

A number of major developers, notably Evergrande, breached all three financial limits and are in effect required to reduce their debt by selling assets and paying off old loans. The tightening of regulations had had the desired effect of reducing finance and increasing borrowing costs for the sector. With the tighter financing conditions, defaults began to emerge among these developers who were the most extended and leveraged. Evergrande defaulted on $1.2 billion in bond payments and is undergoing a forced restructuring. The government is trying to protect the people, more than one million in number, who paid for apartments to be constructed by Evergrande but that have not yet been built. In the resolution, bondholders are likely to take a big haircut and shareholders will probably be wiped out. But while Evergrande has garnered the headlines, there have been many more missed payments by real estate developers. Kaisa Group defaulted on a payment of $400 million. Shimao Group failed to pay ¥645 million of a total of ¥792 million due December 25. Guangzhou R&F said it would default on $725 million due January 13. Sinic Holdings defaulted on $250 million in offshore bonds last October. China Properties Group defaulted on $226 million worth of notes on October 15. Fantasia Holdings defaulted on $206 million in early October. And many more developers are now at risk.[12]

Meanwhile, actual construction is in freefall. In 2021, housing starts were down 11.4 percent from the previous year. Land sales were down 15.5 percent, indicating that the housing slump

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[10] Ibid.

[11] Xinhua News, "央行再次明确：坚持"房住不炒"推动金融、房地产同实体经济均衡发展" (Central Bank of China Asserts: Insist on "Houses Are for Living Purposes, Not For Investment" to Boost Finance and Real Estate Development For Balanced Development with the Real Economy), July 23, 2021, at http://www.xinhuanet.com/fortune/2021-07/23/c_1127685582.htm

[12] Anne Stevenson-Yang, "Soft or Hard? China's Property Sector Is Coming In for a Landing," *Forbes News,* January 16, 2022, at https://www.forbes.com/sites/annestevenson-yang/2022/01/16/soft-or-hard-chinas-property-sector-is-coming-in-for-a-landing/?sh=38aa940d1cac

will continue into 2022.[13] In December, major developers Vanke, Greenland Holdings, and Shimao Group all saw sales declines of more than 50 percent year-on-year.[14] Regulators had wanted to contain the excesses in the real estate sector, but they were probably surprised by the depth and breadth of the downturn, affecting not only the most financially vulnerable firms but rather the entire sector. The regulators quickly moved to undo or ease some of their measures: Banks were instructed to loosen mortgage requirements and speed up issuances. The proposed property tax was mothballed, or at least delayed. Restrictions on lending to developers were loosened. The People's Bank of China (PBOC), for the second time since July, cut the reserve requirement by 50 basis points in December. The 50 bp cut freed roughly ¥1.2 trillion for new lending. For the first time since April 2020, the PBOC in December trimmed the benchmark lending rate, reducing the one-year prime rate from 3.85 percent to 3.8 percent. Purchase restrictions on housing were dropped in many cities. About thirty cities put floors on the prices at which housing transactions may be registered.[15]

The dilemma for the government is that it is trying to reduce the role of real estate in the economy to a sustainable level without causing a more general financial or economic crisis. The regulators would like to see the very high prices in tier 1 cities come down. But if there is a countrywide collapse in apartment prices, then ordinary households will be poorer and will likely consume fewer other goods and services. To cool off the excesses while allowing other construction activity to continue, is a very narrow target at which to aim. Under any scenario, it is likely that real estate will be a drag on Chinese growth for the next few years. If poorly managed, it could presage a long period of slow growth, as occurred in Japan. If well managed, it will be a modest drag as it contracts to a more realistic share of GDP.

Will the Tech Crackdown Spill Over to the Entire Private Sector?

Since November 2020 there have been a number of high-profile regulatory crackdowns on major tech firms. First there was Ant Financial; financial regulators pulled the plug on its IPO at the eleventh hour. Just days earlier, founder Jack Ma had criticized Chinese regulators publicly for an excessive focus on risk minimization rather than innovation promotion. Soon thereafter, the ride-sharing giant, DiDi, had its wings clipped: after its IPO, regulators intervened to stop the company from signing up new users. There were also new regulations for Meituan online shopping and delivery. The new regulations involved the use of customers' data.

China also banned online tutoring in school curriculum subjects. The ostensible reason was that this industry was contributing to difficulties for both students and parents by encouraging excessive study and academic competition. Families were spending more and more to help their children get ahead, and the leaders were worried that the cost of raising children would discourage births (fertility again hit a new low in 2021).

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[13] 中国国家统计局 (National Bureau of Statistics of China), 2021年全国房地产开发投资增长4.4% (National Real Estate Development Investment Increases by 4.4% in 2021), January 17, 2022, at http://www.stats.gov.cn/tjsj/zxfb/202201/t20220117_1826408.html

[14] Stevenson-Yang, "Soft or Hard? China's Property Sector Is Coming In for a Landing."
[15] Ibid.

All of these tech firms are private and they tend to be among the most innovative firms in the country. Clearly the authorities wanted to rein in their independence. Some internet companies have been forced to shut down, while others are suffering from huge losses or disappointing earnings. Many publicly listed companies have seen their share prices fall by half, if not more. In the third quarter of last year, China's biggest internet company, Tencent, posted its slowest revenue growth since its public listing in 2004.[16] The profitability of e-commerce giant Alibaba declined by 38 percent from the previous year.[17] A good summary indicator is the Hang Seng Tech Index, which includes most of these firms. It is down 33 percent over the past year, compared to a decline of 14 percent for the overall Hang Seng Index.[18]

These regulatory moves came at the same time that the top leaders were talking more about "common prosperity." It is not clear yet what policies this might actually entail, but there is a fear that constraining the wealth and independence of China's big tech entrepreneurs is part of the agenda. This will inevitably dampen innovation in the sector. An important question is whether it will spill over to the entire private sector. Tech in fact is just one small sector in the Chinese economy. There are over 20 million private companies in China. Many are small, but there are quite a few large private companies, spread across most sectors of the economy. Throughout 2021 overall private investment grew at a healthy rate. Fixed asset investment in 2021 increased 4.9 percent from the previous year; within that, private investment grew at 7.0 percent. Also, the value added of private industrial companies continued to increase more rapidly than that of state enterprises.[19] So, in the statistics, there is no sign of a general reining in of the private sector.

Also, foreign investors continue to flock to China. Inward FDI was up 14 percent in 2021, hitting a new historic high. This was encouraged by further modest liberalization of rules on foreign investment. The "negative list" of sectors with restricted FDI was shortened.[20] The most visible liberalization in recent years has been in automobiles and financial services. In these two sectors, limited foreign investment was allowed through joint ventures with Chinese companies,

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[16] Brenda Goh, "China's Regulatory Crackdown Pushes Tencent to Slowest Revenue Growth since 2004," Reuters, November 10, 2021, at https://www.reuters.com/business/media-telecom/tencent-reports-3-jump-third-quarter-profit-beating-expectations-2021-11-10/

[17] Arjun Kharpal, "Alibaba Shares Drop 11% as Its Slashes Guidance and Earnings Plunge on China's Slowdown," *CNBC News*, November 18, 2021, at https://theloadstar.com/cnbc-alibaba-shares-drop-as-its-slashes-guidance-and-earnings-plunge-on-chinas-slowdown/

[18] 恒生指数 (Hang Seng Indexes), 恒生指数及分类指数 (HSI and Categorized Indexes), January 2022, at https://www.hsi.com.hk/chi/indexes/all-indexes/hsi

[19] Tianlei Huang and Nicholas Lardy, "China's Tech Crackdown Affects Only a Small Share of Its Digital Economy and Total GDP," Peterson Institute for International Economics, October 20, 2021, at https://www.piie.com/research/piie-charts/chinas-tech-crackdown-affects-only-small-share-its-digital-economy-and-total

[20] 中华人民共和国中央人民政府 (State Council of P.R.China), 2021年我国引资再创新高 未来如何"稳"住？(A New Record High for Foreign Investment in 2021, How to "Stabilize" in the Future?), January 17, 2022, at http://www.news.cn/fortune/2022-01/17/c_1128268624.htm

usually state enterprises. This is the structure that led to many complaints about "forced technology transfer," as investors shared their technology with Chinese partners who were also their competitors. With the liberalization allowing 100 percent foreign ownership in automobiles and financial services, there has been a surge of new investment from international firms.

The evidence to date is that the top leadership is not trying to strangle the private sector. Rather, on the one hand, it is showing its preferences for innovation and investment in areas such as hi-tech manufacturing, heavy industry such as autos, and modern services, especially finance. On the other hand, it is less enthusiastic about the digital economy. There are risks in making this distinction, however. First, entrepreneurs in the favored sectors are well aware that the political winds could shift against them. The crackdown on the digital economy was swift and unpredictable. It could have been handled better in terms of preparation and communication. There has to be some chilling effect on overall innovation when the value of companies can be suddenly slashed via new regulations. Second, even if policy can neatly discriminate among different sectors, in the real world the inter-linkages are highly complex. Manufactured products, favored by the leadership, have more digital content both because the products themselves are increasingly "smart" and because complex value chains use digital services to manage production and distribution. So, reining in the digital economy may have the indirect effect of hurting manufacturing as well.

Can China Sustain the Export Boom and Trade Truce with the U.S.?

Before the pandemic hit, trade had been playing an increasingly smaller role in China's growth. China's trade surplus had come down after the Global Financial Crisis, and since then the growth of exports and imports were typically lower than the growth of GDP. All that changed with the pandemic. China has had an export boom, and to a lesser extent an import boom. Compared to the previous year, exports and imports both increased 30 percent in 2021.[21] Because China already had a substantial trade surplus, equal growth rates of exports and imports ballooned the surplus even further — to a new historic high of $676 billion. Even though the U.S. maintains 25% tariffs on about half of what it imports from China, China's exports to the U.S. increased 28 percent and its imports increased 33 percent. According to Chinese statistics, the bilateral imbalance hit a new record of $397 billion, while according to U.S. statistics it did not quite reach its 2018 peak.[22]

The trade surge to a large extent can be explained by the different responses of the major economies to the COVID pandemic. The U.S., in particular, and Europe as well, used a government stimulus to sustain household income while people stayed home. China's stimulus, on the other hand, focused on getting production back online. Simply put, American and European demand met Chinese supply. Working from home and entertaining themselves at

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[21] 中华人民共和国海关总署 (General Administration of Customs. P.R.China), 进出口商品总值表（人民币值）(Total Value of Trade Goods [in CNY]), January 18, 2022, at http://www.customs.gov.cn/customs/302249/zfxxgk/2799825/302274/302277/302276/4127510/index.html

[22] United States Census Bureau, *Trade in Goods with China*, at https://www.census.gov/foreign-trade/balance/c5700.html

home, Americans' demand shifted from services to goods. People ordered laptops, smart phones, TVs, furniture, exercise equipment – precisely those manufactured products that China specializes in. The surge in demand put strains on supply chains for many products. The sheer volume of trade put stress on U.S. logistics. In addition, ongoing COVID outbreaks affected the operation of ports, trucking, and warehousing. At the worst, about 100 ships were waiting off the southern California coast to unload at the ports. Despite these glitches, overall trade held up well and exports and imports recorded historic amounts.

U.S.-China trade took place under the aegis of the Phase 1 trade deal that the Trump administration negotiated with China in early 2020. The heart of the agreement was a purchase commitment from the Chinese government during 2020 and 2021 to increase specific imports from the U.S., totaling $200 billion of extra purchases compared to 2017 levels. The agreement was widely criticized by economists at the time of its signing. This amounted to a kind of managed trade rather than an opening of the Chinese economy. Furthermore, the target was unrealistic as it will require increases of U.S. exports to China of more than 40 percent per year. Also, the 25 percent tariff was left in place, a burden that is largely paid for by American firms and households.

A number of observations about the Phase 1 deal: First, U.S. imports from China have continued at a very high level, showcasing American demand for Chinese goods, even with a 25percent tax in place. Second, U.S. exports to China have grown at a healthy rate, reaching a historic high in 2021 and constituting one of the few bright spots in the U.S. economy. Still, China fell far short of its purchase commitments, reaching about 60 percent of its commitments. There were a few areas, such as soybeans, where actual trade was close to the commitment, but, in general, managed trade failed because governments could not anticipate what will happen in terms of demand for many products. For example, the U.S. was supposed to sell significant quantities of energy to China, but with the pandemic-induced economic slowdown they did not materialize.[23]

The Biden administration now faces a difficult situation in terms of China trade. As noted, U.S. exports have hit a historic high, and different sectors of the U.S. economy are prospering by selling to China. On the one hand, to re-ignite the trade war in such an environment will be bad for the U.S. economy. On the other hand, China did not meet the targets in the Phase 1 deal and Biden is likely to be criticized for being soft on China if he gives the Chinese a pass. The continuing 25 percent import tariffs on the U.S. side are hurting the economy. One option is to negotiate a new agreement with China that exchanges dropping the U.S tariffs for specific opening moves on the Chinese side. The lack of trust between the two sides, however, makes it difficult to negotiate in this way. The administration is likely to leave the trade situation in limbo during 2022, creating uncertainties for producers on both sides of the Pacific.

While China's overall volume of trade was impressive during 2021, there were some subtle shifts in trade patterns that may portend future trends. First, what we did not see was any significant re-shoring of production to the U.S. To the contrary, overall the U.S. imported more than ever before. And while U.S. imports from China were surprisingly robust, U.S. imports grew even faster from countries such as Vietnam. A certain amount of labor-intensive assembly

[23] Chad P. Brown, "US-China Phase One Tracker: China's Purchases of US Goods," Peterson Institute for International Economics, December 23, 2021, at https://www.piie.com/research/piie-charts/us-china-phase-one-tracker-chinas-purchases-us-goods

has shifted out of China to countries in Southeast and South Asia. This is driven by economics as wages have gone up in China and are now higher than those in much of the rest of the Asian developing world. But politics is no doubt a factor as well. Assembly elsewhere than in China enables producers to get around U.S. import tariffs. And given the potential for the U.S.-China trade war to re-accelerate at any time, shifting some production from China to elsewhere in Asia is a smart hedge. From China's point of view, the U.S. has become a less important market; ASEAN is now China's largest trade partner, with the EU as number two. Much of the trade back-and-forth between China and ASEAN consists of parts, components, and machinery. So China is not being pushed out of value chains; rather its position in many chains is shifting as it provides machinery and sophisticated components to firms in ASEAN that then make final products.[24]

Such shifts observed so far in trade patterns are likely to be reinforced by new trade agreements. Most important is the Regional Comprehensive Economic Partnership (RCEP) among ASEAN, China, Japan, South Korea, Australia, and New Zealand. RCEP ends tariffs on more than 90 percent of goods, offers preferential market access for specific products, including chemicals, plastics, and processed foods, as well as streamlined customs procedures that will, among other things, guarantee that express items such as perishable foods are released within six hours. Now that eleven countries have ratified it, the RCEP agreement has entered into effect (four ASEAN countries – Malaysia, Indonesia, Philippines, and Myanmar - have yet to ratify it).[25]

The RCEP establishes simple rules of origin which should solidify Asia's position at the heart of most supply chains. The larger economies in this grouping also tend to be members of the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), to which China and South Korea are now applying. China's membership could take some time to be worked out, but it is likely that China will ultimately join, and this deeper agreement will be the foundation for future trade rules in the Asia-Pacific region. Meanwhile, the U.S. is missing in action from Asia-Pacific trade deals.

Trade is likely to continue to be positive for the Chinese economy in 2022. However, it is not likely to continue to grow at the rates seen in 2021. Demand for manufactures may remain high, but it is unlikely to increase again at the same rate. Americans, for example, bought 20 percent more durable goods (other than autos) in 2021, but it is virtually impossible for their purchases to go up an additional 20 percent in 2022. Furthermore, the overall world economy is slowing. After accelerating to 5.5 percent growth in 2021, world GDP is projected to grow at 4.1 percent in 2022 and 3.2 percent in 2023, according to the World Bank's *Global Economic Prospects*.[26] On the plus side, as the RCEP enters into effect, China should have better access to nearby economies, and this will provide lasting benefits. The wild card in the short run is U.S.-China

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[24] World Bank, *China Economic Update,* December 2021.

[25] Ministry of Commerce of P.R.China, *China FTA Network*, February 8, 2022, at http://fta.mofcom.gov.cn/english/index.shtml

[26] World Bank, *Global Economic Update*, January 2022, https://www.worldbank.org/en/publication/global-economic-prospects

relations. On the one hand, the status quo will be acceptable; a re-acceleration of the trade war, on the other hand, will create additional headwinds for China.

Conclusion

The takeaway from all this is that China's economy will face an unusual amount of uncertainty in 2022. It is starting the year with growth of about 4 percent, and that will set a benchmark for the year. Other things being equal, some easing of monetary policy and real estate regulations could move growth closer to 5 percent. With the all-important Party Congress scheduled for the end of the year, the leaders will want steady growth but also stability. The main uncertainties are in the areas of COVID, real estate, policies toward the private sector, and trade. The pandemic situation might improve (mRNAs boosters for the Chinese population) or become worse (new variants that are resistant to Chinese vaccines). On the one hand, for real estate, too much tightening might lead to a collapse in prices that will result in panic selling and weakened household wealth and confidence. But too much easing, on the other hand, might reignite the bubble and lay the foundation for a larger financial crisis. The regulatory crackdown might affect additional sectors or might leave most of the private economy untouched. In trade, the risk is a re-acceleration of the U.S. trade war, with the global economy too weak to make up for it by trading with other partners. All in all, it makes for a year of growing dangerously.

About the Contributor

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