**ARTICLE FOR THE EDGE**

# IS THE CHINESE ECONOMY AT A TURNING POINT?

The news headlines paint a dismal picture of the Chinese economy - one that is beset with drought and resulting power shortages, covid restrictions that have crushed consumer confidence to its lowest level since surveys started, a slumping property market and defaulting companies. Youth unemployment is also at a record high and flagging animal spirits among entrepreneurs are hurting investment. And to top it all off, exports which have keep growing, could be poised to falter. It almost seems as if nothing can go right anymore.

There is little doubt that China's economy is facing its greatest challenge since the 2008 global financial crisis. However, there are some signs that policy support is likely to be stepped up, which could help turn the economy around. What is not clear is how effective that policy intervention will be and what the implications are for the rest of the Asian region. We think China's economy will pick up momentum in the next few months but that overall economic performance will remain mediocre through 2023.

## The bad news - recent developments show an economy in grave danger

Since our last column which assessed the Chinese economy in May, things have changed for the worse.

First, despite stringent control measures, covid infections continue at a level that require frequent lockdowns. The authorities are doing a better job of ensuring that public health measures do less damage to factory production and transportation. But the frequency and unpredictability of these measures are depressing consumer spending which then reduces the incentive for businesses to invest in expanding capacity. Thus, domestic demand has become weaker and more fragile.

Second, bad weather has unexpectedly added to the economic woes. The worst drought and highest summer temperatures in decades have dealt a body blow to hydro-electric power generation and also to food production. Since this source of electricity accounts for 18% of China's power generation, it is a concern. However, last year's power crunch was probably worse and it is Sichuan province which is bearing the brunt because of its disproportionate reliance on hydro-power. While Sichuan is China's most populous province, it accounts for just 5% of the country's GDP. Still, while we should not exaggerate the impact of the drought, the power-related headwinds come at a time when economic momentum is already flagging unlike last year.

Third, the global economy is clearly weakening, casting a dark shadow over China's export engine. The latest purchasing manager surveys show economic activity in the big developed economies losing momentum rapidly in August, especially in Europe and Japan. But the indicators for the US economy were not encouraging either, particularly as the housing sector there is close to a recession. With the pipeline of new orders declining and inventories building up across the largest developed economies, there is little doubt that their import demand will weaken in coming months. That means, China – the factory of the world – will see lower export growth over the coming few quarters, depriving it of the one engine of China's growth that had been still expanding.

Fourth, the economic slowdown is aggravating the property slump, creating knock-on effects which are feeding into the rest of the economy and further depressing demand. As negatives feed on negatives, there is a rising risk of a downward spiral. Property-related activities account for more than a fifth of the economy, so the downsides are potentially serious.

For example, local governments depend heavily on land sales to finance their activities. But declining home sales, a mortgage boycott by home buyers fed up with property

developers delaying delivery of built houses, the weakening balance sheets of real estate companies and the prospect of further declines in property prices have all combined to depress land sales. With their revenues depleted, local governments are reported to be cutting back on civil servants' compensation while also slowing down the capital spending needed to bolster the weakening economy. There are even reports that civil servants in some small towns in Yunnan have not been paid for more than six months.

The weak property market also means less spending on home furnishings and appliances, which then feeds back into the industrial sector. With construction companies unsure that property development companies will pay them for work done, the construction sector is also looking unsteady. As defaults and other financial stresses build up in the real estate sector, the risks of a wider financial mess are growing.

**Potentially good news - signs that policy making could be turning more aggressive**

Given this context, the critical need is for policy interventions that are bolder and more effective.

The optimistic read is that the political calendar could make it easier for policy makers to adjust policies without facing criticisms. The informal leadership meetings in Beidaihe, where many critically important political and policy decisions are made, have just ended. It is likely that the most significant decisions for the forthcoming 20th Chinese Communist Party congress have been made already – including on appointments and overall political direction as well as the contentious issue of the extension of President Xi Jinping's term as leader of the Chinese Communist Party. With all that out of the way, the senior leadership can now make economic policy decisions without fearing political consequences within the ruling elite.

Another development that could suggest a policy shift is that policy makers must now realise that their highly targeted and cautious approach to supporting the economy is not working effectively.

- First, as a result of the depressed sentiments, demand for consumer and business loans has weakened, even as the policy makers have encouraged banks to lend and cut rates to stimulate credit. This has created a "liquidity trap" in which there is money in the banks available to be lent out but not enough takers among the creditworthy.

- Second, existing measures are producing perverse results. For example, it has been revealed that many banks are hesitant to lend to the credit-constrained parts of the economy – mainly the small private sector companies because of fears of bad loans. They are getting around the central government's instructions in various ways, for example, by offering loans to good companies that don't need them.

Indeed, looking at statements made by senior leaders after they returned from Beidaihe, it would seem that there is now an added sense of urgency about the economy. Prime Minister Li Keqiang, for instance, summoned officials of the economic powerhouse provinces of Jiangsu, Zhejiang, Shandong, Henan, Sichuan and Guangdong provinces, which together comprise more than 40% of the economy to a meeting where he urged them to step up efforts to shore up the economy. Around the same time, the Chinese media began reporting comments by several officials and economists calling for more policy emphasis on expanding domestic demand and stabilizing employment.

In recent days, actual policy measures have been announced. The People's Bank of China has cut lending rates and called on financial institutions, especially the top state-owned banks, to expand credit extension with emphasis on credit support for small- and micro-enterprises, green development, scientific and technological innovation and other fields. The authorities have also announced a large fund of around CNY200 billion to be used to

get construction at stalled housing projects moving so that home buyers might gain more confidence. The central government is also looking at offering credit guarantees to back bond issuance by troubled real estate companies, so that they can raise the funds they need to resume construction activities.

We believe that these measures will help but are not in themselves sufficient to stabilise the economy. More measures are needed and are likely to be announced soon. We expect the next set of measures to include a larger investment programme in "new infrastructure" – including ultra-high voltage electricity grids to facilitate adoption of renewable energy and bigger spending on creating urban mega-cities. Together with the announced measures to stabilise the housing sector and to loosen monetary policy, these will go some way towards enabling higher economic growth in the second half of the year.

The question is whether this set of stimulus measures will be enough. Given the headwinds and the reduced effectiveness of monetary policy in a liquidity trap situation, we believe that even more will need to be done - such as a big boost to aggregate demand through direct cash transfers to the household sector and expanded schemes to extend credit to small private company. In addition, President Xi needs to give a clearer signal to local government officials and bank credit officers that they will not be unfairly penalised if the new contracts they sign off to stimulate infrastructure spending or the new loans they approve to help small companies encounter difficulties later. Xi also needs to provide more assurance to tech entrepreneurs that the government crackdown on big tech companies has run its course, so as to restore confidence in that key sector.

The government seems hesitant to do all of this. That being the case, our best guess is that the economy will end up rebounding modestly in the second half of the year, with full-year growth just above 3%. Growth will continue to improve in 2023 but will still be under-whelming in comparison with the dynamism of previous years.

**Implications for the rest of Asia**

In the best case of a modest turnaround in China's economy, the rest of the world and China's neighbours in Asia are likely to benefit.

First, once China starts showing better economic numbers, global business and investor confidence should improve. After all, China is the second largest economy in the world now and the most important trading partner for most countries. So, a turnaround there will alleviate concerns about the world economy. Higher business confidence should help improve capital spending by companies around the world.

Second, China is a big market and its rebound will offer more export possibilities for others. As a rebound is likely to be the result of stepped-up infrastructure spending and improved real estate activities, raw materials to produce inputs used in these sectors will benefit. Industrial production will also revive and so benefit exporters of intermediate goods such as electronic components.

Third, commodity prices should gain – prices of thermal coal, metallurgical coal, base metals, rubber and energy should rebound.

Fourth, if China's economy stabilises, the current downward pressures on the Chinese Yuan should reverse. Recent fears that the Yuan might have to depreciate have hurt confidence in emerging Asian currencies which tend to be correlated with the Yuan.

**Conclusion**

China's policy makers' original bet, that incremental and targeted measures would suffice to stabilise the economy, has not worked out. The increasing risks to the economy have now persuaded them to step up their stimulus efforts. Although not likely to go all

the way we would like to see, the policy turn should suffice to steady the economy and produce a modest economic revival which will have benefits for the rest of Asia.

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