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What's wrong with China's post-covid recovery and how to deal with it?

Measured policy support means recovery could take even longer

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FLASH NOTE

SUMMARY

- After a strong but brief rebound following the lifting of covid restrictions at the end of 2022, the Chinese economy lost momentum again in Q2. Soft domestic demand is the main reason and waning global demand has also contributed to the weakness.
- Several policy shocks that happened in the three years since 2020 have caused great damage to the economy. Among these, the slump in the property sector has likely had the greatest impact.
- While we expect the Chinese government and the central bank to provide more policy support in the coming months, the measures will likely be targeted and delivered in a piecemeal manner and be of modest magnitude.
- Hence, the trajectory of China's post-covid recovery will likely be even flatter and longer than we had earlier expected.

A REBOUND THAT SPLUTTERS

Following the sudden lifting of covid restrictions at the end of 2022, the Chinese economy had a strong rebound in early 2023. However, growth momentum quickly lost steam after the initial surge. Manufacturing PMI dropped into contraction territory again in April, along with a broad-based weakening of most economic indicators in the following months.

The recently released GDP figures for Q2 confirm the sharp loss of velocity. According to the National Bureau of Statistics of China, the economy expanded by 6.3% year-over-year (y-o-y) in the second quarter. The seemingly high growth rate is mainly due to a low base effect created by the large-scale covid lockdowns in April-May last year, and the growth rate missed the market consensus of 7.1% by a wide margin. On a sequential basis, the Chinese economy expanded by only 0.8%

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quarter-over-quarter (q-o-q, after seasonally adjustment) in Q2, significantly slower than the 2.7% growth recorded in Q1.

At the same time, inflation in China is dropping quickly and approaching deflation territory, in contrast with the rest of the world where higher prices remain a concern. In the month of June, headline inflation hit 0.0% and PPI inflation reached -5.4%, the lowest reading since end-2015.

WHY DID CHINA'S RECOVERY LOSE MOMENTUM SO FAST?

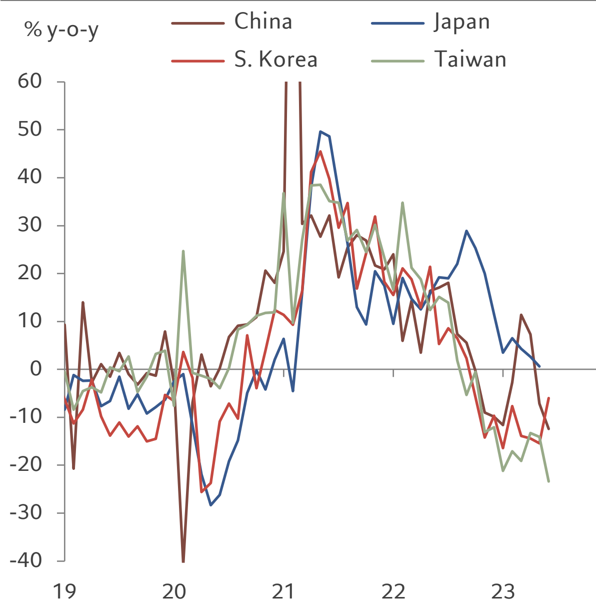
An intriguing question is "why?" After all, almost every country in the world has experienced a post-covid rebound, but why did the recovery in China lose momentum so quickly, when there is obviously still a lot of slack in the economy (as shown by weak inflation)?

Waning global demand is one reason. As many economies reopened from covid restrictions, consumption generally has turned from physical goods to services, leading to a decline in demand for Chinese goods.

But waning global demand is not unique to China. Many Asian exporters have experienced a similar slump in export growth (Chart 1A), but in most of these economies domestic recovery continues to unfold. For example, among the four north Asian economies, only Japan still lags behind China in nominal retail sales, while South Korea and Taiwan have taken a lead by a wide margin (Chart 1B). In our view, **China's weakness is not mainly export-led, but instead lies more in its soft domestic demand.**

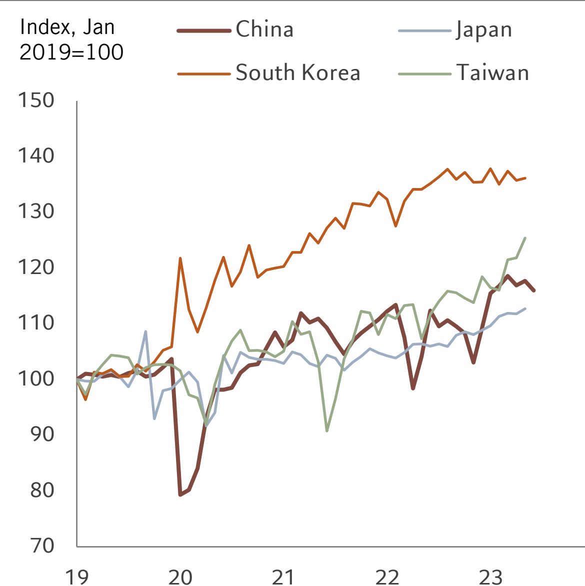
Then what are the reasons behind China's weak domestic demand?

Chart 1A: Growth in exports of selected Asian economies



Source: Pictet Wealth Management, Bloomberg Financial LP, July 2023

Chart 1B: Retail sales in selected Asian economies, with seasonal adjustment



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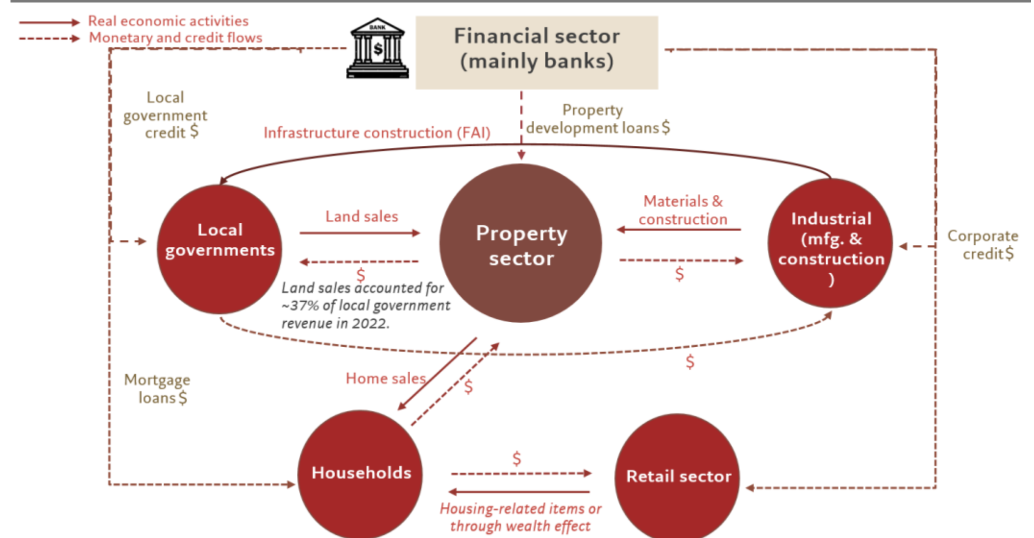
An important point to note is that between 2020 and 2022, covid was not the only shock to hit the economy. In August 2020, the Chinese government imposed new policy guidance on selected property developers to limit their leverage (the so-called "three red lines"). The scope of this policy was widened in 2021 and has since caused significant financial stress in the real estate sector. This eventually led to a sector-wise credit crunch and a hard landing in housing-related activities. In late 2020, the Chinese government launched a regulatory campaign against some large Chinese internet companies, starting with the ecommerce giant Alibaba. In mid-2021, the government issued new policies that cracked down on the private tutoring industry, which basically wiped out the entire sector overnight. In other words, besides covid restrictions, **several other major shocks happened almost simultaneously over the three years since 2020, hitting different parts of the economy**. Hence, **while lifting the covid restrictions was a major positive, it has proven to be insufficient to lead to a sustained rebound of the economy**.

Among these shocks, **the hard landing of the housing sector has probably caused the greatest damage**.

It's hard to overstate the importance of the housing sector to the Chinese economy. While real estate development only accounted for about 7% of Chinese GDP, the overall importance is much larger due to the close connection of this sector to many other parts of the economy. It's widely estimated that property-related activities contributed about 30% of Chinese growth over the past decade.

Essentially, the property sector works as a "credit amplifier" that channels the vast amount of household savings, with leverage through the banking sector (including shadow banking), to other parts of the economy, such as mining and materials in the upstream, and home appliances and various services in the downstream. Local governments also developed a high dependence on the property sector through land sales, which at a point accounted for more than 30% of local public revenue and partly funded the rapid growth in infrastructure investment for many years (Chart 2).

Chart 2: A simple illustration of the Chinese property sector's role in the economy



Source: Pictet Wealth Management. July 2023.

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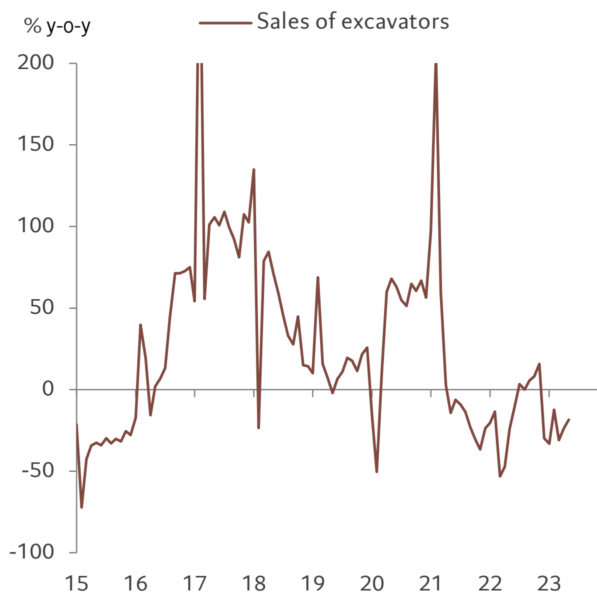
The stringent restrictions on property developers' leverage and the covid-led slump in housing sales eventually led to a hard landing for the property sector in China, staring in late 2021. Housing sales and property investment both dropped by double digits and many developers defaulted on their debt.

The ripple effect is wide and strong and has shown up in various statistics (Chart 3A & 3B).

Chart 3A: Growth in sales of excavators



Source: Pictet Wealth Management, Wind, July 2023

Chart 3B: Growth in output of plate glass

Source: Pictet Wealth Management, Wind, July 2023

There might be good reasons behind the Chinese government's determination to rein in the property sector, such as the change in the long-term demand and supply dynamics in the housing market and concerns about some developers' excessive leverage and so on. But the fact that a main growth engine of a USD18 trillion economy got shut down almost instantaneously obviously caused a lot of damage. Apart from the credit crisis among the real estate developers and bond defaults, it has also led to lost jobs and income, which then hurt consumption. More importantly, the decline in prices for housing, which forms the bulk of Chinese households' assets, has shifted people's expectations and resulted in more precautionary savings. Chinese households have significantly reduced their allocation of income to home purchases since 2021. The current level was not only way below the peak reached in 2021, but also notably below the average between 2009 and 2015, before the last round of housing stimulus (Chart 4A). In the meantime, household bank deposits keep rising, even after more than six months since restrictions were lifted (Chart 4B).

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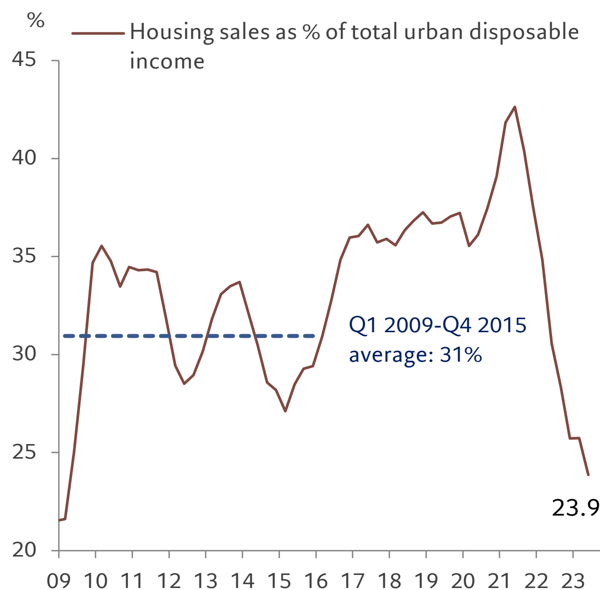
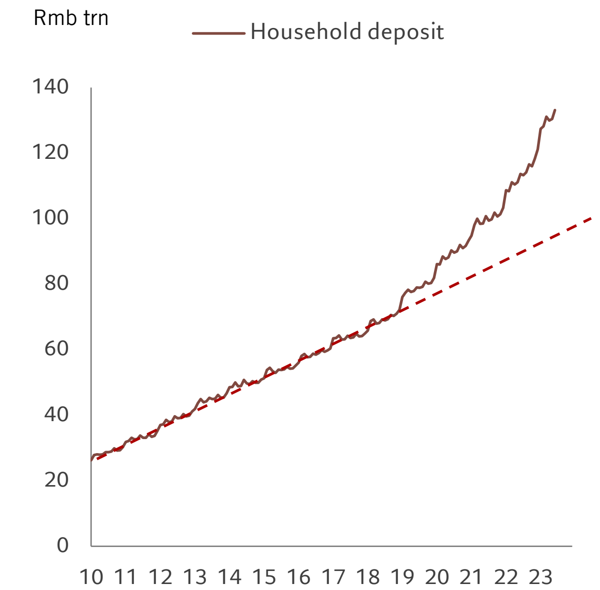
Chart 4A: Housing sales value as % of estimated urban disposable income in China



Source: Pictet Wealth Management, Wind, July 2023

Chart 4B: Chinese household bank deposit and historical trend



Source: Pictet Wealth Management, Wind, July 2023

STIMULUS OR NO STIMULUS? THAT IS THE QUESTION

Conventional wisdom would suggest that in a situation like this, the Chinese government should use strong policy stimulus to jump start the economy, like it did during previous downturns. But it turns out things are not so straightforward this time around.

In the Chinese domestic public forum, views about stimulus are highly divided. While almost everyone agrees more policy support is necessary, people disagree on what kind of policy support should be applied and to what degree.

There are people who believe the government should come up with much more aggressive stimulus as soon as possible to turn around very low confidence levels and to avoid the economy from falling into prolonged deflation, i.e., to avoid the "Japanisation" of the economy. This school of thought refers to the famous "balance sheet recession" theory by Richard Koo, who recently expressed similar views. According to this theory, government should significantly increase fiscal spending to support growth and it is the only way out. The longer the government waits, the more serious the problem.

On the other hand, there are also people who believe that the Chinese government should avoid massive stimulus because of the pursuit for "quality growth", especially due to the concern of ballooning public debt. Indeed, since China's last round of economic stimulus in 2015-16 (again to bail out the troubled property sector), Chinese local government debt rose from about 60% of GDP to an estimated 77% in 2022 (including debt taken by the local government funding vehicles, LGFVs. Chart 5). Basically, strong stimulus is considered harmful and unsustainable in the long term as it will create even bigger problems down the road, according to this school of thought.

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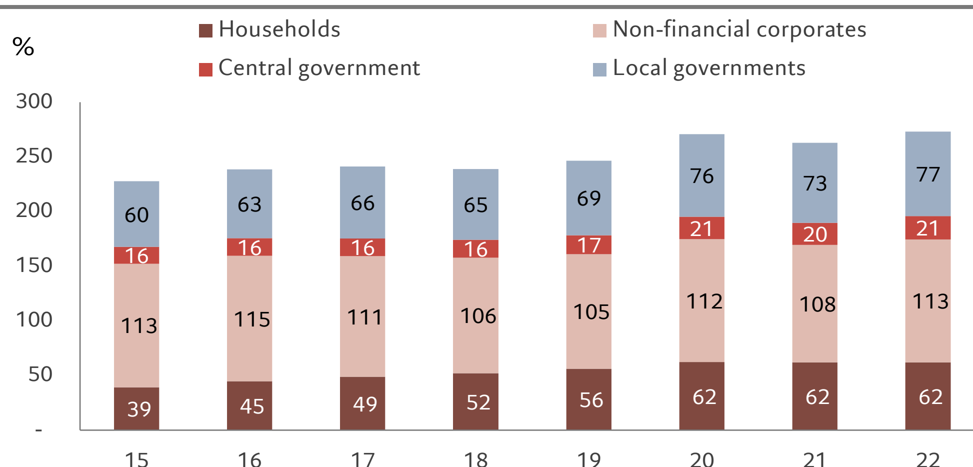
Chart 5: Debt-to-GDP ratios for non-financial sectors in China



Source: Pictet Wealth Management, Wind, July 2023

Our observations suggest that the top decision makers in China may have subscribed to the second school of thoughts, i.e. **to refrain from strong and broad-based stimulus in the near term**. For example, on 6 July, *Qiushi*, a leading political journal by the Chinese Communist Party, published an article on its website entitled "Establish a correct view of government achievements". In this article, the author reiterated President Xi Jinping's speech during the National People's Congress in March that emphasises quality growth and argues against policies that aim at fast growth in the near term at the expense of long-term benefits. The timing of this publication does not look consistent with any imminent large-scale stimulus.

SO WHAT TO EXPECT AHEAD?

To be clear, we still **expect more policy support to come in the near term, but the measures will likely continue to be piecemeal and targeted and of a fairly modest magnitude**. For example, along with the recent 10bps policy rate cut by the People's Bank of China, the government has extended a tax break program for new-energy vehicles until end-2027, and also announced that it would introduce new policy support for "green" home appliances, with details to be released later. Additional easing in the property sector is being considered as well, according to some news report, including measures like removing certain home purchase restrictions in top-tier cities like Beijing and Shanghai.

If policy support indeed remains modest, then it means that **the trajectory of economic recovery in China will likely be even flatter and longer.** We recently revised down our full-year GDP forecast for China in 2023 to 5.2% (from 5.5% previously), which is slightly above the government's target of 5.0%. This reflects the downside surprise in the Q2 GDP figures as well as our expectation of only targeted policy support in the near term.

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