



# 2Q2022 Outlook: Beijing Aims for Stability First, Growth Second

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## 2Q2022 Key Takeaways:

- The 2022 growth target of 5.5% has become largely meaningless as exigencies force Beijing to pivot to a “stability first, growth second” strategy in the second quarter and likely for the remainder of this political year.
- The assumed correlation between stability and growth is actually rather weak. So long as Beijing can maintain a growth floor of ~4%, it is unlikely to launch a forceful stimulus and instead opting to coast on slower growth while preventing systemic risks.
- A Chinese economy that slows to below 5% will bring further downside risks to an already fragile global economy, potentially leading to stagflation.

The Chinese government’s announcement of a 5.5% growth target at the March National People’s Congress was dead on arrival. Covid-19 has interjected yet again, as lockdowns in Shanghai and other regions of China will make it almost impossible for Beijing to achieve its 2022 growth target.

Beijing will instead pursue a “stability first, growth second” strategy for the rest of this political transition year, when risk tolerance is low. A significant ramp-up of stimulus will only happen when growth risks falling below 4%, still an unlikely scenario in the second quarter.

Ensuring stability without being pro-growth may seem contradictory. But the correlation between growth and stability is somewhat spurious. With a labor force aging rapidly into retirement, the relationship between jobs and GDP has weakened, which means that social stability doesn’t just fall apart if growth dips below some assumed level.

While Beijing should be able to contain significant economic fallout with a raft of relief lending and programs to help small businesses stay afloat, a dramatic slowdown of the Chinese economy will have spillover effects on the global economy. In particular, China’s slowdown will increase the risk that major central banks’ tightening cycles will push the global economy closer to the edge of a recession.

### Stability First, Growth Second

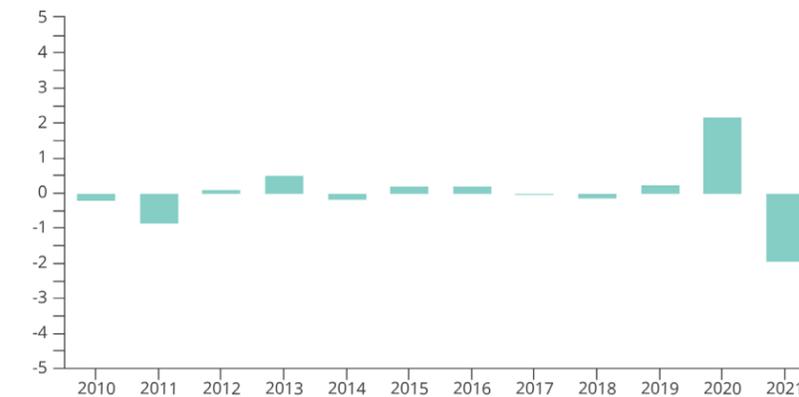
The impact of the Covid lockdowns will likely lead to two months of lost growth in 2Q2022. But given that Covid outbreaks could percolate throughout the year—and assuming that “Zero Covid” holds until at least November—full-year growth will likely be at least one percentage point lower than the 5.5% target.

While second-quarter growth will almost certainly be abysmal, China’s unemployment will hold at around ~5.5%, a level that won’t be sufficient to trigger a larger stimulus. This is because a declining labor force and Chinese baby boomers retiring en masse mean that slower growth will have a smaller impact on unemployment.

It’s certainly possible for China to stimulate its way to 5.5%, but that is unlikely in the near term because the options on the table are either too risky or require a paradigm shift in fiscal policy. Most forms of stimulus, such as local government investment, have been pushed to their limits. The continued reliance on these approaches offers diminishing returns but increases financial risks.

That basically leaves central government deficit spending as the only viable option to stimulate while avoiding downside risks. Yet [that requires overcoming](#) Beijing’s entrenched fiscal conservatism when it comes to increasing the central budget deficit. Even in 2020, during the depths of the pandemic, Beijing was only willing to increase the deficit by 2% of GDP (see Figure 1). Although that was the largest deficit spending in recent history, it was still insufficient to meet the task at hand.

Figure 1. Beijing Has Been Reluctant To Rely on Deficit Spending (percentage points)



Note: Annual change in deficit as % of GDP.

Source: Wind and MacroPolo.

Meanwhile, Beijing has already made it clear that fiscal prudence will rule in 2022, as [it focuses on](#) “maintaining fiscal sustainability.” Therefore, Beijing will be loath to raise the deficit short of more catastrophic conditions—that is, when unemployment breaches 6%, which roughly corresponds to growth dipping below 4%.

That scenario is unlikely to materialize in 2Q2022, which means that Beijing will accept slower growth in the near term while prioritizing stability. That will take several forms. First, Beijing will aim to contain destabilizing systemic risks, which will likely involve extending debt repayment periods for local governments to prevent cascading defaults across fiscally vulnerable regions.

Second, ensuring stability runs through employment. Beijing will likely gradually increase relief spending to a level similar to 2020 to prevent massive bankruptcies among small and medium businesses that create the most jobs.

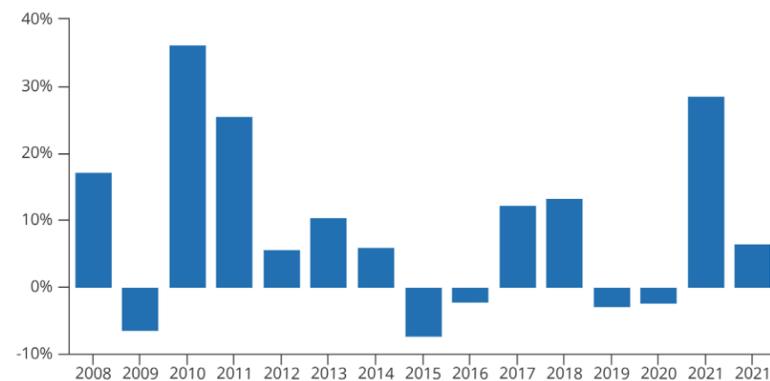
Moreover, Beijing will seek to shift some of the job creation burden onto big tech, particularly platform companies that lord over millions of small vendors. Food delivery platforms are already being forced to reduce fees they charge to restaurants, while e-commerce giants will likely have to cut their fees for small vendors.

## China Slowdown Will Impact Global Growth

The global implications of China's slowdown may be underappreciated. Although a weaker yuan may affect inflation, the slowdown's effect on global growth will be more significant. This increases the risk that the US Federal Reserve's tapering and tightening cycle will trigger a recession.

During previous slowdown cycles, China's non-oil imports tended to decline by about 3% in US dollar terms (see Figure 2). Given that global trade is expected to grow by more than 6% in 2022, this means that China's imports this year will be about ~\$200 billion lower than the baseline estimate. This in turn reduces global ex-China demand by ~0.3%.

**Figure 2. China Imports Tend to Contract During Slowdown Cycles**



Note: Figure shows only non-oil imports growth.

Source: Wind and MacroPolo.

While that decline in demand seems modest, it is occurring at a time when the global economy appears increasingly fragile. With major central banks entering tightening cycles, stubborn inflation, and the ongoing Russia-Ukraine war, a China slowdown further tips the global economy in the direction of a recession.

That's because a slowdown in China will not help inflation as much as it could hurt global growth. A depreciating yuan in theory should mitigate inflation as Chinese goods become cheaper. But historically, there isn't a perfect 1:1 correlation between currency depreciation and lower export prices.

During the 2015 slowdown, Chinese export prices fell only ~2% even though the yuan depreciated by ~6%, likely because a large share of Chinese exports [are priced in](#) US dollar (see Figure 3).

Moreover, Chinese exports to the United States only account for 2% in US consumer inflation. As such, China's slowdown may help inflation at the margins, but it will probably have a negligible impact on energy prices in the near term.

**Figure 3. Currency Depreciation Doesn't Lead to Equival Declines in Export Prices**



Source: Wind and MacroPolo.

For central banks that are trying to strike a delicate balance between growth and inflation, China's slowdown adds another wrinkle to the already difficult calculus. At a minimum, a Chinese economy that moderates to 4% in 2022 raises the risk of a "stagflation" scenario in the US and EU economies.

Stagflation in advanced economies will also eventually come back to bite China, leading to a potentially vicious cycle. Although China could stimulate now to sustain growth in anticipation of slowdowns in advanced markets, but for the reasons outlined above, Beijing is much more focused on domestic stability in 2022 than coordinating macroeconomic policy.

## Everything Is Challenging Everywhere

Reality [isn't quite](#) a Michelle Yeoh multiverse sci-fi flick, but it is shaping up to be a year of multipronged economic challenges without much coordination as countries focus inward on domestic economic priorities.

It just so happens that the near-term priorities are divergent: inflation is the main concern in Western markets while preventing instability is the main preoccupation in China. That divergence means countries will be focused on dousing the immediate fires in front of them without thinking much about the knock-on effects of their policy actions. This could well lead to a global economy that's considerably weaker by the end of 2022 than how it began the year.