Between Shocks and Stimulus

Special Topic - Real Estate Vulnerabilities and Financial Stability in China

WORLD BANK GROUP

China Economic Update - June 2022

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List of Abbreviations

ALMP	Active Labor Market Programs
AQR	Asset Quality Review
BIS	Bank for International Settlements
CAICT	China Academy of Information and Communications Technology
CAMA	Computer Assisted Mass Appraisal
CAR	Capital Adequacy Ratio
CBIR	China Banking and Insurance Regulatory Commission
CDI	China Development Institute
CEADS	Carbon Emission Accounts and Datasets
CFETS	China Foreign Exchange Trade System
COVID	Coronavirus Disease
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
Delta	Delta Variants of Coronavirus Disease 2019
DRC	Development Research Center of the State Council
EAP	East Asia and the Pacific
EIA	Energy Information Administration of the United States
EMDE	Emerging Market and Developing Economy
ETS	Emissions Trading Scheme
FDI	Foreign Direct Investment
FX	Foreign Exchange
GDP	Gross Domestic Product
GEP	Global Economic Prospects
H1	First Half Year
H2	Second Half Year
hukou	Household Registration System
ICT	Information and Communications Technology
LGFV	Local Government Financing Vehicle
LGSB	Local Government Special Bond
IMF	International Monetary Fund
LPR	Loan Prime Rate
LT	Long term
MLF	Medium-term Lending Facility
MOF	Ministry of Finance
MSE	Micro and Small Enterprises
NBS	China National Bureau of Statistics
NHC	National Health Commission of China
NPL	Non-performing Loan
Omicron	Omicron Variants of Coronavirus Disease 2019
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PBC	People’s Bank of China
POE	Private-owned Enterprise
PPI	Producer Price Index

PPP	Purchasing Power Parity
PSL	Pledged Supplementary Lending
q/q	Quarter-on-Quarter
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
REIT	Real Estate Investment Trust
RHS	Right Hand Side
RMB	Renminbi
ROA	Return on Assets
ROE	Return on Equity
RRR	Reserve Requirement Ratio
SAFE	State Administration of Foreign Exchange
SHIBOR	Shanghai Interbank Offered Rate
SLF	Standing Lending Facility
SME	Small and Medium-sized Enterprise
SML	Special Mention Loan
SOE	State-Owned Enterprise
SPRF	Special-Purpose Refinancing
TMLF	Targeted Medium-Term Lending Facility
TVET	Technical and Vocational Education and Training
U.S.	The United States
USD	U.S. Dollar
VAT	Value-added Tax
VTB	Village and Township Bank
y/y	Year-on-Year
ytd	Year-to-Date
3mma	Three-month Moving Average
7dma	Seven-day Moving Average

Executive Summary

After a strong start in early 2022, the largest COVID-19 wave in two years and resulting mobility restrictions have disrupted China's growth normalization. The global environment has also significantly worsened following Russia's invasion of Ukraine which led to higher commodity prices, significant supply-chain disruptions, and slower trade flows. Despite the deteriorating global environment and the impact of the recent Omicron wave, China posted robust economic growth of 4.8 percent year-on-year (y/y) in the first quarter of 2022. However, economic momentum plunged in March and April with broad-based weakness in production activity and a notable deterioration in domestic demand conditions. The outbreaks also led to a dip in trade flows on the back of already softening external demand.

Real gross domestic product (GDP) growth is projected to slow sharply to 4.3 percent in 2022 – 0.8 percentage points lower than projected in the December *China Economic Update*. This downward revision largely reflects the economic damage caused by Omicron outbreaks and the prolonged lockdowns in parts of China from March to May. Growth momentum is expected to rebound in the second half of 2022, helped by aggressive fiscal stimulus, monetary easing, and further relaxation of housing sector regulations to mitigate the economic downturn. The normalization of domestic demand conditions is expected to be gradual and will only partly offset the economic damage caused by the pandemic in the earlier part of the year.

The growth outlook assumes that China's dynamic zero COVID policy will be maintained in the short term to avoid stressing its health care system. The likely scenario is recurrent and localized COVID outbreaks with short-lived mobility restrictions that are expected to be less disruptive than in 2022Q1. Investment growth, driven by infrastructure investment, is projected to accelerate, partly offsetting weakness in real consumption growth. As external demand weakens and supply-side constraints persist, the current account surplus is projected to narrow to 1.3 percent of GDP in 2022. With higher imported food and fuel prices, consumer price inflation is expected to rise but remain below the People's Bank of China (PBC) annual "about 3 percent" inflation target.

Risks to China's growth are unevenly balanced and downside risks prevail. The most prominent downside risks remain those related to the pandemic. The reemergence of new, highly transmittable variants could lead to more prolonged disruptions and complicate the exit from China's COVID strategy. Risks could also emanate from persistent stress in the real estate sector with wider macroeconomic and financial ramifications. This could be triggered by recurrent COVID outbreaks which discourage prospective buyers, reduce financing of the sector, and weigh on distressed and healthy developers alike. China's economy is also vulnerable to risks related to the global outlook. The fallout from the invasion of Ukraine and related ongoing global supply and trade disruptions may prove more persistent than expected, contributing to burgeoning inflation pressures, as evidenced by sharp increases in global input costs. On the upside, if the pandemic is brought under control and domestic restrictions are fully lifted, full year growth could be higher than currently projected, thanks to the recently announced additional stimulus measures.

In the short term, China faces the dual challenge of balancing COVID-19 mitigation with supporting economic growth. The government has stepped up macroeconomic policy easing with large public spending, tax rebates, policy rate cuts, and a more dovish stance on the property sector.

While China has the macroeconomic space to counter the growth slowdown, the dilemma facing decision-makers is how to make the policy stimulus effective, as long as mobility restrictions persist. Protracted COVID outbreaks are adding to economic uncertainty, which in turn is weighing on private investment and consumption and reducing the effectiveness of policy measures.

Beyond the dilemma of policy effectiveness in the midst of recurrent COVID outbreaks, there is a danger that China remains tied to the old playbook of aiming to boost economic growth through debt financed investment stimulus. The resulting growth model is ultimately unsustainable and the indebtedness of many corporates and local governments is already too high. Instead, policymakers could shift more of the stimulus onto the balance sheet of the central government and direct public investment towards the greening of public infrastructure. Recent announcements seem to go in this direction. Fiscal support could also shift beyond tax relief for enterprises to target measures to encourage consumption directly. For example, the wider use of consumption vouchers could lift consumer spending in the short term in locations where COVID-related restrictions have been lifted. Reforms to strengthen automatic stabilizers such as unemployment insurance and other social safety nets could also encourage greater consumption, particularly among the poor and vulnerable that have a lower propensity to save.

To achieve high-quality growth, policymakers should not lose sight of critical structural reforms, despite the current challenging environment. Decisive action to encourage a shift toward consumption, tackle social inequality, and rekindle innovation and productivity growth—including in technologies vital for China's dual carbon goals—would help achieve a more balanced, inclusive, and sustainable growth trajectory for China.

China Economic Outlook	***2020***	***2021***	***2022f***	***2023f***	***2024f***
Real GDP growth (%)	2.2	8.1	4.3	5.2	5.1
Consumer Price Index (CPI) (% change, average)	2.5	0.9	2.3	2.0	1.9
Current account balance (% of GDP)	1.9	1.8	1.3	1.2	1.1
Augmented fiscal balance (% of GDP) *	-8.6	-4.4	-7.1	-5.5	-4.4

Sources: World Bank.

Notes: f = forecast. * World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the General Public Budget (excluding adjustment from the Stabilization Fund), the Government Fund Budget, the State Capital Operation Budget and the Social Security Fund Budget.

Focus Chapter: Real Estate Vulnerabilities and Financial Stability in China

China's housing market downturn in the midst of an economic slowdown has put real estate sector vulnerabilities in the spotlight. For over two decades, China's real estate sector has grown at a remarkable pace and become a principal engine of economic growth. As of end-2021, total real estate investment stood at 12.9 percent of GDP, much larger than in many other countries. Meanwhile, property prices in China are among the most expensive in the world with house price-income ratios in Beijing and Shanghai much higher than in cities such as New York, Paris, and Tokyo. One key feature of the expansion of the property market has been the high levels of leverage among property developers. Recent efforts by the authorities to reduce developers' indebtedness triggered a liquidity crisis in the second half of 2021, as several large developers defaulted on their debt obligations and were forced into a fire sale of assets to repay creditors. As the distress of developers created downward pressures on the property markets, the authorities recently unveiled a series of measures to stabilize the property market. These include giving developers easier access to presale funds held in escrow, reducing down payment ratios and allowing commercial banks to lower mortgage rates.

Although the financial sector appears resilient to the immediate shocks from the property market downturn, there are vulnerabilities that warrant close attention going forward. The overhang of uncompleted housing, especially in some lower-tier cities, the rising pressures on household balance sheets, the ongoing distress of developers, and the economic slowdown could keep demand for new houses weak. Further relaxation of regulatory controls to reignite investment risks storing up more trouble down the road. The aim for policy in the short run should thus be to stabilize the market and create the conditions for its orderly restructuring. For example, extending the transition period for compliance with the “three red lines” beyond end-2023 would give developers more breathing space to adjust but allow the authorities to continue to monitor developers closely to ensure there is genuine progress toward deleveraging.

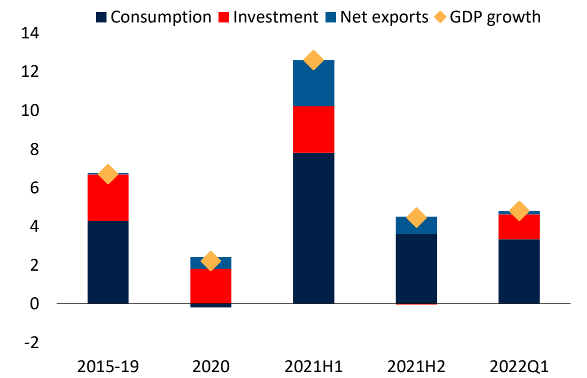
In addition to finding the right balance between stabilizing the market and controlling risks in the short term, several structural reforms would put the real estate sector on a sounder footing over the long-term. For example, there is significant scope to enhance the livability and economic vitality of inner cities in China, whilst increasing their density and thus moving away from the extensive model of urbanization followed to date. Changes to urban master plans and floor area regulations could unlock private investment in urban regeneration. Such a shift will also require investment into upgrading public spaces, improving public transport, and enhancing the delivery of public services. Fiscal reforms to give cities access to new sources of revenue beyond land sales would need to be introduced in parallel. Financing options for real estate developers could be broadened through the expansion of project-based financing or the greater participation of institutional investors such as Real Estate Investment Trusts (REITs), which are oriented toward property development. The distress of large developers has also underscored the need for a robust and predictable framework for debt resolution and corporate insolvencies, which would facilitate the reallocation of capital to support a more innovation-driven, private sector-led growth. Finally, further liberalization of the financial system is essential to expanding the range of financial assets available to households as investment options and reduce the propensity to buy and hold empty properties as investment vehicles.

Figure 1. The *China Economic Update* at a glance

China posted robust growth in the first quarter, driven by stronger investment amid fiscal support

A. GDP demand components

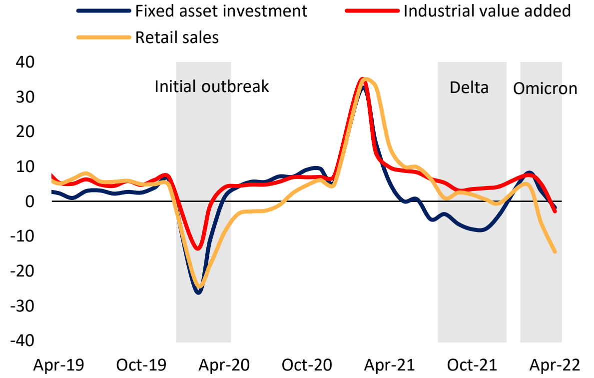
(Contribution to growth, percentage points)



But the largest COVID-19 wave in two years has disrupted China's growth normalization

B. Fixed asset investment, industrial value added and retail sales

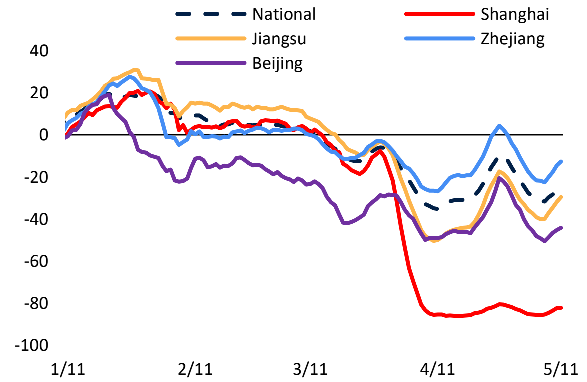
(y/y percent)



Tightened mobility restrictions have affected China's supply chains

C. Truck logistic freight flow

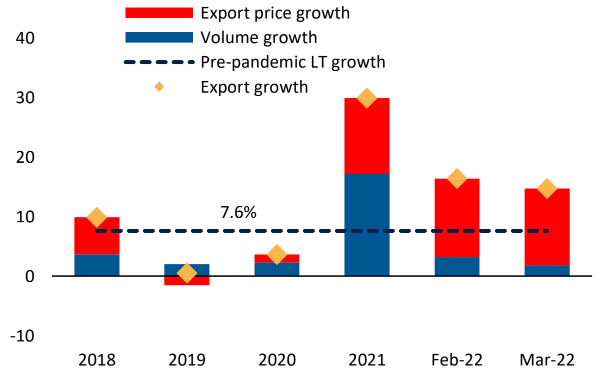
(y/y percent, 7dma)



And led to a dip in trade flows on the back of already softening external demand

D. Goods export growth

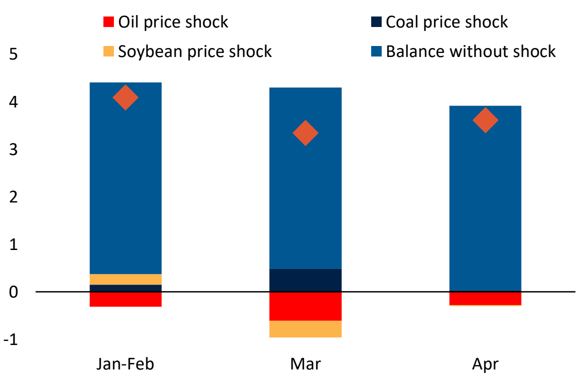
(y/y percent)



Higher commodity prices had a limited impact so far on China's trade balance despite its position as a net commodity importer

E. Commodity price shock impact on trade balance

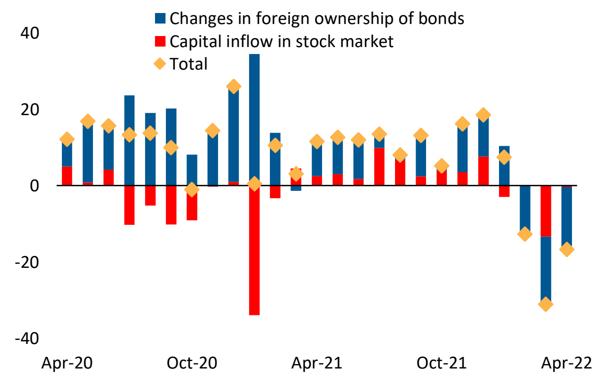
(Percent of monthly GDP)



Fed tightening and higher uncertainty amid Omicron outbreaks and geopolitical developments led to capital outflows

F. Portfolio investment

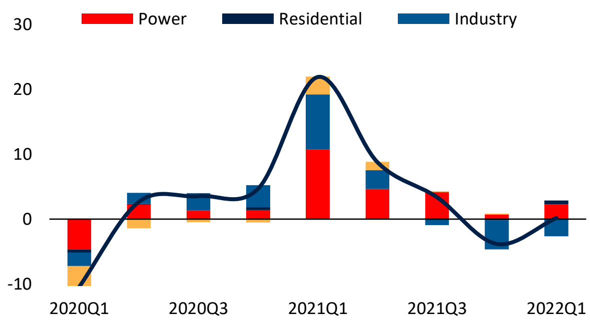
(Billion USD)



Carbon emissions only marginally increased reflecting weak industry activity amid COVID outbreaks

G. Carbon emission growth

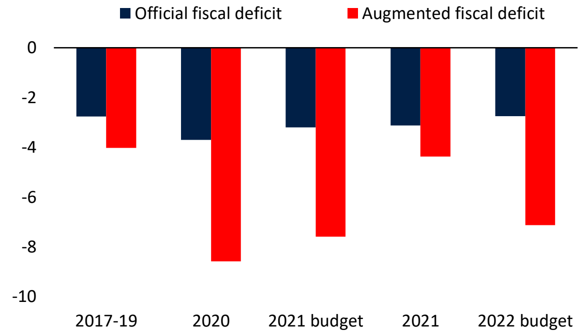
(y/y percent)



To counteract growth headwinds China has embarked on an aggressive fiscal expansion

H. Fiscal expansion

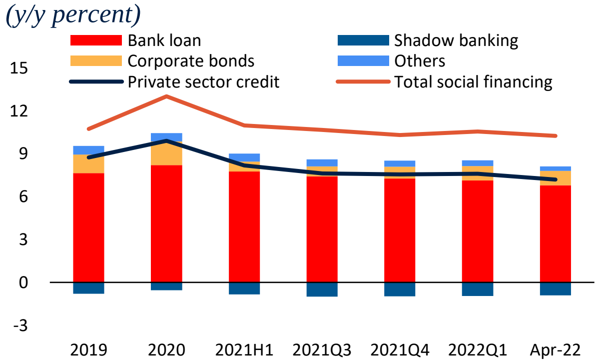
(Percent of GDP)



Private sector credit demand remains weak despite modest monetary easing

I. Total social financing and private sector credit growth

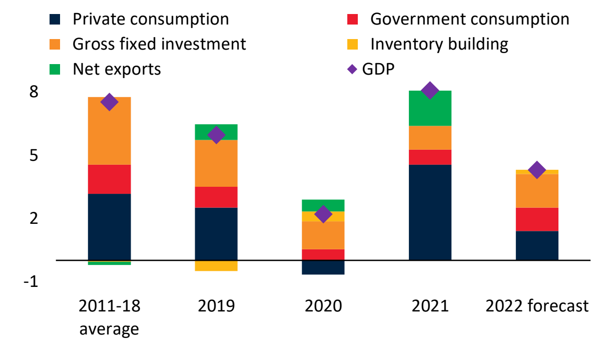
(y/y percent)



Growth is projected to slow to 4.3 percent in 2022, well below its potential rate

J. GDP growth

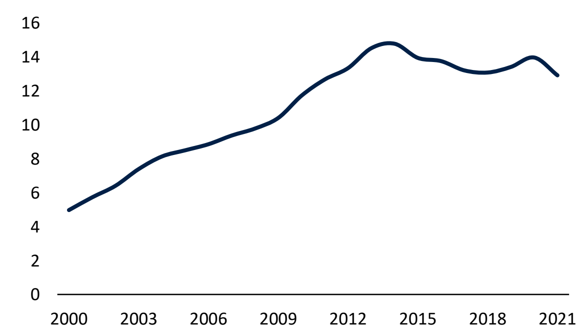
(Contribution to growth, y/y percent)



Real estate investment has grown remarkably, serving as driver for economic growth

K. Real estate investment

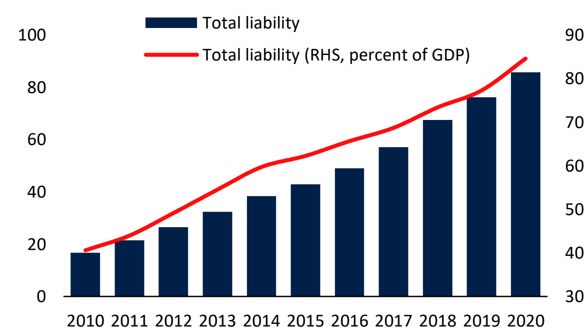
(Percent of GDP)



Growth in property market is fueled by developers' borrowing

L. Total liability of developers

(Trillion RMB; percent of GDP)



Source: China Customs; Wind Information Database; China National Bureau of Statistics (NBS); Federal Reserve Economic Data; State Administration of Foreign Exchange (SAFE); People's Bank of China (PBC); Carbon Monitor; Ministry of Finance (MOF); Haver Analytics; World Bank.

Note: Figure C. 7dma refers to seven-day moving average. Figure D. Pre-pandemic LT (long-term) growth refers to annualized growth rate between 2009 and 2019. Figure E. Based on estimations that simulate the impact of different commodity price shocks to the trade balance. Figure H. The augmented fiscal balance adds up the General Public Budget (excluding adjustment from the Stabilization Fund), the Government Fund Budget, the State Capital Operation Budget and the Social Security Fund Budget. Figure I. The private sector excludes government bonds but includes credit to state-owned enterprise (SOEs) and local government financial vehicles (LGFVs). RHS refers to right hand side.

I. Recent Economic Developments

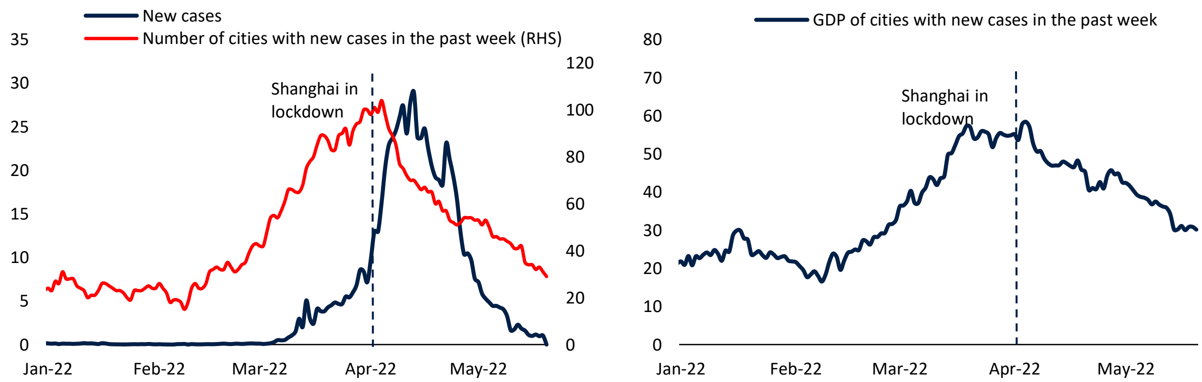
Severe COVID outbreak has disrupted the growth normalization

After a strong start in early 2022, COVID-19 outbreaks disrupted economic activity in March and April. China experienced the largest COVID-19 wave in two years, with more than 750,000 COVID cases since the start of 2022 (Figure 2.A). In response, the authorities tightened mobility restrictions and introduced partial and full lockdowns in various parts of the country (Figure 2.B). The prolonged lockdown measures in Shanghai—China's leading financial and industrial center—caused severe economic fallout. Activity contracted and transportation, logistics, and major supply chains faced disruptions, with knock-on effects on trade flows (Box 1).

Figure 2. China experienced the largest COVID-19 wave in two years

A. New domestic cases and cities affected
(Thousand cases; Number of cities)

B. GDP impacted by COVID outbreaks
(Percent of national GDP)



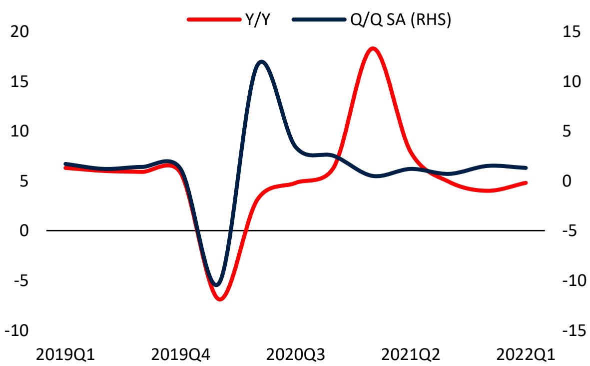
Source: National Health Commission of China (NHC); World Bank.
Note: Figure A and B. New cases include asymptomatic cases.

The global environment has significantly worsened after Russia's invasion of Ukraine followed by a number of countries imposing a variety of sanctions on Russia. Global inflation has risen sharply, and global financial conditions have tightened amid soaring energy and food prices. The US 10-year yield approached 3 percent in early May, a level last seen in 2018. Global activity and trade have decelerated faster-than-expected, led by the manufacturing sector amid high inflation, tighter financing conditions, and persistent supply strains.

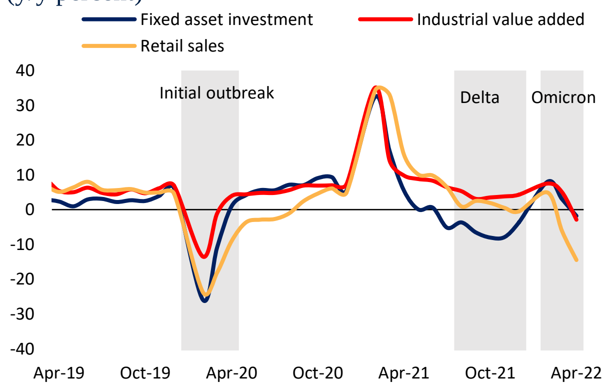
China posted robust economic growth in the first quarter of 2022, despite the deteriorating global environment and the impact of new Omicron outbreaks. China's GDP expanded by 4.8 percent y/y in the first quarter of 2022, driven by a recovery in infrastructure investment and still robust manufacturing investment (Figure 3.A). This marked an acceleration of growth from 4.5 percent y/y in the second half of 2021. The rebound was supported by a significant easing of fiscal policies and energy constraints. Despite strong quarterly growth, economic activity weakened toward the end of the quarter following tightened mobility restrictions. April activity data deteriorated sharply with broad-based weakness in production activity and a notable slowing of domestic demand conditions (Figure 3.B).

Figure 3. Growth rebounded in Q1, but momentum slowed toward the end of the quarter

A. GDP growth
(y/y percent; q/q percent, seasonally adjusted)



B. Fixed asset investment, industrial value-added, and retail sales
(y/y percent)



Source: China National Bureau of Statistics (NBS); World Bank.

Box 1. The economic impact of the Omicron outbreak in Shanghai

This box assesses the economic impact of the Omicron outbreak in Shanghai, a global transport, manufacturing and trade hub. After several weeks of unsuccessful attempts to suppress the largest COVID outbreak in two years, Shanghai moved to a lockdown at the end of March, which was extended in April. As COVID cases have fallen sharply by the middle of May, the authorities in Shanghai released a roadmap to gradually re-open the city.

The large COVID outbreak impeded domestic production and disrupted supply chains. In Shanghai, real industrial value added contracted sharply by 10.9 percent year-on-year (y/y) and 62.6 percent y/y respectively in March and April, compared to an expansion of 11.9 percent y/y in January-February (Figure 4.A). Meanwhile, domestic logistics have also been hampered by tightened mobility controls. Truck freight flow decreased by more than 80 percent y/y in Shanghai and 24.5 percent y/y nationwide during April, significantly disrupting connectivity between ports, factories, and suppliers (Figure 4.B).

COVID-related restrictions have posed considerable challenges to external trade. Shanghai made up 7 percent of China’s exports and 15 percent of imports in 2021. Mobility restrictions have interrupted logistics at the Port of Shanghai, which, as the largest port in the world, handles over 5.5 percent of world container throughput and 17 percent of containers in China. Growth in container throughput decelerated to 5.1 percent y/y and -17.2 percent y/y in March and April, respectively, from 8.1 percent y/y in 2021 (Figure 4.C). Meanwhile, the contraction of cargo transport growth at Pudong airport in Shanghai, the world’s third-busiest cargo airport, deepened from 8.2 percent y/y in February to 19 percent in March.

Direct and indirect economic costs related to the COVID outbreak in Shanghai are significant. In 2021, Shanghai accounted for about 3.8 percent of China’s GDP and was ranked among the top five suppliers of inputs in 21 provinces (Figure 4.E). Through production linkages, the stringent mobility measures could affect more than 6.5 percent of GDP in China, as disrupted supply chains would undermine economic activities in places that are dependent on parts and components from Shanghai. We estimate that the Covid outbreak in Shanghai may lower China’s annual GDP growth by around 0.8

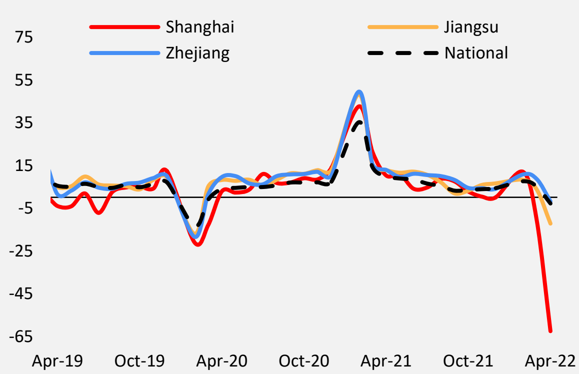
percentage points, with a larger impact on the auto manufacturing industry, financial and commercial services, as well as the retail and wholesale sector[1] (Figure 4.D).

High transmissibility of Omicron prompted authorities in the neighboring provinces to tighten mobility restrictions, which has exacerbated the economic impact of the outbreak. In particular, Jiangsu and Zhejiang provinces—two manufacturing hubs accounting for 10.1 percent and 6.4 percent, respectively, of China's GDP—also experienced a deterioration in logistics at the outset of the Omicron wave in Shanghai (Figure 4.B). We estimate that tightened mobility restrictions in the bordering provinces would lead to an additional 0.2 percentages point reduction in GDP growth this year.

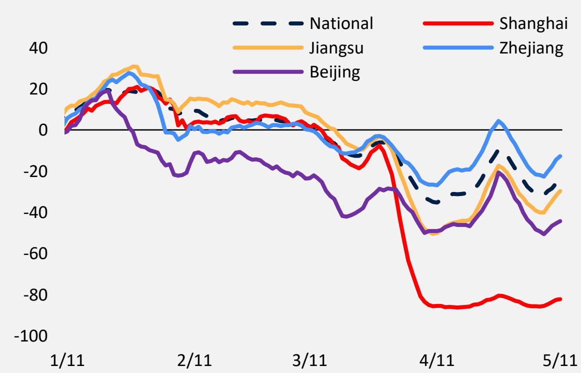
Logistics and production started to slowly recover amid rapidly falling COVID cases in Shanghai since May. After daily new Omicron cases dropped from about 17,850 on average in April to below 70 at the end of May, authorities in Shanghai issued a 50-point action plan to support the reopening of the economy, including rent and tax reduction and abandoning a whitelist for businesses to resume operation. Logistics have been improving nationwide and especially in the neighboring provinces around Shanghai since late April (Figure 4.B).

Figure 4. The economic impact of the COVID outbreak in Shanghai

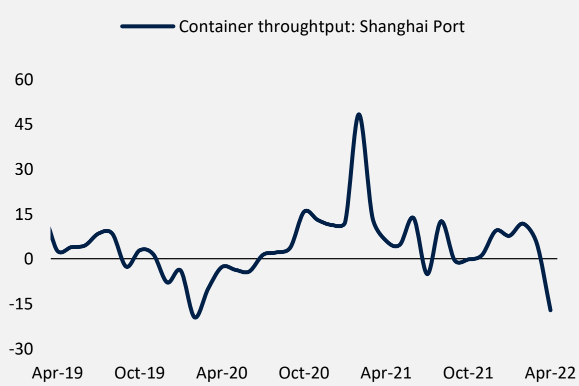
A. Real value added of industry
(y/y percent)



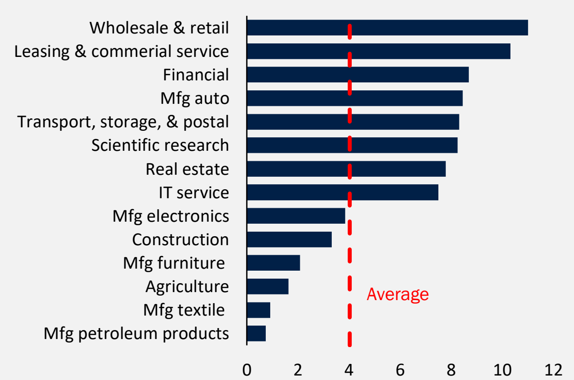
B. Truck logistic freight flow
(y/y percent, 7dma)



C. Container throughput at Shanghai Port
(Percent y/y, days)

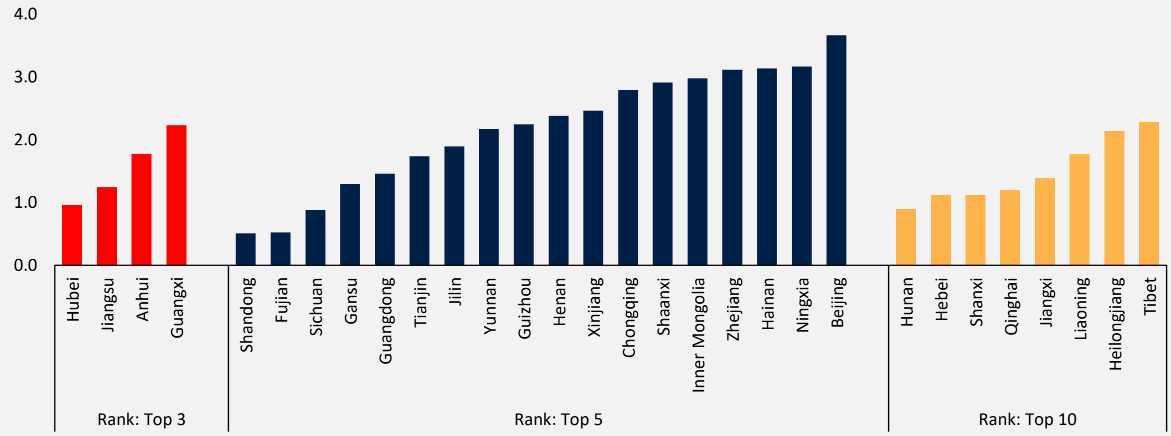


D. Sectorial dependence on intermediates from Shanghai
(Share of inputs from Shanghai, percent)



[1] The impact on GDP is estimated using multi-regional input-output tables and the severity of the COVID impact is proxied using changes in the truck freight flow index.

E. Provincial dependence on intermediates from Shanghai
(Share of inputs from Shanghai, percent)



Source: Wind Information Database; NBS; China Multi-regional Input-output Table 2017 (CEADS); World Bank.
Note: Figure E. The rankings show Shanghai's rank as input provider in the province. Top 3 means Shanghai is the 1st - 3rd largest supplier of the inputs to those provinces, Top 5 means Shanghai is the 4th-5th largest supplier, top 10 means Shanghai is the 6th-10th largest supplier in those provinces.

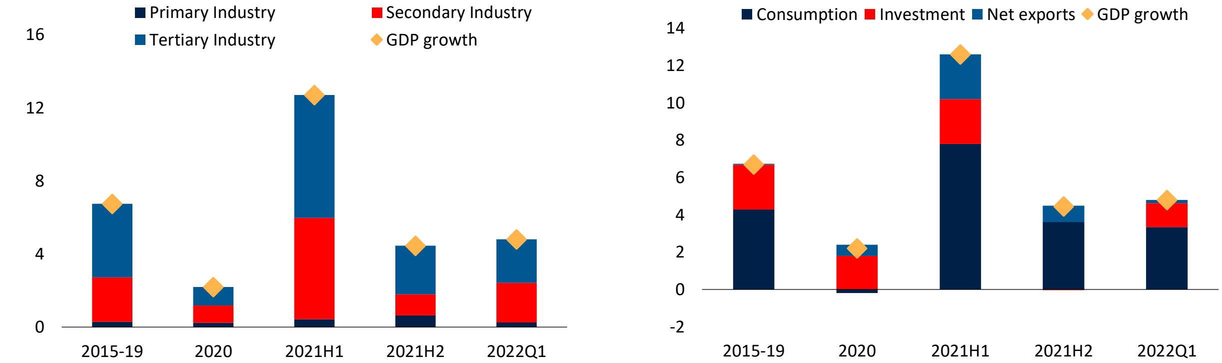
Stimulus-led investment in 2022Q1 supported industrial production growth, but services sector activity stagnated because of protracted COVID-related restrictions (Figure 5.A). Growth in industrial production accelerated to 6.4 percent y/y in 2022Q1 from 3.8 percent y/y in 2021Q4, supported by robust manufacturing activity. The mining sector continued to outperform, reflecting easing of energy shortages. Growth in the construction sector bottomed out amid an infrastructure push but continued to show relatively weak performance, reflecting COVID-related disruptions. Growth in the services sector decelerated to 4.0 percent y/y in the first quarter of 2022 from 4.6 percent y/y in the previous quarter. The slowdown was particularly evident in hotel and catering, transport, and the wholesale and retail sectors. Growth in agricultural output moderated to a still strong 6.0 percent in the first quarter of 2022 from 6.4 percent y/y in the previous quarter, reflecting the lingering effect of severe floods in the second half of last year and a decrease in poultry meat production.

On the demand side, fiscal policy easing supported the rebound in investment. The contribution of investment tripled from -0.5 percentage points in the previous quarter to 1.3 percentage points to GDP growth in the first quarter of 2022 (Figure 5.B). Investment growth was led by infrastructure investment which experienced a sustained acceleration following a period of subdued performance last year. Manufacturing investment also held up well on the back of robust export growth. Meanwhile, the contraction in real estate investment eased somewhat in the first quarter after regulators took several steps to stabilize the real estate sector.

Figure 5. Industry and investment drove GDP growth

A. GDP sectoral composition
(Contribution to growth, percentage points)

B. GDP demand components
(Contribution to growth, percentage points)



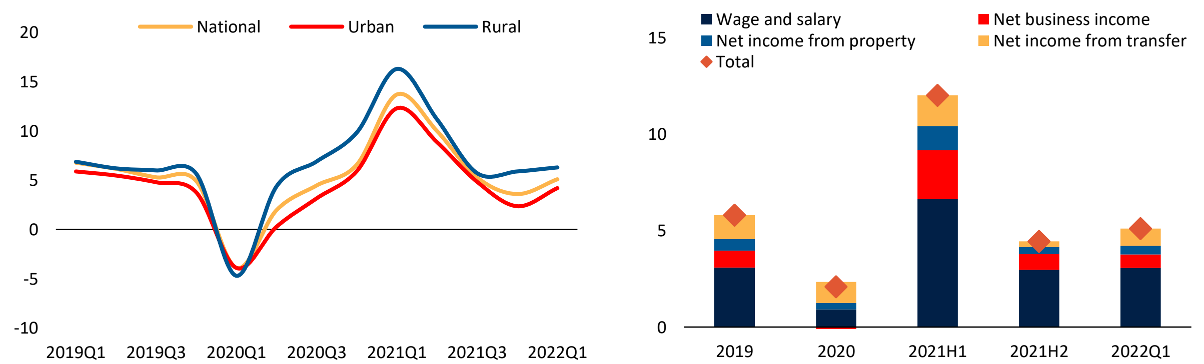
Source: NBS; World Bank.

Consumption has stagnated over the past two quarters despite improved household incomes. The contribution of consumption to growth was broadly unchanged over the past two quarters (Figure 5.B). Although household income growth rebounded in the first quarter of 2022, Omicron outbreaks and restrictions led to a moderation in consumer spending growth (Figure 6.A and B). Additionally, a slowing labor market and higher uncertainty also weighed on consumer sentiment. Real disposable income per capita growth accelerated to 5.1 percent y/y in the first quarter of 2022 from 4.4 percent y/y in the second half of 2021, particularly on higher transfers, while household per capita spending growth dropped to 5.7 percent y/y from 8.7 percent y/y during the same period (Figure 6.C). Consequently, the savings rate, particularly among urban households, increased to 32.3 percent at the end of the first quarter from 31.0 percent at the end of last year (Figure 6.D).

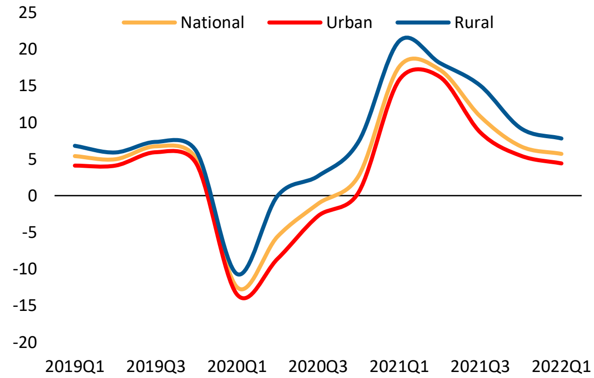
Figure 6. Consumer spending growth slowed despite rising disposable income

A. Per capita disposable income
(y/y percent)

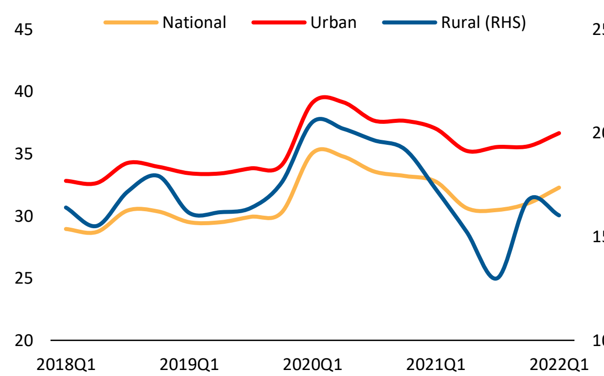
B. Per capita disposable income in the first quarter
(Contribution to growth, percentage points)



C. Per capita household expenditure
(y/y percent)



D. Savings rate
(Percent, seasonally adjusted)



Source: NBS; World Bank.

Outbreaks and the Shanghai lockdown led to a dip in trade in April

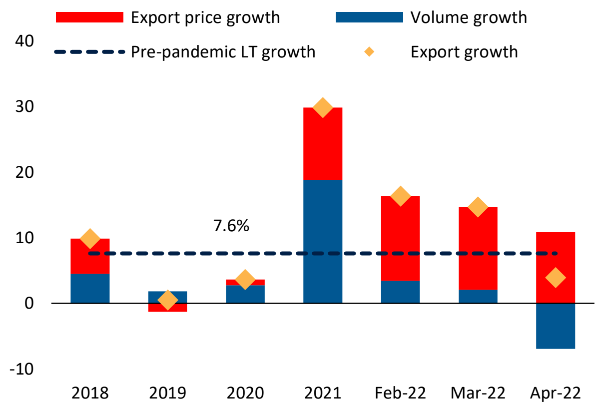
Following a strong first quarter, export growth of goods plummeted in April, reflecting disruptions caused by the COVID outbreak in Shanghai. After expanding by about 15.8 percent y/y in 2022Q1, China's exports growth slowed markedly to 3.9 percent y/y in US dollar terms in April 2022, despite higher export prices (Figure 7.A). In volume terms, exports contracted by 6.9 percent in April. The slowdown in export growth was broad-based, spanning from lower-end consumer goods to tech products (Figure 7.B). Notably, China's export deceleration in April was more severe compared to some other regional exporters, which experienced robust export growth. This suggests that the slower growth may have been mainly led by Omicron-related supply chain and logistic disruptions. Import demand in much of Asia also remained resilient in contrast to other regions more directly exposed to the war in Ukraine, including advanced economies whose import demand plummeted in April.

Following a robust performance in the first two months of 2022, import growth contracted in March and remained flat in April. After growing at about 15.5 percent y/y in the first two months, import growth contracted mildly on a y/y basis in March and remained subdued in April in US dollar terms. Excluding price effects, imports in volume terms contracted by 19.1 percent y/y in April, reflecting weakening of domestic demand and the likely turn in inventory cycle following the peak in late 2021 (Figure 7.C). The downturn followed a long period of double-digit import growth, which was supported by rebuilding inventories following the first wave of COVID-19 in early 2020 and fiscal policy easing to stimulate infrastructure investment in the second half of 2021 (Figure 7.D). Following the war in Ukraine, China stepped up imports of some strategic commodities, including soybeans, and grains.

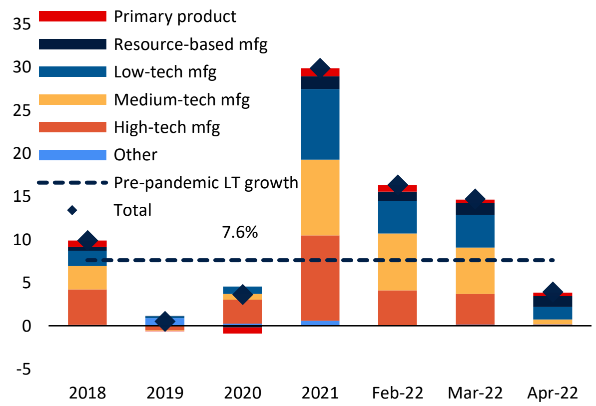
Trade in services slowed on the back of logistical bottlenecks and depressed tourism. Growth in services exports slowed from last year's highs as export of transport services moderated owing to softer merchandise exports (Figure 7.E). Meanwhile, services imports also decelerated, driven by weaker import of transport and financial services (Figure 7.F). Tourism contributed positively to services imports on low base effects. Tourism activities remained muted due to stringent travel restrictions.

Figure 7. Trade has slowed

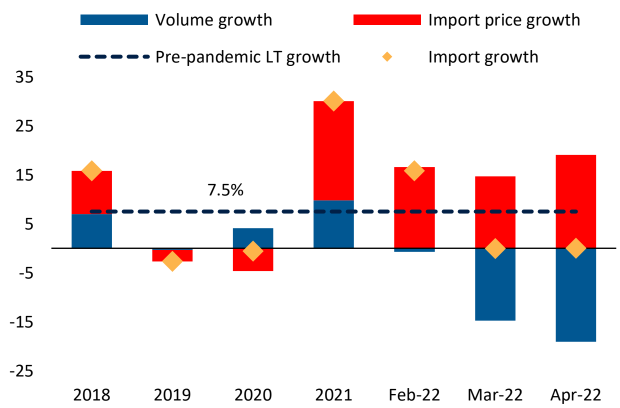
A. Goods export growth
(y/y percent)



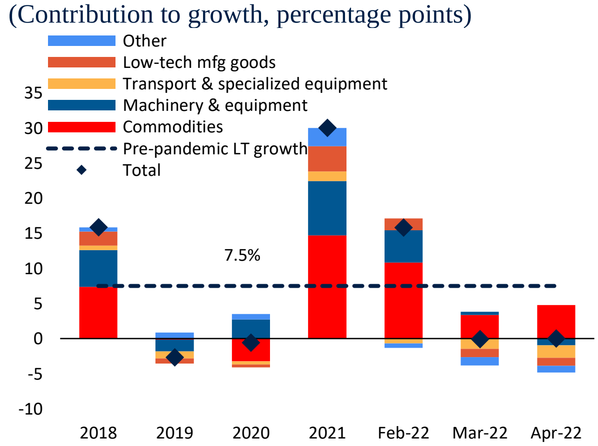
B. Composition of goods exports
(Contribution to growth, percentage points)



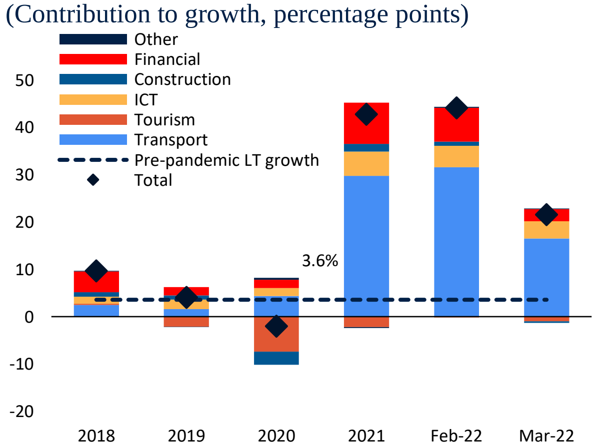
C. Goods import growth
(y/y percent)



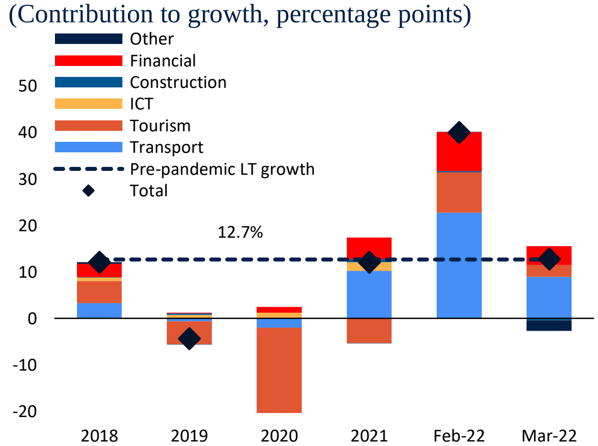
D. Composition of goods imports
(Contribution to growth, percentage points)



E. Service export growth
(Contribution to growth, percentage points)



F. Service import growth
(Contribution to growth, percentage points)



Source: China Customs; NBS; World Bank.
Note: Other in Figure 5.E and F includes personal, cultural and recreational service, and government service not classified elsewhere. Pre-pandemic LT (long-term) growth refers to annualized growth rate between 2009 and 2019. Mfg refers to manufacturing

The global economic environment has worsened significantly after Russia's invasion of Ukraine. The war has led to higher commodity prices, impaired global trade, and accelerated the global economic slowdown, triggering second-round impacts on China's economy (Box 2).

Box 2. Estimating the spillovers of the commodity price shock from the war in Ukraine

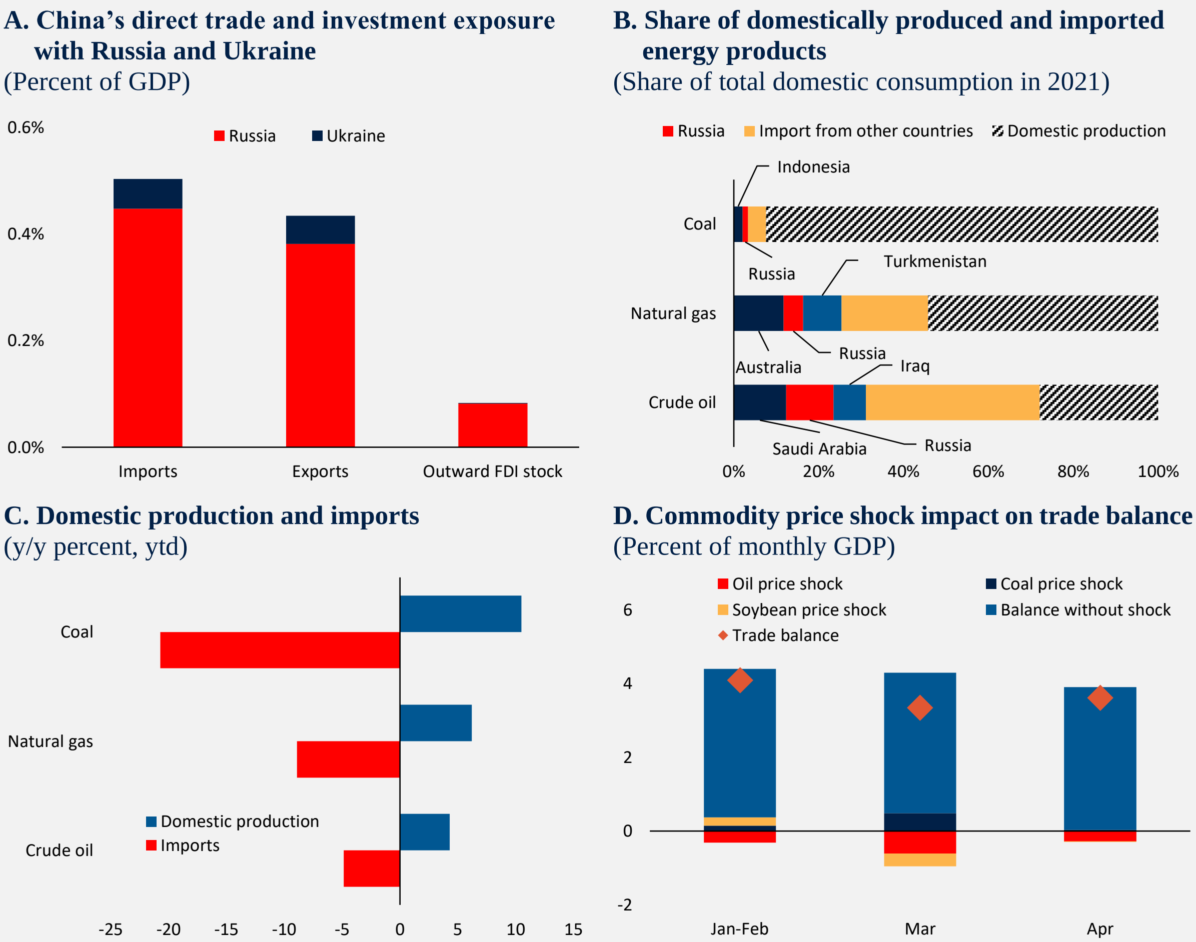
China is the largest importer of crude oil, liquefied natural gas, and coal in the world. China imports around 72 percent of domestically consumed crude oil, 46 percent of domestically consumed natural gas, and about 8 percent of domestically consumed coal. In 2021, China's crude oil, natural gas, and coal imports accounted for 9.6, 2.1, and 1.3 percent of its total imports equivalent to 1.5, 0.3 and 0.2 percent of GDP, respectively. Among these, Russia is the second largest supplier of crude oil and coal and the third largest supplier of natural gas to China. While China has otherwise limited direct trade and investment exposure with Russia, it purchased around 80, 12, and 55 million tons of crude oil, natural gas, and coal from Russia in 2021, representing 16, 10, and 17 percent of China's total oil, natural gas, and coal imports, respectively (Figure 8.A and B).

China has turned into a net importer of food, but its net imports of food still represent a very small share of GDP. Amid continuously increasing food demand, China has shifted from a net food exporter to a net importer over the past decade, but its net imports of food are negligible as share of GDP (around -0.3 percent of GDP on average in 2000-2019). Around 6.7 and 3.2 percent of wheat and rice consumed in China are imported. In contrast, China imports 85.5 percent of its soybean consumption (about 0.3 percent of GDP). The impact of higher food prices, except for soybeans, should have a limited impact on China because of its low import reliance.

In response to power shortages in 2021 and surging global commodity prices, China has stepped up its production of energy commodities. The prices of imported oil, soybean, and wheat in China have spiked in tandem with global prices in the first four months of 2022. During this period, the volumes of imported coal, natural gas, and crude oil declined by 21 percent, 9 percent, and 5 percent year-on-year, respectively. In contrast, domestic production of coal, natural gas, and crude oil increased during the same period by 11 percent, 6 percent, and 4 percent respectively (Figure 8.C). Coal has been substituting natural gas in power and industrial heat generation. Because most of the coal is supplied domestically, its price has been less affected by global market price fluctuations.

The commodity price shock from the war has had a limited impact on China's trade balance so far, despite China's net commodity importer status. In general, higher commodity prices would worsen China's terms of trade, increase imports in value terms, and narrow the trade surplus. To quantify the impact of changing imported commodity prices on the trade balance, we estimate the impulse responses of price shocks based on the local projection method (Jorda, 2005). The analysis finds that increases in the price of imported crude oil knocked off 0.6 percent and 0.3 percent, respectively, of monthly GDP from the trade surplus in March and April. Similarly, the higher prices of imported soybeans reduced the trade surplus by 0.3 percent of monthly GDP in March. At the same time, falling prices of imported coal improved the trade surplus by 0.5 percent of monthly GDP in March (Figure 8.D).

Figure 8. China's trade performance worsened after the war in Ukraine



Source: China Customs; Ministry of Commerce; Wind Information Database; NBS; Federal Reserve Economic Data; World Bank.
Note: Figure A. Direct investments reflect China's outward direct investments into Russia and Ukraine. The latest available year for China trade data is 2021 and for direct investment data is 2020. Figure B. The other suppliers of crude oil include Oman, Angola, the United Arab Emirates, Brazil and Kuwait. The other suppliers of natural gas include mainly the United States, Qatar, Malaysia, Indonesia, and Kazakhstan. Figure C. Year-to-date covers January to April. Imports are in volume terms. Figure D. Analysis uses local projection method based on Jorda (2005), which simulates the impact of different commodity price shocks to the trade balance.

Sustained current account surplus and volatile capital flows

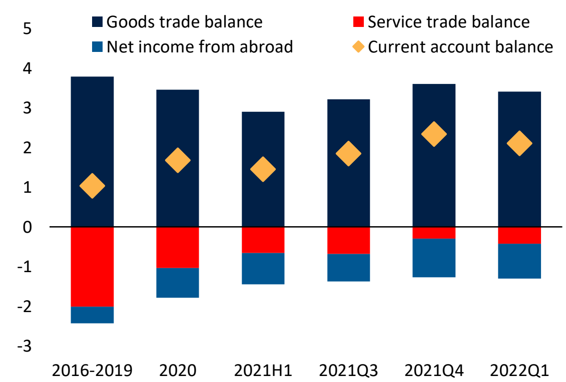
China maintained a large current account surplus in 2022Q1 thanks to a robust goods trade surplus. The current account surplus moderated slightly to 2.1 percent of GDP from the historic high of 2.3 percent of GDP in 2021Q4 (Figure 9.A). A large trade surplus backed by buoyant export prices and declining imports more than offset the services trade and income deficit.

The deficit in the financial and capital account widened in the first quarter of 2022. The financial and capital account deficit (including errors and omissions) doubled from 0.6 percent of GDP in the previous quarter to 1.2 percent of GDP in the first three months of 2022. The sharp increase in the deficit was driven by portfolio outflows and outflows reflecting increases in overseas deposits of Chinese banks and corporations, which more than offset strong FDI inflows. Despite heightened global uncertainty, net FDI inflows increased substantially, amounting to 1.5 percent of GDP (Figure 9.B). Following an extended period of net portfolio inflows, portfolio investments experienced a period of significant net outflows during February and April to the tune of US$60.5 billion (1.3 percent of GDP) (Figure 9.C). Bond outflows dominated, reflecting narrowing interest rate differential and higher uncertainty amid Omicron outbreaks and geopolitical concerns (Figure 9.D). While foreign exchange (FX) reserves declined by US$130.4 billion (1.1 percent of GDP) in the first four months of 2022, China's overall external position remains strong, with FX reserves at US$3.1 trillion (the equivalent of around 14 months of imports) by the end of April (Figure 9.E).

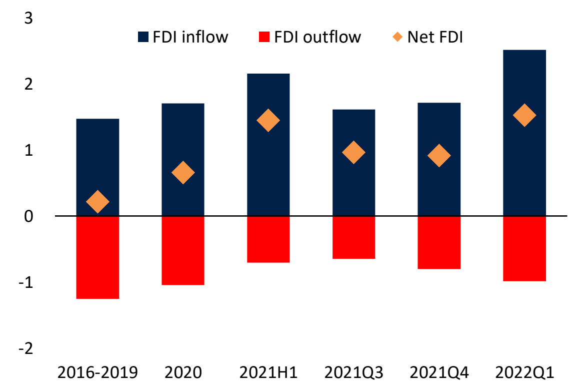
Sharp capital outflows combined with US dollar strength caused a rapid weakening of the renminbi (RMB) in recent months, ending a two-year rally. After appreciating against the US dollar in 2021 on the back of robust capital inflows, the RMB weakened by about 4.4 percent against the US dollar year-to-date (Figure 9.F). Concerned about the rapid depreciation of the RMB, the People's Bank of China (PBC) in April lowered the reserve requirement ratio on FX deposits for financial institutions by 1 percentage point to 8 percent. Last year, the central bank increased the same FX reserve ratio twice to slow the rapid strengthening in the RMB.

Figure 9. China sustains a comfortable external position

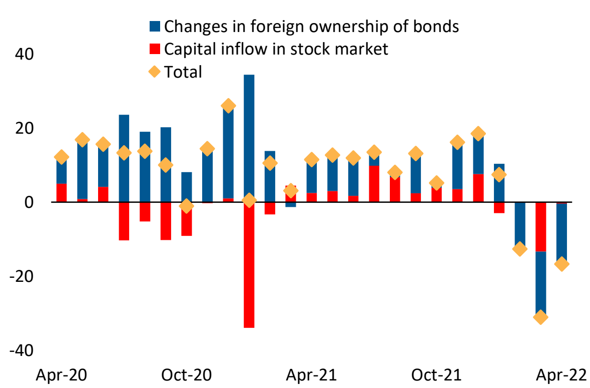
A. Current account balance
(Percent of GDP)



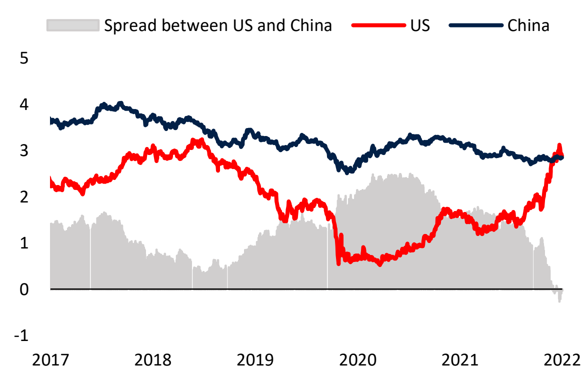
B. Foreign direct investment
(Percent of GDP)



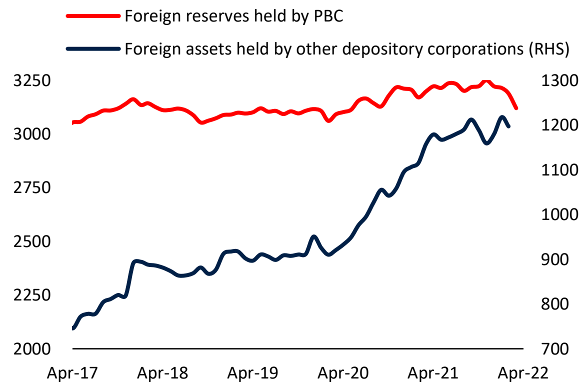
C. Portfolio investment
(Billion USD)



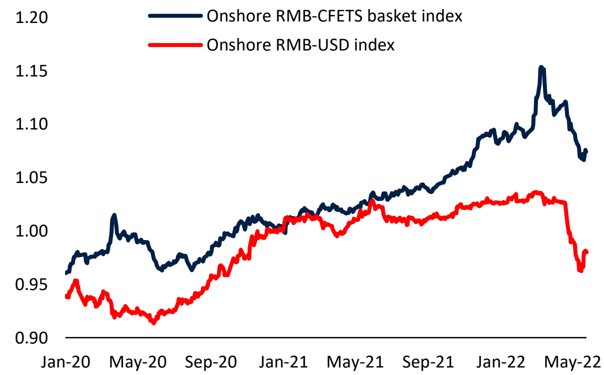
D. 10-year treasury bond yields in China and the US
(Percent)



E. Foreign reserves accumulation
(Billion USD)



F. Exchange rate
(Index, December 31, 2020 = 1)



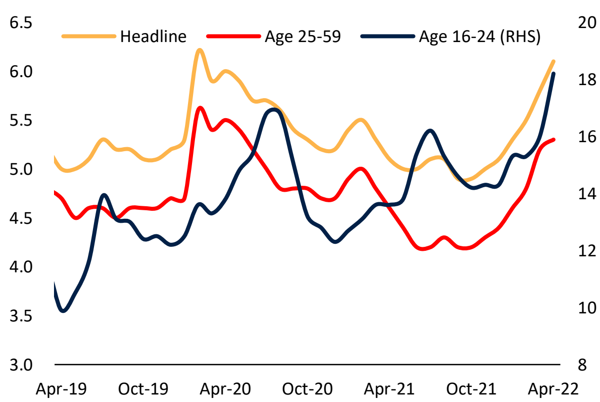
Source: State Administration of Foreign Exchange (SAFE); People's Bank of China (PBC); World Bank.
Note: Figure E. RHS refers to right hand side. Figure F. CFETS refers to China Foreign Exchange Trade System.

Rising labor market concerns amid COVID-related restrictions

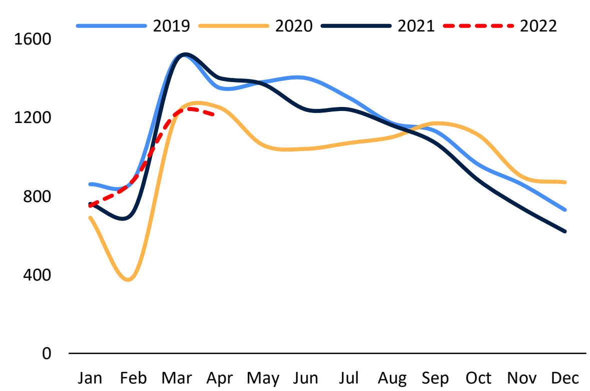
Strict mobility measures have temporarily restricted both the demand for and supply of labor. On the demand side, especially, labor-intensive services sectors have been facing stronger headwinds amid the Omicron outbreak (Box 3). On the supply side, the number of migrant workers, which account for around 30 percent of the labor force in urban areas, dropped below its pre-pandemic level. The urban surveyed unemployment rate spiked to 6.1 percent in April, back to the level last seen during the national lockdown in early 2020. Youth unemployment rate (aged 16-24) also climbed to 18.2 percent in April, even higher than before the pandemic (Figure 10.A). The upcoming graduation season will release about 10.8 million fresh graduates into the job market, the highest level on record. China has set a target of creating 11 million urban new jobs in 2022, the same as last year. Despite a challenging economic context, the economy generated 4.1 million new urban jobs in the first four months, but lower than the 4.4 million jobs created during the same period last year (Figure 10.B).

Figure 10. Deteriorating labor market conditions

A. Surveyed urban unemployment rate
(Percent)



B. Monthly new urban jobs
(Thousands)



Source: NBS; World Bank.

Box 3. Labor market trends and dynamics in China

China's labor market is experiencing multifaceted challenges. The uncertainty of the COVID-19 pandemic and geopolitical tensions continue to exert pressure on the Chinese economy and its labor market. In the long run, technological advancement, climate change, and aging will bring new challenges to China's labor market. This box provides an overview of China's labor market trends and dynamics and offers avenues for further reforms to address these challenges.

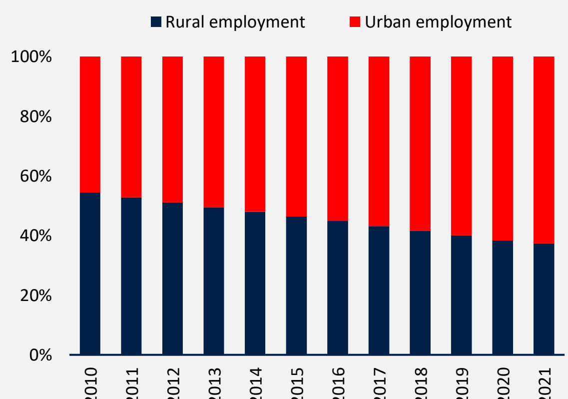
Labor market trends

The dual structure of the labor market with segmented urban and rural labor markets has played an important role in shaping China's labor market dynamics. With hukou (household registration system) and labor policy reforms, the linkage between urban and rural labor markets has been strengthened over time, but the two markets are still segmented. A large pool of the rural labor force operates like a "reservoir" that could infuse cheap labor into urban and non-agricultural sectors. The rural labor market could also act as a buffer in helping absorb return migrant workers when the urban labor market faces excess employment pressure. Over time, rural employment, in absolute terms and as a share of total employment, has declined, but in 2021 still accounted for 37.3 percent of total employment (about 750 million) (Figure 11.A).

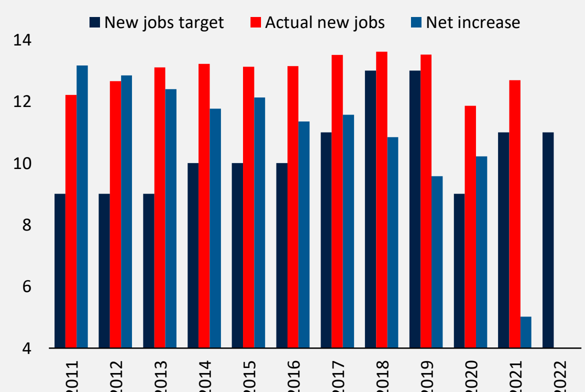
The government has long been paying attention to urban job creation and employment. Annual targets for urban job creation and unemployment rates are formulated in the annual workplan of the government and medium-term targets are proposed in the Five-Year Development Plan. Over the past ten years, actual annual urban job creation has always exceeded the annual target, even in 2020 when China faced a large shock due to the pandemic. However, the annual net increase of urban employment dramatically dropped to a record low of 5 million in 2021 (Figure 11.B).

Figure 11. The dual structure and importance of China's labor market

A. Composition of total employment
(Share of total)



B. Urban job creation
(Million)



Source: NBS; World Bank.

Employment Challenges

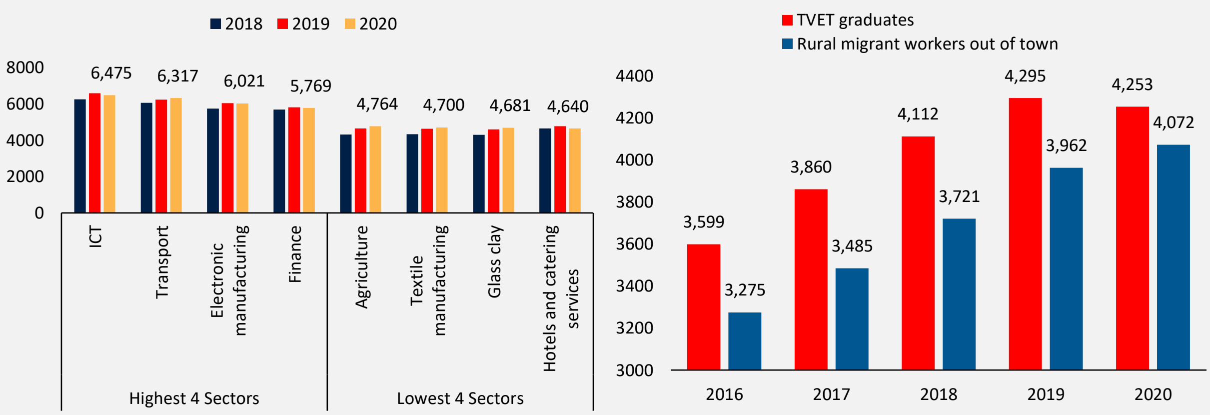
The pandemic has exacerbated the pre-existing vulnerability of migrant workers. The initial COVID outbreak in March 2020, which coincided with the Chinese New Year holiday period, trapped millions of rural migrant workers at home. This led to a 1.8 percent contraction in the total migrant workforce, which was not captured by the surveyed urban unemployment rate. The recurrent COVID outbreaks and subsequent restrictions have shuttered businesses, leading to fewer jobs for migrant workers at large manufacturers and service-related small businesses. Many rural migrant workers are poorly skilled, with more than 70 percent of them having educational attainment at the secondary school level and below. The surveyed unemployment rate for rural migrant workers keeps rising and outpaced that of urban workers with local hukou since February 2022. Its rate was 6.9 percent in April 2022, 1.2 percentage points higher than the unemployment rate for urban workers.

Wage growth has stagnated, particularly for fresh graduates. Starting wages for college graduates stagnated in many sectors and even faced declines in some sectors. The information and communication technology (ICT) and transport sector pay higher starting salaries in contrast to hoteling and catering services and the agricultural sector, which are on the lower end (Figure 12.A). Meanwhile, the average monthly wage for rural migrant workers has increased at a faster pace than for graduates from technical and vocational education and training programs (TVET). As a result, the wage gap between rural migrant workers and TVET graduates closed to 4 percent in 2020, down from 10 percent in 2016 (Figure 12.B).

Figure 12. Wage growth of graduates has stagnated

A. Initial monthly wages of college graduates, by sector
(RMB)

B. Wage comparison between TVET graduates and rural migrant workers
(RMB)



Source: NBS; Mycos; World Bank.
Note: Figure B. Data is the average wage after six months upon graduation.

Regulatory interventions on specific sectors, including private tutoring and the real estate sector, have put additional pressure on the urban labor market. The government issued regulations in July 2021 to close more than 700,000 off-campus training institutions[2] that employ over 6.8 million employees. Meanwhile, the slowdown in the real estate sector also carries employment implications as many real estate enterprises have filed for bankruptcy in 2021.

In the medium term, China's commitment to green transition and digital transformation will bring significant challenges and opportunities to its labor market. Preliminary estimates show that potential challenges to employment are sizeable in the high carbon-intensive industries, accounting for 54.4 million jobs in the formal sector (15 percent of total employment) or about 300 million jobs (39 percent of total employment) if both formal and informal sector workers are included. In the meantime, the rapid development of ICT technologies and the digital transformation in China has created numerous new jobs that have become an important part of the urban labor market. Estimates by the State Information Center

[2] Estimated by *China Entrepreneur* in July 2021.

point to about 84 million platform workers in 2020. The digital-related jobs in China are estimated to rise to 379 million in 2025 from 191 million in 2018.[3]

Implications for labor market policies

Implementing pro-employment policies to stabilize employment and the labor market. Given the worsening labor market conditions, policymakers could pay greater attention to labor market stabilization and job creation. The government already cut taxes, deferred social security contributions, and lowered financing costs to support, especially, small- and medium-sized enterprises (SMEs). Additional measures to stabilize the labor market could include public employment services for job matching and public work programs.

Expanding the coverage of unemployment insurance can strengthen social protection for informal sector workers. The unemployment insurance scheme covers only about 47 percent of total urban employment, most of which is comprised of formal sector workers. Expanding the unemployment insurance coverage requires delinking benefits from the urban local hukou. Pooling unemployment insurance funds from prefecture to province and finally at the national level will be crucial. An integrated national unemployment insurance system can facilitate labor mobility and strengthen social protection for workers when facing unemployment risks.

Strengthening the relevance, quality, and effectiveness of the existing active labor market programs (ALMPs) to cope with the current and future employment challenges. ALMPs can play an important role in increasing human capital and promoting labor mobility, job matching, and good-quality employment. Building upon the existing ALMPs, there is room to increase public inputs, and enhance their relevance, quality, and effectiveness through innovative design. An important prerequisite to facilitating stronger ALMPs will be an enhanced and integrated labor market information system, fully inclusive of migrant workers as well as more interoperable across jurisdictions. Profiling workers with customized employment services and offering reskilling opportunities could promote their employability and support high-quality growth.

Developing an integrated labor market monitoring system to inform the design of more effective policies. With the evolving labor market and the changing nature of work, further reforms are needed to strengthen labor market statistics. Integrated employment and unemployment statistics covering urban and rural labor markets will be important to monitor the overall trends and challenges and can inform evidence-based decision-making that can help achieve the policy objectives of full employment with quality.

Consumer price inflation ticked up while producer inflation softened

Consumer price inflation has risen moderately, reflecting rising fuel prices amid muted consumer demand. After dipping to 0.9 percent y/y in January-February, headline CPI inflation accelerated to 1.8 percent y/y on average in March-April. The increase was mainly driven by higher transport costs; fading food price deflation, reflecting a slower decline in pork prices; and an uptick in grain-related prices due to higher international commodity prices (Figure 13.A). Meanwhile, core inflation, excluding volatile food and energy prices, stayed muted at 1.1 percent y/y in the first four months, as consumer demand remained weak amid multiple Omicron outbreaks.

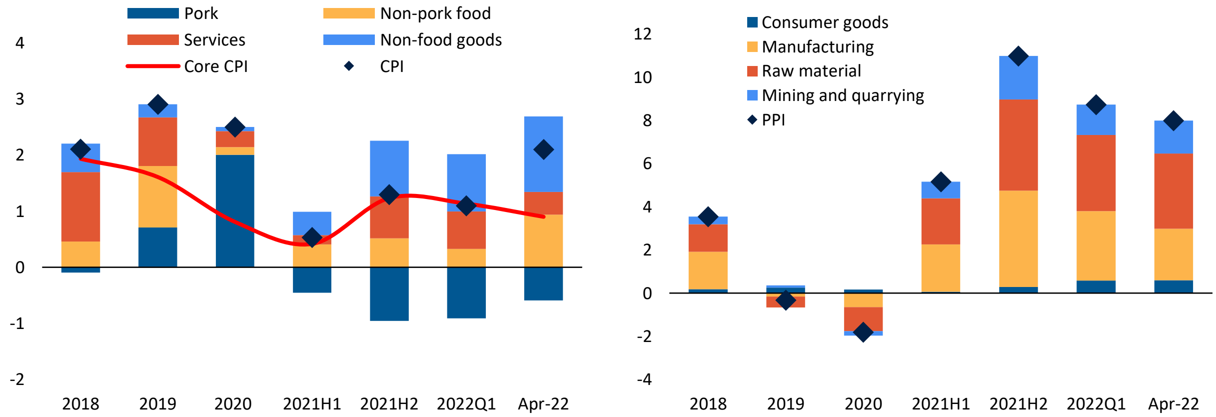
[3] Estimation from China Academy of Information and Communications Technology (CAICT) and China Development Institute (CDI).

Producer price inflation eased on a high base, despite higher import prices and supply chain disruptions. PPI inflation moderated gradually to 8.6 percent y/y on average in January-April from the peak of 13.5 percent y/y last October, reflecting primarily high base effects. Higher international energy and metal prices, driven by geopolitical tensions and coupled with domestic supply chain bottlenecks, kept China's PPI inflation in upstream sectors elevated in the first four months of 2022 (Figure 13.B). Meanwhile, PPI inflation in downstream sectors has remained mostly flat at around 0.5 percent y/y since 2021H2, suggesting limited inflation pass-through effects from upstream to downstream sectors.

Figure 13. CPI inflation ticked up while PPI inflation continued to moderate

A. CPI decomposition (Contribution to growth, percentage points)

B. PPI decomposition (Contribution to growth, percentage points)



Source: NBS; World Bank.

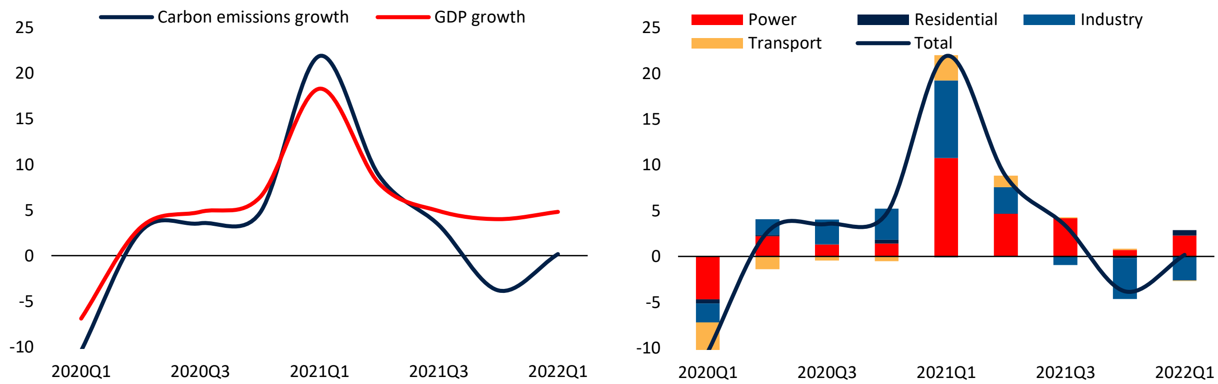
China's carbon emissions have temporarily increased

China's carbon emissions increased marginally in the first quarter of 2022, following a sharp slowdown in the second half of last year. China's carbon emission growth increased by 0.2 percent y/y in the first quarter of 2022 after contracting 3.8 percent y/y in the previous quarter, driven by the slump in real estate and infrastructure investment (Figure 14.A). The increase was driven largely by higher emissions from the power sector, which offset the decline in emissions stemming from industrial activity (Figure 14.B). The government's efforts to boost coal production have contributed to higher carbon emissions from the power sector. The power crunch experienced by several provinces in the second half of 2021 and the sharp increase in coal prices sparked concerns about energy security. As a result, policymakers reasserted the role of coal and coal-fired power projects, boosted domestic coal production, and slashed import tariffs for coal to zero in April 2022. China's coal production reached 1.4 billion tons in the first four months of 2022, an increase of 11.8 percent compared to the same period last year.

Figure 14. Carbon emissions increased marginally in the first quarter

A. Carbon emissions and GDP growth
(y/y percent)

B. Carbon emissions by sector
(Contribution to growth, percentage points)



Source: Carbon Monitor; World Bank.

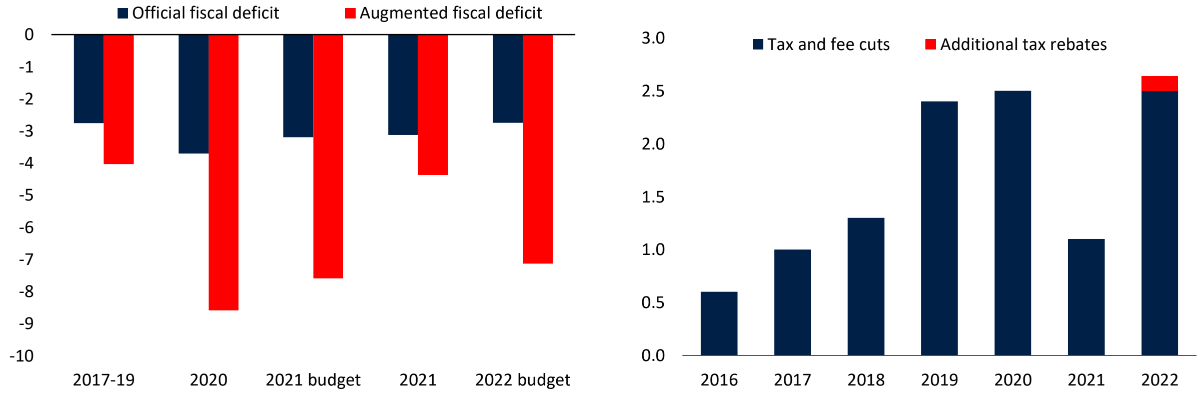
Significant fiscal expansion to support growth

China has embarked on an aggressive fiscal expansion to counteract growth headwinds. While the narrowly defined headline fiscal deficit target for this year remains conservative at 2.8 percent of GDP, the budgeted augmented government balance, which, in addition to the headline budget, also includes other budgetary accounts, is set to widen to 7.1 percent of GDP for 2022 from 4.4 percent in 2021 (Figure 15.A). This year's fiscal expansion follows a fiscal tightening equivalent of 4.2 percentage points of GDP in 2021, when the authorities took advantage of the post-pandemic rebound to rebuild fiscal buffers (Table 1). The 2022 budget envisages large infrastructure spending financed mostly by local government special bond (LGSB) proceeds. Although the government set the 2022 quota for special local government bond issuance at RMB 3.65 trillion (3.0 percent of GDP), the same as in 2021, the actual quota will likely be higher due to the carryover of last year's under-utilized LGSB proceed (around RMB 1.06 trillion). On the revenue side, the budget includes sizable tax cuts and rebates benefiting mainly small- and medium-sized enterprises (SMEs) and exporters of RMB 2.5 trillion (2.0 percent of GDP), more than double that of last year (Figure 15.B). The budget also foresees an increase in central transfers to local governments by 18 percent y/y, to about RMB 9.8 trillion (8.0 percent of GDP), which could compensate provinces for shortfalls in land sale revenues. In May, policy makers introduced additional policy measures to stabilize the economy, including further tax rebates to a broader set of industries, extending delayed social security payments to the year-end, reducing the auto purchase tax, and doubling the quota for loans aimed at SMEs among others.

Figure 15. Fiscal expansion

A. Official and augmented fiscal deficit
(Percent of GDP)

B. Tax cuts and rebates
(Trillion RMB)



Source: Ministry of Finance (MOF); World Bank.
Note: The additional tax rebates in 2022 were announced at the State Council meeting on May 23, 2022. The augmented fiscal balance adds up the General Public Budget (excluding adjustment from the Stabilization Fund), the Government Fund Budget, the State Capital Operation Budget, and the Social Security Fund Budget

Table 1. Government finances

(Billion RMB unless otherwise noted)	***2019***	***2020***	***2021 Budget***	***2021***	***2022 Budget***
General Public Budget					
Revenues	**21,259**	**20,920**	**21,442**	**21,425**	**23,343**
Revenues (% of GDP)	**19.3**	**18.0**	**17.7**	**17.7**	**17.1**
Central government	8,931	8,277	8,945	9,146	9,488
Local government (excludes transfers from central budget)	10,108	10,012	10,820	11,108	11,526
Withdrawal from Stabilization Fund and other adjustments	2,220	2,630	1,677	1,171	2,329
Expenditures	**24,019**	**24,673**	**25,012**	**24,996**	**26,713**
Expenditures (% of GDP)	**24.2**	**24.2**	**22.4**	**21.5**	**21.8**
Central government (excludes transfers to local governments)	3,512	3,510	3,502	3,505	3,557
Local government	20,374	21,049	21,461	21,127	23,106
Contribution to Stabilization Fund and other adjustments	133	114	50	364	50
Official fiscal balance	**-2,760**	**-3,753**	**-3,570**	**-3,571**	**-3,370**
Official fiscal balance (% of GDP)	**-2.8**	**-3.7**	**-3.2**	**-3.1**	**-2.8**
Government Fund Budget balance	-714	-2,451	-3,674	-1,564	-4,035
Social Security Fund Budget balance	841	-201	277	686	786
State Capital Operation Budget balance	168	222	123	256	161
Augmented fiscal balance *	**-4,552**	**-8,699**	**-8,471**	**-5,001**	**-8,737**
Augmented fiscal balance (% of GDP)	**-4.6**	**-8.6**	**-7.6**	**-4.4**	**-7.1**
Memo: Nominal GDP **	98,652	101,357	111,563	114,367	122,545

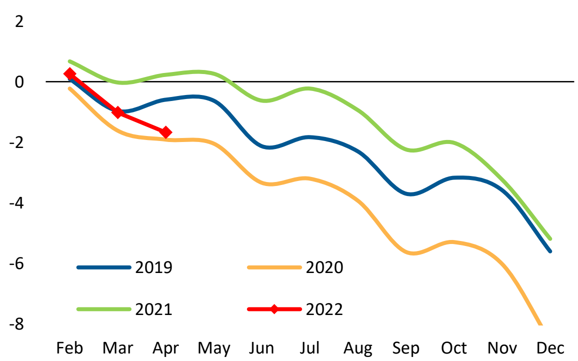
Source: MOF; World Bank.
Note: * The augmented fiscal balance = General Public Budget balance (excluding adjustment from Stabilization Fund) + Government Fund Budget balance + Social Security Fund Budget balance + State Capital Operation Budget balance. ** Nominal GDP in 2022 is a forecast.

In the first four months of 2022, the consolidated fiscal deficit widened significantly following strong expenditure growth and lackluster revenue growth. The consolidated General Public Budget and Government Fund Budget registered a deficit of 1.7 percent of GDP in the first four months of 2022, compared to a balanced position during the same period last year (Figure 16.A). The widening in the deficit was driven by a sharp increase in spending, due to frontloaded policy support to counteract strong growth headwinds (Figure 16.B). Growth in fiscal expenditure accelerated to 12.8 percent y/y in the first four months, the bulk of which was spending on infrastructure. Meanwhile, consolidated fiscal revenues contracted by 10.2 percent y/y, owing to weaker tax revenues on the back of a slowing economy. Non-tax revenues held up better thanks mainly to the PBC's profit transfer. In contrast, revenues from the sale of land-use rights contracted sharply, by 29.8 percent y/y in the same period, reflecting the ongoing downturn in the real estate sector.

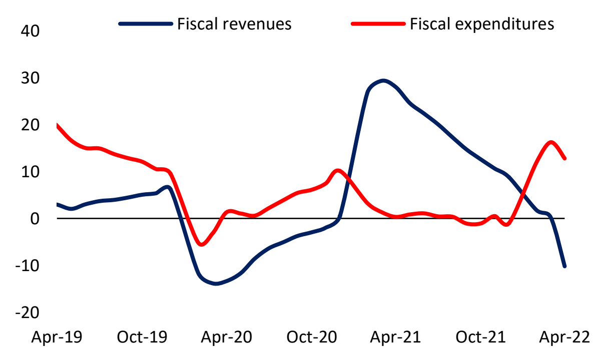
Local government special bond (LGSB) issuance to finance public investment started strongly in 2022 reflecting the frontloaded nature of the fiscal stimulus. By the end of April, 38.4 percent of the annual LGSB issuance quota was already met (Figure 16.C). As a result, net financing from government bond issuance increased to 1.6 percent of GDP in the first four months compared to 0.8 percent of GDP during the same period last year (Figure 16.D).

Figure 16. The consolidated fiscal deficit widened

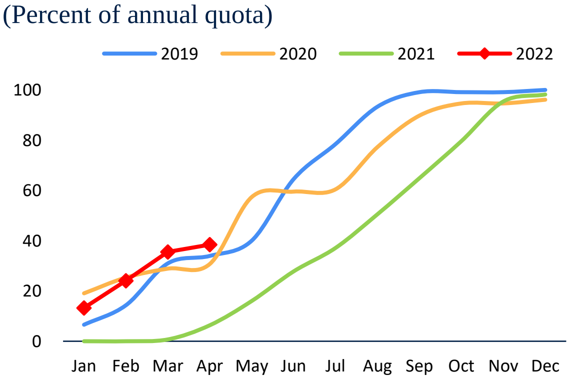
A. Consolidated fiscal deficit
(Percent of GDP)



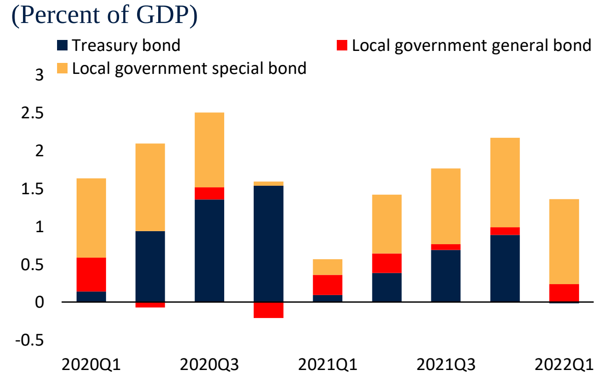
B. Growth in consolidated fiscal revenues and expenditures
(y/y percent, ytd)



C. Local government special bond issuance
(Percent of annual quota)



D. Net financing from government bond issuance
(Percent of GDP)



Sources: NBS; MOF; World Bank
Note: Figure A. The consolidated fiscal balance adds up the General Public Budget balance and the Government Fund Budget balance.

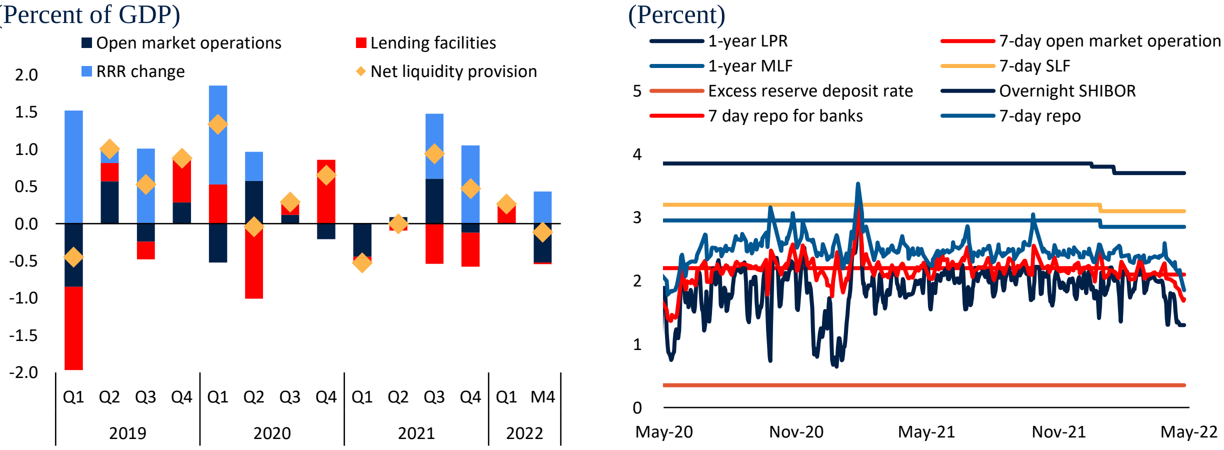
Weak private credit demand on Omicron disruption

The People's Bank of China (PBC) has loosened its policy stance to support economic growth. The PBC has continued to rely on window guidance through the introduction of multiple relending facilities to channel credit to the real economy. In recent months the PBC launched a host of new relending programs that target transport and logistics, technology and innovation, and green industries among others. The central bank has recently cut the five-year loan prime rate (LPR)—the benchmark for mortgage rates—by 15 basis points to 4.45 percent but left the one-year LPR—the benchmark for bank's lending rates—unchanged at 3.7 percent. This followed modest cuts in the one-year and five-year benchmark rates by 10 and 5 basis points, respectively, in January. The central bank has also cut the reserve requirement ratio (RRR) by 25 basis points for all banks. Market interest rates have been edging down in recent weeks despite higher uncertainty thanks to adequate liquidity provision (Figure 17.A and B).

Figure 17. Adequate liquidity provision drove down market rates

A. Net liquidity injection
(Percent of GDP)

B. Market rates
(Percent)

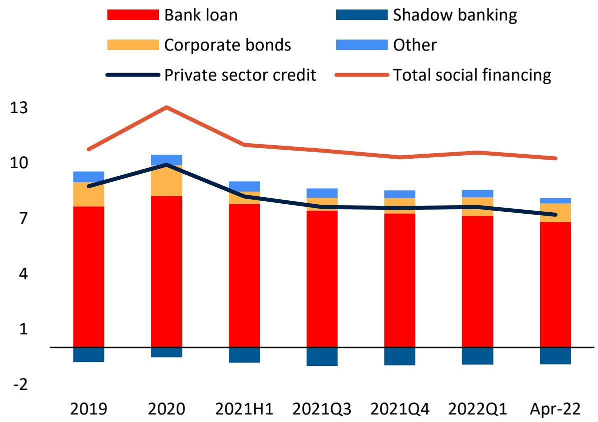


Source: PBC; World Bank.
Note: Figure A. Net liquidity injection provided by the PBC through standing lending facility (SLF), the medium-term lending facility (MLF), the targeted medium-term lending facility (TMLF), the pledged supplementary lending (PSL), the special-purpose refinancing (SPRF), and the special relending or rediscounting facilities. RRR = Reserve requirement ratio. Figure B. LPR = Loan prime rate; SLF = Standing lending facility; MLF = Medium-term lending facility; SHIBOR = Shanghai interbank offered rate. M4 = April.

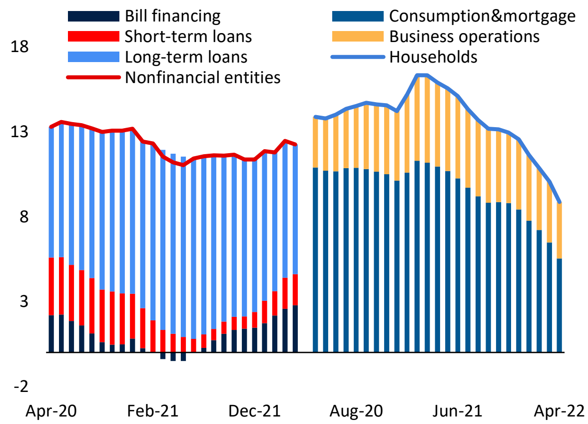
Although credit growth has picked up, private sector credit demand remains weak. Total social financing growth—a wide measure of credit growth—ticked up from a 10.3 percent y/y in 2021Q4 to 10.6 percent y/y in 2022Q1, before dipping to 10.2 percent y/y in April amid the Omicron outbreak (Figure 18.A). The initial rebound in credit growth was driven by the accelerated issuance of local government special bonds and a further upturn in corporate bills. Despite the frontloading of policy support, private sector credit demand remained weak due to higher uncertainty caused by the COVID shock. Both short-term and long-term household loan growth decelerated reflecting weak confidence and reduced demand for mortgage loans. Long-term corporate loan growth also softened, but at a slower pace than in previous months, which might suggest incrementally stronger infrastructure-related loans partly offsetting weaker private sector loans (Figure 18.B).

Figure 18. Credit growth picked up modestly, but private sector demand remained weak

A. Total social financing and private sector credit growth
(y/y percent)



B. Corporate and household loan growth
(y/y percent)



Source: PBC; World Bank.
Note: Figure A. The private sector excludes government bonds but includes credit to state-owned enterprise (SOEs) and local government financial vehicles (LGFVs).

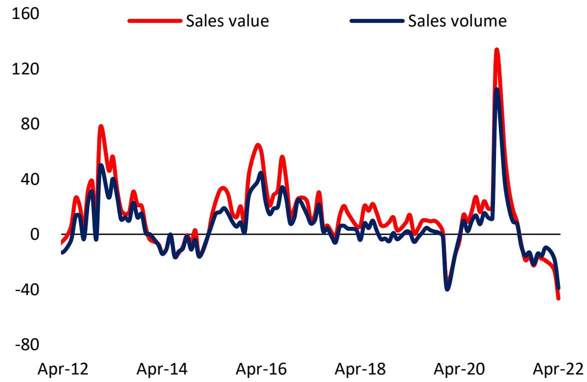
Housing market correction continues despite regulatory policy easing

The downturn in the property market, which began in the second half of 2021, continued into the first quarter of 2022. By the end of April 2022, the growth in value and volume of new home sales had contracted by 29.5 percent y/y and 20.9 percent y/y, respectively, as homebuyer confidence remained weak in the face of negative market sentiments and a renewed outbreak of COVID-19 (Figure 19.A). House price inflation continued to fall for both new and second-hand housing across all tiers of cities (Figure 19.B). The authorities further eased their policy stance in in recent weeks, with the PBC cutting the five-year LPR. Several municipalities also relaxed restrictions on home purchases, and banks received official guidance to accelerate mortgage approvals and lower mortgage rates.

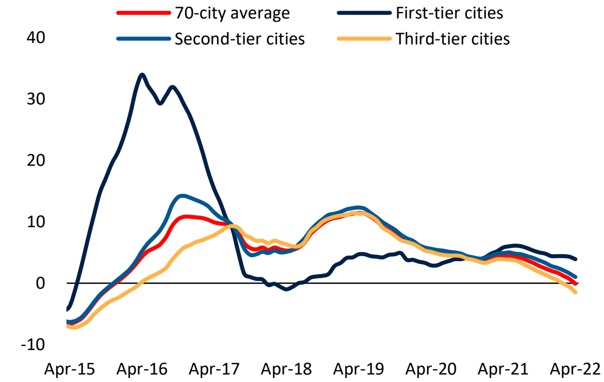
The access of property developers to debt markets remains limited. In the first four months of 2022, developers issued an average of only RMB 57.4 billion of bonds per month in the onshore and offshore markets together, compared to a monthly average of RMB 102.1 billion during the same period in 2021. As concerns persist about the financial condition of developers, net bond financing for developers has contracted and weak investor confidence means yields on property developers' offshore US dollar bonds remain elevated (Figure 19.C and D). The weakening of the RMB in recent months will raise debt servicing costs on developers' offshore bonds and make any refinancing of their debt more expensive. Under these circumstances, the pressure on developers' liquidity is unlikely to abate soon and more cases of default and rating downgrades might arise.

Figure 19. Housing market correction continues in China

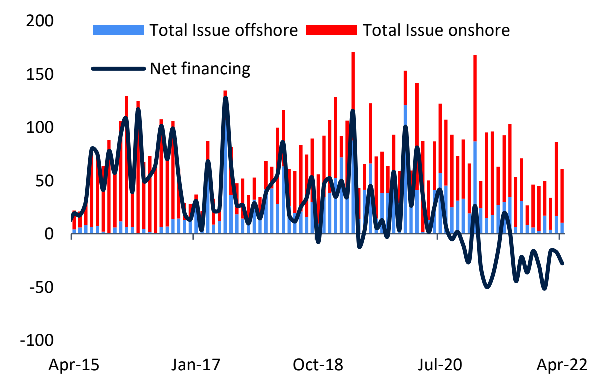
A. Changes in value and volume of new home sales
(y/y percent)



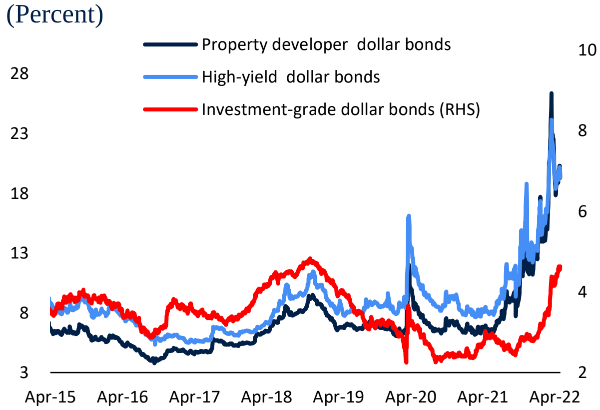
B. Changes in new home prices
(y/y percent)



C. Net financing for developers
(Billion RMB)



D. Offshore corporate bond yield
(Percent)



Source: NBS; Wind Information Database; World Bank.
Note: Figure D. RHS refers to right hand side.

Fiscal expansion has paused deleveraging efforts

China's debt ratio has risen this year on the back of a sizable fiscal expansion and monetary easing. China's debt-to-GDP ratio, including external debt, increased by 4.5 percentage points to 283.1 percent of GDP at the end of the first quarter of 2022 (Figure 20.A). This follows last year's deleveraging efforts by the government as a result of which China's debt ratio fell by 7.4 percentage points in 2021. Meanwhile, total external debt remained stable and low at an estimated 12.1 percent of GDP at the end of 2022Q1. The aggregate debt-to-GDP ratio is now 23.6 percentage points higher than the pre-pandemic level.

The infrastructure push led to a build-up in public sector debt. Although central government debt has remained broadly stable, both the on-budget and off-budget debt of local government has increased. The downturn in the real estate sector has suppressed local government revenues from land sales, pushing local governments to increase borrowing. As a result, the debt of local governments increased to 27.3 percent of GDP in the first quarter of 2022 from 26.6 percent of GDP at-end 2021 (Figure 20.B). Meanwhile, the debt of state-owned enterprises (SOEs) and local government financial vehicles (LGFVs) also accelerated due to increased bank lending for infrastructure projects.

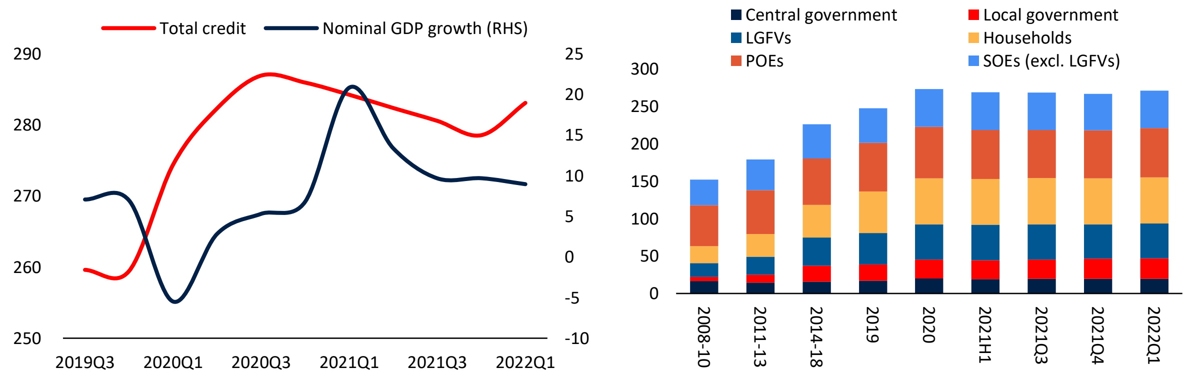
Corporate sector debt increased, while households' leverage position has continued to improve. Corporate sector (excluding LGFVs) debt rose to 115.8 percent of GDP at the end of 2022Q1, up from 112.6 percent of GDP in the previous quarter. Both privately owned enterprises and SOEs (excluding LGFVs) evenly accounted for the increase. The increase in short-term corporate debt has been more pronounced, partly owing to the policy response such as liquidity injection in response to cash flow shortages and reduced profits in the corporate sector. Meanwhile, the slowdown in the property market led to a moderation in household leverage on declining mortgage loans. Non-housing consumer debt also eased because of weak consumer sentiment. Household debt moderated from a peak of 61.7 percent in 2021Q3 to 61.4 percent of GDP in 2022Q1.

Corporate defaults in onshore and offshore markets picked up led by the real estate sector. In the onshore market, defaults in 2022Q1 amounted to RMB 12.7 billion (US$2.0 billion) compared to RMB 4.5 billion (US$679.8 million) in 2021Q4. About 76 percent of these defaults were concentrated in the real estate sector. Meanwhile, in the offshore market, bond defaults amounted to US$2.3 billion in 2022Q1, all of which by real estate enterprises.

Figure 20. The debt-to-GDP ratio has risen

A. GDP growth and total credit stock to GDP
(Percent of GDP; percent)

B. Domestic non-financial debt by sector
(Percent of GDP)



Source: PBC; Wind Information Database; CEIC Data; World Bank.
Note: Figure A. RHS refers to right hand side. Figure B. LGVFs = Local government financial vehicles; POE = Private-owned enterprise; SOE = State-owned enterprise.

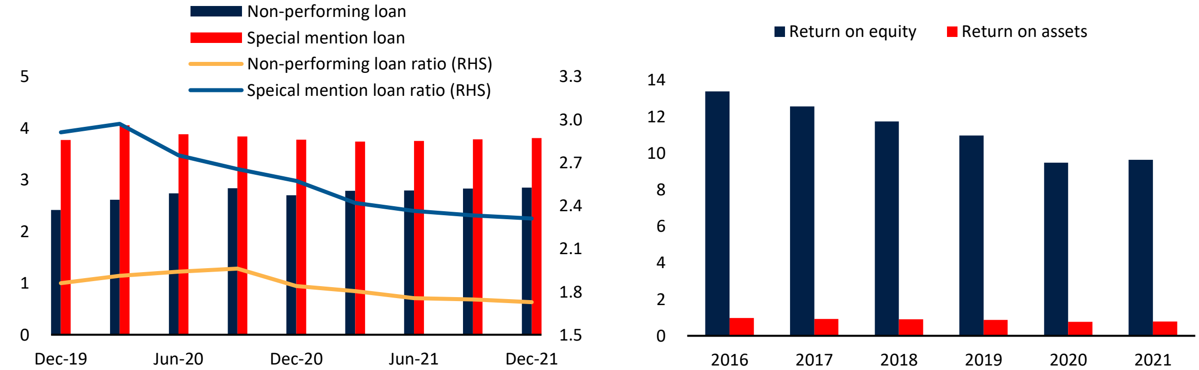
Banks are generally sound but rural banks show vulnerabilities

The credit quality of commercial banks' loan portfolios has improved on aggregate, but banking sector profitability remained weak. The reported aggregate non-performing loan (NPL) ratio and special mention loan (SML) ratio continued to decrease, standing at 1.7 percent and 2.3 percent respectively at the end of 2021, both lower than pre-pandemic levels (Figure 21.A). The proactive resolution of problem loans may have contributed to the improvement in 2021, as commercial banks resolved RMB 3.1 trillion of NPLs, representing 1.9 percent of total outstanding bank loans. The conclusion of regulatory forbearance for micro and small enterprise (MSE) loans, continuing property sector weakness, economic disruptions due to COVID-related restrictions and geopolitical uncertainties, are likely to add to banks' credit quality stress. Meanwhile, wider recognition of problem loans and increased provisioning, along with a compression of net interest margins has weighed on profitability. Although the aggregate return on equity (ROE) and return on assets (ROA) in 2021 improved from one year ago, both measures are still markedly lower than end-2019 levels (Figure 21.B).

Figure 21. Credit quality improved but profitability remained weak

A. Non-performing loan and special mention loan growth
(Trillion RMB; percent)

B. Return on equity and return on assets in the banking sector
(Percent)



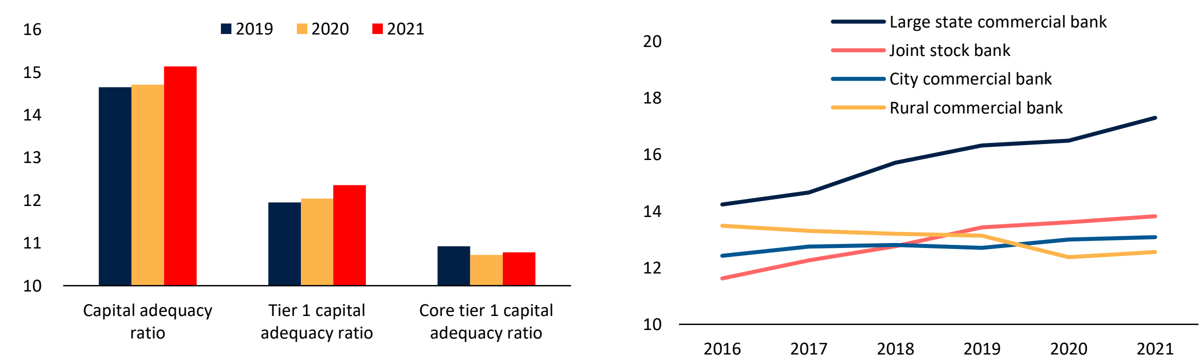
Source: Wind Information Database; World Bank.
Note: Figure A. RHS refers to right hand side.

The banking sector appeared to be well capitalized, possibly driven by significantly better capital positions among large state banks. The aggregate capital adequacy ratio (CAR) of commercial banks reached a high of 15.1 percent at the end of 2021, 43 basis points higher than a year ago and almost 50 basis points higher than end-2019 level (Figure 22.A). Large state banks, which account for 46.8 percent of total commercial bank assets, reported a significant y/y CAR increase in 2021, whereas joint-stock bank and local bank groups showed much more muted improvements (Figure 22.B). Smaller local banks and joint stock banks have less favorable capital positions in comparison, rendering them less capable to serve the local economy and withstand adverse market conditions.

Figure 22. Banking sector is well capitalized

A. Capital adequacy ratios
(Percent)

B. Capital adequacy ratio by banking group
(Percent)



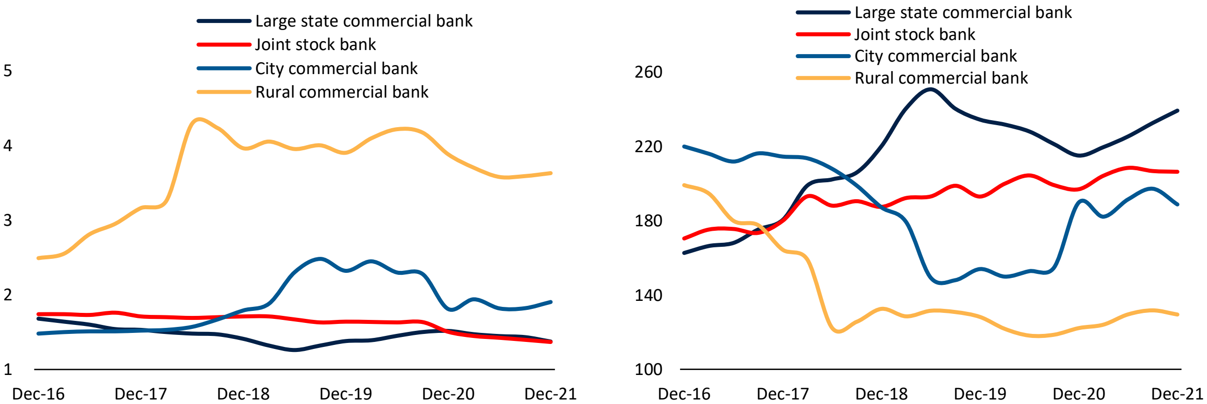
Source: Wind Information Database; China Banking and Insurance Regulatory Commission (CBIR); World Bank.

Rural banks remained the most at-risk segment and continued to display localized vulnerabilities. Despite some improvement in 2021, rural commercial banks have significant lower loan quality and loan loss coverage than the other banking groups, with the segment's NPL ratio standing at 3.6 percent and provision coverage ratio at 129.5 percent at end-2021 (Figure 23.B). Including village and township banks (VTB) and credit cooperatives, rural financial institutions remained the most at-risk, according to the PBC's 2021Q4 assessment, although the number of "high-risk" financial institutions has been on the decline.

Figure 23. Rural banks remained the most at-risk segment

A. Non-performing loan ratio by banking group (Percent)

B. Provision coverage ratio by banking group (Percent)



Source: Wind Information Database; World Bank.

II. Outlook, Risks and Policy Considerations

Global outlook

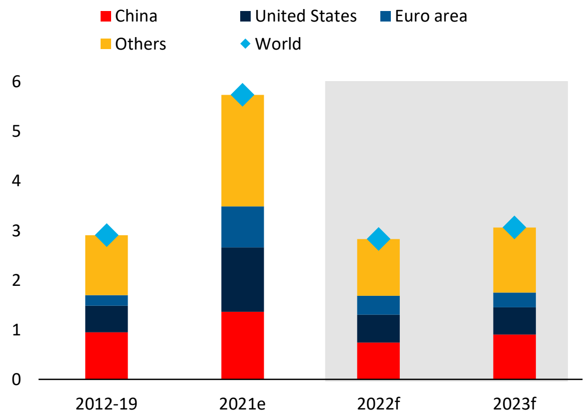
China will face a very challenging global environment in 2022. The recovery of the global economy from the pandemic is being dampened by surging energy prices and trade disruptions, which have been exacerbated by Russia's invasion of Ukraine and associated sanctions. According to June World Bank projections, global growth is expected to slow to 2.9 percent in 2022 from 5.7 percent in 2021. This marks a downward revision from the January World Bank projections by more than 1 percentage point (World Bank 2022). In advanced economies, growth is projected to decelerate from 5.1 percent in 2021 to 2.6 percent in 2022, reflecting the unwinding of the fiscal and monetary policy support provided during the pandemic and the fallout from the war in Ukraine. Emerging market and developing economy (EMDE) growth is projected to roughly halve this year, slowing from 6.6 percent in 2021 to 3.4 percent in 2022, despite a still incomplete recovery from the pandemic.

The war in Ukraine has intensified price pressures, with inflation rates in many countries reaching multi-decade highs that hover above inflation targets and push up inflation expectations. To contain inflation, major central banks have increased nominal policy rates but real rates in many countries remain negative. Further efforts to rein in inflation will lead to continued tightening of global financing conditions, higher borrowing costs, and slower growth. The expectations for advanced-economy policy interest rates hikes have increased, with the market pricing around 30 basis points of additional tightening in 2022 in both the United States and the euro area since early April. Combined with weak growth, persistently high inflation could set the stage for a period of stagflation.

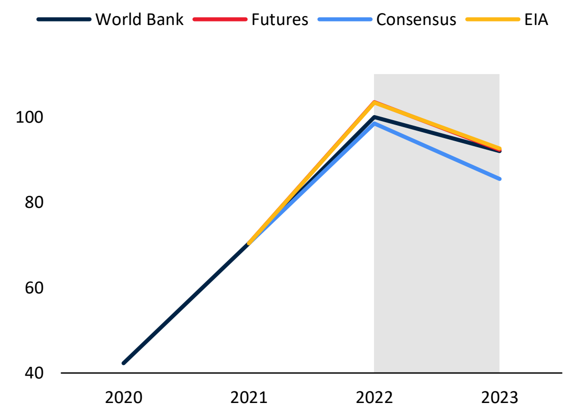
Global trade growth is projected to slow to 4.0 percent y/y in 2022, as the war in Ukraine further disrupts global trade flows and trade intensity of the global recovery gradually diminishes. International mobility is expected to improve, but will remain subdued amid heightened global uncertainty, fast cooling of global demand, and high transportation costs associated with the war. Energy prices are forecast to rise 52 percent y/y in 2022, with Brent crude oil prices projected to average US$100/barrel. Agricultural prices are forecast to rise 18 percent y/y this year, reflecting weaker grain production from Russia and Ukraine, as well as much higher input costs, including for fuel, chemicals, and fertilizers. Metal prices are expected to rise 12 percent y/y in 2022, and the effects of the war are expected to have less of a lasting impact on metals prices than on energy prices, given Russia's more modest role as a global exporter.

Figure 24. Global economy is projected to moderate in 2022

A. Global growth to slow in 2022
(Percentage points)



B. Oil price forecasts
(USD per barrel)



Source: Bloomberg; Haver Analytics; Organization of Petroleum Exporting Countries (OPEC); U.S. Energy Information Administration (EIA); World Bank.
Note: Figure shows contributions to global growth forecast for 2021 and 2022 compared to average contributions to growth in 2015-2019 period. Shaded area indicates forecasts. Figure A. 2022 and 2023 are based on the World Bank June 2022 Global Economic Prospects (GEP) forecasts. Figure B. Shaded areas indicate forecasts. "Consensus" refers to the March 2022 consensus survey. "Futures" refers to the March 2022 futures price. "EIA" refers to the EIA's Brent crude oil forecast (IEA 2022).

China outlook

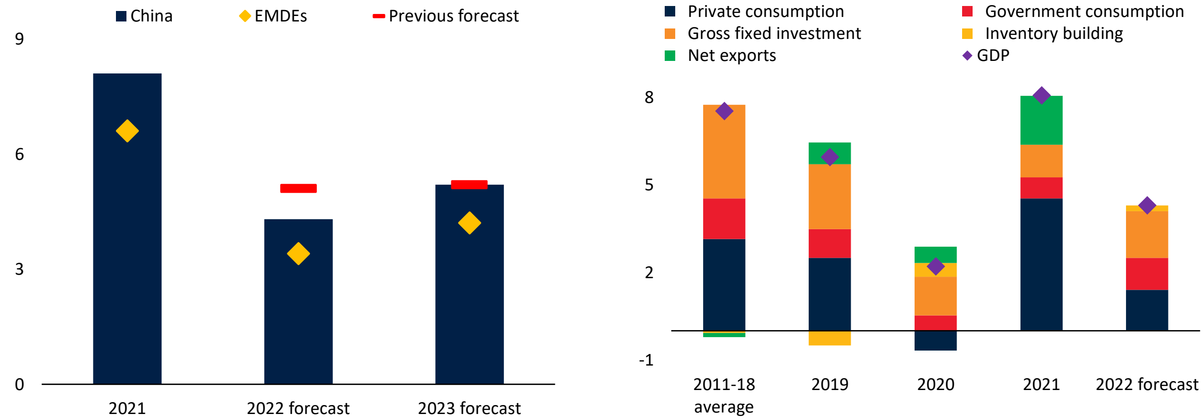
After reaching 8.1 percent in 2021, China's growth is projected to slow sharply to 4.3 percent in 2022, well below its potential rate (Figure 25, Table 2). The downward revision reflects the materialization of downside risks from the new and much more contagious COVID variants**.** More efficient control of COVID will help growth momentum to rebound gradually in the second half of 2022 on the back of aggressive fiscal stimulus, moderate monetary easing, and further relaxation of housing sector regulations to mitigate the economic downturn. The rebound, however, will not be enough to fully undo the economic damage caused by Omicron outbreaks and the prolonged restrictions in March and April.

The growth forecast for 2022, which marks a downward revision by 0.8 percentage points from the December *China Economic Update*, rests on several assumptions. First, China is expected to maintain its zero COVID strategy, aiming to intervene early and thereby avoid large scale lockdowns; second, China will continue to experience recurrent COVID outbreaks but less disruptive and costly than in 2022Q2; third, activity will normalize but only gradually in 2022Q3 amid declining exports and weak consumer and business confidence; fourth, the baseline does not envisage additional fiscal stimulus to what has already been announced and budgeted, although additional monetary easing and further relaxation of regulations to stabilize the property sector are possible under the baseline.

Figure 25. Growth projections

A. Full year GDP growth forecasts
(y/y percent)

B. GDP expenditure components
(Contribution to growth, percentage points)



Source: Haver Analytics; World Bank.
Note: Figure A. EMDE refers to Emerging Market and Developing Economies. EMDE aggregate is based on the data published in the June 2022 Global Economic Prospects report (World Bank 2022).

The structure of aggregate demand is expected to shift in favor of domestic demand. Investment growth, driven by infrastructure investment, is projected to accelerate, partly offsetting weakness in real consumption growth which has suffered from recurring COVID-19 outbreaks, resulting mobility restrictions, and subdued consumer confidence. Efforts to expand green investment, supported by a technological shift away from high polluting and energy-intensive industries, will intensify amid heightened geopolitical tensions and the fallout from the war in Ukraine. Given the projected sharp slowdown in global growth, net exports will play a negligible role in supporting economic growth.

On the supply side, industrial production will remain the main driver of economic growth. Industrial production growth is expected to accelerate on the back of strong infrastructure investment growth, with a shift toward higher value-added, less polluting, and less energy-intensive manufacturing sectors, while the mining sector will sustain high growth amid the government's efforts to ensure energy safety. The recovery in services will be delayed again, hampered by recurrent COVID outbreaks and weak housing market activity, which will weigh on real estate services.

The current account is projected to register a smaller surplus in 2022, equivalent to 1.3 percent of GDP, reflecting weaker global demand and supply-side constraints. China is expected to face a sharp decline in global demand as growth in major economies slows and global trade growth falls below 5 percent. Export growth is projected to moderate from last year's high, as the base effect becomes less favorable and global demand weakens. In addition, supply-side constraints—including the global semiconductor shortage, shipping disruptions, and high freight rates—are expected to persist for some time and weigh on exports, especially in 2022. Import growth is expected to remain subdued amid weak domestic demand and supply chain disruptions.

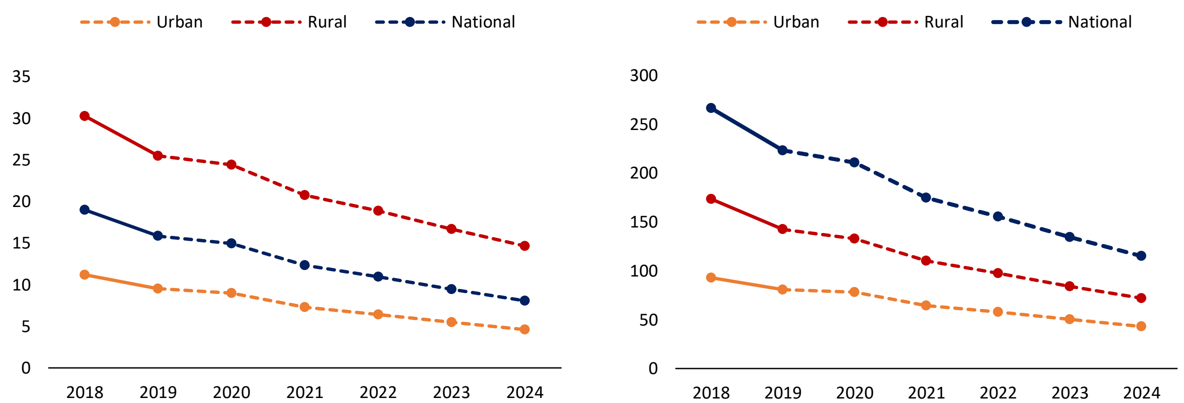
Higher commodity prices will contribute to a mild acceleration of consumer price inflation, to 2.3 percent in 2022. Inflation dynamics will reflect some pass-through from higher imported food and fuel prices and higher domestic food prices, as the deflation in pork prices, a major driver of CPI inflation in China this year, eases on dissipating base effects. Core inflation is projected to remain stable, reflecting weak consumer spending amid recurring COVID-19 outbreaks.

The slowdown in the economy and the acceleration of inflation will slow the pace of poverty reduction. While rural extreme poverty by national definitions (US$2.30/day per person in 2011 purchasing power parity (PPP)) has effectively been eliminated, about 11 percent of the Chinese population (155 million people) is expected to have consumption levels below the typical upper-middle-income poverty line of US$5.50/day per person (2011 PPP) in 2022 (Figure 26.A). Using this threshold, an additional 19 million people are expected to be lifted out of poverty in 2022, compared with 36 million estimated for 2021 (Figure 26.B). Among the remaining poor, 37 percent reside in urban areas, suggesting that policies to improve the welfare of the most vulnerable would need to be directed to both rural and urban areas.

Figure 26. Poverty reduction is expected to return to a pace as observed in pre-COVID years

A. Poverty rate
(US$5.50 per person per day, percent)

B. Number of poor
(US$5.50 per person per day, millions of persons)



Source: World Bank staff estimates using tabulated data from China’s National Bureau of Statistics (NBS) and World Bank’s GDP growth projections.
Note: Last grouped data available to calculate poverty is for 2019. Projections based on per capita GDP growth estimates, using a neutral distribution assumption with pass through 0.85 to per capita household consumption.

Table 2. China selected economic indicators

Annual percentage change, unless otherwise indicated	*2019*	*2020*	*2021*	*2022f*	*2023f*	*2024f*
Real GDP growth, at constant market prices	6.0	2.2	8.1	4.3	5.2	5.1
Private consumption	6.5	-1.8	12.2	3.6	6.7	6.6
Government consumption	6.0	3.2	4.3	7.1	4.1	4.4
Gross fixed capital formation	5.3	3.2	2.7	4.2	5.2	4.8
Exports, goods and services	2.2	1.4	17.5	2.9	3.2	3.0
Imports, goods and services	-1.7	-1.7	9.9	4.2	4.4	4.4
Real GDP growth, at constant factor prices	6.0	2.2	8.1	4.3	5.2	5.1
Agriculture	3.1	3.1	7.1	3.2	3.1	3.1
Industry	4.9	2.5	8.2	4.6	4.9	4.4
Services	7.2	1.9	8.2	4.2	5.8	5.9
Inflation (Consumer price index)	2.9	2.5	0.9	2.3	2.0	1.9
Current account balance (% of GDP)	0.7	1.9	1.8	1.3	1.2	1.1
Financial account balance, excl. reserves (% of GDP)	0.1	-0.5	0.2	0.1	0.2	0.4
Net foreign direct investment (% of GDP)	0.4	0.7	1.2	0.9	0.9	0.8
General public budget balance (% of GDP)	-2.8	-3.7	-3.2	-2.8	-2.8	-2.7
Augmented fiscal balance (% of GDP) *	-4.6	-8.6	-4.4	-7.1	-5.5	-4.4
Government debt (% of GDP)	38.5	45.4	45.1	49.6	51.7	52.6
Primary balance (% of GDP) *	-3.6	-7.4	-3.2	-5.9	-4.2	-3.0

Source: World Bank.

Note: f = forecast (baseline). * World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the General Public Budget (excluding adjustment from Stabilization Fund), the Government Fund Budget, the State Capital Operation Budget and the Social Security Fund Budget. The primary balance is the difference between revenue and non-interest expenditures.

Risks

Risks to China's growth outlook are unevenly balanced and downside risks prevail. The most prominent downside risks remain those related to the pandemic. Economic disruptions due to strict COVID-related mobility restrictions across major cities and provinces would further postpone the already delayed recovery of consumption and services, discourage private investment, disrupt trade flows, and reduce growth. Low vaccination rates among the elderly and capacity constraints in hospitals leave China vulnerable to recurrent outbreaks. The emergence of new highly transmittable variants like Omicron could further complicate the exit from China's zero COVID strategy and weigh on the normalization of domestic consumption.

Risks in China could also emanate from persistent stress in the real estate sector with wider macroeconomic and financial ramifications. The effects of the pandemic could continue to discourage prospective buyers, reduce financing of the sector, and weigh on distressed and healthy developers alike. A prolonged downturn in the property market will have significant implications for economic growth, given the property sector's links with upstream and downstream sectors, its dominance on households' balance sheets, its importance for local government financing, and its contribution to investment. Although distress among real estate developers is unlikely to cause a systemic financial crisis, around 40-50 percent of total bank loans are property-related. A significant decline in collateral values may, therefore, sharply reduce the willingness of banks to lend, worsening the credit crunch.

A sharp slowdown in growth would complicate the calibration of the government's policy efforts to rebalance the economy and meet its growth targets. An aggressive countercyclical policy response to slowing growth could escalate medium-term macro-financial risks. In this environment, traditional policy support, including accelerating infrastructure spending, channeling credit to SOEs, and rekindling the real estate sector, could undo rebalancing efforts, impair hard-won gains in economic deleveraging, and worsen the housing market's supply overhang. Some recommendations on how to address these difficult policy trade-offs are offered in the next section.

China's economy is also vulnerable to risks related to the global outlook, including possible global stagnation. Global geopolitical tensions could further disrupt economic activity, increase policy uncertainty and, if persistent, lead to fragmentation in global trade, investment, and finance, particularly if tensions weigh on China's import of critical technology, slow the transfer of productivity-enhancing innovations, and foster a decoupling of high-tech supply chains. Additional adverse shocks would increase the possibility that the global economy will experience stagflation, that is, the possibility of stubbornly high global inflation accompanied by economic stagnation, reminiscent of the situation in the 1970s (World Bank 2022). Central banks may be forced to tighten monetary policy more rapidly than currently expected to bring rising price pressures under control. This, in turn, could trigger a sharp tightening of global financial conditions with adverse spillovers to China's economy. The simultaneous materialization of several downside risks could result in a sharper and more prolonged global slowdown, with global growth declining to 2.1 percent and 1.7 percent in 2022 and 2023, respectively.

On the upside, if COVID-19 is controlled more effectively with fewer restrictions, full year growth could be higher than currently projected, thanks to the recently announced additional stimulus measures. Government efforts to boost vaccination among the elderly and ramp up the country's health care capacity could gradually allow China to reduce the stringency of restrictions and plan for an exit from zero-COVID. This would strengthen business and consumer confidence, improve the effectiveness of government stimulus measures, support a recovery of domestic demand in 2022H2, and result in higher full year growth than projected in the baseline.

Policy implications: Countering the growth slowdown while addressing longer term challenges

China faces the dual challenge of balancing COVID-19 mitigation with supporting economic growth. Following last year's tight fiscal stance, the authorities have embarked on an aggressive fiscal expansion to backstop the economy. The fiscal expansion has been accompanied by moderate monetary easing, largely in the form of multiple relending programs. The macroeconomic policy mix should support domestic demand and is aimed at achieving a rapid rebound from the recent Omicron-induced slump. However, while China has macroeconomic space to counter the growth slowdown, the dilemma facing the authorities is that as long as outbreaks recur, the recovery of consumption demand will be delayed, and investor confidence may not recover quickly. These countervailing forces reduce the effectiveness of economic stimulus, all the more, if COVID-related restrictions also hamper supply. The more contagious nature of recent COVID variants thus reduces the likelihood of a V-shaped rebound.

Beyond the dilemma of policy effectiveness in the midst of recurrent COVID outbreaks, there is a danger that China remains tied to the old playbook of aiming to boost economic growth through debt financed investment stimulus. This would lead to a further build-up in corporate sector debt, especially among already highly leveraged real estate developers. Moreover, some local governments have little additional debt-carrying capacity and may not benefit from the additional bond quota, given controls on excessive local debt accumulation. This in turn might limit the effectiveness of the special bond quotas in boosting local infrastructure investments, even if their issuance is front-loaded. The government has rightly highlighted the need to avoid unproductive local infrastructure spending and placed continued emphasis on strict fiscal discipline. Policy makers could shift more of the stimulus on the balance sheet of the central government as opposed to using local government and off-balance sheet debt and direct public investment more toward the greening of public infrastructure.

To counter the economic effects of the pandemic, fiscal support could target measures to encourage consumption directly. The authorities have so far preferred to provide relief to businesses, including through the reduction of corporate income taxes, value-added taxes (VATs), and a variety of local government fees for small- and medium-sized enterprises (SMEs) in particular those in hard-hit consumer-facing services, such as tourism, catering, and retail. Accelerated VAT refunds will support businesses at a time of worsening terms of trade and uncertain prospects in key export markets. However, tax reductions are less effective when enterprises are faced with a sharp reduction in demand and not just a rise in costs. While some richer provinces already use consumption vouchers, a wider use of this scheme, supported also by the central government, could lift consumer spending in the short term in locations where COVID-related restrictions have been lifted, especially if targeted to hard-hit service sectors that are labor intensive. Such measures could be combined with a shift in spending towards supporting automatic fiscal stabilizers to cushion workers from the downturn in employment demand.

Fiscal resources for local governments could also be used more explicitly to encourage economic rebalancing. A welcome aspect of recent government stimulus measures is the increase in central government transfers to the local level, recognizing the particular fiscal challenges faced by subnational authorities. The increase in transfers to the local level offers an opportunity to tie inter-governmental transfers more explicitly to measures to encourage rebalancing. Such measures could include widening access to services for migrant workers, strengthening public employment services, and deepening social security reforms. These measures could cushion negative income shocks, encourage labor mobility, and may reduce the need for precautionary household savings, thereby supporting the rebalancing toward consumption.

Controlling risks arising from the property markets without damaging growth. The current downturn in the property markets and the prevailing atmosphere of uncertainty mean that it is critical for the authorities to maintain flexible macroeconomic and regulatory policies. In the short term, the authorities should maintain adequate liquidity provision to ensure that financial markets continue to operate well and contain any emerging market turbulence. However, in the medium-term, it is important not to abandon efforts to reduce the leverage of property developers and to closely monitor the exposures of financial institutions and markets to the sector. The new Financial Stability Law contains several provisions that are useful for this purpose, and it also includes the establishment of a new Financial Stability Fund, which will be used to deal with major episodes of financial distress, including those originating from the property markets. This could be complemented by more robust bank and corporate resolution frameworks to mitigate financial sector risks. Accelerating the workout of impaired assets on bank balance sheets and rapidly resolving insolvent corporates and banks would reduce the build-up of additional financial and corporate sector risks. It would also mitigate the risk that a loosening of monetary policy encourages the roll-over of non-performing loans (NPLs).

Policy makers should also not lose sight of deeper structural reforms needed to enable a more balanced, inclusive, and sustainable growth trajectory for China. Previous editions of the *China Economic Update* (World Bank 2021a, 2021b) already emphasized the importance of market-oriented reforms, especially in factor markets, complemented with policies to rebalance the economy toward a high-quality growth trajectory. Signaling policy intent could help shape market expectations, even if in the face of short-term challenges, the authorities are likely to adopt a gradual pace of reform. For example, setting a clear mass-based emissions target in addition to China's dual carbon goals could encourage private sector innovation in low emission technologies, while efforts already under way to strengthen the monitoring, reporting and verification (MRV) system could make future enforcement or carbon trading smoother. Similar considerations apply to other reform priorities, such as pooling social security funds, abolishing the hukou or introducing competitive neutrality as a policy framework to manage state-owned enterprises. The growth dividends of these structural reforms would be considerable over the medium-term. Sending clear signals of reform intent today could help smooth the required adjustment.

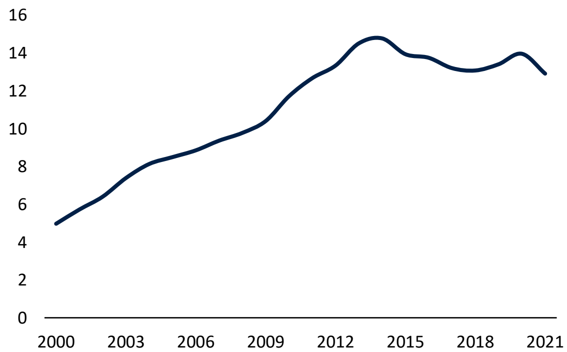
III. Real Estate Vulnerabilities and Financial Stability in China[4]

Growth and importance of the real estate sector

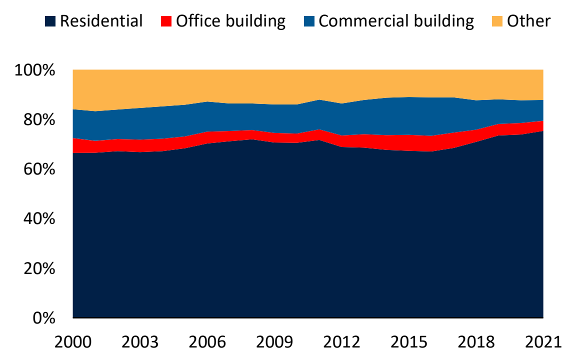
For over two decades, China's real estate sector grew at a remarkable pace. Total real estate investment rose from around 3 percent of GDP in 2000 to a peak of 14.8 percent in 2014 and stood at 12.9 percent of GDP at end-2021, compared to an average of around 5 percent in OECD countries (Figure 27.A)[5]. Investment in residential real estate is the primary driver of trends in the sector, consistently accounting for almost 70 percent of total real estate investment (Figure 27.B)[6].

Figure 27. Real estate investment has grown remarkably

A. Real estate investment
(Percent of GDP)



B. Composition of real estate investment
(Percent of total real estate investment)



Source: China National Bureau of Statistics (NBS), World Bank.

But the importance of the sector goes beyond direct investment numbers given its strong upstream and downstream linkages. Around 30 percent of China's GDP comes from real estate and various activities along its supply chain, including the use of inputs such as steel, cement and glass, plus the use of labor in construction, maintenance and upgrades. The growth of residential housing also influences the demand for household appliances and furniture. In addition, the sector receives financing from financial institutions and markets and is an important source of revenue for local governments through land sales. Further, evidence indicates that a significant proportion of household and corporate loans is secured by real estate. Lastly, according to some estimates, real estate and construction account for about 20 percent of total urban, non-private employment (Rogoff and Yang, 2020).

[4] This note was prepared by Abayomi Alawode (Lead Financial Sector Specialist, FCI), Radu Tatucu (Senior Financial Sector Specialist, FCI) and Jun Ge (Short-Term Consultant, MTI). The authors are grateful to Martin Raiser, Hassan Zaman, Sebastian Eckardt, Ibrahim Saeed Chowdhury, Zafer Mustafaoglu, Yusha Li, and Yan Yi for their helpful comments as well as Zhenyang Xu and Deyun Ou for their excellent research assistance.

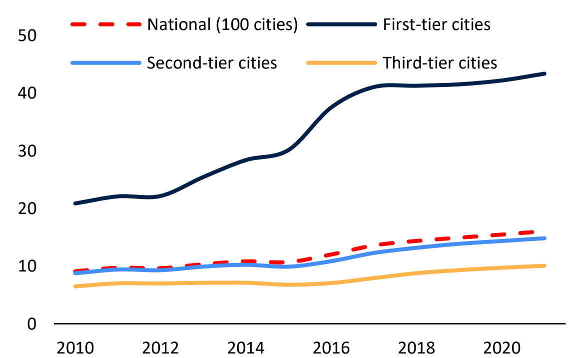
[5] Please note that this is a comparison of fixed asset investments and does not include consumption spending on housing services.

[6] This chapter will therefore focus more on residential real estate although there will be occasional references to commercial real estate.

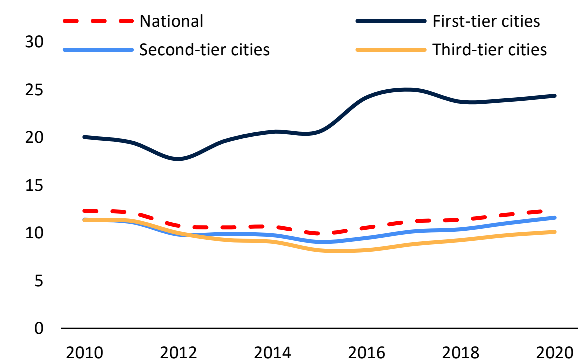
The boom in the real estate sector was most evident in price trends. Available data on average prices across 100 major Chinese cities show that residential housing prices in Tier 1 cities[7] rose from around RMB 20,000 per square meter in 2010 to roughly RMB 43,000 per square meter in 2021 (Figure 28.A). Prices in Tier 2 cities were much lower but still rose from around RMB 8,000 per square meter to RMB 14,000 per square meter over the same period. The growth of house prices has outpaced income growth as shown by high home price-to-income ratios across all city-tiers (Figure 28.B). Indeed, with prices at 24 times annual income, houses in China's Tier 1 cities are among the most expensive in the world (Figure 28.C and D).

Figure 28. Housing prices have risen sharply in Tier 1 cities

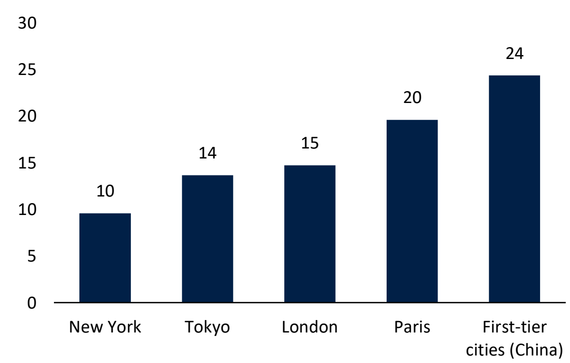
A. Residential prices
(Thousand RMB per square meter)



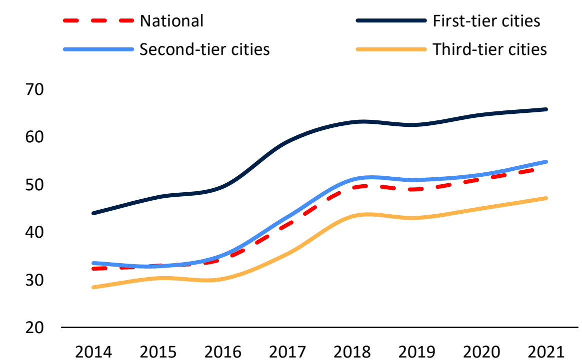
B. Home price to income ratios for city tiers
(Ratio)



C. Home price to income ratios for major cities
(Ratio, 2021)



D. Home price to rent ratios
(Ratio)



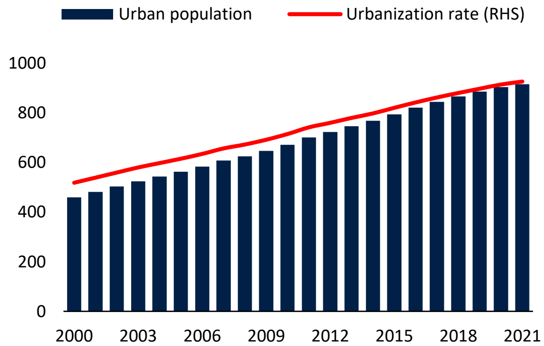
Source: NBS; Numbeo, World Bank.

The sustained boom in the sector is attributable to multiple factors. Aside from the housing market reforms of the late 1990s and the deliberate government policy to make housing an engine of growth, the rapid urbanization in China created strong demand for residential housing (Figure 29.A) while the limited availability of other investment options has made real estate the most important asset class for Chinese households, amounting to about 59.1 percent of urban household assets in 2019 (Figure 29.B).

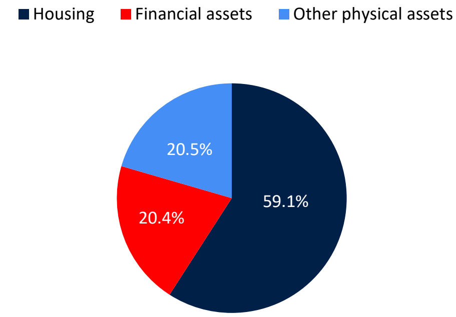
[7] Tier 1 cities are those with a population of 15 million or more (Beijing, Shanghai, Guangzhou and Shenzhen), while Tier 2 cities have populations greater than 3 million but less than 15 million (e.g., Changsha, Chengdu, Chongqing, etc). Tier 3 cities have populations of between 150,000 and 3 million (e.g., Yangzhou, Guilin, Hohhot, Nanyang, etc.).

Figure 29. Urbanization created strong housing demand

A. Urbanization trends in China
(Million persons; percent)



B. Household assets in urban areas
(Share of total, 2019)

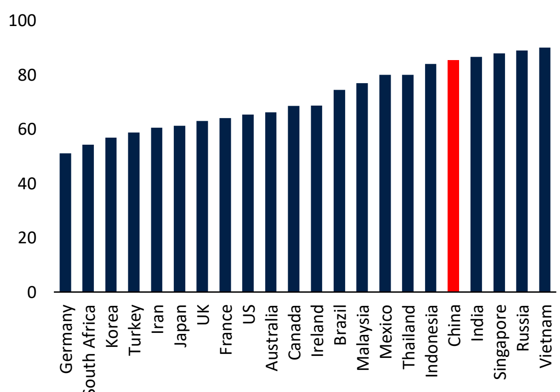


Source: NBS; People's Bank of China (PBC); World Bank.
Note: Figure B. Other phyiscal assets include automobile, stores, factories and equipment, etc.

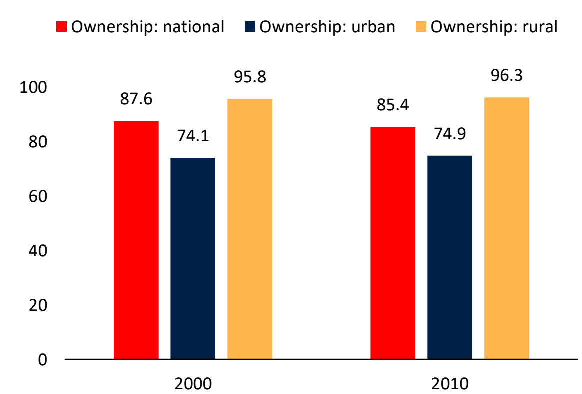
China has one of the highest homeownership rates in the world (Figure 30.A). According to the 2010 census data, over 85 percent of Chinese own their homes with higher rates of ownership in rural areas (Figure 30.B). A more recent survey of 31,000 urban households carried out by the PBC in 2019 indicated that 96 percent of respondents already owned at least one house, with high levels of multiple home ownership, which is suggestive of speculative purchases by homebuyers. Available data for 2018 show that average floor space owned reached close to 40 square meters per person in urban areas and almost 50 square meters in rural areas, up from 20 and 24 square meters, respectively in 2000 (Figure 30.C). Smaller cities tend to have larger living space per capita with average residential space ranging from 34.6 square meters per person in Tier 1 cities to 43.5 square meters per person in Tier 3 cities (Figure 30.D).

Figure 30. China has high homeownership rate

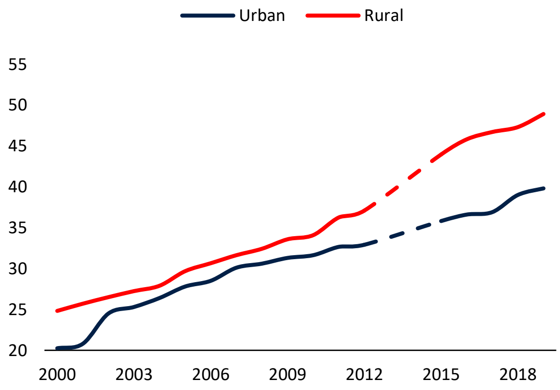
A. Cross-country homeownership rates
(Percent)



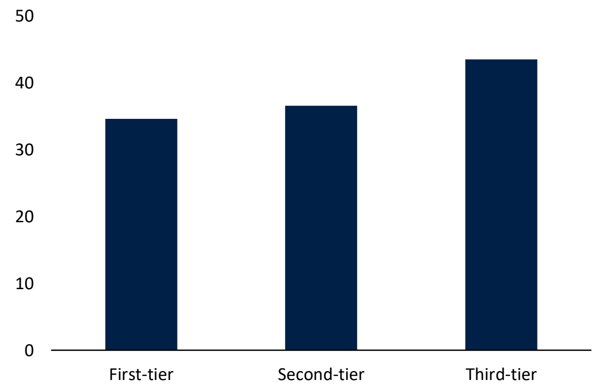
B. China homeownership rates
(Percent)



C. Residential space owned
(Square meter per capita)



D. Urban residential space across cities
(Square meter per capita)

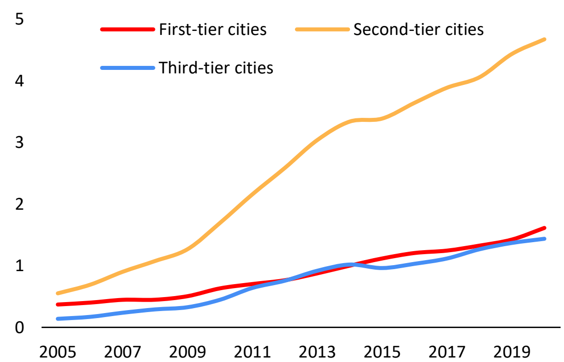


Source: Statista, Chinese Census (2000, 2010), NBS, World Bank.
Note: Figure A is based on latest available data between 2018 and 2021. Figure B, numbers for the 2020 census are not yet available. In Figure C, dotted lines refer to missing data in 2013 and 2014.

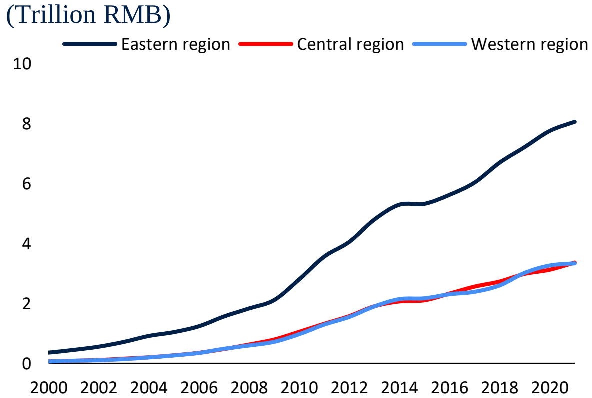
China's property market is heterogeneous with variations in key features across regions and cities. Although four Tier 1 cities have higher average prices per floor space and higher price-to-income ratios, the bulk of real estate investments takes place in Tier 2 cities (Figure 28.D and Figure 31.A). On a geographical basis, China's relatively more developed eastern region is dominant in terms of total investment value, but the growth patterns are broadly synchronized across regions (Figure 31.B and C). The volume of pre-sold but uncompleted housing is substantial across provinces, especially in those with relatively low income (e.g. Guizhou, Guangxi and Yunnan) (Figure 31.D).

Figure 31. Investment in real estate varies across cities

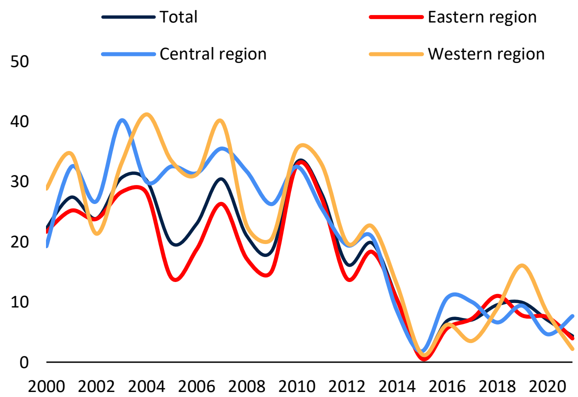
A. Total real estate investment by cities
(Trillion RMB)



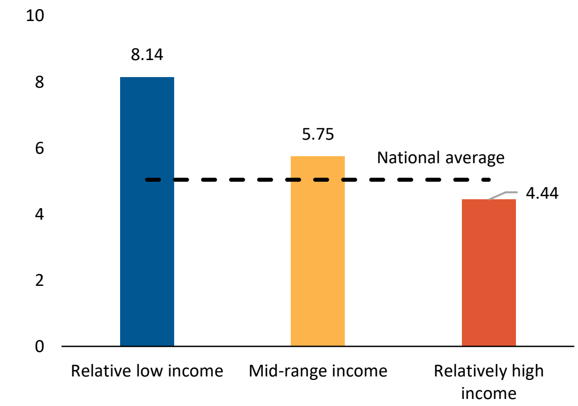
B. Total real estate investment by region
(Trillion RMB)



C. Total real estate investment by region
(y/y percent)



D. Pre-sold but not completed residential housing across provinces, 2021
(Ratio of pre-sold but not completed to completed)

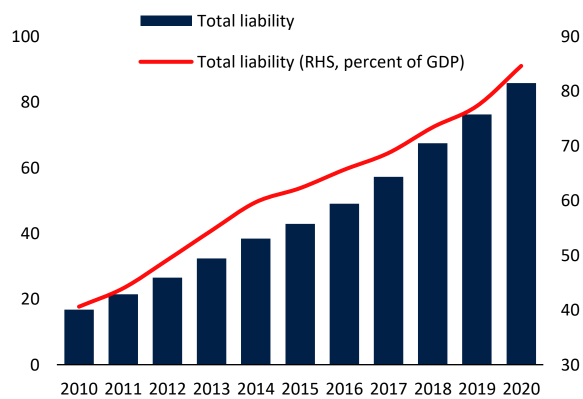


Source: NBS; World Bank.
Note: Ratio of pre-sold but not completed to completed is calculated as the cumulative floor space pre-sold but not yet complete in 2021 divided by the floor space completed in 2021. Relative low-income provinces include Guizhou, Guangxi, Yunnan, Qinghai, Hebei, Tibet, Henan, Gansu, Jilin, Xinjiang, and Heilongjiang. Mid-range income provinces include Sichuan, Shaanxi, Jiangxi, Hunan, Hainan, Anhui, Liaoning, Shandong, Shanxi, and Ningxia. Relative high-income provinces include Hubei, Guangdong, Fujian, Chongqing, Zhejiang, Jiangsu, Inner Mongolia, Shanghai, Tianjin, and Beijing.

Distress of property developers has triggered property market downturn

The rapid growth of the Chinese property market in recent years has been fueled by high levels of borrowing by developers. As total liabilities of developers rose rapidly to reach nearly 84.6 percent of GDP in 2020 (Figure 32), the authorities introduced the so-called "three red lines" policy to force deleveraging in the sector with future access to borrowing depending on a company meeting the following criteria: (i) liabilities to asset ratio of less than 70 percent; (ii) net debt to equity ratio of less than 100 percent; (iii) ratio of short-term debt to cash of less than 100 percent. This was supplemented with ceilings on banks' property and mortgage loans in a bid to also contain their overall exposure to the property market (i.e., the so-called "two red lines")[8].

Figure 32. Growth in property market is fueled by developers' borrowing
(Trillion RMB; percent of GDP)



Source: NBS; World Bank.

[8] The ratio of property-related loans to total loans was capped at 40 percent for large banks, 27.5 percent for medium-sized banks and 22.5 percent for small banks.

Table 3. Three red lines policy for property developers

Color code	*Number of lines breached*	*Allowable annual debt growth*
Green	0	15%
Yellow	1	10%
Orange	2	5%
Red	3	0%

Source: PBC; Ministry of Housing and Urban-Rural Development.

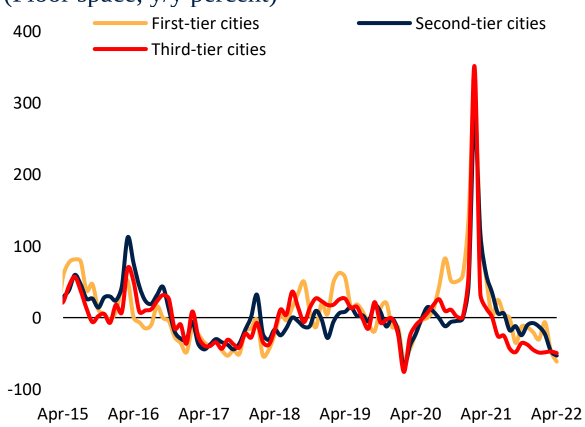
These restrictions triggered a liquidity crisis in several large developers during the second half of 2021. The largest, *Evergrande Group* with reported total liabilities amounting to over US$300 billion (on-shore and off-shore) missed several bond payments before eventually formally defaulting on December 9, 2021. Other developers such as *Sunac*, *Kaisa*, *Fantasia Holdings Group*, *Modern Land (China) Co.* and *Xinyuan Real Estate Co.* also missed payments or defaulted. Several developers experienced significant credit rating downgrades in domestic market and were forced into fire sale of assets to repay creditors, including heavily discounting prices of properties for sale. The impact rippled through the supply chain as these developers also owed money to suppliers, contractors, advertisers, and homebuyers.

The distress of developers created negative sentiments and downward pressures on the property markets which intensified on the back of recent COVID outbreaks. Given the concerns of homebuyers on the financial condition of developers and the impacts of COVID-related mobility restrictions, new home sales have fallen dramatically in both value and volume terms nationwide since Omicron outbreak started in March (Figure 19.A and Figure 33.A). The growth of housing prices for new and second-hand housing also decelerated sharply, turning negative in early 2022 (Figure 19.B and Figure 33.B). As developers wrestled with liquidity challenges, there was a substantial fall in land sales across city-tiers and a decline in new residential construction starts (Figure 33.C and D). Although the recent finetuning of policies helped to stabilize the property markets in the first two months of 2022, homebuyer confidence remained weak in the face of recent COVID-related lockdowns in March and April.

Figure 33. Property market currently struggles with multiple headwinds

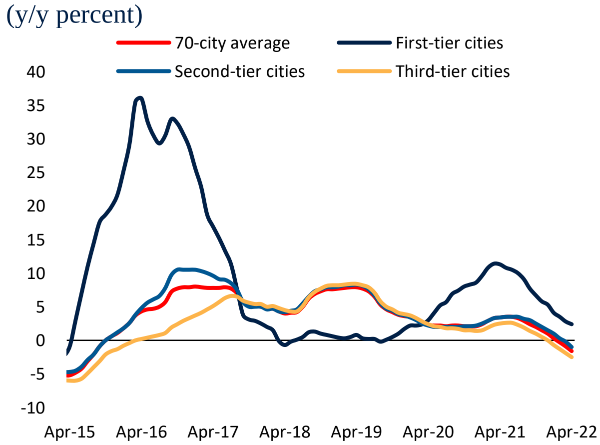
A. New home sales

(Floor space, y/y percent)

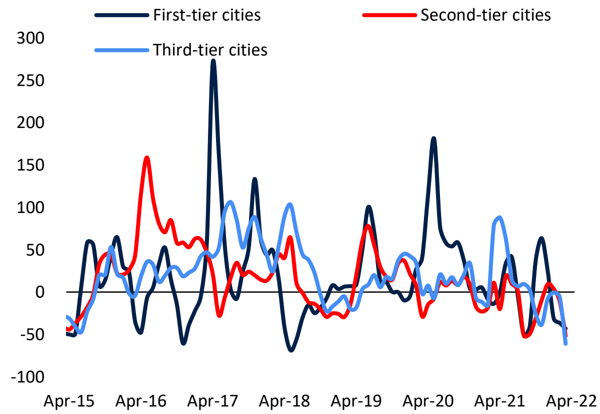


B. Second-hand housing price inflation

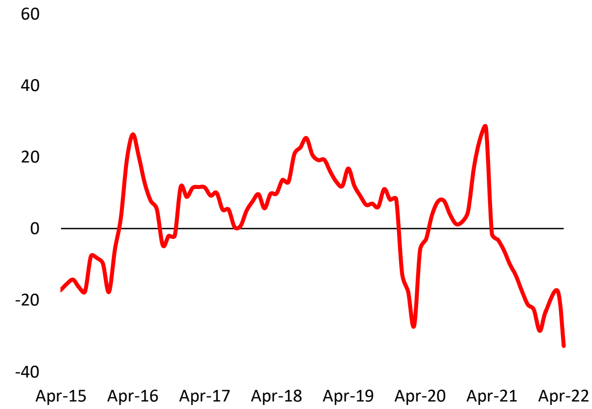
(y/y percent)



C. Land sale values
(y/y percent, 3mma)



D. New housing starts
(y/y percent, 3mma)



Source: NBS; World Bank.
Note: 3mma refers to three-month moving average.

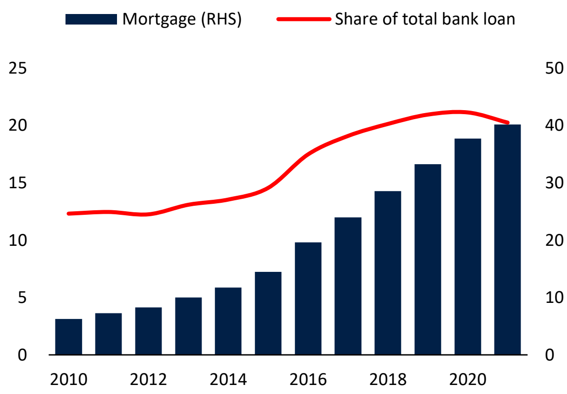
Property markets pose threats to financial stability

Chinese banks have substantial exposures to the real estate sector but are strong enough to withstand immediate shocks. As at end-2021, mortgage loans totaled RMB 40.2 trillion, representing 20 percent of total bank loans, while direct loans to property developers amounted to 6 percent of total loans (Figure 34.A and B). The exposure of banks on mortgages is mitigated by relatively high down payments as on average, first time home buyers are required to put up 30 percent with much higher levels required for mortgages on second homes (Figure 34.C and D). In theory, this represents an important layer of protection against potential default since such significant "skin-in-the-game" makes the idea of defaulting on mortgage payments unappealing to borrowers. Property-related non-performing loans (NPLs) are relatively low but are higher than overall NPL ratios for state-owned banks, city commercial banks and joint stock banks (Table 4).[9] But at this juncture, Chinese banks appear to have sufficient buffers with capital levels above regulatory requirements and provision coverage ratios averaging 196.9 percent at the end of 2021[10]. Nonetheless, regulators should watch closely the potential balance sheet pressures for some individual banks with relatively large exposures to key property developers.

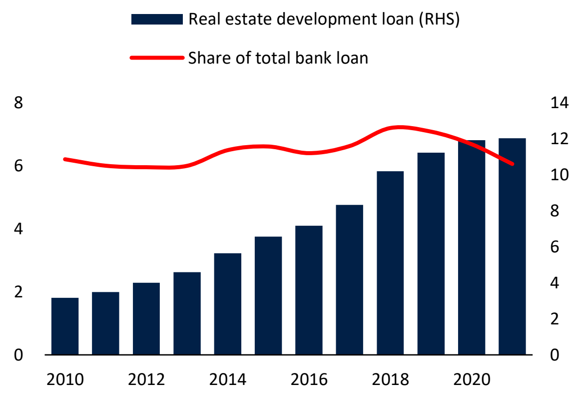
[9] These NPL figures may be understated due to ongoing pandemic-related regulatory forbearance on recognition of NPLs.
[10] Regulators have pushed banks to increase provisions in anticipation of pandemic related NPLs.

Figure 34. Banks' exposure to real estate sector is substantial

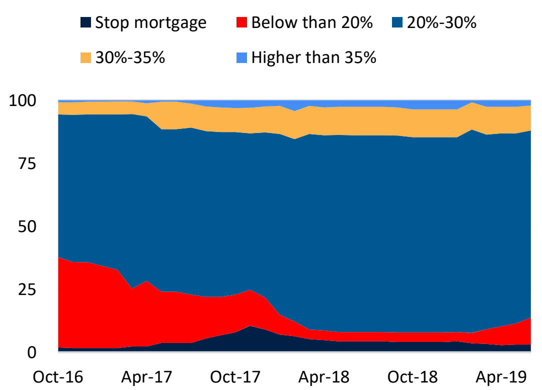
A. Mortgage loans as share of total bank loans
(Trillion RMB; percent)



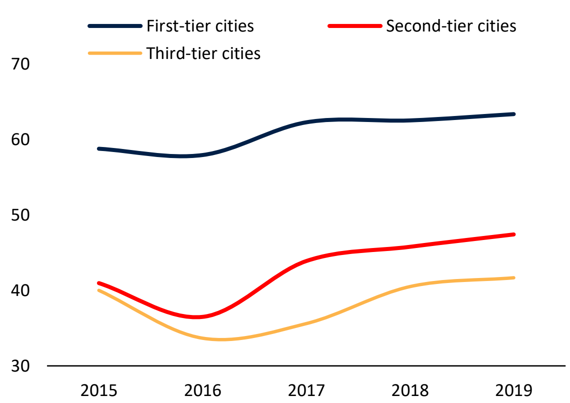
B. Developer loans as share of total bank loans
(Trillion RMB; percent)



C. Proportion of banks requiring different down payment ratios
(Percent)



D. Average down payment on second properties
(Percent of property value)



Source: Wind Information Database; World Bank.
Note: Figure D. Data are the average down payment ratios of 4 first-tier cities, 26 second-tier cities and 5 third-tier cities.

Table 4. Property-related NPL ratios by banking group

Type of Bank	*Property-related NPL ratio*	*Overall NPL ratio*
Rural commercial banks	1.0%	3.6%
Large state-owned banks	2.3%	1.4%
City Commercial banks	3.2%	1.9%
Joint stock banks	2.7%	1.4%

Source: Wind Information Database; World Bank.
Note: Data ends in December 2021. Overall NPL ratio is calculated as the share of NPL in total loans. Property-related NPL ratio is computed as the share of property-related NPL in total loans to the real estate sector.

The latest downturn in the property markets has therefore raised concerns about potential threats to financial stability if there is a generalized collapse of prices. The outsized contribution of the property sector to GDP growth and its close links to the balance sheets of households, local governments, firms and the financial system create a scenario where a prolonged downturn in the market can destabilize the financial sector and negatively impact economic growth. Despite the limited immediate risks to banks, a significant decline in collateral values may trigger a credit crunch**.** If loans collateralized by land or property are added to mortgages and real estate development loans, total banking sector exposure to the real estate sector may be as high as 40-50 percent of total banking loans. Should the value of collateral deteriorate significantly, banks could be forced to curtail lending.[11]

There are multiple sources of property-related risks and vulnerabilities:

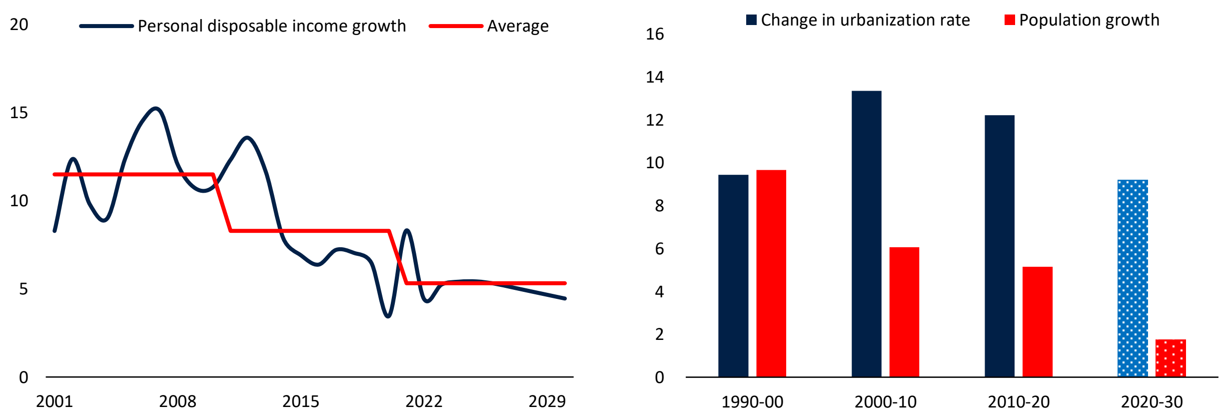
(a) Overhang of uncompleted housing plus weakening demand

The large stock of uncompleted housing combined with weakening demand from homebuyers is concerning. There are numerous pre-sold housing projects currently underway that run the risk of never being completed as more developers run into liquidity problems. Estimates by the IMF indicate that the current backlog of uncompleted pre-sold housing across the country will take five years to complete, assuming no new housing starts (IMF 2022, Figure 31.D). Meanwhile, some of the fundamentals underpinning China's property boom are weakening. In the first place, the era of double-digit economic growth is over, as China reaches the limits of its capital-intensive growth path. A slowdown in the growth of personal disposable income is therefore projected in the coming years, in addition to ongoing demographic changes such as lower birth rates, a decline in new marriages, and slowing urbanization (Figure 35). China's working age population is declining as China's population is aging, with the number of the elderly projected to reach 20 percent of the population by 2025 (Mao et al. 2020). A combination of these factors could produce a structural downward shift in the demand curve for housing.

Figure 35. Demand for housing is trending downwards

A. Personal disposable income growth projections (Percent)

B. Population growth and urbanization rate (Percent)



Source: NBS; United Nations; World Bank.
Note: Figure B. Data for 2020-30 are forecast.

[11] A property market correction will also impact shadow banking products that are exposed to the property market (e.g., trust loans).

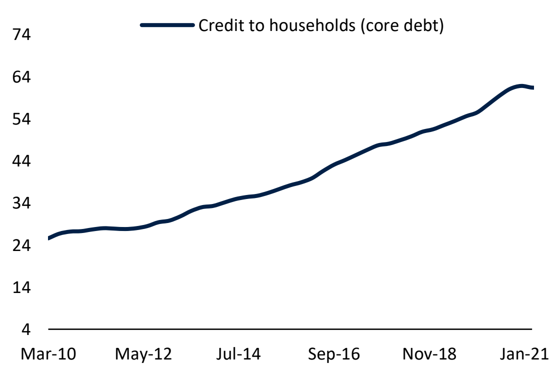
The distress of developers and recent COVID outbreaks have also reduced the demand for housing. Many potential homebuyers have become risk averse as they realized that developers can go out of business and leave housing projects uncompleted. Although the current efforts by the authorities to ease financing constraints on developers and stabilize the market could help to restore homebuyer confidence, the trend in presales is not expected to return to the levels observed in previous years. As China experiences another wave of COVID-19 outbreaks, property sales are still weak and may remain depressed well into the second half of 2022. However, the increased supply of low-income housing—with some estimates suggesting China may add as many as 2.4 million units in 2022 (three times as much as in 2021)—could cushion some of the impact on the construction industry.

(b) Pressures on household balance sheets

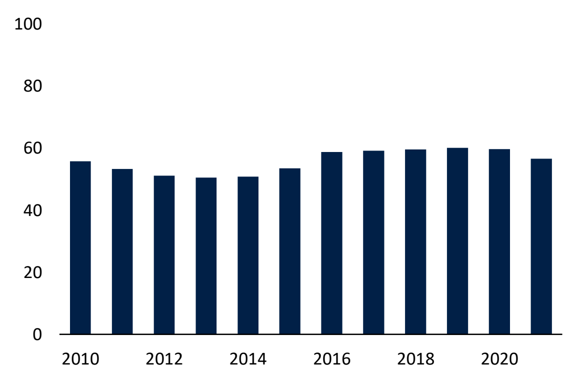
There are signs that household balance sheets are coming under increasing pressure which may threaten households' ability to service mortgage loans. First, total household debt has been rising consistently, increasing from 27.3 percent of GDP in 2010 to an estimated 61.4 percent of GDP by 2022Q1 (Figure 36.A). About 56 percent of household debt is in the form of mortgages (Figure 36.B). Increasing household indebtedness and slowing growth of disposable income, when combined with the fact that many homebuyers are buying properties valued at multiples of their annual incomes, could lead to a scenario where the ability of some households to meet their mortgage obligations is compromised.

Figure 36. Mortgages have driven up household debt

A. Household debt to GDP ratio
(Percent)



B. Mortgage loans as share of household debt
(Percent)

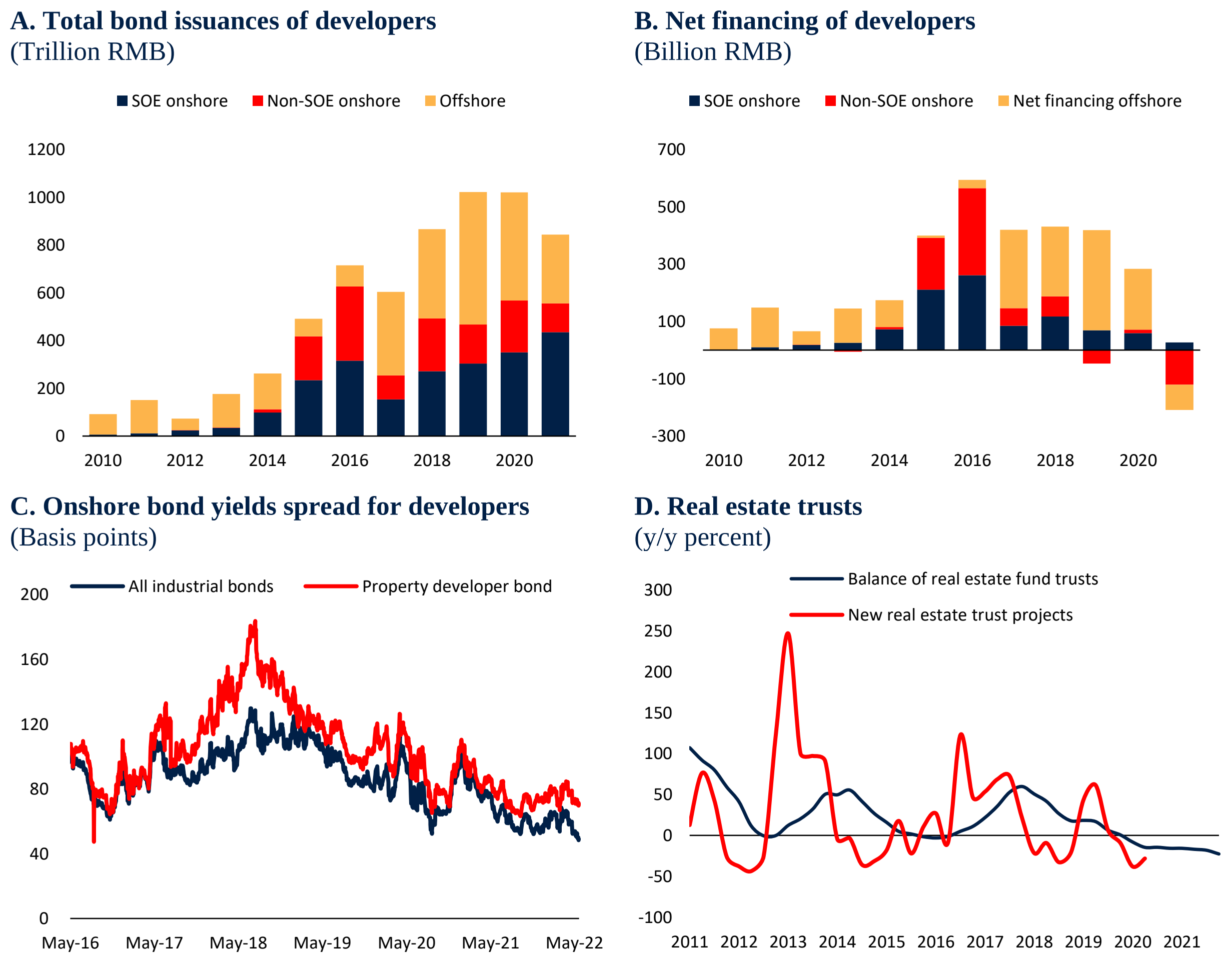


Source: BIS (Bank for International Settlements); PBC; World Bank.

(c) Ongoing distress of property developers

Property developers continue to face increasing costs and harder access to financing from onshore and offshore markets. Both onshore and offshore bond issuances were down in 2021 and net financing through both markets has turned negative (Figure 37.A and B). Yields on developers' offshore bonds remain elevated, while the yield spread for developers' onshore bonds stayed above the industrial average (Figure 19.D and Figure 40.C). With 53 percent of developer financing coming from customer funds in 2021, the increasing reluctance of potential homebuyers to engage in pre-sale transactions and the contraction of financing from trust companies have put additional pressures on developers' cash flows (Figure 40.B and Figure 37.D). The turbulence has opened a clear demarcation in access to financing between state-owned enterprise (SOE) and non-SOE developers. In the first four months of 2022, SOE developers issued RMB 158 billion in onshore bonds compared to RMB 23.9 billion for non-SOE developers (Figure 19.C). SOE developers were also able to maintain a net positive financing overall.

Figure 37. Property developers are facing financing difficulties

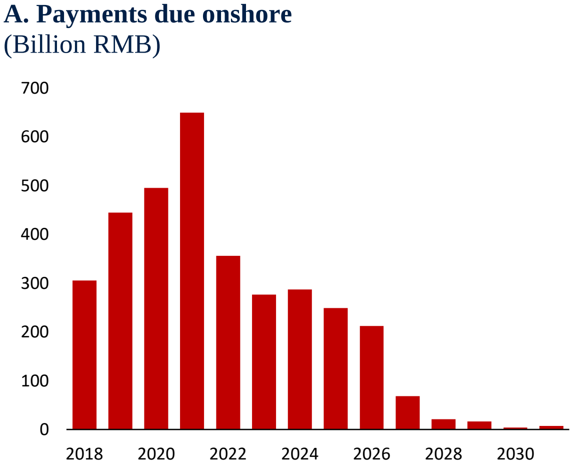


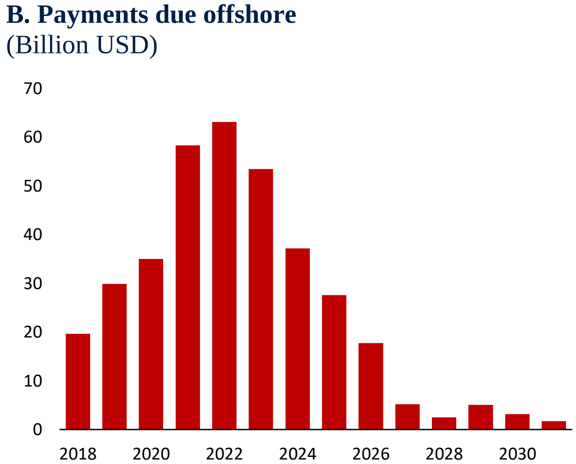
Source: Wind Information Database; China Trustee Association; World Bank.

The recent default of Sunac Holdings on a US$741.6 million bond indicates that the liquidity pressures on developers will persist for a while. Large amounts of existing onshore and offshore debt come due during 2022 (RMB 355 billion and US$63 billion, respectively) and several developers may continue to struggle to make payments for the next two to three years although obligations due fall off significantly by 2027 (Figure 38.A and B).[12] As mentioned in Chapter 1, the recent weakening of the RMB will raise debt servicing costs on developers' offshore bonds and make any refinancing of their debt more expensive in RMB terms.

[12] Please note that these are obligations on existing debt, and the declining obligations do not account for possible new bond issuances.

Figure 38. Real estate sectors are struggling with liquidity pressure





Source: Wind Information Database; World Bank.

The distress of property developers could have significant ramifications beyond the real estate sector. Many developers are large conglomerates consisting of numerous subsidiaries. For example, aside from property development, Evergrande Group is involved in tourism and recreation, sports, automotive, entertainment, food, and agriculture, as well as financial services. Therefore, a major crisis in the property business of large developers has the potential to create significant negative spillover effects across the various subsidiaries and associated sectors.

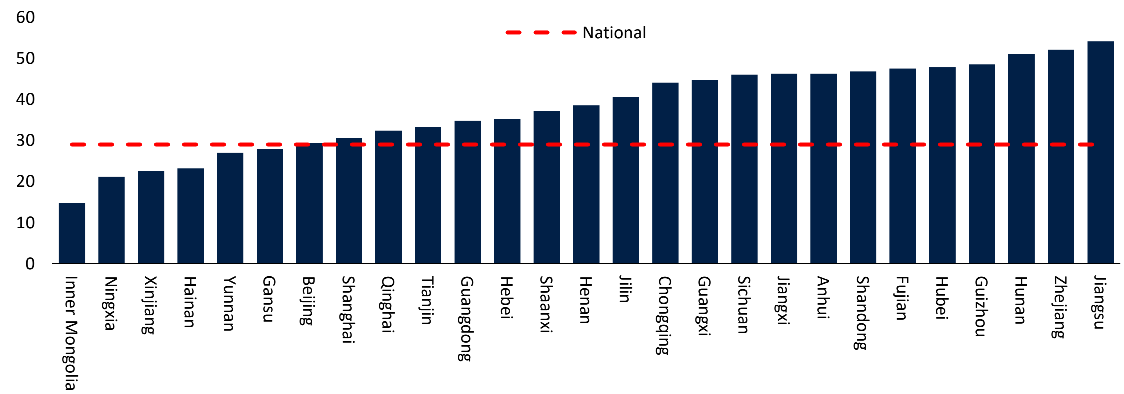
(d) Macroeconomic slowdown

The macroeconomic impact of a property market slump perhaps poses the biggest threat to financial stability. The outsized role of real estate in China's GDP means that prolonged market-wide uncertainty and loss of confidence may substantially reduce real estate sales and investment, dampen economic growth, and raise overall credit risks. A prolonged real estate slump would also have a negative impact on consumer confidence and consumption spending through the wealth effects on household balance sheets, given the fact that housing is the most important asset in household wealth and homeownership ratios are high. Further, property-related sectors, including construction, would see weaker demand and lower production. Using input-output data, Rogoff and Yang (2020) found that a 20 percent fall in real estate activity could lead to a 5-10 percent drop in GDP, even without amplification from a banking crisis or accounting for the importance of real estate as collateral.

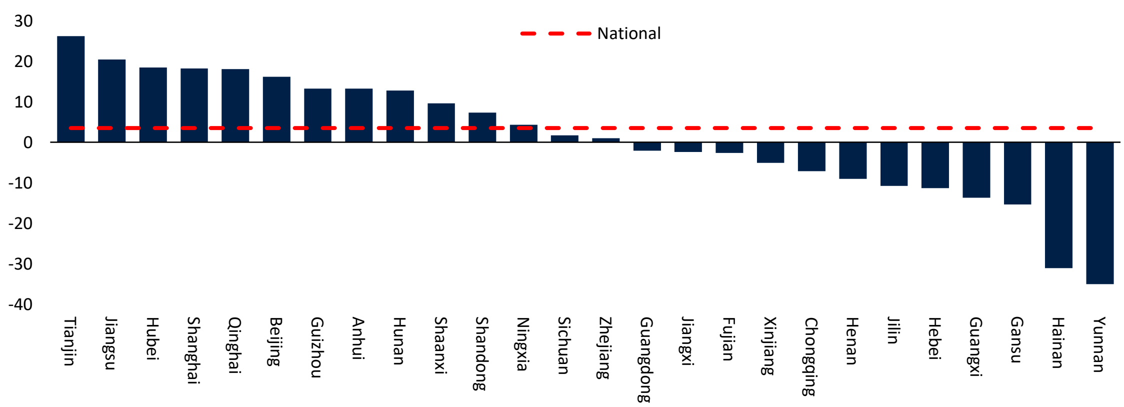
The impact of a property market downturn on local government finances is another potential source of headwinds for economic growth. Land sales are an important source of revenue for local governments in China. A look at Figure 39.A shows that in 2021, revenue from land sales averaged 29.5 percent of consolidated fiscal revenues in China, with provinces like Hunan, Jiangsu, and Zhejiang raising more than 50 percent of consolidated fiscal revenues from land sales. In addition to direct proceeds from land sales, Local Government Financing Vehicles (LGFVs) also use future land sale revenues as collateral to raise debt financing. The downturn in the sector in the second half of 2021 has resulted in a dramatic fall in the sales of land use rights across several provinces (Figure 39.B). A sustained reduction in revenue from land sales may therefore jeopardize the ability of local governments to fund infrastructure projects, a key driver of growth in the past. Other forms of local government expenditure will also be affected. This might explain why this year's budget envisages a large increase in central transfers to local governments by RMB 1.5 trillion (or 18 percent y/y), which could compensate local governments for shortfalls in land sale revenues.

Figure 39. Land sales are essential to local government revenue

A. Share of land sales in consolidated fiscal revenue in 2021
(Percent)



B. Provincial land sales in 2021
(y/y percent)



Source: Budgetary reports from provincial finance bureaus; World Bank.
Note: Consolidated fiscal revenue is the sum of revenues from the general public budget and government-managed fund

Policy implications: Controlling financial risks without harming economic growth

The government faces a macroeconomic policy dilemma of controlling risks in the property sector without doing too much damage to economic growth (Glaeser et al. 2017; Rogoff and Yang 2020). In the short run, monetary and fiscal policy should be flexible in responding as necessary if the current uncertainties persist. This will serve to mitigate knock-on effects on consumption, employment, and economic growth. In particular, the PBC should stand ready to maintain liquidity support to ensure that financial markets continue to operate well and contain any emerging market turbulence.

The debt-fueled expansion of China's property sector threatens financial stability. The government's de-risking and deleveraging campaign is therefore necessary and should not be completely abandoned in the face of short-term financial stability and macroeconomic headwinds. Despite the difficult dilemma of balancing financial stability with maintaining reasonable growth, there are a number of policy options the authorities could consider to mitigate the trade-offs. First, the transition period for compliance with the three red lines could be extended beyond end-2023 to give developers more breathing space to adjust and transition to a more sustainable business model. In addition, there should be close monitoring of developers to ensure there is genuine progress toward deleveraging.

Measures are needed to stabilize local government finances so they can move away from land sales as a key source of revenue. The substantial revenues obtained from these sales create perverse incentives for local authorities to favor construction projects over other forms of investment, which may perpetuate overdevelopment and an excess supply of housing. While the postponement of property tax pilots may be necessary to prevent further downward pressure on the sector, the idea should not be discarded altogether, given the benefits of such a tax, including the potential to provide a more stable source of revenue for local governments. Given the usual unpopularity of property taxes, a successful introduction of recurrent property levies may require bundling them with other measures—such as a reduction in taxes on property transactions and a reform of inter-governmental finances—to reduce the gap between local governments' expenditure responsibilities and their share of total revenues (Box 4). It is notable that the 2005 property tax reform in Korea was also combined with reductions in property transaction taxes and an increase in inter-governmental grants to compensate for any reduction in revenue capacity (OECD 2021). Furthermore, wealth taxes also remain underutilized in China and could play an important role in reducing imbalances in local government budgets.

Box 4. Potential benefits and challenges of a property tax in China

Background

China does not have a recurrent tax on residential property and most of its property-related taxes pertain to levies on real estate transactions. Since 2003, the authorities have been exploring reforms to the land and property tax regime, and in 2006, six cities were selected to conduct pilot projects. Starting in 2011, the cities of Shanghai and Chongqing introduced property taxes on a pilot basis, and in October 2021, the Chinese legislature authorized the government to implement regional pilots of a property tax.

However, as the recent real estate downturn deepened and concerns mounted about a prolonged impact on growth, the authorities announced in March 2022 that the planned pilots would be suspended.

Benefits of property taxes

Stabilizing local government finances. A property tax could provide a more stable source of revenue for Chinese local governments, many of which are highly indebted and under fiscal stress due to a large gap between expenditure responsibilities and revenue capacity (Man 2012). Local governments currently generate substantial amounts of revenue from land sales which can be irregular and unreliable in the long run since the supply of land is limited. The reliance on revenues from land sales has also created perverse incentives for local governments to overdevelop land for urbanization (Liu 2021).

In many countries, property taxes provide local governments with steady and reliable revenue streams. For example, across OECD countries, property taxes average 19 percent of local government revenue, with the ratio exceeding 50 percent in Canada, Israel, and the United Kingdom (OECD 2021). Indeed, if we focus on property tax as a share of tax revenues of local governments, the property tax accounts for more than half of the local tax revenue in 14 of the 38 OECD countries, with this share higher than 70 percent in Australia, Canada, Ireland, New Zealand, the United Kingdom, and the United States (OECD 2021).

In the United States, property taxes are the primary way in which local governments cover expenses for various services, including: i) police and fire protection; ii) water and sewer systems; iii) public hospitals and public health services; iv) highways, roads, and streets; v) public transit, parks, and recreation services; vi) waste collection; vii) community colleges; and viii) a mix of administrative functions such as courts, record keeping, and voting (Fischer 2021). Therefore, in a highly decentralized country like China, stable revenue from property taxes can increase the capacity of local governments to provide public services.

Reducing income and wealth inequality. Although China taxes the interest and dividends from investments in securities, most Chinese households hold their wealth in the form of real estate, which is not taxed. In addition, mortgage interests are deductible when calculating taxable income. With urban homeownership rates exceeding 90 percent, introducing a tax on residential property could help to reduce income and wealth inequalities and contribute toward a more progressive tax system (OECD 2019; OECD 2021).

Reducing speculation. With a high homeownership rate, many homebuyers have multiple properties that are purchased purely in expectation of price increases and often stay vacant. A residential property tax will increase the carrying costs of housing investments and reduce the prevalence of speculative home purchases. This could also lower the volatility of house prices especially if the taxable value of properties increases in line with market prices.

Promoting green buildings. Since the building sector is often responsible for high levels of energy consumption, solid waste generation, and greenhouse gas emissions, many countries are designing property taxes to promote green buildings (Shazmin et al. 2016). The typical approach is to provide tax relief for buildings that meet certain energy efficiency or renewable energy standards and/or grant exemptions to value increases that are due to energy efficiency investment (OECD 2021). Given China's extensive urbanization over the past two decades, greening buildings have a major potential to help the country meet its commitments under the Paris Climate Agreement and achieve carbon neutrality by 2060.

Challenges of property taxes

Timing of implementation. Property tax reforms are tricky to implement, especially if a new tax is being introduced from scratch. It is important not to make such big changes during an economic slowdown or when there is a downturn in property markets (OECD 2021). Otherwise, there is a risk that the introduction of a new tax will amplify the decline in prices and sales (Yao 2021).

Tax administration. The need to revalue properties frequently makes the administration of recurrent property taxes challenging, and it is therefore essential to have in place a robust property valuation and billing system such as the Computer Assisted Mass Appraisal (CAMA) system being used by the Shenzhen Assessment Centre—a municipal statutory agency that was established to assist the collection of taxes on real estate sales and transactions in Shenzhen (Man 2012 and OECD 2021). The CAMA, however, requires availability of data on sales transactions plus trained government officials to use the system. Infrequent revaluations may also result in sudden increases in tax obligations.

Stakeholder resistance. It is not surprising that new property taxes often invite strong opposition from many stakeholders. Property taxes tend to be unpopular and government officials sometimes worry about the potential impact on the demand for houses. This has been the case in China as well. It is therefore prudent to get more buy-in by engaging and communicating with key stakeholders, gradually phasing in the new tax, or combining it with the elimination or reduction of taxes imposed on property transactions (Brys et al. 2013). Other incentives such as allowing payment in instalments or providing tax relief for asset-rich but income-poor households could also be considered (OECD 2021).

Additional measures should be taken to enhance the resilience of housing markets. First, the authorities should maintain conservative policies on down payments, especially the higher down payments for second or third home purchases, which is a valuable macro-prudential tool for reducing speculation. Also, when the current pains in the market recede, pressuring developers to reduce leverage should continue, in addition to exploring more stable funding models (see below). Finally, there is a need to address the risks of the pre-sale housing system by ensuring that funds in escrow accounts are closely matched to specific projects and disbursed against clearly defined construction progress (Box 5).

An important component of controlling financial risks is to closely monitor the exposures of financial institutions and markets. The new Financial Stability Law contains several provisions useful for this purpose, and it also includes the establishment of a new Financial Stability Fund which will be used to deal with major episodes of financial distress, including those originating from the property markets. Notably, the law elevates the monitoring of financial risks to the State Council level under a new "National Financial Stability and Development Coordination Mechanism" as well as early warning systems to identify financial risks and take appropriate early actions. This and existing mechanisms should be deployed consistently for surveillance of emerging risks from the property market. In addition to monitoring systemic risks, the financial sector regulators should also regularly assess the exposures of individual banks to the real estate sector and direct any bank with large exposures to increase provisioning as appropriate to the level of credit risks.[13] Regular stress testing to assess resilience to shocks from the property sector is also essential.

[13] Asset Quality Reviews (AQRs) of banks and other lenders with large exposures to the property sector could be considered.

Box 5. Vulnerabilities of China's pre-sale housing system

Chinese developers rely on a system of home pre-sales as the primary mode of financing construction projects, with homebuyers purchasing properties before they are constructed. Annual advance payments from customers have increased from only RMB 500 million in 2010 to RMB 10.6 trillion by end-2021, representing 53 percent of developers' funding (Figure 40.A and B).

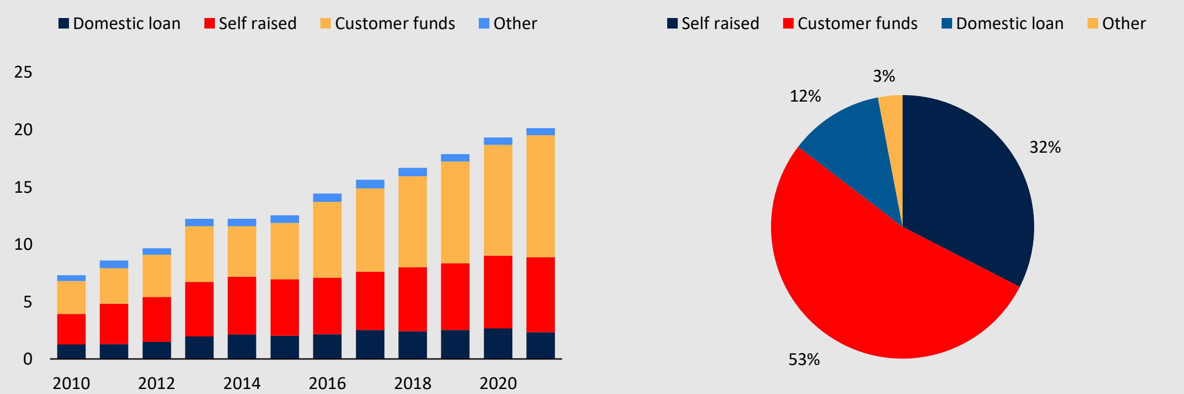
Benefits

For developers, the pre-sale model is attractive because it reduces the amount of debt they need to assume, lowers financing costs, and mitigates the risk of building properties that cannot be sold if demand changes in the time period between when construction is started and completed. They can also lock in a price for the sold units, thereby mitigating the risk of price fluctuations. For homebuyers, buying pre-sale is often cheaper since properties are usually available at substantial discounts, and they may have the option of customizing the interior design, layout, or fittings of their units.

Figure 40. Developers rely heavily on presales funding

A. Funding sources for real estate developers
(Trillion RMB)

B. Funding sources for real estate developers
(Share of total, 2021)



Source: NBS; World Bank.

Risks

Misuse of funds. The risk of developers diverting pre-sale funds to unapproved uses is well-recognized in many countries where this housing system exists. Safeguarding the funds collected through pre-sales is therefore critical, and many countries have put in place arrangements such as India's Real Estate Regulation and Development Act. Introduced in 2016, the act requires all developers' projects to get registered and approved, in addition to using escrow accounts to receive deposits. Under a law enacted in 2007, the Dubai Government made it mandatory for developers to open an escrow account for each off-plan project with advance payments disbursed to developers according to verified progress on construction.[14]

China also requires that advance payments for properties be put into escrow. Although the Ministry of Housing and Urban-Rural Development centrally administers pre-sales of commercial properties throughout the country, the *de facto* authority to regulate pre-sales is in the hands of local authorities,

[14] Law No. (8) of 2007 Concerning Escrow Accounts for Real Estate Development in the Emirate of Dubai.

leading to wide variations in rules regarding how developers can use the proceeds in such accounts. There is some evidence that many developers have considerable latitude on the use of proceeds, including cases where they have used those funds to finance non-related projects (PWC 2020).

Construction and liquidity risks. In a pre-sale model, construction risks are effectively transferred to homebuyers who may not be able to bear or manage those risks. In a situation of asymmetric information, where the developer knows much more than the homebuyer about the construction project (quality, progress, etc.), homebuyers do not have the specialized knowledge or the resources to assess whether their best interests are being served (Leung et al. 2007). There have been many complaints from homebuyers of long delays in delivering units, poor quality of construction, smaller sizes than agreed upon, as well as poor fitting and finishing.[15] There is also a risk of project incompletion, as shown by the recent episodes of distress among Chinese developers which made real the likelihood of developers, going out of business before delivering promised units. Committed homebuyers have no easy recourse if a developer goes bankrupt or runs out of liquidity needed to deliver a project. Consequently, the reliance of developers on pre-sale funds raises liquidity risks if a negative shock reduces the willingness of prospective homebuyers to sign pre-sale contracts.

Policy Options

As a result of these risks to homebuyers, pre-sale housing systems require solid consumer protection arrangements. Although escrow accounts are commonly used, robust enforcement is necessary to ensure that funds are matched to specific projects, disbursed against clearly defined construction progress, and that developers cannot easily divert funds to other uses.

Following the distress of property developers in the second half of 2021, several local governments imposed strict rules on the access of developers to funds in escrow accounts, to ensure that projects are completed and homebuyers are protected. However, this had the unintended consequence of further worsening the liquidity pressures on several developers and the suspension of construction work on numerous projects. Although some local authorities have subsequently eased these controls, the Ministry of Housing and Urban-Rural Development is reportedly considering standardizing at the national level all rules regarding how pre-sale proceeds can be used by property developers.

To protect homebuyers from construction risks without creating negative liquidity shocks for developers, it is important to broaden the financing options for real estate developers through the expansion of project-based financing or the greater participation of institutional investors such as Real Estate Investment Trusts (REITs), which are oriented toward property development. China introduced infrastructure REITs in 2021, and these institutions could incorporate real estate assets into their portfolios, thereby helping to reduce the dependence on pre-sales as the dominant form of financing property development in the country.

In addition to controlling risks in the short term, the sustainable development of housing markets requires appropriate medium- to long- term policies and structural reforms.

- **Improving urban development policies:** There is substantial scope to optimize the use of land resources in China's urban areas. China is the only country in East Asia to have a declining population density in its large cities, as the expansion of urban boundaries has outpaced population inflows (Kim et al. 2021). Therefore, it is critical to encourage urban regeneration

[15] There are anecdotes of developers allegedly adopting a low-cost strategy to increase profit margins, which compromised the quality of projects.

to increase the density of city centers, which will enhance livability and economic vitality. This will require measures such as upgrading public spaces, improving public transport, and enhancing the delivery of public services (World Bank and Development Research Center 2014). Stricter land use controls through spatial planning are also necessary to reduce urban sprawl. Lastly, while the recent government guidelines to lift hukou restrictions in all counties is a step in the right direction, extending hukou liberalization to China’s large cities would provide additional support to urbanization as an engine of growth by creating a more productive labor force with equal access to public services.

- **Modifying the funding model for developers:** The recent liquidity distress of developers underscores the importance of broadening their financing options through the expansion of project-based financing or the greater participation of institutional investors such as Real Estate Investment Trusts (REITs), which are oriented toward property development (Box 5). This will reduce the dependence on pre-sales as the dominant form of financing property development and put the developers’ funding structures on a sounder footing.

- **Strengthening the insolvency framework:** The distress of large developers has also underscored the need for a robust and predictable framework for debt resolution and corporate insolvencies. Indeed, financial risks are often exacerbated by the lack of such frameworks, especially in the face of the distress and default of large and complex firms such as Evergrande. A more robust insolvency framework would also facilitate the allocation of capital to support a more innovation-driven, private sector-led growth.

- **Expanding financial liberalization:** As mentioned earlier, real estate is the most important asset class for Chinese households. Further liberalization of the financial sector, such as opening up the banking and insurance industries and reforming pension systems, will therefore expand the range of available financial assets for household investment and help reduce households’ propensity to buy and hold empty properties as investment vehicles.

- **Exploring new drivers of growth:** In the long run, the authorities need to start thinking about how to transition from property to a new engine of growth. China’s commitment to decarbonization and fostering green growth offers an opportunity here as green technology and green industries could become the pillars of growth in the coming years. There is an opportunity to promote green buildings, since the building sector is often responsible for high levels of energy consumption, solid waste generation, and greenhouse gas emissions.

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