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PICTET WEALTH MANAGEMENT

China: 2024 macro outlook

Moderate recovery on continued policy support

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FLASH NOTE

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SUMMARY

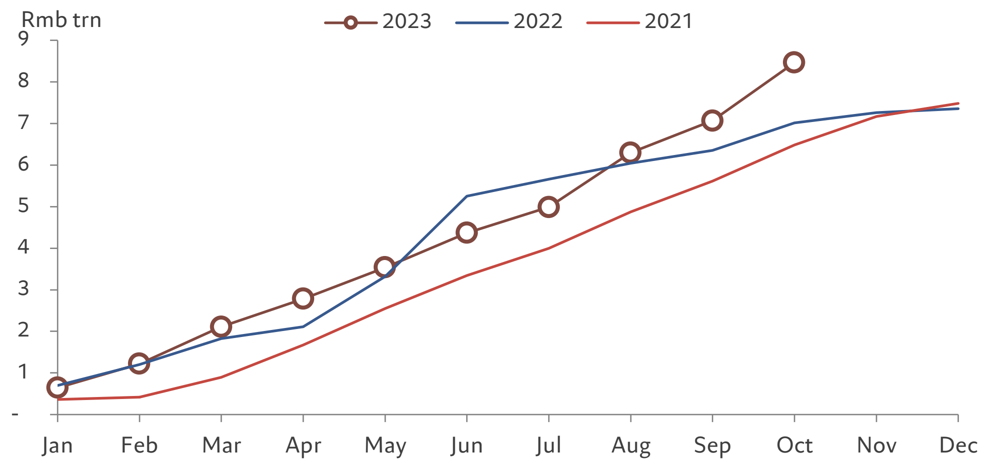
- We expect a moderate recovery in the Chinese economy to extend into 2024 as recently beefed-up government policy support will likely continue.
- The property sector will likely remain a drag on growth, although to a lesser extent than before. More financial support to developers is needed to stabilise the sector, but some recently announced measures seem to point in the right direction.
- Fiscal stimulus will likely play a key role in supporting growth in 2024. In addition to maintaining a relatively large fiscal deficit target, addressing the financial stress facing many local governments is another important task for policy makers.
- With continued policy stimulus and a possible moderate improvement in the property sector, China may pull itself out of deflation in 2024. Reflation in the industrial sector will be key.
- There are three risks to our central scenario: policy that remains behind the curve, a severe global deceleration and a resurgence in US-China tensions.

MODERATE RECOVERY TO CONTINUE

China's post-covid recovery in 2023 turned out to be a disappointment, as the property sector's hard landing not only threw many developers into distress, but also hurt employment and greatly damaged consumer confidence.

The authorities' policy support has only started to pick up strength in earnest since the end of August. A series of measures aimed at boosting property demand was first introduced, followed by much stronger fiscal stimulus to support infrastructure growth. For example, the pace of local government bond issuance has risen sharply since August and has surpassed the level reached in 2022 (*see chart 1*). In addition, the Chinese government has taken the rare decision to increase its fiscal deficit by Rmb1 trn through the issuance of special Chinese government bonds. The step-up in policy support led to a notable improvement in growth momentum in Q3, when annual GDP (4.9%) exceeded consensus forecasts.

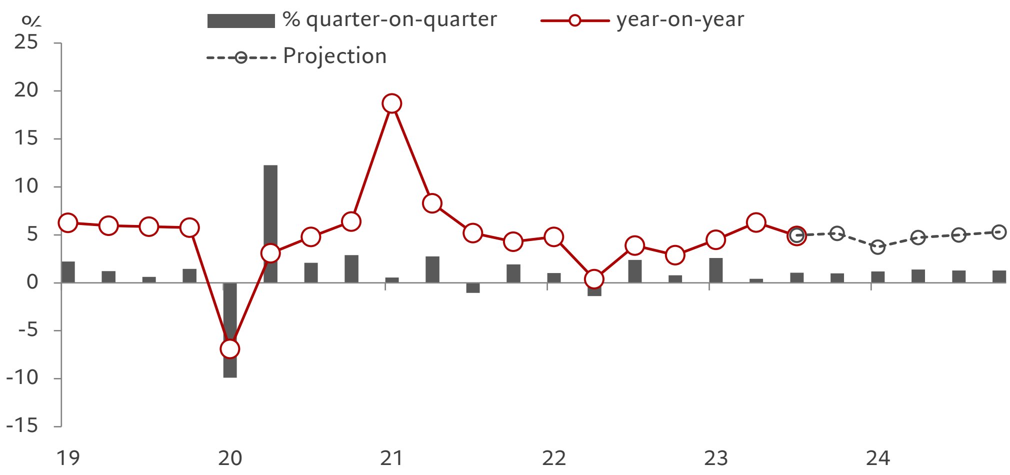
Chart 1: Cumulative local government bond issuance in China: 2021-2023



Source: Pictet Wealth Management, Wind, 7 December 2023

We expect a moderate recovery to extend into 2024, but it could be bumpy. Our full-year GDP forecast for 2024 stands at 4.7%, down from the expected 5.2% in 2023 (*see chart 2*).

Chart 2: Growth in Chinese real GDP, including Pictet's forecast



Source: Pictet Wealth Management, National Bureau of Statistics of China, 7 December 2023

PROPERTY SECTOR TO BE LESS OF A DRAG

The property sector will likely remain a drag on growth in 2024, but to a less extent than this year. In our view, the downturn in the housing sector is structural, reflecting the shifting balance between demand and supply as the Chinese population peaks and the pace of urbanisation slows. But the lack of confidence among

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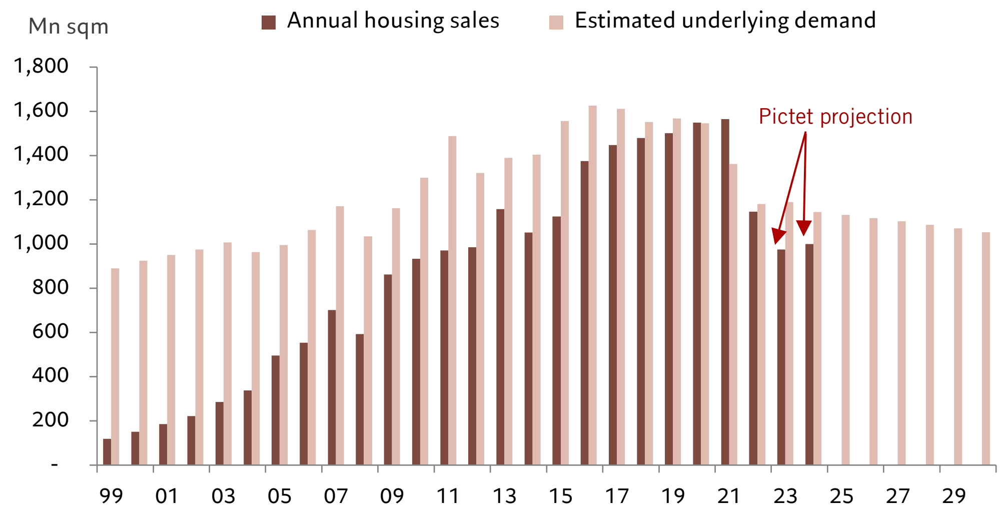
potential home buyers has exacerbated the current downturn, with home sales in 2023 falling significantly below real underlying demand, according to our estimate (*see chart 3*). Hence, more policy measures aimed at boosting confidence are still needed. A move to encourage banks to provide more credit support to selected developers points in the right direction on this score.

Chart 3: Housing sales and estimated underlying demand in China



Source: Pictet Wealth Management, National Bureau of Statistics of China, 7 December 2023

In our base-case scenario, we expect a small rebound in housing sales in 2024. New project starts may not increase but might at least stop declining further. Total property investment could improve moderately as more stalled projects resume thanks to policy-induced financial support.

As we elaborated in an earlier publication (*China: fear of systemic risks and equity outlook*), we still do not expect the housing crisis to cause systemic risks in the financial sector, although it surely dampens the earnings outlook of many related corporates, including banks.

FISCAL SUPPORT IS THE KEY

We expect fiscal stimulus to continue to play an important role in supporting growth in 2024. At the central government level, the fiscal deficit target will likely stay at around the same high level as in 2023, about 3.8% of GDP. However, to address the on-going debt problem at the local government level arguably is more important to boost growth outlook in the near term than the headline deficit level.

The pandemic hit Chinese local governments' revenue hard. Land sales and home sales again plummeted in 2023, putting local governments under tremendous financial pressure. They have had to cut back on their traditional responsibility for infrastructure investment, and in some extreme cases day-to-day spending has had to be reduced.

This effective tightening of fiscal conditions contributed to the weakness of the Chinese economy in the first half of 2023. But starting in Q3, the central government started to address financial stress at local governments seriously. For example,

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about Rmb1.5 trn of special refinancing local government bonds were issued to swap out the "hidden debt" borne by some local government financing vehicles (LGFVs). The debt swap reduces their funding costs by half and extends the maturity of their debt by three to five years on average.

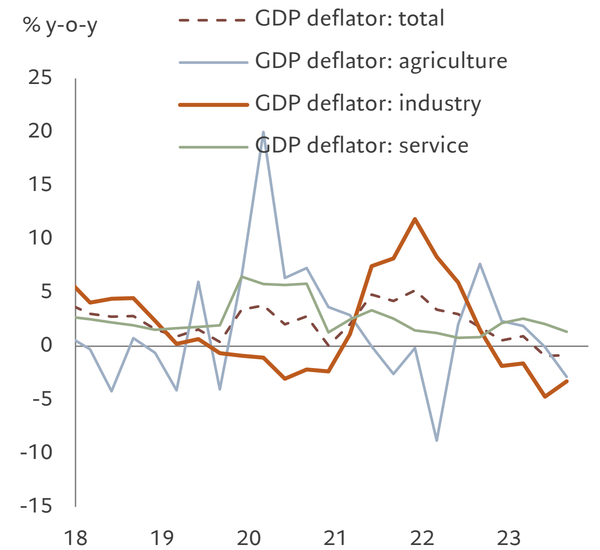
Following the call to establish a long-term mechanism for controlling local government debt risk during the Central Financial Work Conference at the end of October, efforts to deal with the local government debt problem will likely continue in 2024. We could see various forms of debt restructuring, including more debt swaps, asset sales by local governments or outright loan extensions. While fully addressing this problem will take years, alleviating local governments' financial stress could enable them to play a role in promoting growth again in 2024.

To accommodate the increase in government bond issuance, the People's Bank of China (PBoC) will likely maintain an accommodative policy stance by providing ample supplies of liquidity. We expect at least one 25bps cut in banks' required reserve ratio (RRR) in 2024, possibly in the first half of the year, and we cannot rule out the possibility of rate cuts as well.

A MODERATE REFLATON TO UNFOLD

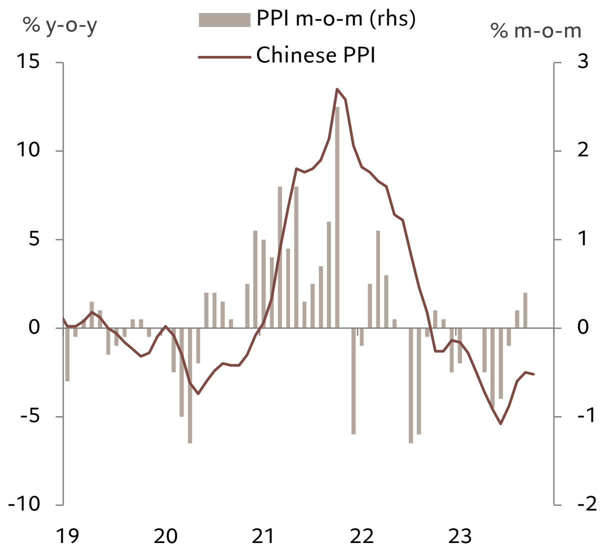
In sharp contrast to the fight against inflation that has occupied much of the rest of the world, China suffered deflation in 2023 due to weak domestic demand. China's GDP deflator sank into negative territory in Q2 2023 and continued to contract in Q3, despite some minor improvement. Deflation was most serious in the industrial sector, where prices dropped by 4.7% y-o-y in Q2 before improving slightly to -3.3% in Q3. Price changes in the services sector have been positive, but insufficient to offset negative momentum in the industrial and the agricultural sectors (*see chart 4A*).

Chart 4A: Chinese GDP deflator by sector



Source: Pictet Wealth Management, National Bureau of Statistics of China, 7 December 2023

Chart 4B: Changes in Chinese PPI



Source: Pictet Wealth Management, National Bureau of Statistics of China, 7 December 2023

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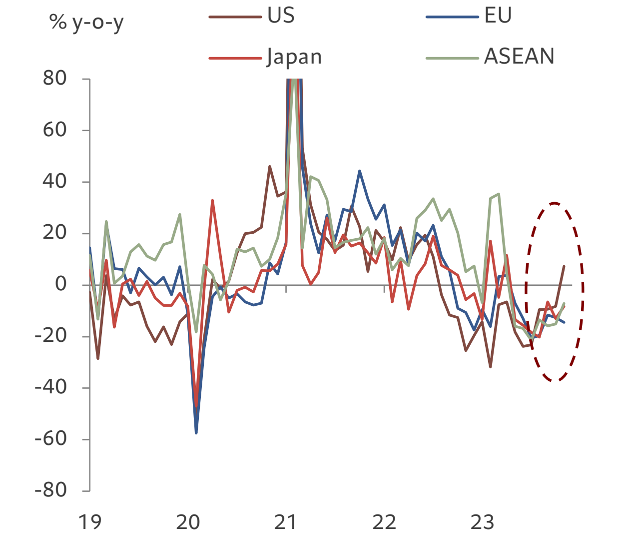
There are signs that industrial prices may have troughed, as indicated by the producer price index (PPI, *see chart 4B*). The government's continued policy support is essential to boost industrial demand through sustained infrastructure investment. A moderate improvement in housing construction could also add demand on the industrial front.

Chinese exports declined sharply in 2023 as consumers in the developed world shifted their spending from goods to services. While the global economy may decelerate further, the worst may be over for Chinese exports, which have shown some signs of stabilisation in recent months (*see chart 5A* and *chart 5B*). Hence, in 2024 we expect net exports to cease being a drag on growth and a contributor to deflation.

Chart 5A: Chinese exports and imports (value in USD)

Source: Pictet Wealth Management, China Customs, 7 December 2023

Chart 5B: Growth in Chinese exports by major destination



Source: Pictet Wealth Management, China Customs, 7 December 2023

WHAT ARE THE RISKS?

In our view, the biggest risk to our benign scenario of a moderate recovery in 2024 is that policy making remains behind the curve. Partly due to intensifying US-China strategic competition, national security issues have been elevated in China to a level unseen in the past three decades. So-called 'common prosperity', green development and curbing financial risks are other top priorities for the government. The era of a single-minded pursuit of economic growth has gone. Given the multiple, and sometimes conflicting, objectives, policy making may slow and become less effective.

A global deceleration that turns out to be more severe than we currently expect is another risk. For the time being, we expect only a mild recession in the US in H1 and we think the euro zone will skirt one in 2024. But an unexpectedly weak global economy could add more pressure on China's export sector and hurt the reflationary process.

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Last but not least, geopolitical risks cannot be ignored. Although US-China tensions seem to have subsided somewhat since the meeting between President Biden and President Xi in November, there are plenty of flash points. Taiwan's presidential election in early 2024 and the US presidential election at the end of next year could both be disruptive. Such risks will likely limit foreign investors' interest in China, both in terms of direct investment and portfolio inflows.

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