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The Big Picture: Boosting growth while eyeing the long-term. What are the policy options for China?

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- **The soft Chinese recovery post lockdown reflects limited demand stimulus and the economic transition.** The modest pace of the recovery after 1Q is consistent with our expectation. Industrial trends continue to diverge as the economy shifts from property-led growth, yet manufacturing has been solid and green investment has even accelerated, pointing to an emerging industry cycle. Services face more headwinds from the property downturn and slow recovery in business services, adding to job market pressure.
- **Significant fiscal or credit easing is unlikely the optimal policy choice to counter the slowdown.** Corporate debt is rotating from property to more productive sectors, suggesting that overall credit has not been a constraint to an industrial upgrade. Local government debt is also limiting the scope for significant fiscal expansion.
- **We expect a gradual recovery.** Further recovery will be led by manufacturing strength, normalization of activities, and policies to improve sentiment. More fiscal support and structural policies to broaden growth, especially in services, will help cushion the downturn and mitigate risk. Large liquidity easing would have a limited impact and therefore seems unlikely.
- **Renminbi exchange rate still supported.** The renminbi exchange rate is being supported by China's manufacturing and trade strength. We expect depreciation pressure from the rebounding US dollar to be temporary.

The latest Chinese data indicates a modest recovery post pandemic, with diverging sectoral trends. After the strong rebound in 1Q, the Chinese economy grew at a more modest pace of 0.8% in 2Q. The latest data paints a mixed picture: while industrial growth and investment outperformed market expectations in Jun, the incipient consumption recovery disappointed.

Slow recovery and the diverging trends

The direction of the Chinese economy has been largely in line with our expectation of a softer recovery after an initial rebound, consistent with the government's modest growth target of 5%, which we consider achievable. Several trends underpin this slow recovery:

First, there has been a more muted demand stimulus in China than was seen in western countries. For instance, the IMF estimates that direct US fiscal support during the pandemic was around 25% of GDP, a quarter of which was in the form of direct household subsidies. Large fiscal expenditure in the West supported consumption and contributed to excess inflation. In China, as in most emerging markets, fiscal support has much less abundant and mostly in the form of targeted relief, thus having a smaller impact on demand, less inflation, and possibly lower debt risk.

Second was the property sector downturn in China. After almost 10 years of expansion China's property sector cooled in the last few years, dampening demand for construction materials, home furnishing and associated business expansion.

Industrial cycle gathering pace with manufacturing showing resilience

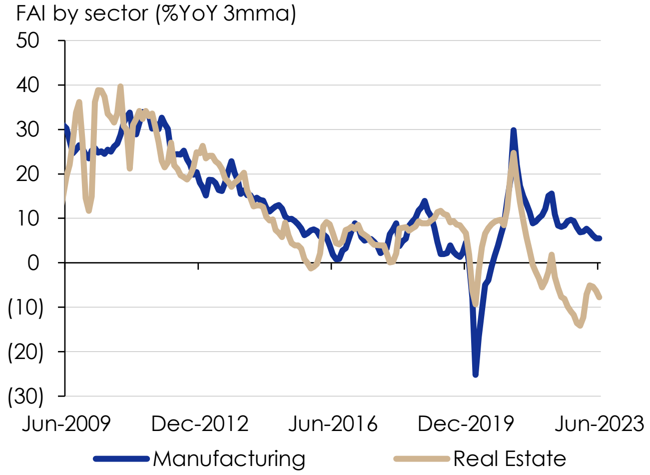
The impact of the property downturn on the economy has been diminishing. Despite the drag from the property sector, heavy industry, a key sector affected by property, has held up well with output exceeding the pre-pandemic trend. It helped that during the pandemic, supply chains were maintained with few interruptions. In addition, manufacturing capex maintained solid growth, and in the process, decoupled from the property cycle (Fig 1).

Among private enterprises, manufacturing expansion has been robust, particularly in auto, electronics, and equipment. Potent manufacturing drivers such as industrial upgrades, supply chain reconfiguration and the green transition have contributed to growth momentum.

The recent lull in global manufacturing demand has weighed on near-term manufacturing growth (Fig 2). A shift in demand from goods to services, tighter financial conditions in developed markets, and the downturn in the semiconductor cycle have been headwinds to global manufacturing and trade. China trade, in keeping with the global trend, fell from its peak last year.

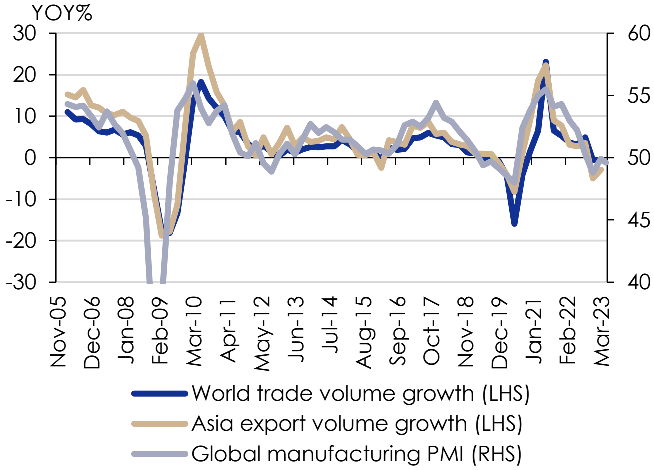
However, this global downturn is likely to be shallow, in our view. Strong demand and capex momentum in the DM economies are likely to be more consequential to manufacturing in the next few years. Anemic sales of semiconductors, which account for more than 10% of global trade, have weighted on manufacturing trade though this trend is likely to bottom out later this year.

Fig1: Industrial capex decoupled from housing cycle



Source: CEIC, CCBIS

Fig 2: Global manufacturing weighing on Asia trade

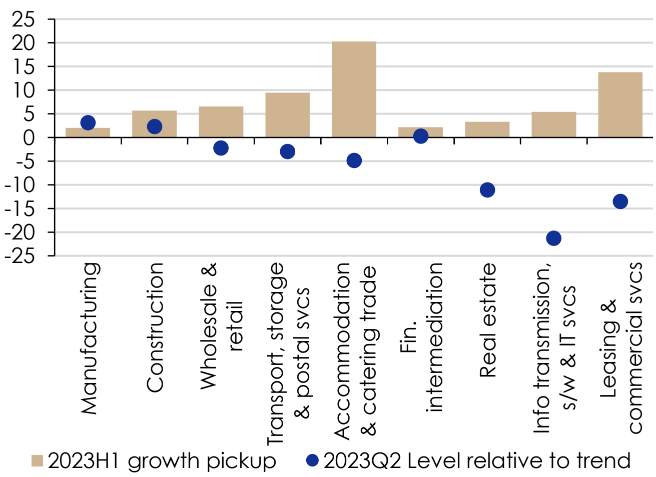


Source: WIND, CCBIS

Headwinds to services reflect the property down-cycle and other constraints. Services sector growth recovered this year, though the level of activity is still about 10% below the level had the pre-pandemic trend continued. Retail, travel, and catering, bore the brunt of the pandemic but have bounced back this year, a sign that normalization is taking place now that controls have been lifted. Meanwhile, business services such as technological and communication services, which were less affected by the pandemic due to work-from-home arrangements, slowed visibly since the pandemic and have yet to experience a full recovery (Fig 3). The latter likely reflected recent regulatory changes that slowed sectoral expansion.

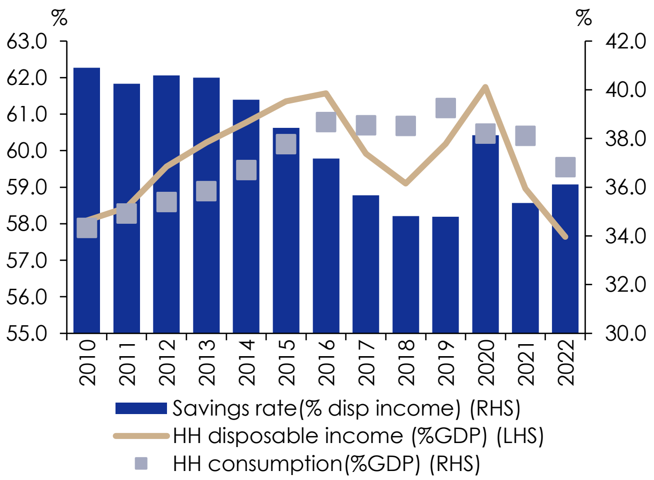
Therefore, while headwinds from the pandemic are receding, service sector growth is still constrained, including the lack of spillover from rapid growth in manufacturing. As the services sector is important to job creation, slow growth in this area has had a knock-on effect in recent years, whereby soft job and income growth ended up hurting consumption growth (Fig 4).

Fig 3: Sectors have seen uneven recovery



Source: WIND, CCBIS

Fig 4: Slowdown in income growth weigh on consumption



Source: CEIC, CCBIS

Large credit easing to counter the slowdown is unlikely

China's debt ratio climbed in a similar fashion to DMs. Overall leverage increased by more than 30ppt of GDP since the pandemic, on the back of a soft economy and eased macro policies to cushion liquidity shortfalls. The overall increase in debt in China in 2019-2022 was remarkably similar to that of the main economies between 2019 and mid-2021 before their recovery from the pandemic.

As was the case in developed markets, the increase in China's debt ratios has been led by the government and the corporate sector (Fig 5), while households generally refrained from large borrowing as household savings increased.

Increase in corporate debt during the pandemic was relatively contained, amid "structural leveraging", as a rise in industrial and infrastructure debt offset property sector deleveraging (Fig 6), which we examined previously. The property sector continues to face headwinds on sectoral consolidation and has continued to deleverage. Meanwhile, industrial debt picked up modestly following several years of deleveraging, helping to repair corporate balance sheets. Even so, leverage within the manufacturing sector in China is still well below what it was in 2014-2016.

Government debt in China climbed during the pandemic as the central government introduced special government bonds and increased quotas for local bond issuance to fund the increase in public spending and tax reduction. But at 53% of GDP, government debt in China is modest by international standards**.**

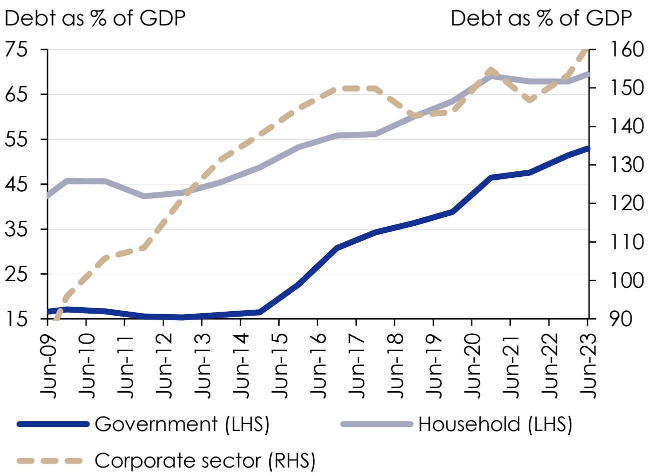
The rise in LGFV debt, however, is associated with more liquidity issues by local governments that also need to manage the shortfall in land revenue.

Infrastructure investment financed by a mixture of public and corporate debt accelerated during the pandemic with a clear tilt towards "new infrastructure". We estimate that infrastructure-related borrowing in the form of LGFV bond issuance and service loans accounted for three quarters of all new corporate borrowing since the pandemic. Recent infrastructure spending has been dominated by sectors such as renewable energy, environmental protection, and communications (Fig 7), which are more conducive to long-term productivity growth than property or traditional infrastructure now seeing productivity diminish. However, the nature of long-term investment (delayed cash flows) is that it tends to be accompanied by a rise of accounts receivable days (Fig 8), suggesting more liquidity pressure.

The debt picture in China also suggests that the possibility of large fiscal stimulus to revive the economy, or even to counter a "balance sheet recession", is remote for several reasons. First, the risk of a so-called balance sheet recession – whereby deleveraging by the private sector suppresses aggregate demand and weakens growth – appears low. Household borrowing has slowed yet households are maintaining a steady leverage ratio rather than deleveraging. For corporates, credit tightening in recent years come hand-in-hand with corporate expansion as financial resources are directed away from property towards more productive areas. Thus, there is no broad corporate deleveraging either.

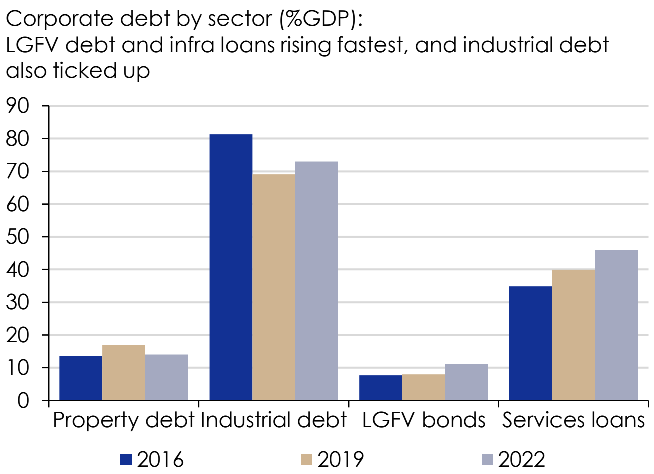
Adding to the debt load may not support quality growth. Our earlier research suggests that the new economy sectors, technology, high-tech, and the service sectors are generally net cash and more reliant on equity than debt financing. The sectoral outlook, the regulatory environment, and multi-layered financing that rewards innovation are likely more important.

Fig 5: Government and corporate debt climbed



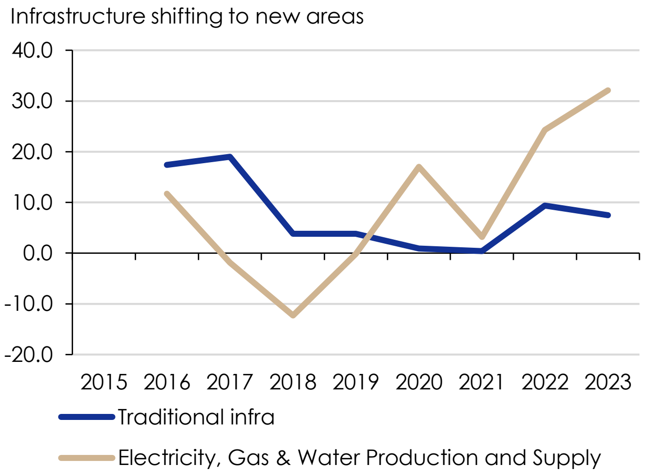
Source: CEIC, CCBIS

Fig 6: Corporate debt shifting away from property sector



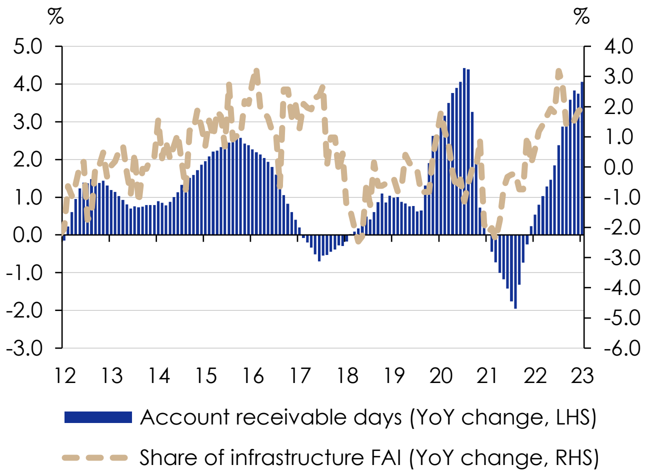
Source: IMF, CCBIS

Fig 7: Infrastructure picking up in new areas



Source: WIND, CEIC, CCBIS

Fig 8: Rising infrastructure vs liquidity issues



Source: WIND, CEIC, CCBIS

Growth and policy outlook

We see the Chinese economy as being at the intersection of a rising industrial cycle, where new drivers are emerging (and having an uneven impact) amid a cooling private debt cycle. Our view remains that it will be the industrial cycle rather than the debt cycle that will underpin sustainable growth in China over the next few years. The fact that the economy is shifting gears from growth driven by the credit cycle (led by property) to growth led by the industrial cycle is, in our view, positive to medium-term resource allocation and controlling financial risks.

Meanwhile, public debt pressure, particularly LGFV debt, has increased due to the impact the pandemic had on liquidity. Near-term challenges include a soft demand recovery, liquidity problems post pandemic, and competing needs for fiscal support.

Our base scenario features a soft yet continued recovery. Manufacturing remains key to near-term growth and medium-term productivity. Global manufacturing headwinds are also likely to peter out later this year, providing some cyclical support. The services sector will repair gradually, supported by further normalization of offline activities, a moderate increase in cyclical policy support, and policy measures designed to stabilize sentiment and job growth.

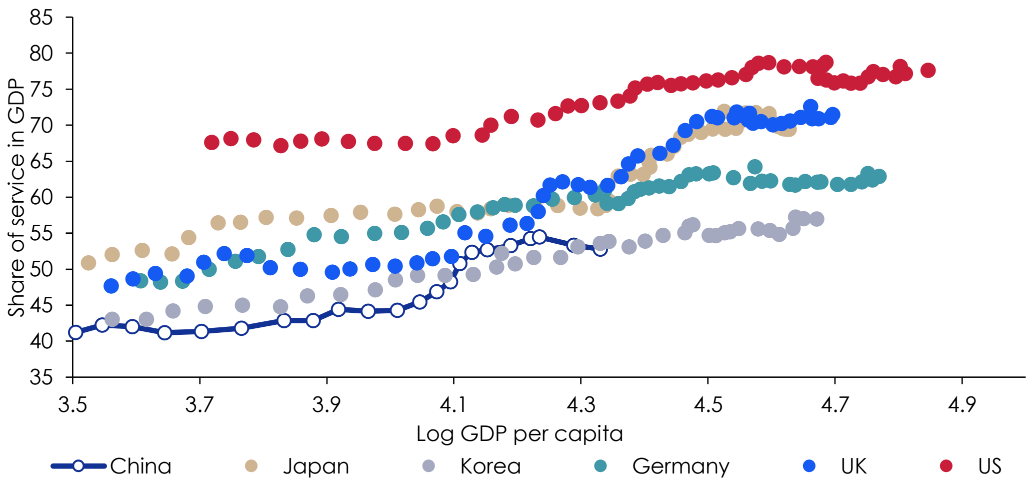
Cyclical policy support and medium-term reforms will be critical to moderating the downturn and lifting the outlook, in our view.

Macro policy – sustained fiscal support for longer. In recent months, fiscal revenue outpaced spending as the government turned its attention to debt stabilization. We do not expect significant macro easing, though sustained fiscal support is likely to be afforded in order to moderate the downturn, which would in turn be conducive to debt stabilization. Over time, more fiscal (local finance transparency, revenue sharing of central and local government) and financial reforms (long-duration financing for infrastructure projects) will be needed to reduce local debt risk.

While we expect policy makers to leave liquidity conditions accommodative, we also see **limited scope for further liquidity easing**. Fundamentally, lower real rates will transfer resources from net creditors (households) to debtors (public and corporate) and could suppress household income and consumption even further, without any material impact on investment.

Reforms for broader recovery. In recent months, the government has announced various measures to buoy sentiment and support private enterprises. Given the sluggish recovery of the services sector and its impact on job growth, boosting services growth will be particularly important, in our view. China's services as a proportion of the overall economy remains well below that of DMs at a similar development stage (Fig 9). We believe increasing the share of services within the wider economy is critical to job growth, improving consumption, and manufacturing productivity. Taking the green transition as an example, we find that investment in green assets such as renewable equipment and NEVs has been strong, yet the greening of the economy also requires the transformation of traditional sectors and more environmental services. Energy saving technologies, environmental assessment and monitoring, a carbon credit system, and transitional financing are important growth areas. Incentivizing private sector participation will be critical to continued technological innovation and productivity growth.

Fig 9: China's services sector share below most economies at a similar income level



Source: Penn World Table, OECD, CCBIS

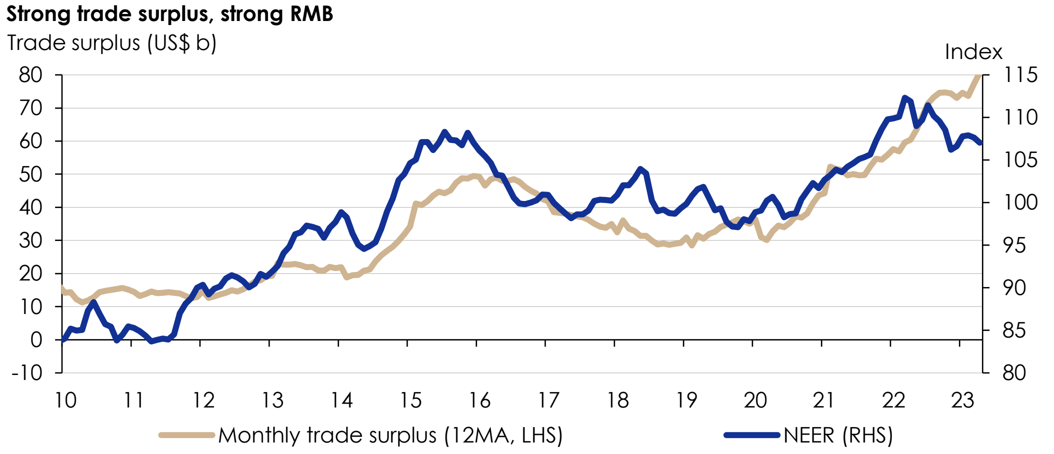
Renminbi outlook

One of the pillars of the industrial cycle in China has been the competiveness of Chinese firms, which continue to benefit from the sheer scale of the domestic economy and industrial upgrades. Strong industrial winners such as auto, along with domestic substitution, are fueling industrial upgrades and the trade surplus, which is structurally positive to the renminbi (Fig 10).

Despite the disparity in the pace of cyclical growth between China and the DMs, and the resulting negative interest rate gap between onshore and offshore, which has increased outflows by foreign portfolio investors, the magnitude of outflows has been small due to global diversification needs.

In our view, recent weakness in the renminbi against the dollar reflects the softer global trade cycle that depressed most Asian exporters. Some bottoming out in the global trade cycle and a weaker US dollar would see the renminbi strengthen modestly before year-end.

Fig 10: Chinese currency supported by external trade strength



Source: WIND, CEIC, CCBIS

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