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BRAZILIAN CENTER FOR INTERNATIONAL RELATIONS

ASIA PROGRAM

XXXI CHINA ANALYSIS GROUP MEETING

REPORT XXXI, YEAR V

DECEMBER 7, 2022

Online discussion panel via Zoom

CHINESE ECONOMY: PRESENT TRENDS - A DIALOGUE WITH HUANG ZHANGKAI

BRAZILIAN CENTER FOR INTERNATIONAL RELATIONS

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The Brazilian Center for International Relations (CEBRI) is an independent think tank that contributes to establishing an international agenda for Brazil. For the last twenty three years, the institution has engaged in promoting pluralistic and proposal-oriented debates on the international landscape and Brazilian foreign policy.

CEBRI prioritizes themes with the greatest potential to leverage the international insertion of Brazil into the global economy, proposing pragmatic solutions for the formulation of public policies. CEBRI's work was recognized by the University of Pennsylvania's top global think tank ranking, which considered the institution the 2nd best think tank in South and Central America in 2020.

The Asia Program is one of the twelve regional and thematic programs currently operating at CEBRI. The Program is coordinated by CEBRI's International Advisory Board member Ambassador Marcos Caramuru. External experts can be invited to participate in ad hoc activities, projects, and seminars, according to the Program's agenda.

ASIA PROGRAM

The Program promotes a systematic monitoring of matters relevant to international relations and Brazilian development, particularly those related to China. Special attention has been given to monitoring the ongoing economic reforms and political transformations in China, considering their global effects and impacts in Latin America and Brazil. This continuous examination allows CEBRI to provide information and analysis to its members, partners and to the Brazilian government, contributing to the construction of Brazil's strategic position towards China, as well as helping increase knowledge about China within Brazilian society.

INTERNATIONAL BOARD

Marcos Caramuru

Caramuru is a Member of the International Advisory Board of the Brazilian Center for International Relations (CEBRI). Marcos Caramuru de Paiva, partner and member of KEMU (Shanghai) Consultancy, is a former Brazilian diplomat with a long experience in finance. Having lived in Asia from 2004 to the end of 2019, he was Ambassador in Beijing (2016-2018), Consul General in Shanghai (2008-2011) and Ambassador in Malaysia and Brunei (2004-2008). In his previous professional trajectory, he was Chairman of the Financial Intelligence Unit in Brazil (2003), Vice-Minister of Finance for International Affairs (1996-2002) and Executive Director at the World Bank in Washington DC (1993-1996). Marcos de Paiva is a Counselor of the Brazilian section of the Brazil-China Business Council.

Marcos Caramuru de Paiva kept for a few years in the past a column at the Brazilian newspaper Folha de São Paulo, in which he wrote regularly about China and Asia. Nowadays he contributes occasionally to newspapers and academic publications. He is also a frequent speaker at seminars both in China and Brazil.

Marcos Caramuru de Paiva holds a B.A in Administration from the Federal University of Rio de Janeiro. He also holds the undergraduation and the High-Level Course diplomas from the Brazilian Diplomatic Academy (Institute Rio Branco).

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Report by: Léa Reichert

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Introduction

The XXI China Analysis Group focused on the characteristics and trends of the Chinese economy, in a global context of post-pandemic economic normalization and rising inflation, and of economic slowdown in China as a result of the zero-Covid policy.

Huang Zhangkai, associate professor at Tsinghua University's School of Economics and Management, was invited to share his outlook in a dialogue with former Brazil Ambassador to China Marcos Caramuru and BOCOM BBM Bank Chief Economist Cecilia Machado. During the discussion, he analyzed the current state of the Chinese economy, the main factors impacting growth, and the perspectives and challenges he anticipates in the short- and medium-terms.

Professor Zhangkai's research focuses on corporate finance, political economy and economic development. He holds a PhD from Oxford University, and taught at Beijing and Lancaster Universities before joining Tsinghua. He published in top academic journals, including the American Economic Review.

This report summarizes the main takeaways of the event, which can be visualized **here**.

Guiding Questions

During its 31st Meeting, the China Analysis Group focused on three main themes and questions:

1. What is the current state of the Chinese economy and of its main drivers of growth, and what are the prospects for the months to come? What are the characteristics of present-day economic policy in China?

2. To what extent should the lifting of Covid-related restrictions boost market confidence and investments? Can sustained economic growth be expected in the medium and long-term?

3. What are the forecasts for the international projection of the Chinese economy? Will China's participation in global trade and supply chains expand, with a stronger, more internationalized renminbi? Will China remain open to foreign investments?

XXXI Meeting Report

1. What is the current state of the Chinese economy and of its main drivers of growth, and what are the prospects for the months to come? What are the characteristics of present-day economic policy in China?

After a period of monetary and fiscal stimulus in the wake of the Covid-19 pandemic, Europe and the USA are now tightening their monetary policy to combat inflation, which should lead to economic slowdown. In China, the situation is different. While strict Covid-related restrictions have had a negative impact on economic growth in the past two years, the relatively quick pace of opening-up as well as a reversal of the country's contractionary policies should bode well for economic recovery in 2023. In Zhangkai' view, and that of the market, the Chinese economy should have a healthy come-back in the short run.

The lifting of restrictions in other countries has led to increased consumption and mobility, with positive impacts on economic growth. In China, the population will likely adopt a careful stance when the restrictions are lifted, by fear of contamination and uncertainties, but it should also adjust relatively quickly to the new reality, leading to positive effects on consumption and travel. It is also unlikely that the government will roll back on its opening and go back to imposing harsh lockdowns. The good results in the stock market in the last weeks of 2022, especially in the entertainment and travel industries, are testimony to the optimistic forecasts for 2023.

It should be noted, when analyzing Chinese economic trends, that policy and reform formulation has considerably changed in China over the last five years. There has been a shift from a trial and error, gradual and experimental process – which differed from the shock therapy implemented in Russia and eastern European countries – to a more centralized approach. While economic reforms were previously rather decentralized, they now tend to be top-designed, carried out by the central government. This can lead to volatility in economic policy, due to the gap between policy formulation and the situation – and information – on the ground. China's economic policy uncertainty (as measured by the economic policy uncertainty index, for instance) has therefore risen in the past five years, and according to Zhangkai this can be attributed to top-designing.

This top-down model of economic management has an impact on historical driving forces of the Chinese economy, such as infrastructure investments, which largely depend on the action of local governments. In 2020, the merger between the regional and central taxes reinforced China's centralization, leaving regional governments with less fiscal freedom and economic autonomy. Zhangkai highlighted that after two decades of rapid growth in the infrastructure sector, the marginal rate of return on those investments has dwindled, reducing the gains. This fact, coupled with greater centralization, will no doubt hinder the infrastructure sector's role in the economy, as investments shrink.

The real estate sector, another enabler of economic growth, also experienced a major slowdown due to strict central bank policies targeting real estate developers' capacity to be financed through external debt. These measures, which were somewhat of a shock therapy, put the sector on hold and came as a surprise. The contractionary policies are now being reversed, with the government injecting more liquidity into the sector, thereby increasing stock price. Nonetheless, the sector should take time to recover its former dynamism, and performance indicators such as new house sales remain relatively low.

The Chinese government has taken a U-turn in many of its contractionary policies. China is reopening up very quickly and at a pace which has taken many observers, including many Chinese, by surprise. The market consensus, which is also my opinion, is that the Chinese economy is going to have a relatively healthy coming back next year.

In the past five years, the Chinese government has taken on a more centralized way of doing things. [...] It has changed from an observer of decentralized reforms to someone who sits at the top of the pyramid to carry out top design. If reforms and economic policies are top designed, there's going to be a big gap between the policy formation and the information which comes from the bottom. So that's why you see lots of volatilities in China's economic policy in recent years.

2. To what extent should the lifting of Covid-related restrictions boost market confidence and investments? Can sustained economic growth be expected in the medium and long-term?

While the Chinese central bank has taken steps to stimulate the economy, injecting liquidities and reducing banks' reserve requirements, and despite a relative availability of credits and resources in the economy, investor confidence has not reached expected levels.

Covid-19 restrictions are a short-term factor that can partly account for this lackluster performance, as lockdown measures discourage investments. However, other structural, long-term factors weigh in. The recent restrictions in the tech industry and educational sectors, and crackdown on some companies, which came in sharp contrast with the business-friendly stance of the past three decades, have led to uncertainty in the business community, and to a relative loss of confidence in investments. This active government intervention in the allocation of resources in certain areas represented a shift from official declarations on the role of the market, dating back for instance to the third Plenum of the Party Congress. Going forward, professor Zhangkai's take is that the government should adjust this posture.

Looking into the real estate sector specifically, there is some discussion among government officials as to how to promote confidence and growth, as several trends have to be contemplated, and as the sector is particularly sensitive due to its potential impact on the stability of the financial market as a whole. The skyrocketing housing prices in cities such as Shanghai or Beijing have led to discontent. However, the sector's links with the debt market and financial institutions have shown in the past that it needs to be handled carefully so as to avoid a market-wide crisis. The government's contribution has been to inject liquidity into real estate developers, which has yet to translate into a rise in the volumes of real estate traded. More active policies are likely, this time on the demand-side, with an easing of the restrictions on housing acquisition.

On the long run, however, structural reforms would be necessary. Among them are financial sector liberalization and privatization of state-owned companies which require large volumes of resources but have not generated sufficient returns. For Zhangkai, there is no guarantee that these reforms will be implemented in the next three to five years. A more optimistic prospect for economic growth Professor Zhangkai underlined is the role of human capital and innovation. China is producing the largest number of STEM (Science, Technology, Engineering, and Mathematics) graduates yearly, and local scientists and companies are making quick progress when it comes to innovation. Cheap labor is no longer the key to Chinese companies' success, and technology intensive industries are blooming in the country, in promising segments such as electric vehicles or solar energy.

Lastly, when it comes to uncertainties related to the consequences of the end of the zero-Covid policy, Zhangkai highlighted the Chinese government's capacity to mobilize resources and to control the narrative regarding the dangerous nature of Covid, thereby reducing the risk of a breakdown of the health system or of instability with the lifting of Covid restrictions.

If we look at these short-term factors, certainly Covid-19 restrictions are not working to support people's confidence. Naturally, you do not want to invest if you are locked down in your apartment. […] But there are other, more important long-term structural factors. In the past three decades the Chinese government has been very business friendly in promoting economic growth. They welcomed all kinds of entrepreneurs. But several things took place in recent years. If you look at the crackdown on the tech industry, on the educational sector, at occasional companies, these policies are not going to boost people's confidence. This is the most important source of uncertainty many businessmen and many entrepreneurs are feeling today.

China is already producing the largest number of STEM graduates every year, and Chinese scientists and firms are catching up very fast in innovation. Two decades ago, if you visited China, if asked why Chinese firms succeed, you would probably hear answers like, well, because of cheap labor. But then if you look at China's electric vehicles and solar energy industry, you can see that it is catching up very fast in those technology intensive industries. I think that's probably the brightest part of Chinese economy in the very long run […], the ultimate driver of economic growth.

3. What are the forecasts for the international projection of the Chinese economy? Will China's participation in global trade and supply chains expand, with a stronger, more internationalized renminbi? Will China remain open to foreign investments?

After a period of depreciation, the renminbi (RMB) has recently strongly appreciated with the removal of the Covid-19 restrictions. Although a weak currency can be good for trade, the example of Japan – where the yen depreciated in the past years with no significant positive impact on the volume of exports – illustrates that currency value is not sufficient in and of itself to boost trade. Maintaining a stable currency is, in Zhangkai's view, of utmost importance to attract foreign investment and boost investor confidence. China's central bank has intervened occasionally to avoid further depreciation of the RMB, and the recent appreciation has certainly come as a relief.

China has been the leading country in terms of exports and volumes traded over the past few years. This active engagement in international trade should in theory lead to an internationalization of its currency. However, there has been little progress on that front, partly because of the government' risk-aversion to capital account liberalization. Such a liberalization would be necessary to truly internationalize the RMB, but international capital account management is risky and this would entail a political decision that has not yet been taken.

It is worth noting that even before the 2018 trade war between the US and China, there has been a shift in supply chains and a growing integration between China and other East Asian economies, due to rising labor costs in China and subsequent relocation of production resources to countries in Southeast Asia, India and Bangladesh. This process was only accelerated by the trade war and the pandemic. Although the Chinese government could subsidize companies to avoid delocalization, on the long run this strategy may not be effective, as it diverts fiscal resources to the export industry. Zhangkai's take is that China should rather work to boost domestic confidence through streamlined regulation and a better business environment, which would benefit the economy more, albeit without immediate effects. Moreover, he highlighted that the main objective of the dual circulation policy put in place by the government is to prevent excessive dependence on the US, and that this should not have an impact on the flow of investments to other countries, such as Brazil. The government is likely to continue attracting foreign direct investment, and should not cut back on liberalization.

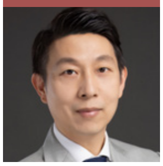
Lastly, China has an ambitious plan to reduce carbon emissions and invest in sustainable energy, with assertive policies to this end. These policies have been formulated from the top-down, with regional governments and economic actors reacting actively. With the reopening of the economy, the new energy and environmental protection sectors are likely to be an important driver for growth, receive heavy investments and generate profits.

> *If you want a true international currency, you need capital account liberalization. Now, this is something considered very dangerous or very tricky. I think everybody knows that China will probably benefit from a true international currency. But nobody knows how to achieve this without causing unnecessary risk. It's not just an economic issue, it is also a political issue.*

> *Even powerful governments like China's cannot work against basic economic principles. China benefits tremendously from globalization and there's no way China could its turn back to it. In the coming decades we should see more Chinese investments in countries like Brazil, and Chinese governments will continue to attract foreign direct investments.*

Participants

Keynote Speaker



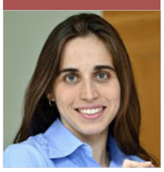
Huang Zhangkai

Associate professor of finance at the School of Economics and Management of Tsinghua University, China. He got his Ph.D. from the University of Oxford. Before he joined Tsinghua, Professor Huang taught at Peking University and Lancaster University, U.K. Professor Huang is doing research in corporate finance, political economy, and economic development. He published widely in top academic journals including the American Economic Review.

Interviewers

Marcos Caramuru

Marcos Caramuru is member of the International Advisory Board of the Brazilian Center for International Relations (CEBRI). Brazil's Former Ambassador to the People's Republic of China, Consul General in Shanghai, Ambassador of Brazil to Malaysia, President of the Financial Activities Control Council (Coaf), Secretary of International Affairs at the Ministry of Finance and Executive Director of the World Bank. He was also a partner and manager at KEMU Consultoria. He has a degree from the Rio Branco Institute (IRBr) and a degree in Administration from the Federal University of Rio de Janeiro (UFRJ).



Cecilia Machado

Cecilia Machado is Chief Economist at BOCOM BBM Bank and a Professor at the Brazilian School of Economics and Finance of the Getúlio Vargas Foundation (EPGE/FGV). She is a columnist for Folha de São Paulo Newspaper, where she writes every two weeks. She holds a bachelor's degree in economics from the Federal University of Rio de Janeiro, a master's degree in economics from PUC-Rio, and a_PhD_in_economics_from_Columbia_ University.

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