China: Assessing the Economic Challenges

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Highlights

- Expectations had been high for a material surge in China's economy as the country abandoned its restrictive zero-Covid policies at the beginning of 2023, but it now seems likely that Chinese growth will only just match the (relatively low by historical standards) 5% government growth target announced at the beginning of the year.
- Previous economic downturns in China have been met with sizeable stimulus packages. In contrast, this time around there appears to be little appetite from the authorities to deliver the same kind or scale of stimulus.
- Several China experts have suggested that the slowdown in growth is in fact not new, and that the Covid lockdowns merely obscured the wider structural issues facing China. Notably, the political economist Zongyuan Zoe Liu, argues that there are four structural factors that are likely to act as a persistent drag on Chinese economic growth going forward. These can broadly be characterized as weak household demand, high levels of local government debt, demographic changes, and a decoupling between the West and China.
- These longer-term structural factors add fuel to the more immediate fire of a property market liquidity crisis and booming government debt and may make it harder for China to see a return to significantly higher GDP growth rates.
- Developments in the Chinese economy have significant implications for the global economy, both via direct and indirect channels. Work from Banco de España shows that a 1pp reduction in the pace of Chinese growth could cause global growth to decline by 0.4pp in a year. The impact is also unevenly distributed with the largest impact being felt by China's trade partners and commodity producers.
- This has particular implications for GCC countries, given their role in global oil markets and the importance of China as a trade partner.

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Chinese growth disappoints

Recent weeks have seen no shortage of reports pointing to disappointing economic performance from China. Expectations had been high for a material surge in growth as China abandoned its restrictive zero-Covid policies at the beginning of 2023, but it now seems likely that Chinese growth will only just match the (relatively low by historical standards) 5% government growth target announced at the beginning of the year. Several commentators have even suggested that China could end up on a similar path to that experienced by Japan in the 1990s, characterized by stagnant economic growth and deflation on the back of a collapsing asset price bubble. So, what does the current data suggest and what does it mean for China, global growth, and the UAE in particular?

The current state of affairs

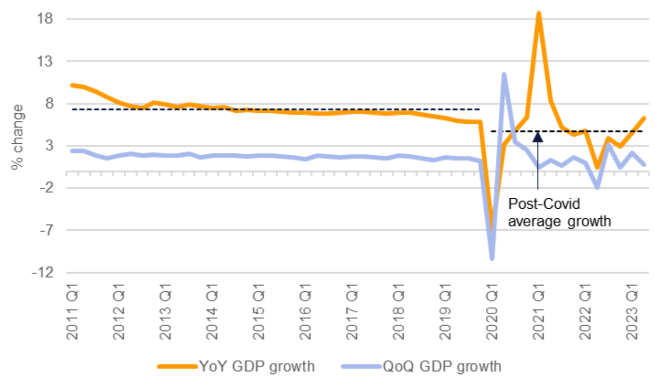
Optimism was high at the beginning of 2023, with the Chinese government having decided to abandon the strict zero-Covid rules which had been in place for much of the pandemic. Chinese growth initially rebounded strongly, with Q1 2023 real GDP rising 4.5% y/y and 2.2% q/q. Much of that growth was however driven by household consumption, with retail sales benefiting from rising consumer confidence and pent-up demand.

Since then, indicators of economic activity have deteriorated. While Q2 GDP growth came in at a robust 6.3% y/y, the annual figure was flattered by a particularly weak base in Q2 2022 due to lockdowns in major Chinese cities. In contrast the q/q GDP figure painted a much weaker picture, growing just 0.8% in Q2. Retail sales have also faltered, with y/y growth falling to 2.5% in July from a peak of 18.4% y/y in April. The underlying weakness in activity is exemplified by recent weak inflation data, CPI rose just 0.1% y/y in August, after having declined 0.3% y/y in July.

There has also been a worrying surge in youth unemployment, which rose to a record high of 21.3% in June. The country's National Bureau of Statistics has since announced that it will suspend publication of the measure. Exports, a traditional engine of Chinese growth have also slumped in recent months, as export markets tackle their own economic headwinds.

On top of this, there are continued concerns about the state of the Chinese property market. With estimates[1] suggesting that the property market accounts for upwards of 20% of Chinese GDP, the recent financial difficulties being faced by several large property developers has the potential to depress economic activity further. Furthermore, there are concerns that the difficulties faced by property developers will spill over into financial markets, with some shadow banks highly exposed to property developer debts.

Chinese GDP growth



Source: Bloomberg, ENBD Research

What are Chinese authorities doing in response?

Previous economic downturns in China have been met with sizeable stimulus packages. The Chinese government announced a USD 586bn stimulus package after the 2008 financial crisis; while estimates[2] point to the 2015-16 credit expansion (designed to stop the Chinese stock market and housing crash) costing in the region of USD 805bn. In both instances the stimulus packages supported export growth and infrastructure spending.

In contrast, this time around there appears to be little appetite from the authorities to deliver the same kind or scale of stimulus. This is likely in part due to longer-term

1 The Economist, 24 August 2023. "China's economy is in desperate need of rescue"

2 Beijing's stock rescue has $800 billion bark, small market bite | Reuters

negative consequences of previous stimulus packages. In both instances the stimulus saw local governments issuing debt to finance property developments and local infrastructure. Not only has that left local governments weighed down with excessive debts (one estimate suggests that by 2025 over 25% of Chinese provinces will spend more than 50% of their revenue on paying for debt) but also fueled significant price rises in the residential property market. The Chinese government is now likely attempting to walk a tightrope of increasing activity without re-inflating property prices.

Stimulus thus far has therefore been relatively limited. The PBOC has cut rates marginally but cannot slash them for fear of destroying bank's profit margins. Other measures include the government announcing a cut to the duty paid on stocks. On the property market, the Chinese government had in late 2022 announced a 16-point plan to provide support to the sector, including measures like allowing banks to extent maturing loans, reducing the size of down payments, and boosting bond issuance; with the PBOC announcing in July 2023 that some of these support measures would be extended until the end of 2024.

But faltering economic activity is not a new phenomenon

Several China experts have suggested that the slowdown in growth is in fact not new, and that the Covid lockdowns merely camouflaged the wider structural issues facing China. Indeed, aggregate GDP growth has been on a downward trajectory since early 2011: average annual GDP growth in 2010 was around 10.7%, declining to 6% in 2019.

What are the structural factors holding back growth?

The political economist Zongyuan Zoe Liu argues that there are four structural factors that are likely to act as a persistent drag on Chinese economic growth going forward. These can broadly be characterized as:

1. Weak household demand,
2. High levels of local government debt,
3. Demographic changes,
4. A decoupling or de-risking between the West and China.

China's growth model has traditionally been one in which low household consumption builds excess savings. These savings are then in turn channeled into spending on infrastructure, real estate and capital-intensive investments. While this growth model may have been appropriate in the China of the early 1980s, because of a plethora of productive investment and infrastructure opportunities, it is less clear that it is a useful model today. This is particularly true in the context of sizeable post financial crisis stimulus packages which spurred the issuance of debt to fund projects of arguably diminishing utility.

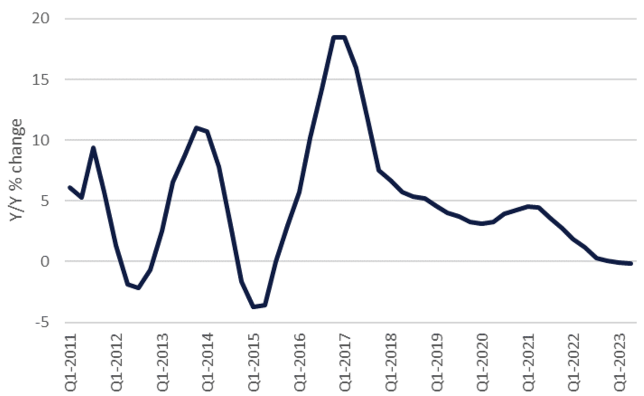
Many commentators have flagged the need for China to move away from the current growth model, to one in which household spending, rather than infrastructure spending, drives growth. The government has acknowledged that consumption needs to pay a larger role in driving growth, releasing two separate reports in 2022 detailing proposed measures to boost consumption. There are, however, strong structural reasons why China's households tend to prioritize saving over spending. These include the impact of the country's one-child policy which has led to a fall in old-age support, as well as a weak social security system (particularly when thinking about health care and pensions) and heightened uncertainty over job security after moving to a market economy.

It is also worth highlighting the link between a deteriorating housing market and domestic demand. Property prices have risen steadily over the past decade, with a marked increase in the pace of price rises after 2015. But in early 2020 the Chinese property market came under pressure as the Covid-19 pandemic brought activity, and with it, the cash flow of heavily indebted developers, to a halt.

The government responded by introducing the three red lines policy, a set of measures designed to deleverage the balance sheets of property developers. These measures have caused a decline in both the volume of construction as well as the demand for new properties. Aggregate house price growth has stalled since 2021, while the price of new-build properties has fallen in recent months.

This deterioration in the housing market is systemically important to the economy because not only does the real estate sector account for a material share of China's economy, but also because according to a 2020 survey from the PBOC, property accounts for almost 60% of household wealth and roughly 75% of household liabilities.

House price index



Source: OECD, ENBD Research

With prices no longer trending upwards, the health of household balance sheets has come under the spotlight, creating a precautionary savings motive which will likely weaken consumption. Furthermore, declining activity in the housing market may dampen demand for building materials, as well as consumer durables such as furniture.

A deterioration in the property market also links to the second structural impediment, high levels of local government debt. The vast stimulus packages of 2008 and 2015 saw Local Government Financing Vehicles (LGFV) taking on significant amounts of debt, equivalent to 44% of GDP[3]. Local governments across China have until recently been very dependent on the sale of land to property developers as a source of income. With growth in property prices stalling and demand for residential properties falling, developers are no longer purchasing significant parcels of land from local governments.

A change in demographics is also likely to act as a long-term impediment to growth. China's population declined for the first time in 2022, with UN estimates suggesting that India is now the world's most populous country. There have been several changes to China's one-child policy, with all restrictions on family size being lifted as recently as July 2021, but these won't have any impact in the near to medium-term.

An ageing population brings with it issues of labour productivity, with a smaller working age cohort required to produce the same output. This smaller cohort of working age people may make it more difficult for firms to fill roles, which can cause declines in productivity, upward pressure on wages and a deterioration in international competitiveness. An ageing population also puts pressure on the fiscal balance, with a larger share of the population drawing on pensions and using health care services.

Finally, the fourth structural challenge is that of decoupling or de-risking. This has arguably become particularly acute in the aftermath of Covid-19, as Western economies seek to on-shore supply chains, thereby moving away from cheaper Chinese exports. The use of sanctions or export restrictions will also hurt Chinese manufacturing, with firms such as Huawei suffering significant revenue declines after being sanctioned by the US government.

China has sought to deepen ties with other nations even as those with the US potentially deteriorate. Examples include the recent announcement of a planned first phase expansion of the BRICS bloc to include six other countries as well as the Belt and Road Initiative which is China's global infrastructure development strategy.

3 J.P. Morgan research report, Feb 2023. "Five Questions About China's Economy in 2023".

These longer-term structural factors add fuel to the more immediate fire of a property market liquidity crisis and booming government debt and may make it harder for China to see a return to significantly higher GDP growth rates.

What is the impact of weaker Chinese economic growth on global growth?

Developments in the Chinese economy have significant implications for the global economy, both via direct and indirect channels. This is because apart from the outsized share of China in global GDP, the economy is also a key player in international trade and production chains. The primary direct channels through which a Chinese slowdown would affect other nations would likely be through international trade and demand for commodities. There is also however an indirect effect of a slowdown in China's growth, causing uncertainty to rise and consumer confidence to fall.

Several academic papers have attempted to quantify the impact of a slowdown in Chinese GDP on the rest of the world. In particular, a 2019 paper from Banco de España[4] uses an econometric model to assess the impact of permanent economic shocks which reduce China's growth rate by 1 percentage point. That model suggests that a decline of that scale in Chinese growth causes global growth to decline by 0.4pp in a year.

What is the impact on the UAE and the GCC more broadly?

The authors of the Banco de España paper also highlight that the impact of weaker Chinese GDP growth would have a disproportionate impact on commodity producers. They estimate that a permanent decline of 1pp in China's growth is linked to a 7% decline in oil prices and an 8% fall in industrial metals. Recent weaker growth and declining confidence around the Chinese economy appear to have played a role in keeping oil prices lower than might otherwise have been expected in 2023 thus far.

This has particular implications for GCC countries, given their role in global oil markets and the importance of China as a trade partner. Although the impact of a slowdown in China is likely to be negative for commodities, there may be other sectors that benefit – to some extent – from slower Chinese economic growth. Specifically, the real estate and construction sectors in the GCC may stand to benefit from wealthy Chinese investors looking to purchase property in economies other than their own, given current concerns.

China as an export market for GCC nations

Country	Value (2022)	Ranking (X biggest export market)
UAE	USD 45.2mn	3rd
Saudi Arabia	USD 77.8mn	1st
Oman	USD 36.1mn	1st
Kuwait	USD26.4mn	1st
Qatar	USD 22.5mn	1st
Bahrain	China not in top 15 export markets	

Source: Bloomberg, ENBD Research

Recent news from UAE property developer Emaar suggested that the share of Chinese buyers of off-plan property has risen from a low of 4% in 2022 to 8% in the first half of 2023, while property broker Allsopp & Allsopp also pointed to a 130% rise in sales in Dubai to Chinese citizens in H1 2023. Prior to the pandemic Chinese investors were in the top 4 nationalities investing in Dubai properties.

Conclusion

Covid-19 may have exacerbated underlying structural drivers that would have led to slower growth in China regardless of the pandemic. These structural factors include weak household demand, high local government debt and demographic changes. Deglobalisation, or efforts to reduce the West's reliance on China in their supply chains, is also a key structural change that may contribute to slower medium-term growth in China.

4 Banco de España, 2019. Economic Bulletin. "Global Impact of a Slowdown in China"

The short-to-medium term implications of slower Chinese GDP growth are a decline in global growth, with a particular hit to commodity producers and economies that trade heavily with China. Any policy changes to mitigate these structural factors are likely to take a fairly significant amount of time to take effect, meaning that slower Chinese growth may be here to stay in the near-term.

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