CAPITAL ECONOMICS 凯投宏观

CHINA ECONOMICS UPDATE

China's weakness due to further slide in trend growth

- **We estimate that China's trend rate of growth has slowed from 5.0% in 2019 to 3.0% now, based on our China Activity Proxy. This is a steeper deceleration than in the years leading up to the emergence of COVID-19. The official GDP data, while not fully reflecting the extent of recent weakness, are also consistent with a marked decline in trend growth. The main cause is not the pandemic but a structural shift in the property sector. This year's underwhelming recovery is partly a consequence of this slowdown.**
- **There is clearly a cyclical element to China's current economic woes**. Core inflation has fallen close to zero and the labour market has softened again recently, both consistent with a negative output gap.
- **But there may not be as much slack in China's economy as many believe**. Youth unemployment is still climbing and very high. But those aged 16 to 24 only make up 6% of the workforce. The unemployment rate for other age groups is at a record low. And underutilisation of labour doesn't appear to be a problem – hours worked are only a touch off their highest level in more than two decades.
- It is possible that official data are painting an overly rosy picture of the health of the labour market. A lack of timely figures means we don't know the extent to which last year's drop in labour force participation has unwound. There may still be a sizeable number of working age individuals who have yet to return to the workforce or who are looking for work but are not being captured by the unemployment figures.
- But we think the main reason for the apparent lack of significant slack in the labour market despite weak headline growth is simply that **China's trend growth is now a lot lower than it was prior to the pandemic**.
- **The primary culprit is the property sector**. That's evident from the breakdown of the official GDP data, which shows that real estate activity has contracted since the end of 2021, even as the rest of the economy has continued to gain ground. (See Chart 1.) Trend growth in real estate value-added more than halved in the decade leading up to the pandemic but it was still around 4% in 2019. This represented a direct contribution to trend GDP growth of 0.5%-pts. Once the reliance of other sectors on property activity is considered, **the pre-pandemic contribution to trend GDP growth from real estate was around 1.0%-pt**.
- **This source of growth has now evaporated and won't be coming back**. There is scope for a modest cyclical recovery in home sales over the coming year. But this is unlikely to prevent a further contraction in real estate construction as developers will be working their way through a backlog of unfinished projects. The big picture is that housing demand is in the early stages of a protracted structural decline due to the impact of demographics and slower rural-to-urban migration.
- This is analogous to the experience of Japan, where residential investment has declined over 40% from its peak in 1996. (See Chart 2.) A similar outcome in China need not result in a persistent contraction in real estate value-added. In Japan's case, diminishing construction coincided with continued growth in real estate services, with the two largely offsetting each other over the past three decades.
- But **a stagnant property sector is probably the best that policymakers can hope for in the next few years**. And given the extent of over-building in parts of China, the risk is that structural adjustment in the property sector proves even more painful than it did in Japan. By limiting developers' ability to cut prices, Chinese officials are shifting demand to the secondary market, exacerbating the decline in new home sales and construction.
- We estimate that the structural turning point in real estate has lowered China's trend growth rate by 1.2%-pt since the start of the pandemic. That's on top of all the other drags, such as the diminishing returns to infrastructure spending, increasing trade frictions and growth-impairing regulatory shifts. We reckon these

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probably shaved another 0.8%-pts off of trend growth. In total then, our estimates point to a 2%-pt drop in the space of just three and a half years, equivalent to a 0.6%-pt decline per year. That's double the rate at which trend growth was slowing on the eve of the pandemic.

- **Based on measures of economic slack such as capacity utilisation and unemployment, the official GDP figures appear consistent with trend growth of around 4.5%.** But given that the official GDP figures tend to overstate China's economic performance, the true level of trend growth is probably lower. **Our China Activity Proxy (CAP) suggests that it is closer to 3.0%.** (See Chart 3.) Either way, the key takeaway is that **most of the slowdown since the start of the pandemic is structural in nature and won't be reversed by policy stimulus**, at least not on a sustained basis.
- Flattering base effects due to last year's zero-COVID disruptions mean that growth will be above trend in 2023. Further ahead, however, the structural slowdown will become more readily apparent in the annual growth figures.
- **We have long been more bearish than most on China's medium-term prospects. But even we have been surprised by the speed at which trend growth has declined**. The deceleration probably still has further to run given worsening demographics and few signs that policymakers will embrace the kind of reforms needed to reverse the slowdown in productivity growth. In the early days of 2020, before the importance of Wuhan's COVID-19 outbreak became clear, we predicted that China's economy would average growth of 3.2% during the second half of this decade, as measured by the CAP. We now think it will achieve just 2.4% over the same period.
- As for the official GDP figures, as long as they remain politicised and subject to annual targets, they will probably continue to inflate growth somewhat. But we nonetheless expect them to undershoot expectations over the medium-term. (See Chart 4.)

Chart 1: China GDP by Sector (2019 = 100, seas. adj.)

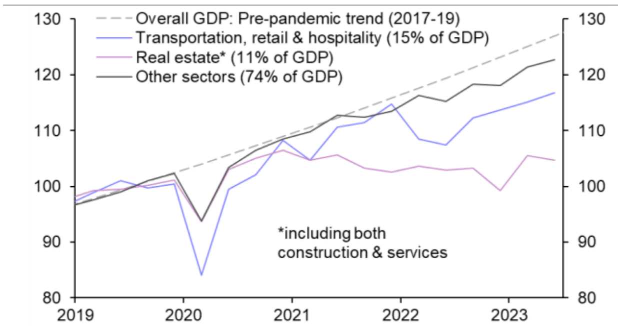


Chart 2: Level of Residential Investment (peak = 100, nominal local currency, seas. adj.)

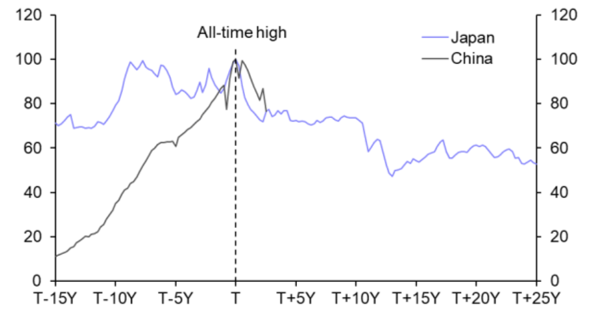


Chart 3: CE China Activity Proxy (% y/y)

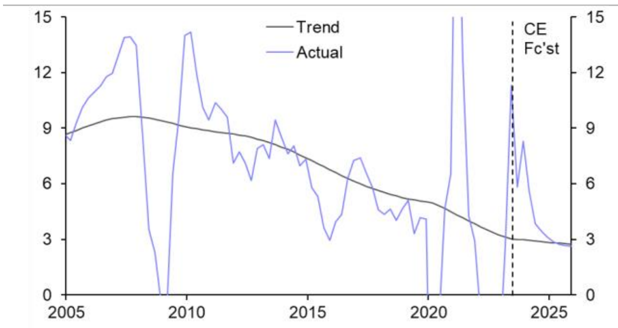
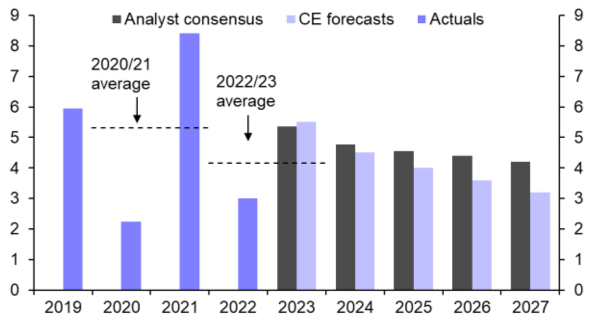


Chart 4: Official GDP (% y/y)



Sources: CEIC, Refinitiv, WIND, Capital Economics