

# CHINA ECONOMICS UPDATE

## A faster-than-expected turnaround

- We had expected disruption from China's reopening wave of COVID infections to weigh heavily on activity well into Q1. But there is mounting evidence that much of China's population has already been infected and that disruption is already fading rapidly. Coupled with a wider shift toward more pro-growth policies, this points a reopening rebound starting this quarter and a stronger 2023 as a whole. We now expect China to grow by 5.5% this year. This will mostly reflect a one-off cyclical bounce, however, and we remain relatively downbeat on China's medium-term prospects.
- When the authorities began to signal a shift away from the zero-COVID policy last November, we argued that the transition to living with the virus would initially be bad for the economy. That proved to be correct – mobility declined sharply in December and the PMIs were the weakest since the Shanghai lockdown.
- We had assumed that the situation would worsen further in January and that disruption would linger for a while, resulting in an economic contraction in Q1. But we failed to anticipate how quickly infections would tear through the country. Evidence is growing that most people in China have caught COVID since late November. Health officials in Henan, China's third most populous province, recently disclosed a cumulative infection rate of 89%. Officials in other parts of the country have also estimated infection rates above 70%. Consistent with this, proxy measures suggest the reopening wave of infections has subsided – online searches for “fever” have returned to normal levels after soaring in December. (See Chart 1.) **A process that took months in other countries has been compressed into the space of a few weeks in China.**
- This rapid transition put a great deal of strain on China's healthcare system, with the number of deaths unclear but likely to have been significant. Nevertheless, it has paved the way for an earlier economic recovery starting this month. **With infections waning, labour shortages are fading and consumers are returning to the streets.** Subway traffic in major cities is rapidly returning to normal. (See Chart 2.)
- This won't be China's last COVID wave. But with much greater natural immunity now in place, future waves are likely to be less intense and there is little sign that the authorities would reimpose restrictions in response. Experience elsewhere also suggests that the behavioural response to future waves will be smaller. The pandemic's role as a key constraint on China's economy appears to be coming to an end far sooner than had seemed likely a few weeks ago.
- **The most obvious consequence is that consumption is probably on the brink of a sharp rebound.** Repeated disruptions from the zero-COVID policy had pushed consumer confidence to a three-decade low ahead of reopening. Now that the policy is history, many households will respond with relief, if not elation.

Chart 1: Baidu Search Index for “Fever” (发烧)

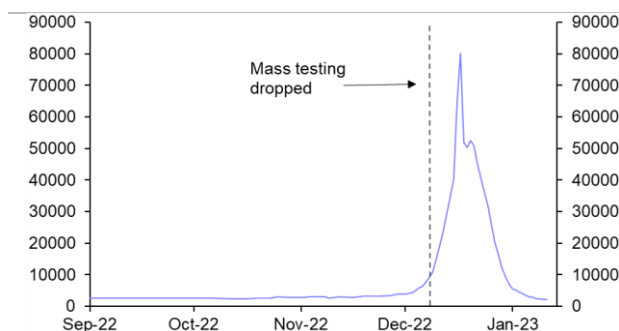


Chart 2: Subway Ridership in 23 Cities (% of 2019 level, 7d ave.)



Sources: Baidu, WIND, Capital Economics



- Admittedly, households in China have not built up as much in excess savings during the pandemic as those in some other countries, in part due to limited fiscal transfers. And negative wealth effects from the downturn in China’s property and financial markets over the past couple of years will keep many consumers cautious. But **given how depressed spending has been recently there is still plenty of scope for a recovery – just getting back to the level of retail sales seen last summer would involve a double-digit pick-up.**
- **What’s more, the rapidly diminishing risk of future virus disruption should help to unlock the benefits of existing policy support.** Regulators relaxed quantitative controls on bank lending markedly last year. Unusually, however, banks struggled to make use of this due to limited appetite for borrowing from households and private firms. (See Chart 3.)
- **With the biggest source of uncertainty for workers and businesses now fading, credit growth is primed for a rebound.** It will be helped along by greater fiscal support, with officials reportedly planning a wider budget deficit for this year and a bigger quota for local government bond issuance.
- **As policy support starts to gain greater traction, the impact will probably be most evident in the property sector.** Although demand for new housing has entered an era of structural decline, the 40% fall in sales volumes since mid-2021 has taken them below our estimate of the level consistent with structural trends.
- Mortgage rates and down-payment requirements have already been slashed to a degree that would usually trigger a cyclical rebound in sales. (See Chart 4.) This proved insufficient to revive demand last year given the uncertainty caused by the zero-COVID policy and concerns about the ability of indebted developers to deliver presold homes.
- Those roadblocks to a housing market rebound are now being dismantled and not only on the virus front. There has also been a shift in government policy toward developers, who are now being funnelled loans instead of being asked to deleverage – the “Three Red Lines” policy that triggered the crisis among developers has reportedly been abandoned. Coupled with increasing fiscal support for stalled projects, this should help restore greater homebuyer confidence in developers. There are already signs in the high-frequency data of a nascent turnaround in home sales. (See Chart 5.)
- **The moves toward supporting real estate developers and living with COVID are part of what looks like a full spectrum push in recent weeks towards more growth-friendly policies.** This change of direction is permeating areas including diplomacy and industrial policy, as well as the regulatory campaign against the tech sector, which officials now say has ended. Coupled with a revival in consumer spending, the shift could give the big tech firms the confidence to start hiring again following a year of layoffs that helped push the youth unemployment rate to a record 19.9%.

Chart 3: Bank Lending & Loan Approvals

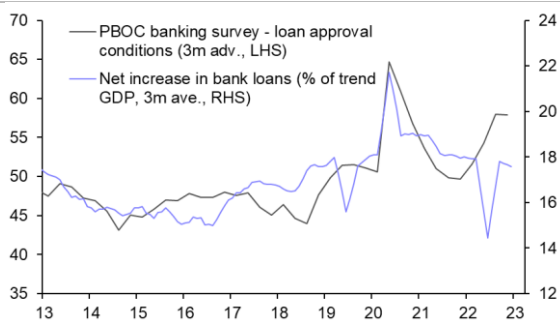
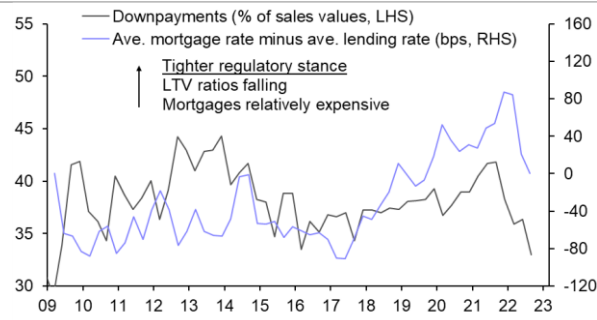


Chart 4: Proxies for Property Controls



Sources: CEIC, Capital Economics



- **While reasons for near-term optimism are stacking up, it's important to recognise the constraints the economy will face this year too.**
- Foreign demand is cooling – China's exports are likely to contract until the middle of the year. Even if home sales have now bottomed out, it will be a while before developers feel comfortable ramping up construction again – initially at least, their focus will be on repairing their balance sheets. If previous housing downturns are any guide then property construction may continue to weaken for another six to nine months.
- In the face of these headwinds, we don't expect the reopening rebound to be as strong as the one China experienced in late 2020 and early 2021, when the economy was firing on almost all cylinders and benefiting from a pandemic-induced surge in global demand for Chinese-made goods.
- All told, we now expect China's economy to expand 5.5% this year on both the official GDP figures and our in-house alternative, the China Activity Proxy (CAP). That's up from a previous forecast of 3.0% for official GDP and 2.0% on the CAP. To a large extent we are simply bringing forward the rebound that we had expected to come in Q2 rather than Q1. But this will allow output to return to trend sooner – by the end of the year, compared with early 2024 previously. (See Chart 6.)
- **Whether or not the medium-term outlook has changed is a trickier question.** The exact timing of the reopening rebound shouldn't make much difference to the state of China's economy in a couple of years' time, though the way zero-COVID was abandoned might raise questions about the quality of leadership and policymaking at senior levels. Conversely, **the broader step back from policies that have been holding back productivity growth, such as the regulatory crackdown on private firms, could have a lasting impact if they prove durable.**
- **We suspect that the retreat is a tactical move in the face of a severe downturn, rather than a fundamental move away from the agenda laid out at the Party Congress in October,** which continued to shift the focus away from market-based reforms in favour of state control and economic security. Unless the leadership's long-run thinking has changed overnight, **a less market-friendly approach may resurface once the current downturn has passed. That's something investors should keep in the back of their minds as they enjoy the reopening rally.**

Chart 5: New Home Sales in 30 Key Cities  
(% of 2019 level, 30d ave.)

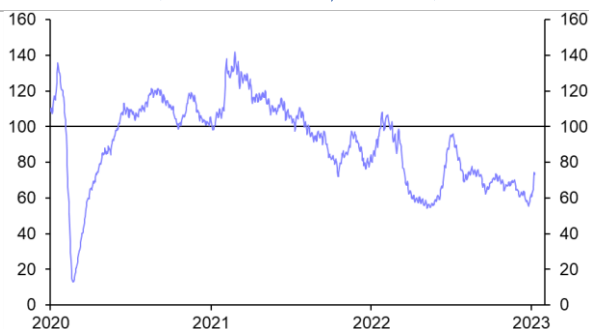
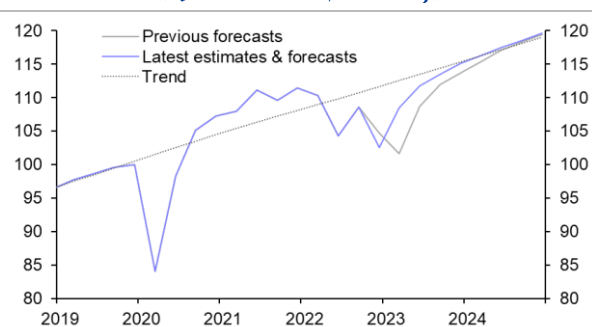


Chart 6: CE China Activity Proxy  
(Q4 2019 = 100, seas. adj.)



Sources: WIND, CEIC, Capital Economics



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