China's economy in transition

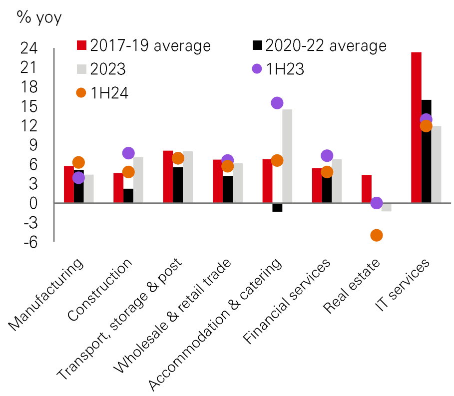
Macro insight | 20 August 2024

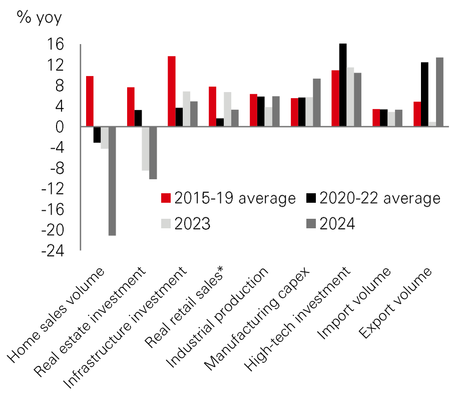
The Third Plenum in July laid out structural reforms for the next five years and reiterated "high-quality development" as the top priority. The Third Plenum was followed by the Politburo's pledge to increase counter-cyclical policy support in H2 2024. GDP growth disappointed in Q2 and puts this year's ~5% real growth target at risk. We think more policy supports and forceful implementation will be needed to restore confidence and fundamentally reflate the economy. We reflect on these challenges in this Macro Insight and review recent data and what it means for the H2 2024 and 2025 outlook.

An uneven cyclical recovery

After a strong start to the year, growth momentum slowed in Q2 amid softer consumption and the ongoing property downturn. Recent macro data continues to point to a patchy and uneven recovery. Export strength and solid investment and production in advanced manufacturing cushioned the growth slowdown, but soft consumer demand sets the economy up to be more vulnerable to global demand shocks and rising protectionism.

Figure 1: Real GDP growth by industries. Figure 2: Monthly macro indicators (Jan-Jul)



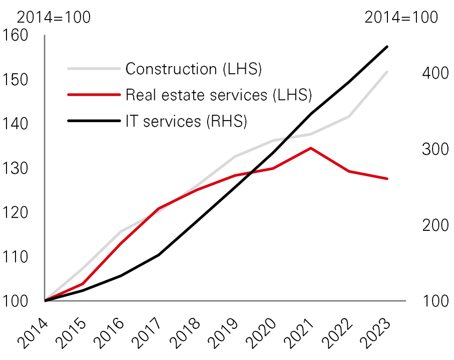


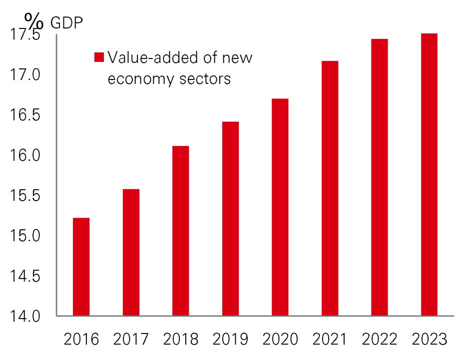
Note: * Adjusted for CPI inflation; Source: CEIC, HSBC Asset Management, as of 15 August 2024.

This information shouldn't be considered as a recommendation to invest in a particular sector shown.

The divergent growth paths across sectors also reflects policy priorities for economic transformation toward quality and innovation-led growth. However, strong growth in new economy sectors has not been sufficient yet to offset the property drag and a fragile consumption trend. Policy and reform measures need to be stepped up.

Figure 3: Real GDP trend (sa.). Figure 4: Value-added of new economy sectors





Source: CEIC, HSBC Asset Management, as of 15 August 2024.

China's uneven recovery reflects domestic supply-demand imbalance and policy priorities for high-quality development

Forceful policy actions are needed to fundamentally reflate the economy amid growing external risks

Our view:

China's near-term and structural challenges are plentiful with difficult policy trade-offs

Countercyclical policy supports are likely under-way to help contain downside risks. Policy implementation is key

Some strategic sectors aligned with China's long-term development goals will likely show stronger growth potential and better earnings visibility and be a medium-term fundamental driver for the overall markets

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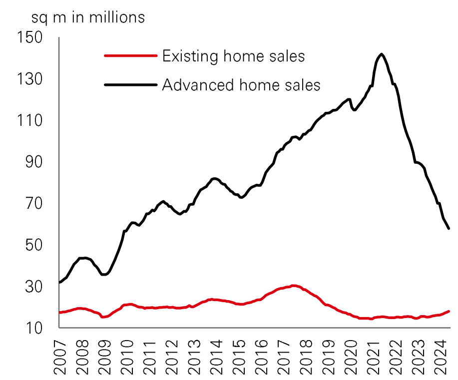
Ongoing policy support mitigates property risks

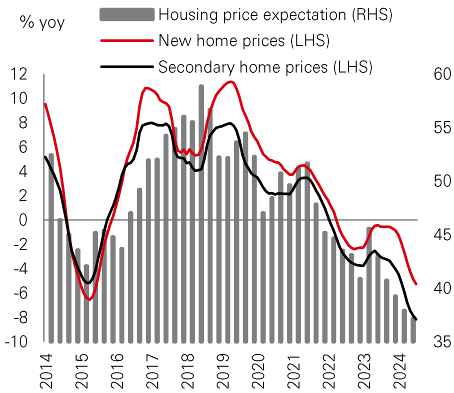
Policymakers have stepped up actions this year to stabilise the property sector, with on-going support for housing demand, efforts to ensure project competition and home delivery (through a whitelist mechanism), and a new CNY300bn relending facility by the People's Bank of China (PBoC) to encourage local governments to purchase existing homes for conversion into affordable housing. Tier-1 cities have relaxed mortgage rules and home purchase restrictions.

Increased policy actions help contain property downside risks, but policy implementation is key

However, property sector activities have stayed depressed. New home sales continued to weaken with price declines, though secondary housing transactions have fared better, albeit when prices are falling. Housing demand remains weak amid concerns over falling house prices, home delivery and income prospects. The destocking policy is in a right direction in restoring the supply-demand balance, but the pace of implementation has been slow and faces execution challenges.

Figure 5: Home sales (12mma). Figure 6: Home prices and expectations



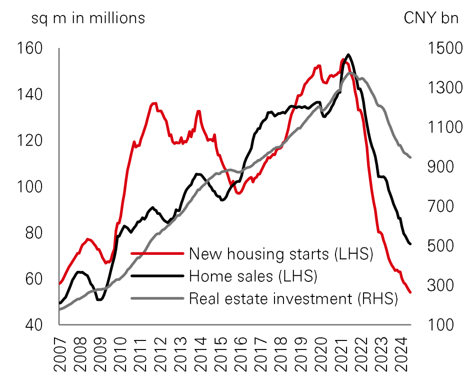


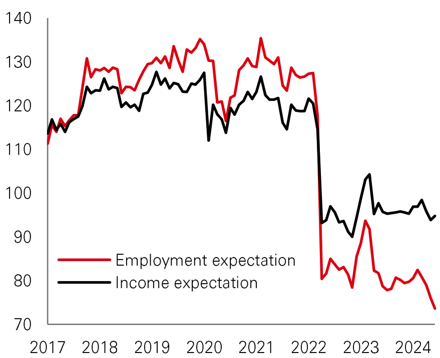
Source: CEIC, HSBC Asset Management, as of 15 August 2024.

We believe policymakers will lean on extending further support until the property market starts to show clear signs of stabilisation. Following substantial adjustments, the property sector is likely to have a smaller drag on overall growth next year, but uncertainty is high about when a turnaround will take place and whether it is sustainable, amid structural .

A quick fundamental turnaround looks difficult

Figure 7: Select property indicators (12mma). Figure 8: Consumer confidence





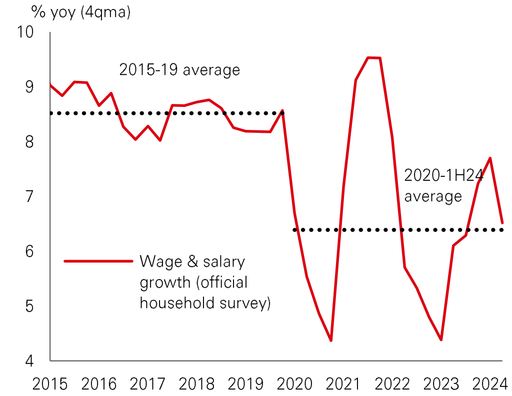
Source: CEIC, HSBC Asset Management, as of 15 August 2024

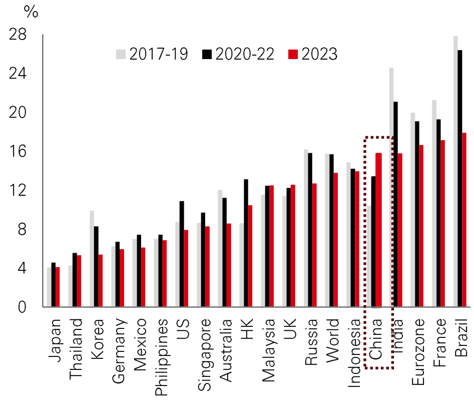
Boosting consumption a policy priority

Consumer confidence has been subdued amid house price declines and concerns about job and income prospects. Wage growth has decelerated in recent years, despite the recent rebound from the 2022 lows. Some sectors have experienced pay cuts/caps (e.g. financial and internet sectors and local governments). The high youth unemployment is a concern. Consumer spending on big-ticket items has been sluggish, while a post-reopening rebound in services consumption has moderated, albeit showing resilience in some areas such as tourism.

Consumer confidence weighed down by house price declines and job concerns

Figure 9: Wage & salary growth. Figure 10: Youth unemployment rate (age 15-24)*



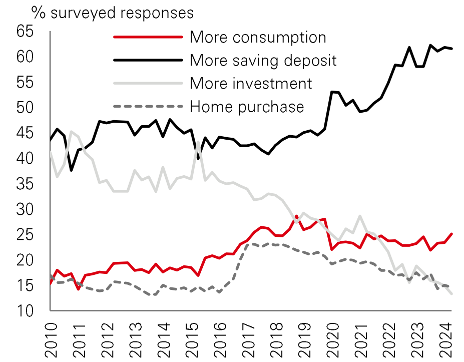


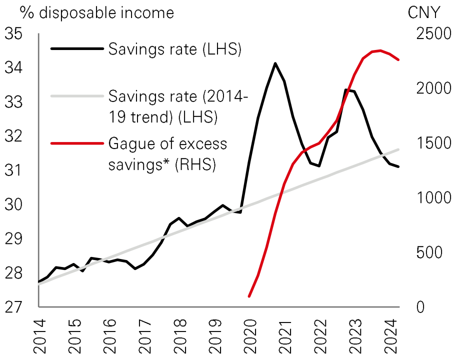
Note: * ILO estimate. Source: World Bank, CEIC, HSBC Asset Management, as of 15 August 2024.

Forceful policy actions are needed to rebuild consumer confidence

The household savings rate is high, despite recent signs of normalisation and initial running down of the "excessive savings" built up during the Covid-19 pandemic. Policymakers have prioritised boosting consumption to expand domestic demand this year. The consumer goods trade-in programme is starting to take effect, but we think it will take more concrete policy and reform actions to rebuild consumer confidence. This will include a stronger social safety net to reduce precautionary savings.

Figure 11: Consumer preference (PBoC survey). Figure 12: Per capita savings (4qma)





Note: * measures as "excess" savings relative to the 2014-19 savings rate trend. Source: CEIC, HSBC Asset Management, as of 15 August 2024.

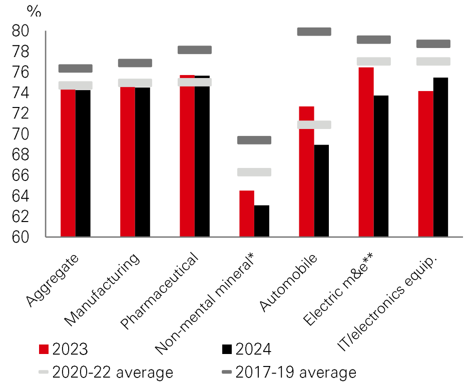
Structural capex push meets overcapacity concerns

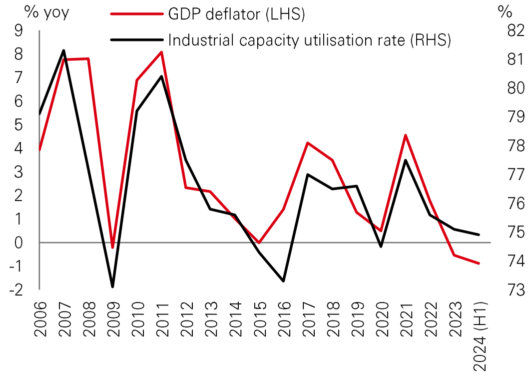
Over-capacity and fierce competition have resulted in lower profitability in some sectors

The government's policy agenda to strengthen technology self-sufficiency and to promote "new quality productive forces" to drive economic development suggests a continued policy push for investment in green and high-tech manufacturing. However, concerns have grown about the growing domestic supply-demand imbalance. Industrial capacity utilisation has fallen from the 2021 peak, though the rate varies widely across companies and sectors. Over-capacity and fierce competition have resulted in weaker corporate pricing power and lower profitability in some sectors. Following a boom, demand growth for the "new three" green-tech industries, i.e. electric vehicles (EVs), lithium-ion batteries and solar cells/panels, has also slowed, leading to intense competition and lower prices.

Policymakers have called for industry self-discipline and market-oriented mechanisms to reduce inefficient production capacity and prevent excessive competition. We have also seen signs of capex control by some listed companies. But the pace of adjustments is likely to be gradual.

Figure 13: Industrial capacity utilisation rate (H1). Figure 14: GDP deflator & capacity utilisation





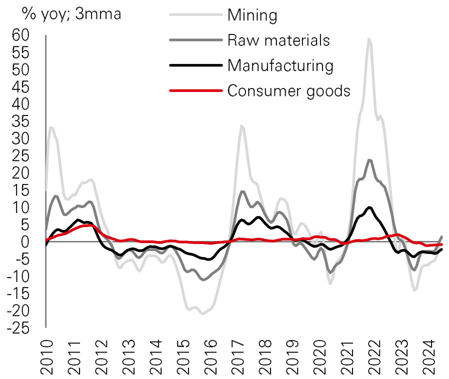
Note: * Likely dragged lower by the property downturn; ** Electric machinery & equipment (m&e) includes solar panels and battery manufacturing. Source: CEIC, HSBC Asset Management, as of 15 August 2024. This information shouldn't be considered as a recommendation to invest in a particular sector shown.

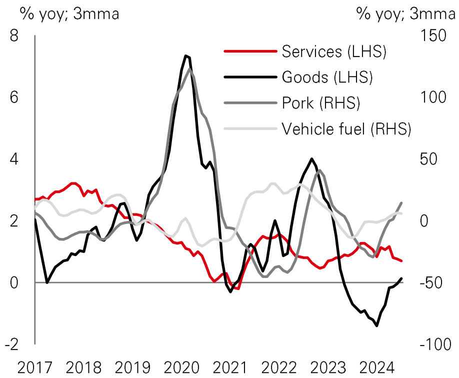
A slow and bumpy reflation journey

Underlying inflation is likely to stay low amid the domestic supply-demand imbalance, despite policy easing

Lingering industrial overcapacity limits upsides for producer prices (PPI) and overall inflation. Fierce competition in downstream sectors is limiting firm pricing power and the pass-through of upstream inflation to consumer prices (CPI). While some factors such as food/pork price deflation that weighed on CPI inflation in 2023 are reversing, housing price deflation, slower wage growth and subdued consumer confidence still exert disinflationary pressures.

Figure 15: PPI by stages of production. Figure 16: CPI by spending category





Source: CEIC, HSBC Asset Management, as of 15 August 2024. This information shouldn't be considered as a recommendation to invest in a particular sector shown.

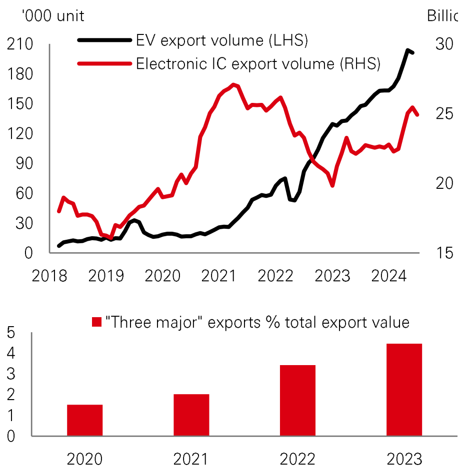
Overall, we expect CPI inflation to rise gradually into 2025, helped by policy easing efforts, but underlying inflation is likely to stay low. China's output remains below potential albeit gradually narrowing. Policy efforts to rebalance China's economy towards consumption and address the domestic supply-demand imbalance are likely needed to tackle structural deflation risks.

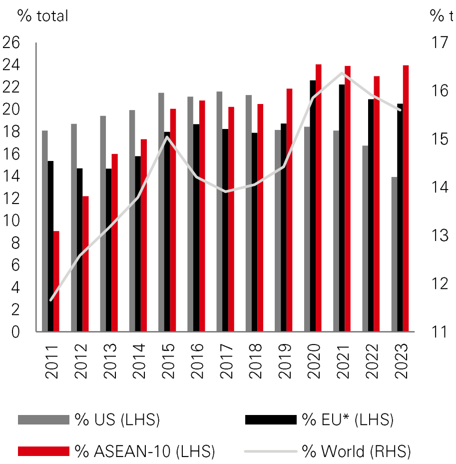
China's export competitiveness faces rising trade tensions

Competitive Chinese exports are expanding and diversifying their external markets

China's export strength has been aided by its rising competitiveness in green-tech products, an ongoing global tech upcycle, and resilient emerging market (EM)/Asia demand, though that has come with falling export prices and weaker profits. China's dominance in the global green energy sector, including its control over supply chains of critical raw materials via domestic and overseas investments, have exacerbated trade tensions. Chinese exporters have continued to expand their ex. US global market share and diversified into the Global South, to mitigate some of the potential drags from US tariffs and tech restrictions.

Figure 17: China's export volume. Figure 18: China's export market share





Note: * In terms of non-EU trade. Source: WTO, CEIC, HSBC Asset Management, as of 15 August 2024.

The US and European Union (EU) have recently announced additional tariffs on selected goods from China, including EVs. We think the immediate impact on China's overall exports will likely be limited and might be even smaller if we consider potential re-routing of exports or trans-shipments. Some tariff hikes will only kick in from 2025 or 2026, with the potential for front-loading ahead of scheduled or threatened tariffs. However, any significant change in external demand or ramp-up in trade tensions – following the US elections – would be clear downside risks to the outlook for 2025 and beyond.

The sustainability of China's export strength faces geopolitical and global-demand risks

Cautious monetary easing with a focus on policy transmission

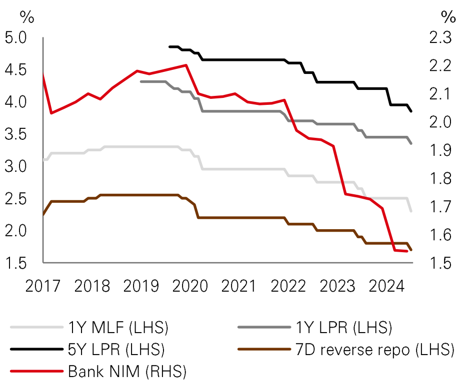
Policymakers at the July Politburo meeting pledged to strengthen countercyclical policy adjustments. That said, we think major new stimulus looks unlikely given policy trade-offs between growth support and risk control and between short-term and long-term objectives. We expect greater focus on better policy implementation and continuing efforts to mitigate risks related to property, local government financial vehicles (LGFVs) and smaller financial institutions.

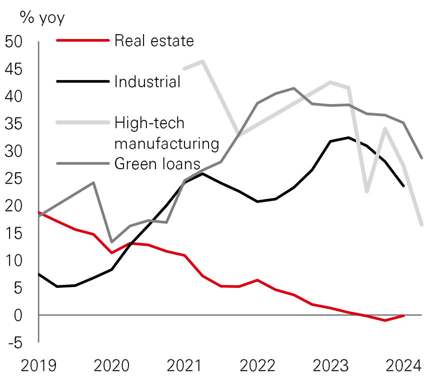
We expect more targeted and piecemeal countercyclical policy easing

We expect an accommodative monetary policy to remain in place. After surprising rate cuts in July, we still see some scope for further small cuts to interest rates or the reserve requirement ratio. But the PBoC is likely to maintain its piecemeal and cautious approach on interest rates given concerns over banks' shrinking net interest margin (NIM) and FX volatility, even as Fed rate cuts may lower the hurdle for PBoC easing. The PBoC will further expand its policy toolbox (e.g. government bond trading) to improve policy transmission and support the government's quality growth agenda via targeted credit support.

A greater focus on policy transmission and quality-growth agenda in monetary easing

Figure 19: Non-financial sector leverage. Figure 20: Bank NIM & key interest rates





Source: CEIC, HSBC Asset Management, as of 15 August 2024. This information shouldn't be considered as a recommendation to invest in a particular sector shown.

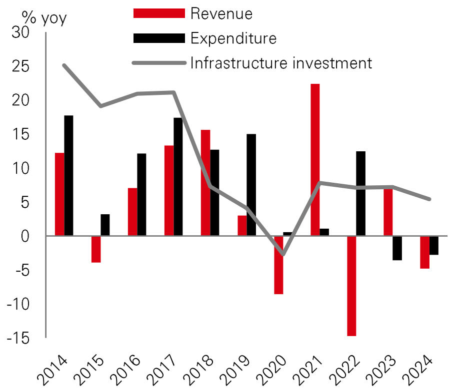
Room for more fiscal support in H2

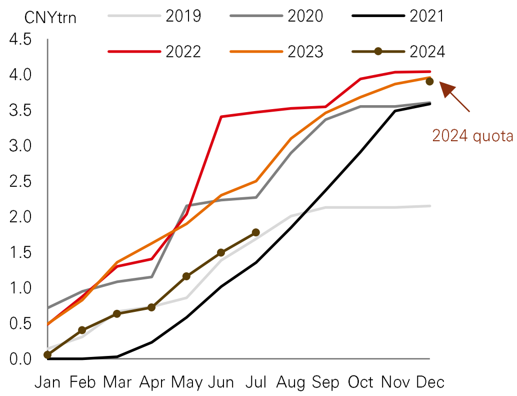
Fiscal policy to focus on better utilization of the budget space and tackle local debt risks

We believe stronger policy effects, especially on the fiscal and property fronts, are needed to secure this year's growth target. The slow pace of budget utilisation in H1 (in terms of special bond issuances and expenditure) implies more room for fiscal support in H2 2024/early 2025. The government will likely ramp up fiscal spending by accelerating the issuance and utilisation of special government bonds. The allocation of CNY300bn special treasury bonds (CGBs) to promote consumer goods trade-ins and equipment upgrades eases the constraint that such bonds can be used only to finance infrastructure projects. We are hopeful that the government may also relax the rule and expand the scope of use of local government special bonds (LGSBs) as mentioned in the Third Plenum. Stronger external headwinds could prompt a step-up in demand-side stimulus in 2025.

We await details of fiscal and tax reform plans to re-align the expenditure and revenue structure between the central and local governments, critical for fiscal sustainability. Policymakers also vowed to put in place a long-term mechanism to tackle local government debt risks.

Figure 21: Budget implementation & infra investment (H1). Figure 22: New LGSB issuance





Source: CEIC, HSBC Asset Management, as of 2 August 2024.

Some final thoughts

Economic transition creates opportunities in sectors prioritised for long-term quality development

A clear pro-growth policy stance improves near-term macro and earnings outlooks. A modest recovery in sequential real GDP growth in H2 2024 is likely from a weak Q2. However, reactive and piecemeal easing suggests that a quick turnaround in private confidence or sustained economic reflation is challenging, amid structural growth headwinds. Weak nominal GDP growth has weighed on corporate earnings, but macro weakness is well reflected in the markets. The pace and effectiveness of policy easing, the property market trajectory, the strength in external demand, and geopolitical developments/US trade policies are key cyclical risks to monitor. Achieving high-quality and sustainable growth will require a wide range of structural reforms to tackle headwinds and address underlying imbalances.

China's economic transition will still need time and could mean ongoing short-term adjustment pains, but effective implementation of structural reforms would help to unlock productivity gains along the way. Some strategic sectors aligned with China's long-term development goals will likely show stronger growth potential and better earnings visibility and be a medium-term fundamental driver for the overall markets. The SOE and corporate-governance reforms could add further support to the market re-rating potential.

Renee Chen, Global Investment Strategy Team

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