CHINA ECONOMICS UPDATE

Policy paralysis has dented near-term outlook

- **China's economy has stalled recently and headwinds are still intensifying on multiple fronts. The lack of a stronger stimulus response partly reflects a greater tolerance for economic weakness. But it also points to a worrying degree of policy paralysis, which suggests that the downturn could persist for a while longer. We now expect q/q growth of just 3.0% annualised over the rest of the year. This rests on the assumption that policymakers will eventually intervene more forcefully. But even then, any economic reacceleration is likely to be modest given the structural decline in trend growth.**
- After a strong start to the year, official GDP growth slowed to just 3.2% q/q annualised in Q2. Momentum has weakened further since then – the data for July suggest that activity was largely stagnant last month. Our in-house alternative to the official GDP data, the China Activity Proxy (CAP), hints at an even deeper downturn – it began to contract outright in June and preliminary estimates suggests July was weak too.
- There are few signs of much imminent relief. High-frequency data point to a further deterioration in economic conditions this month. And concerns are mounting about the health of corporate and financial sector balance sheets, following defaults by Country Garden, a top private developer, and Zhongzhi, an asset manager cum shadow bank.
- **Country Garden's troubles will further undermine confidence in private developers and the wider housing market**, which has already been showing signs of renewed weakness recently. This threatens to more than offset any boost from the recent relaxation of property purchase controls in some major cities.
- Meanwhile, **further losses in the property sector risk spilling over into wider financial instability**, as we are seeing with Zhongzhi. With domestic funds increasingly fleeing to the safety of government bonds and bank deposits, more non-bank financial institutions could face liquidity problems. State ownership provides Chinese banks with a degree of protection against problems elsewhere in the financial system and there are currently few signs of any strains in the interbank market. But even if a wider financial crisis is avoided, shadow bank failures are likely to result in tighter credit conditions for subprime borrowers.
- **Policymakers have taken some steps to tackle these mounting headwinds**. They have directed local governments to accelerate special bond issuance and rapidly spend the proceeds. And plans to bring some off-budget debt on-budget has narrowed credit spreads on local government financing vehicle (LGFV) bonds. Both should help to support infrastructure spending in the near-term. They have also resumed policy rate cuts which, although not large enough to make a big difference to credit demand, will help reduce interest costs for indebted firms somewhat.
- **But the policy response has generally been underwhelming**, especially given the extent of the current economic weakness and the repeated promises of greater support. This restraint partly reflects an increased tolerance for slower growth – evident in the government's decision to set a lower-than-expected growth target of "around 5.0%" for 2023, despite the flattering base effects from last year's COVID disruptions. But we doubt that this tolerance extends to current growth levels. Instead, the lack of more effective support seems to mostly reflect policy paralysis.
- **The problem for policymakers is that many of the headwinds facing the economy are structural in nature** – demographics, slowing rural-to-urban migration, declining private sector dynamism, geopolitical fracturing. These are largely outside of their control, or reflect top-down political choices that aren't easily altered. And while there is also a cyclical element to the current downturn that justifies greater stimulus, policymakers appear concerned that their traditional policy playbook would lead to a further rise in debt levels that would come back to the bite them in future.

Julian Evans-Pritchard, Head of China Economics, julian.evans-pritchard@capitaleconomics.com

- As they vacillate and attempt to hash out the details of a better-targeted and less-costly form of policy stimulus, officials risk delaying much-needed support. In the meantime, the economy's problems may continue to intensify.
- **We now think official GDP growth will come in at 5.0% this year** (down from 5.5% previously). Because of flattering base effects, this is weaker than it sounds – it implies average growth of 4.0% across 2022-23, down from 5.3% during the first two years of the pandemic. **In practice, we think these figures understate the extent of the slowdown**. We expect the China Activity Proxy (CAP), our in-house alternative to official GDP, to expand 6.5% this year (down from 7.0% previously), but that's on the back of an outright contraction last year and implies average growth of just 3.0% q/q annualised over the rest of this year. We are leaving our 2024 and 2025 forecasts unchanged at 4.0% and 2.5%.
- **These projections assume that China's economy will stagnate in Q3 but that policymakers eventually conclude that more sizeable stimulus is needed, resulting in a pick-up in growth from Q4 onwards**. There is clearly a risk that policy support continues to underwhelm, in which case the downturn may end up being more protracted than we currently expect. And even if we do get meaningful stimulus, any reacceleration in growth is likely to be modest. The big picture is that trend growth has fallen substantially since the start of the pandemic and looks set to decline further over the medium-term.

Chart 1: Official GDP & CE China Activity Proxy (2019 = 100, Seas. Adj.)

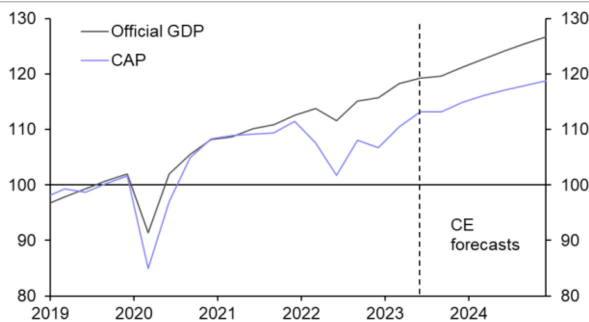
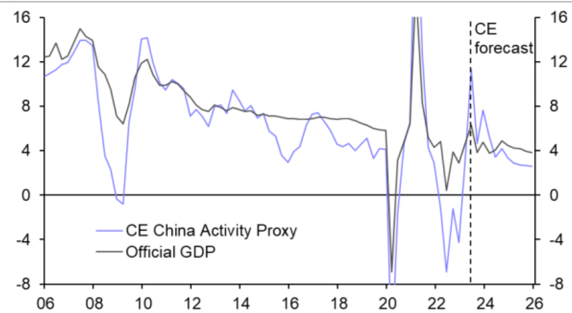


Chart 2: Official GDP & CE China Activity Proxy (% y/y)



Sources: CEIC, Capital Economics

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