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Statement by Mr. von Kleist and Mr. Buetzer on People's Republic of China (Preliminary)
Executive Board Meeting
December 17, 2020

We thank staff for its comprehensive and informative set of reports. We also thank Mr. Jin, Mr. Zhang, and Ms. Liu for their helpful Buff statement. With the outbreak of COVID-19 and the accompanying containment measures, the economy had to cope with a combined supply and demand shock. As a result, China experienced its first quarterly decline in output since records began in 1993 although the economy has by now returned to its pre-crisis growth path.

While we broadly concur with staff's appraisal and recommendations, we would like to highlight the following:

As outlined in the report and Buff statement, the swift recovery was a result of strong and timely containment measures as well as the fiscal and monetary support, which mitigated the impact of the crisis. There are, however, a number of significant downside risks to the short-term outlook, including a COVID-19 resurgence, a sudden tightening of (domestic) financial conditions, increasing default rates, and a further escalation of trade conflicts. Accelerated domestic debt accumulation and a potential downturn in the property market are further risks weighing on the outlook. Beyond the short-term recovery, the growth path appears subject to continued high uncertainty amid a more challenging external environment, underscoring the need to increase the economy's resilience towards adverse shocks to external demand.

We welcome the authorities' intention to strengthen domestic sources of growth and promote resilient, green, and inclusive growth. We note that the concept of *dual circulation* is aiming at a more balanced, high-quality growth model, concentrating on the large domestic market while simultaneously reducing reliance on exports of manufactured goods. At the same time, it will be challenging to strengthen domestic private consumption in the short term against the backdrop of a significant drop in the growth rate of average household income amid still weak labor market conditions and higher precautionary savings due to the crisis. *Could staff provide further comments on the concept of dual circulation, in particular whether it is intended to lead to a greater decoupling from external markets and thereby call into question the credibility of the strategy of market opening?*

We agree with staff that fiscal policy should remain moderately expansionary in 2021. As the recovery is gaining more momentum, we nevertheless consider it warranted to closely monitor fiscal developments in order to ensure a timely return to rebuilding fiscal space. Fiscal adjustment, led by reductions in off-budget local government investment and tax reforms to broaden the tax base, would be key to stabilize public debt over the long term.

In order to make fiscal support more effective and to facilitate economic rebalancing, we support staff's recommendation that funds should be shifted from infrastructure spending towards strengthening social safety nets and promoting green investment. A more comprehensive and effective social safety system would also act as an automatic stabilizer in future crises.

We agree that monetary policy should remain accommodative until there are clear signs that private demand has strengthened and inflation has risen to its target in a sustained manner. At the same time, and with the recovery being underway and financial markets stabilizing, we encourage the authorities to phase-out potentially distortionary measures. In particular, non-interest rate policies such as lending targets and window guidance may increasingly lead to credit misallocation and mispricing problems when in place for a prolonged period of time.

We take positive note that daily fixing of the exchange rate is now more market driven. Like staff, we welcome the removal of the reserve requirement on FX forwards and the phasing out of the counter-cyclical adjustment factor in the daily trading band's central parity formation. Moreover, a further opening-up of financial markets would strengthen the role of markets in determining the exchange rate. We agree with staff that publishing information on FX intervention would improve the transparency, credibility, and communication of the policy framework.

We agree with staff that the authorities should consider further measures to contain financial stability risks, including in the shadow banking system. As the recovery is gaining momentum, exceptional financial support measures such as relaxed NPL recognition standards and repayment moratoria should be phased out as they run the risk of undoing recent progress in strengthening bank transparency and governance. More transparent accounting of credit risks and classification of non-performing loans would allow to better assess adequate capitalization of banks. Moreover, a comprehensive bank restructuring and resolution approach is needed to strengthen the banking system. Additionally, regulatory and supervisory frameworks should be strengthened in line with FSAP recommendations.

We note that digital technologies can help to further improve the transmission of policy support to vulnerable households and firms. In this context, we agree with staff that the PBC's central bank digital currency (CBDC) could potentially promote financial inclusion and payment efficiency. At the same time, other consequences of the implementation of

CBDC should be carefully considered. CBDC will increase competition in the payment market and put pressure on the business models of the dominating tech companies in the market. A crowding-out seems possible as costs associated with the use of CBDC are likely to be lower. Moreover, this could result in a deterioration in payment efficiency as technological innovation by market participants might diminish. Operational risks from potential disruptions and cyberattacks are further aspects that should be considered carefully.

On the structural side, we echo staff's call to implement key structural reforms, in particular to **let market forces operate more freely, further opening up of domestic markets, and reforming SOEs to ensure competitive neutrality**. However, the liberalization of the financial market should be well balanced in order to guarantee free market access for all competitors and to promote a level-playing field.

Looking at climate change mitigation and the status quo characterized by very high emissions and a strong reliance on coal, strong policy measures are needed to achieve China's ambitious goal to reduce CO2 emissions in a manner to reach carbon neutrality by 2060. We welcome the authorities' commitment to actively support the transition to a greener economy as described in the Buff statement. This process should be supported by a significant transformation of the current financial system to address the advent and needs of climate finance, including through the creation of financial instruments and structures. While we thank staff for a very insightful Selected Issues paper on monetary policy, SOEs, and local government financing, looking ahead we would like to encourage staff to also look into critical climate change mitigation strategies in greater detail, given the magnitude of the challenge ahead.

We welcome China's participation in multilateral efforts, including in the G20, to address global challenges. We look forward to further strengthening the constructive dialogue and cooperation in the different international fora in order to jointly promote a strong, sustainable, and inclusive recovery from the crisis. We welcome China's participation in the G20 DSSI, and we hope to see China's full and timely implementation of the agreed Common Framework. Active and constructive participation in multilateral debt discussions, underpinned by transparency, is crucial. We strongly support staff's comments on China's important role in providing debt relief to low-income countries as agreed at the G20 level, as well as in tackling climate change and contributing to a more open, stable, and transparent rules-based international trade and investment system.

Lastly, we encourage the authorities to consent to the publication of the staff report.