Research Institute - Insight

12 September 2023

8:13 minute read

#China / #Growth / #Forecast

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China forecast deep dive: peering through the fog

A difficult adjustment in real estate is likely to remain a headwind to growth for the rest of this year and during 2024, although policy will ease further. We do not fully subscribe to the recent bout of China pessimism, which is now overblown.

Key Takeaways

- Chinese economic data continue to fall short of consensus expectations across a range of key indicators, while high profile troubles in the property and 'shadow banking' sectors have increased the risks of a more serious downturn.
- Indeed, we expect structural headwinds, particularly from the real estate sector, to weigh on growth through to 2025.
- In particular, property weakness is likely to keep the stock of excess household savings unspent. But a normalisation of the savings rate – which is yet to return to pre-pandemic norms – should still provide some support to growth.
- The plethora of incremental policy easing has pushed financial conditions into moderately accommodative territory, implying that policy should start to gain traction and guard against worse outcomes. But a continued focus on de-risking and self-sufficiency means additional stimulus will remain piecemeal and may struggle to change sentiment.
- We recently trimmed our 2023 GDP forecast to 4.9% (-0.2pp) and now expect that growth for 2024 will fall short of consensus expectations (4% vs 4.5%), even as we factor in further policy loosening and a milder US recession. But 'Japanification' fears are wide of the mark.
- Both downside and upside risks around this baseline have risen. By keeping the policy response too tentative, de-risking could spark the crisis it seeks to avoid. On the other hand, a more forceful policy response could unlock the 'coiled spring' of excess savings and lead to a growth surge.

Fears of a China hard landing have intensified

Pessimistic commentary on China is in vogue. A laundry list of interrelated fears includes: deflation, pressures in the real estate sector, falling exports, consumers' unwillingness to spend, high youth unemployment, stress in 'shadow banks', the state of local government finances, geopolitical tensions and a minimalist approach to policy support.

The re-opening rebound has certainly faded much faster than we had hoped (see Figure 1), leading us to mark down of our 2023 GDP forecast over the past few months.

Figure 1: Our China Activity Indicator backs up the picture of a slowdown painted by the official data

Source: abrdn, Haver, Refinitiv, September 2023

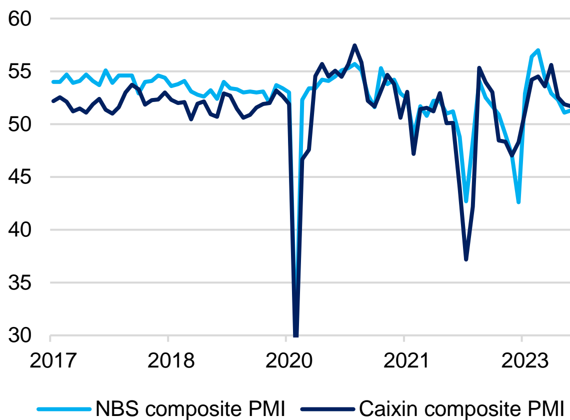
Weak activity prints in July mean that we now expect fairly soft sequential growth in Q3 (~0.6% q/q). Moreover, troubles in the property and 'shadow banking' sectors have

led to concerns that these issues could signal a much deeper malaise.

But there are several reasons why we don't expect a recession to unfold, and why there could actually be *upside* risks around our very near-term growth forecasts.

First, industry was temporarily depressed by adverse weather in July and manufacturing PMIs recovered in August, which was enough to stabilise the composite indices (see Figure 2). A simple mapping from the Caixin PMI to GDP could point to growth of more like 1.2% q/q in Q3.

Figure 2: Composite PMIs stabilised in August, casting some doubt on the most pessimistic views



Source: abrdn, Haver, September 2023

Second, high frequency gauges of travel, such as subway traffic and the Baidu migration index, imply an improvement in August.

Third, exports and imports data continue to imply a fairly tough external environment, but our seasonally-adjusted volumes estimates suggest trade will only be a modest drag on Q3.

There is however some risk that global trade moderates more abruptly. APAC trade values are still 25% higher than pre-pandemic levels, even if they are down 10-15ppts from their peaks (see Figure 3).

Figure 3: The external environment remains tough, but is likely only a small drag going forward

*APAC ex. trade data comprised of: India, Indonesia, Korea, Japan, Malaysia, Philippines, Singapore, Thailand, Vietnam, and Australia.

Source: abrdn, Haver, September 2023

Consumption and real estate are key to our forecasts

The Chinese consumption recovery still has room to run. The household saving rate only declined by 0.8pp in Q2, and at 31.8% it is still 1 to 1.5 percentage points above its steady state. This implies households are still accruing excess savings, which could be drawn down if confidence returns.

But for now, the People's Bank of China's (PBOC) Q2 surveys on household income and employment do not point to a quick normalisation in the saving rate, let alone a tapping of excess savings built up over the pandemic (see Figure 4).

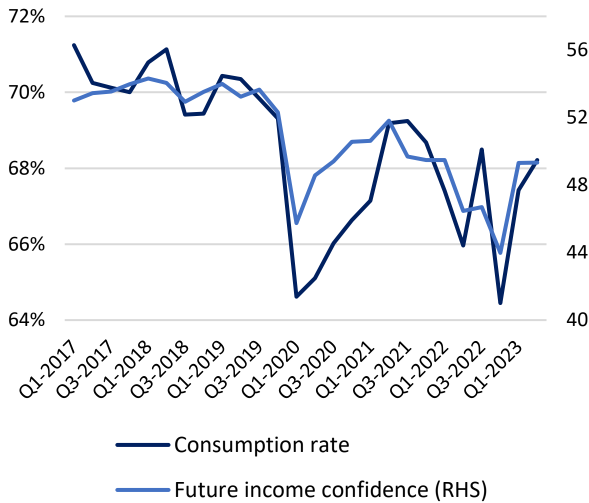
Our forecast is not reliant on 'excess savings' being tapped, but we do assume that the saving rate heads back towards its pre-pandemic level over the next 4 quarters.

There is a risk that the saving rate has been permanently shifted higher by the experience of living through zero-Covid. Households (particularly the self-employed) may want to save even more to insure against a less benign world with a greater number of negative shocks.

On the other hand, while it is difficult to be confident that the authorities will unveil a policy proposal robust enough to unleash household confidence, excess savings remain a route to an upside surprise.

If half of the excess savings pile is spent by end-2024, consumption growth could accelerate from 11% this year to 12.5% next year, rather than easing from 10% to 8% per our baseline forecasts.

Figure 4: The 'coiled spring' of excess savings remains elusive



Source: abrdn, Haver, September 2023

Dude, where's my house?

Cautious household sentiment undoubtedly reflects ongoing stress and uncertainties within property, including the ability of developers to deliver on pre-sold homes.

Key housing metrics continue to slide and the pipeline of housing activity has not been this weak since 2009.

Continued falls in house prices and the trouble at a major developer may keep buyers out of the market in the near-term, even as purchase restrictions are eased and mortgage rates are pushed lower.

This raises two related questions: i) how much further has the pipeline of activity got to fall?; and ii) what impact has this had, and is still to have, on growth?

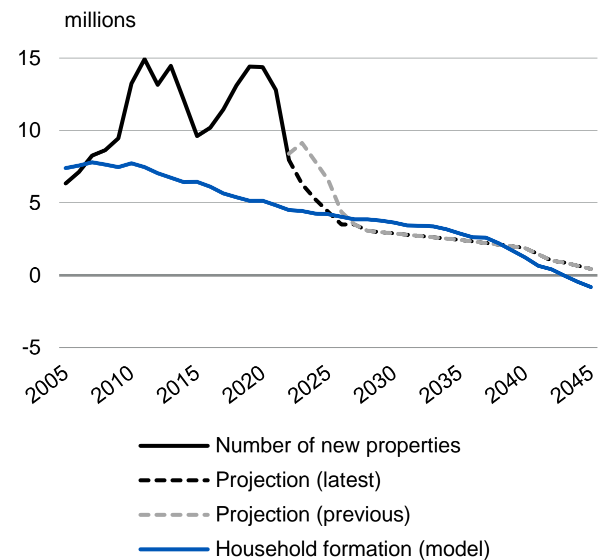
We do not believe that China's shrinking population or the rapid pace of housing construction signal an impending collapse in underlying demand. Urbanisation still has room to run, upgrading needs remain, and a lack of alternative saving vehicles could sustain a high rate of vacancies.

That said, our estimated sustainable household formation run-rate of 4 million additional households per year is a marked step down from the scale of housebuilding over the past decade.

There is no blueprint to indicate what the authorities want to achieve for the homebuilding sector, or what they judge to be a sustainable run-rate that mitigates the long-run risks of almost 20 years of unrestrained building. But we are increasingly of the view that a more abrupt adjustment – which leaves the sector dominated by state-owned developers – is underway.

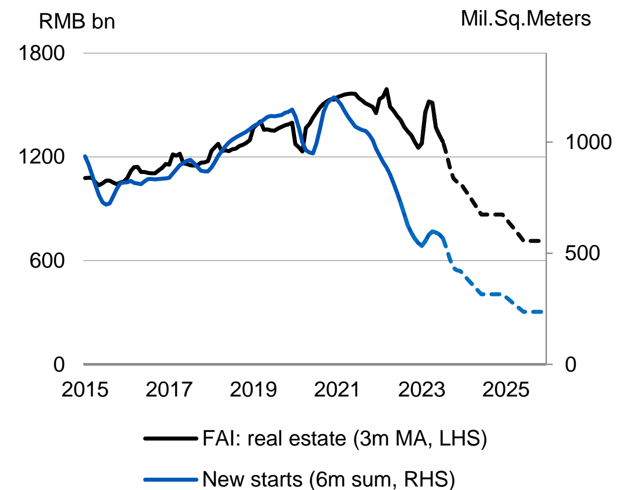
If correct, this implies that new builds are likely to fall by a further third (see Figure 5). The impact on growth is only half way through given the potential lag from the new build pipeline to residential investment and the wider economy (see Figure 6).

Figure 5: Property potentially faces a tough adjustment to get housing starts back to a sustainable level



Source: abrdn, Haver, September 2023

Figure 6: Our best guess is that the shock from real estate is only half way through



Source: abrdn, Haver, September 2023

This adjustment will weigh on potential growth, implying that growth in 2024 is likely to be below consensus (4% vs 4.5%), even as we factor in further policy loosening and a milder US recession.

Japanification fears are overdone

Struggles in the property sector and negative headline inflation in July have raised the spectre of 'Japanification'.

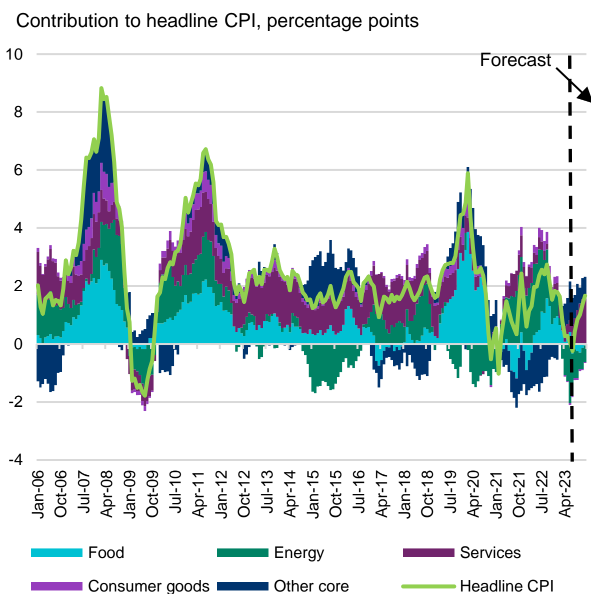
Deflation becoming engrained could be very damaging. If inflation and inflation expectations turn negative, real rates would rise, weighing on economic growth. This could set the

stage for a balance sheet recession in which the state struggles to offset a private sector retrenchment.

The CCP policy bias for supply-side stimulus makes this a long-term risk which is hard to fully discount, and a balance sheet recession is an alternative scenario we formally consider. But there are good reasons to think these fears are overblown.

First, falling food prices and energy base effects account for much of CPI deflation. Core inflation is rising, even if it remains consistent with an economy running below potential. The fading of the energy base effect should push headline inflation back towards 1% y/y by the end of this year (see Figure 7).

Figure 7: July's dip into deflation should prove short-lived, but supply-side policy bias raises future risks



Source: Bloomberg, Haver, abrdn, September 2023

Second, balance sheet recession dynamics are harder to motivate in China's case, absent a very severe and persistent slowdown. Real interest rates should remain below real growth rates. And even though we have marked down potential growth due to the difficult real estate adjustment, we maintain our relative optimism about China's long-term prospects. China should still become the world's largest economy by around 2035.

Policy easing is still gaining traction, while further action should guard against recession

While it is difficult to have confidence that the plethora of incremental policy loosening (see Figure 8) undertaken by the authorities is enough to drive growth materially higher and turn market confidence, we think that enough has been done to push financial conditions into a position of modest accommodation (see Figure 9).

Figure 8: Policy tracker (non-exhaustive)

Time	Policy
Aug-22	-10bp 7-day repo and MLF
Aug-22	RMB 300bn policy bank loan extension
Aug-22	RMB 500bn local government special bonds extension
Sep-22	-200bp FX RRR
Nov-22	Six largest banks ordered to provide RMB 600bn to help finance mortgages and support developers
Nov-22	Cross-border macro-prudential leverage ratio raised to 1.25 from 1
Mar-23	25bp RRR cut
Jun-23	-10bp 7-day repo and MLF
Jun-23	RMB 200bn increase in PBOC's relending and rediscounting to support SMEs
Jul-23	'Urban villages' renovation plan announced
Jul-23	Tax exemption for electric vehicles extended until 2027
Aug-23	-10bp 7-day repo and -15bp MLF
Aug-23	Speeding up of local government bond issuance
Aug-23	MOF extends tax relief for SMEs to end-2027
Sep-23	RMB 1000 tax break on child and elderly care.
Sep-23	Banks pressed to cut existing mortgage rates.
Sep-23	Property downpayments cut and first time buyer classification changed.
Sep-23	-200bp FX RRR

Source: abrdn, September 2023

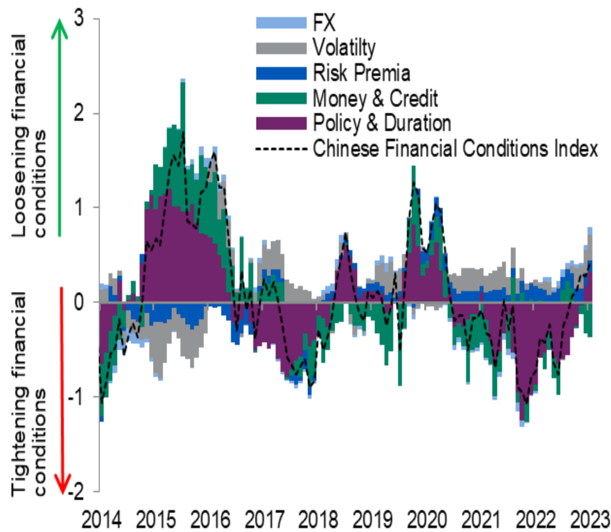
Indeed, there is some risk of being too dismissive of the cumulative policy easing, and our modelling implies that there could be an eight month lag between an easing in financial conditions and the pass through to activity.

But even if policy easing may be yet to work its way through, overall our financial conditions index backs up the assertion that policy easing remains cautious and incremental, likely falling short relative to the headwinds facing the economy. It is clear that easing to date remains well short of previous policy cycles (again, see Figure 9).

Moreover, even if further easing is widely expected (we expect another 20bps reduction in the 7-day repo rate, augmented by -50bps to the RRR), the desire to hold the line on de-risking and bolster domestic resilience while

tensions with the US remain front and centre are strong reasons why we don't anticipate a 'big bang' stimulus. Nor should we expect a clear roadmap for resolving stress in the property sector any time soon.

Figure 9: Financial conditions are in accommodative territory and should ease further in coming months



Source: Bloomberg, Haver, abrdn, September 2023

Conclusion

We think 2023 growth will be around the authorities' 5% target. Given favourable base effects from 2022's weak outturn, only relatively modest sequential growth is needed over H2 to get close to target.

We then expect growth to ease to a below consensus 4% for 2024, mainly reflecting the hit to potential growth from the real estate adjustment, but also the spillover from a mild US recession.

More adverse outcomes are limited by our expectation that policy makers will ease further and have already pushed financial conditions into a position of modest accommodation.

That said, there are two-way risks. De-risking remains a major challenge and by keeping policy too piecemeal could spark the crisis it seeks to avoid. On the other hand, weak growth could cause a more forceful policy response and with it release the 'coiled spring' of excess savings. As such, we judge that both downside and upside risks have risen.

China forecasts:

	2022	2023	2024	2025
Official GDP (%)	3.1%	4.9%	4.0%	4.7%
CPI (%)	2.0%	0.7%	2.2%	2.4%
Policy Rate* (%)	2.0%	1.6%	1.4%	1.5%

*7 day reverse repo. Broader policy stance captured by CFCI.

Source: abrdn, September 2023

Forecasts are offered as opinion and are not reflective of potential performance.
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AA-140923-168283-27