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Assessing the Latest Developments in the Chinese Economy

Anushka Saxena, Amit Kumar, Manoj Kewalramani

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This document compares data on the Chinese economy, and assesses projections surrounding the rebounding of the economy in the aftermath of the scrapping of the Zero-COVID policy. It further highlights the headwinds facing the economy in key areas such as domestic consumption, real estate, net exports, local government debt, and Foreign Direct Investment.

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Table of Contents

I. Introduction

In the aftermath of the scrapping of the dynamic Zero-COVID policy in late 2022, it was expected that the Chinese economy would rebound and witness rapid growth on account of pent-up consumer demand, increased fiscal spending, and policy predictability vis-a-vis efforts to boost market confidence and signal openness.

However, despite a relatively positive Q1 performance in 2023, China's economic data for H1 indicates systemic weaknesses. There are persistent challenges with stimulating domestic demand, in addition to local government debt, property sector fragility, and declining foreign trade and investment.

Some of the key judgements we draw are as follows:

- The pandemic years saw exports become *the* key driver of the Chinese economy. Foreign trade accounts for over one-third of China's GDP. However, in a worsening external environment, particularly with major trading partners like the US and EU actively pursuing de-risking, external demand is likely to weaken further. It is unlikely that alternative markets or domestic consumption will be able to sufficiently compensate for this.

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In the context of this document, **H1** (first half) refers to the period between January and July 2023, while **Q1** (quarter 1) and **Q2** (quarter 2) refer to the periods January to March 2023, and April to June 2023, respectively.

- The Chinese expectation that the end of the zero-COVID policy would result in unleashing pent-up domestic demand has not borne fruit. Several factors are responsible for weak domestic consumption, such as rising unemployment, increased job insecurity, falling property values, a rising elderly population, etc. Critically, despite the repeated exhortations by the Chinese leadership to boost domestic demand, policies so far have focused on supply-side incentives rather than ensuring that consumers have enough cash in hand to spend.
- The real estate sector bubble is a major risk. The sector accounts for 25-30 percent of China's GDI. A steady slump in housing sales, property prices, and property development investments has exposed the vulnerabilities of overdependence on the sector for economic growth. Despite the easing of credit-raising and mortgage restrictions since November 2022, the sector continues to be plagued with declining investment, excess inventory, falling prices, poor sales, and delayed deliveries.
- All of this impinges on the health of key developers, and thereby on the banking sector. Amid this, the Chinese government has followed a policy of tinkering with incentives at the margins without stepping in with a stimulus package. There is no indication that this approach will change anytime soon. That said, given the Chinese central government's control over the banking and information ecosystems, expectations of a 'Lehman moment' are misplaced.

- The fragility of China's property sector also weighs on the broader economy owing to its linkages with local government debt. Local governments earn around 30 percent of their revenue from land sales. This income has been shrinking. At the same time, their expenditure is rising owing to the requirements of the central leadership's high-quality development agenda. This has worsened the overall situation of local government finances. Local government debt was estimated at US$12.8 trillion, or 76 percent of GDP in 2022. A significant chunk of this is also off-the-books debt. While several measures such as emergency liquidity support, debt extensions and broader stakeholder burden sharing are being considered, addressing this challenge effectively will require changes to China's political economy. This appears unlikely at present, given the increased centralisation under Xi Jinping.
- Foreign direct investment into China expanded during the pandemic years. However, it appears that this trend is beginning to reverse. In H1 2023, FDI went down owing to geopolitical tensions between the US and China, and the continued regulatory uncertainty with regard to foreign firms operating in China. Chinese Premier Li Qiang's repeated entreaties to foreign investors do not appear to have had a significant impact. Increasingly, it appears that foreign investors are looking to 'de-risk' and diversify future investments.

- Finally, it is worth noting that increased Party-state intervention in the market remains one of the biggest challenges for the Chinese economy. Under Xi Jinping, the Party-state has grown increasingly intrusive in a bid to direct capital towards what it views as national and strategic priorities. This industrial policy approach has led to some progress in industrial upgradation, development of core and emerging technologies and green technology and low-carbon development. However, it also bred inefficiencies, wastage and market distortion. State-owned enterprises have been called upon to emerge as "pillars" supporting the agenda to develop an innovation-driven economy. Private capital participation in national projects has been encouraged. But lending to the private sector has remained weak, and so has private investment, which has fallen 0.5 percent from January to July 2023 despite the encouragement.

II. Headwinds Facing the Chinese Economy

Weak Exports Due to Structural Challenges and Geopolitical Tensions

For a long time, China has been described as an export-driven economy. To begin with, China's net exports have had a disproportionately higher contribution to its GDP compared to other major and emerging economies. Secondly, the other two drivers of GDP — investment and government spending — have also been relatively export-oriented as opposed to almost completely driven by domestic consumption. However, Chinese exports have faced strong headwinds lately on account of structural challenges and geopolitical tensions. To put things in perspective, while exports[1] as a share of GDP in China averaged 29.9 percent from 2003-2012, the corresponding figure[2] for the succeeding 10 years (2013-2022) declined by almost 10 percentage points to 20.55 percent.

The structural challenge is the poor recovery of overall global demand. Global trade levels have still not recovered to the pre-2008 mark. Further, protectionist policies have gained traction across the world, forcing countries to look inward. This tendency has been accentuated by the supply chain disruptions witnessed during the pandemic. Within China, rising labour costs have made labour-intensive sectors unattractive. The heightening US-China geopolitical contestation and China's overt willingness to weaponise trade have forced foreign private investors to evaluate options such as de-risking and diversifying away from the second-largest economy. As a result, the 'China+1' strategy is being actively deployed by several firms.

Given these challenges, the growth projections for Chinese exports in the near future look grim, and are unlikely to rebound to the levels achieved during years of China's 9-10 percent GDP growth.

Consequently, there is likely to be greater diversification of Chinese export markets going forward along with an effort to boost domestic consumption. However, it is unlikely that alternative markets or domestic consumption will be able to sufficiently compensate for the loss of demand from markets like the US and EU.

Weak Domestic Consumption

The need to rebalance the economy away from exports has brought domestic consumption into greater focus for the Chinese leadership. China's domestic consumption pattern presents an interesting case. Historically, as compared to other advanced and emerging economies, where domestic demand and household consumption contribute at least more than 70 percent of the GDP, the corresponding figure for China has hovered around 55 percent. The larger-than-usual contribution from exports dwarfed the contribution from domestic consumption.

In this context, several measures have been adopted. These include the pursuit of a 'dual circulation' strategy, steps to address local protectionism, policies to build regional clusters or pursue regional integrated development and an effort to establish a unified national market. These efforts have yielded limited success so far.

Moreover, boosting household consumption's share in the country's GDP is as much a challenge as an opportunity. The imposition of harsh measures under the zero-COVID policy had drastic implications for consumer sentiment. Consequently, consumption as a percentage of GDP has fallen[3] from 54.5 percent in 2021 to 32.8 percent in 2022.

Despite a short spike in pent-up demand after the withdrawal of the zero-COVID policy in December 2022, consumer confidence has remained low, mostly owing to a slump in the real estate sector, which accounts for 70 percent of household wealth, and burgeoning unemployment. Depleting savings and wealth are also linked to the fact that Chinese citizens have their money tied up in corporate bonds. Exposure to the risks faced by the private investment market also means that their disposable income is reduced.

So far, the government's response to support consumption has largely been limited to providing supply-side incentives to boost sales of consumer and household goods, automobiles, electronics, property, and services across sports, leisure, culture, and tourism. The failure to provide demand-side intervention is likely to continue to weigh heavily on consumers.

On this front, at a press briefing organised by China's National Development and Reform Commission (NDRC) in July this year, Jin Xiandong, Director of the Commission's Policy Research Office acknowledged that "*the ongoing economic recovery and development still face challenges such as insufficient demand, weak momentum, weak confidence, and accumulated risks in some areas.*"

Demographic Challenges

After the youth unemployment rate hit a record 21.3 percent in June 2023, National Bureau of Statistics (NBS) spokesperson Fu Linghui said at a press conference[4] in August that the Bureau will stop publishing age group-specific unemployment data, citing the need to "*further improve and optimise labour force survey statistics*." This was an acknowledgment of the challenges facing policymakers. It also means that the push towards expanding domestic consumption will be hindered by low confidence in income stability among young people, and a need to invest in savings for taking care of the rising population of elderly.

Data indicates[5] that the age dependency ratio in China, which is the proportion of the dependents' population (people younger than 15 or older than 64) to the working-age population (those aged 15-64), has risen from 37 percent to 45 percent between 2010 and 2022. As social spending has reduced due to an overall decline in fiscal spending, young people are being coaxed to take care of multiple elderly people on a single income. By 2035, it is likely that 30 percent of China's population (i.e. 400 million people)[6] will be over 60 years of age. Hence, a double whammy will be created as more people become older and fewer young people are able to find jobs.

Real Estate Crisis and the Property Bubble

The property and allied sectors account for 25-30 percent of the country's GDP. Following the 2008 financial crisis, China shifted its monetary policy stance from 'prudent' to 'proactive',[7] and as a result of this, the continued flow of cash stimulus and an emphasis on increasing property ownership led to the rapid expansion of an already heavyweight real estate sector. However, this model led to wasteful expenditure, and speculation, resulting in the creation of an unsustainable bubble. Bursting the property bubble in a contained manner, and tackling speculative practices in this market, have since become regulatory challenges.

The shift in policy began in 2016, when at the Central Economic Work Conference in December, Chinese authorities issued the warning[8] that "homes are for residential use, not speculation." Subsequently, policy measures were adopted to restrict monetary flow into speculative housing purchases. In 2020, the central leadership imposed the 'three red lines' regulations (caps on debt-to-cash, debt-to-assets and debt-to-equity ratios) on the property sector. This resulted in several property developers defaulting on their loans. Property delivery also saw delays. The unraveling of the crisis severely hurt consumer confidence, leading to a slump in housing sales and prices, further compounding the balance sheet problem of the real estate sector.

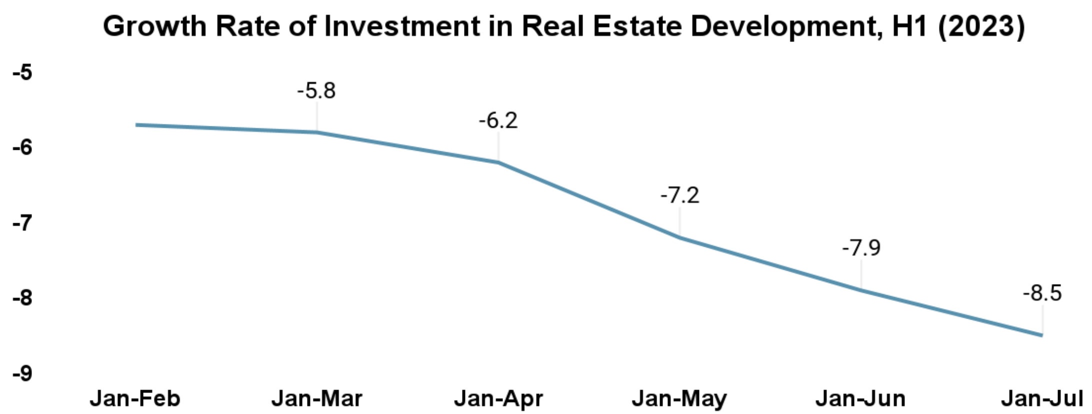
The property sector has the potential to create a fallout in the banking and finance sector due to the large volume of loans invested and the inability of large property developers to repay debt. Evergrande's example indicates that a default on such loans may significantly impact the financial sector and the overall investor sentiment. However, a financial crash is unlikely because of the centrally controlled nature of China's banking sector, as well as the availability of enough liquidity (especially in the form of Forex reserves). The fact that the government is choosing not to go down that route at the moment appears to indicate that it wants to redress the moral hazard that underpins the sector.

Regardless, the problem persists. In August 2023, one of China's largest real estate developers, Country Garden, reported an expected loss of US$7 billion in H1 of 2023.[9] Because of capital crunches imposed by the COVID-19 pandemic, as well as the slump in housing demand amidst dipping savings and rising mortgages (the total household debt in China is about 63.5 percent of the GDP as of Q2),[10] the over-leveraged property sector has been forced to deleverage, leading to defaults on both debt and unfinished projects.

Moreover, according to NBS' July statistics,[11] overall housing prices decreased by 0.2 percent month on month. Additionally, 50 of the 70 cities tracked by the NBS recorded a decline in home prices in July compared to 31 in June.

Prices of second-hand homes rose in only six cities. Furthermore, overall investment in real estate development as of July 2023 fell to 8.5 percent YoY, i.e., 6.77 trillion yuan (US$ 943.5 billion). New home sales also declined 19 percent YoY in July.

In terms of the government's policy response, the readout of the Politburo meeting[12] from July 2023 argued that because of "*great changes in the relationship between supply and demand in China's real estate market,*" there is a need to pursue targeted policy measures. These call for the formulation of city-wise policies to improve housing conditions, transformation and use of idle properties, and greater efforts to deliver affordable housing. However, it remains to be seen if the central government stays the course of this approach.



Source: National Bureau of Statistics of China

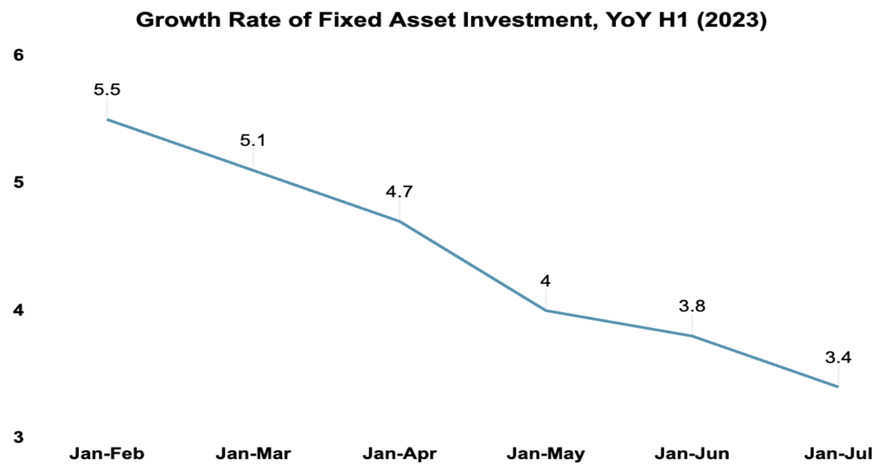
Local Government Debt

China's Local government debt situation is a structural issue intricately linked to the real estate sector crisis. Since the rapid expansion of the real estate sector began taking place in the country, the local governments' earned their maximum revenue (over 30 percent, as of 2021)[13] from their share of land sales. The crisis in the property sector has impacted this figure, and increased spending during the COVID years has stretched their finances further. By the end of 2022, total local government debt was estimated at US$12.7 trillion.

The outstanding, off-the-book debt accumulated by local governments stood at 35 trillion yuan (US$5.1 trillion) according to the Ministry of Finance.[14] Moreover, according to the IMF, debt from Local Government Financial Vehicles (LGFVs) amounted to 66 trillion yuan (US$9 trillion) at the end of 2022. Together, the cumulative debt represents around 74 percent of the national GDP.

Now, as property sector firms are defaulting, so are local governments. Local governments are charged with responsibility for delivering on infrastructure development projects such as schools, bridges, rail networks, and hospitals, and the lack of revenue[15] means defaulting on such commitments. Moreover, because 20-25 percent of all bank loans[16] go into financing LGFVs, the local government debt crisis can cause a major fallout in the banking sector as well.

And because local governments are central to the country's investment-led growth, domestic private investors have significant exposure to LGFVs. This means that if local governments default on the repayment of corporate loans, investment is likely to continue to decline. On the issue of local government debt, the July Politburo meeting suggested the formulation and implementation of a "package of debt-clearing plans." Subsequently, in August, some measures[17] to allow local governments to raise about 1 trillion yuan (US$ 137 billion) from the sale of bonds were put in place. While several further measures such as emergency liquidity support, debt extensions, and broader stakeholder burden sharing are being considered, addressing this challenge effectively will require changes to China's political economy. This appears unlikely at present, given the increased centralisation under Xi Jinping.



Source: National Bureau of Statistics of China

Foreign Investor Confidence

Reports from both the EU and American Chambers of Commerce in China indicate a significant decline in the confidence of businesses operating in the country. The EU Cham Business Confidence Survey,[18] released in June 2023, revealed that 30 percent of European companies operating out of China have declared revenue losses YoY, while 64 percent of the businesses (highest on record) have reported that doing business in the country has become more challenging in the past year. A similar sentiment has been conveyed by the AmCham Business Climate Survey Report[19] released in March 2023. Moreover, media reports suggest[20] that many global asset managers have dumped Chinese onshore assets worth close to US$1 trillion in recent weeks as a sign of loss of confidence in the Chinese growth outlook.

In the specific context of the US, tech restrictions and export controls against China have led to a significant decline in American FDI and venture capital investment into the country. Rhodium Group reported[21] that in 2022, US FDI in China was valued at US$8 billion – the lowest figure since 2005, while venture capital investment went from US$19 billion pre-COVID (2018) to a mere US$1 billion last year. This weakness is likely to persist, and even though investment from some European countries into China has expanded, the EU de-risking strategy is attempting to reduce vulnerabilities against China through similar means.

III. Annex: Data Points

Gross Domestic Product

- In July, the Chinese National Bureau of Statistics (NBS) released data[22] pertaining to the performance of the country's economy in the first half (H1) of the year 2023. It declared that in H1, the GDP growth rate was 5.5 percent year-on-year, as compared to 3 percent for the entire 2022 and 4.5 percent in Q1 (2023).
- The 5.5 percent figure must be seen in light of the strong base effect, when compared to 2022. China's GDP growth rate in Q2 was up by 6.3 percent YoY, well below the estimated number of 7.1 percent. Moreover, the Q1 to Q2 comparison of GDP growth indicates that there was only a 0.8 percent increase.
- Further, China's slowing growth is significant for the global economy. As per International Monetary Fund (IMF) forecasts, China is likely to influence global economic growth the most in the period between 2023 and 2028, representing 22.3 percent of the growth – double that of the United States (11.3 percent).

Consumption and Retail Sales

- NBS declared that retail sales of consumer goods were up by 8.2 percent YoY, and the contribution rate of final consumption expenditure to GDP growth was 77.2 percent.
- The Bloomberg report added that in June itself, China's retail sales went up by 3.1 percent, and industrial output by 4.4 percent, both year-on-year.
- In H1, residential property sales rose by 3.7 percent YoY.

Investments

- An NBS report highlighted[23] that in H1, fixed asset investment went up by 3.4 percent YoY, of which infrastructure investment and manufacturing investment went up by 7.2 percent and 6 percent, respectively.
- Further, it declared that even though overall fixed asset investment increased, that by private companies went down by 0.5 percent YoY.

- The secondary industry (manufacturing) saw the highest increase in investment of 8.5 percent YoY, compared with just 0.9 percent in the primary industries and 1.2 percent in the tertiary industries.

- Further, NBS highlighted in another report[24] that in H1, even though property sales went up (as highlighted above), the property development investment went down by 7.9 percent YoY, deepening consistently since the -5.7 percent figure recorded in February 2023.

Local Government Debt

- First, the sales of local governments[25] from land revenue declined by 20.9 percent in June 2023, YoY. This decline has continued since February 2022.
- Debt of over 60 percent of the Chinese provinces has crossed the global benchmark for local government debt (which is around 50 percent of local GDP). IMF projects provincial governments' debt raised from Local Government Financing Vehicles (LGFVs)[26] to reach US$ 9 trillion in 2023.
- Provinces such as Sichuan, Zhejiang and Tianjin have an LGFV debt close to/over 100 percent of provincial GDP.

Foreign Trade and Investment

- The General Administration of Customs of China (GACC) has released data[27] on Foreign Trade (in USD). It declares that Year-on-Year, as of July 2023, there has been a 14.5 percent decline in total exports.
- ChinaDaily also reported[28] that in H1, in dollar terms, foreign trade has gone down by 4.7 percent YoY, and is valued at US$ 2.92 trillion.
- Caixin reported[29] that China's net FDI (US$ 4.9 billion) came down 87 percent YoY and 76 percent quarter-on-quarter.

Demographic Data

- In June, the 'jobless youth rate' (unemployment among urban residents aged 16-24) reached a record high of 21.3 percent, month-on-month. Adding on to reducing incomes is the burden of taking care of an ageing population.
- China's age dependency ratio, which accounts for the proportion of the dependents' population (people younger than 15 or older than 64) to the working-age population (those aged 15-64), has risen from 37 percent to 45 percent[30] between 2010 and 2022.

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