

China Watch

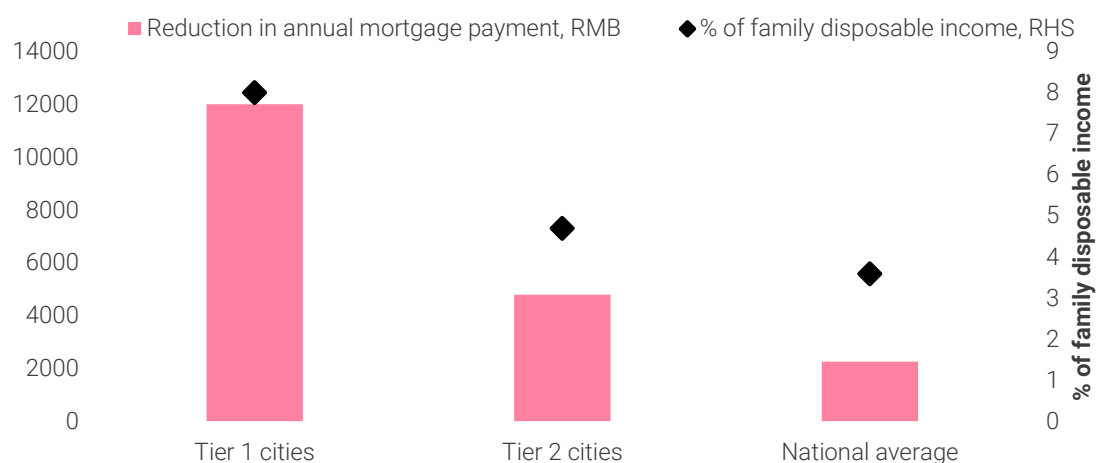
THIS TIME IS DIFFERENT, BUT DOES XI KNOW – AND DOES HE CARE?

Rory Green

- **Property scarring is stressing Beijing's stimulus reaction function**
- **China cannot give up on growth, but policymakers are underestimating the real-estate danger**
- **Stimulus cycle begins, but more needed to stabilize activity**

How scarred and how much stimulus? These are the two questions we have been asking in order to gauge China activity in 2023. We said in January that China was deeply scarred and that this would weigh on growth going into H2/23. The strength of the Covid/property/regulatory hangover is now clear, which leaves the stimulus question. Xi Jinping undoubtedly has a much higher pain threshold than any recent Chinese leader as well as a weaker focus on economics, but that does not mean he can give up on growth. Recently announced measures are the first meaningful stimulus of 2023 – and the strongest indication yet that Beijing is finally cognizant of the country's economic woes. **Nonetheless, the size of the stimulus suggests the central authorities are still underestimating property-related risks and will continue to pursue a measured pace of easing.** China is finally turning more proactively pro-growth, but **the economy is set to decelerate further and will require much stronger stimulus to stabilize real estate.** A more positive policy stance and the recent market sell-off further improves the risk/reward on China equities; however, we remain negative for now. We also remain negative on FX as USD/CNY is likely to test the PBoC defences once again.

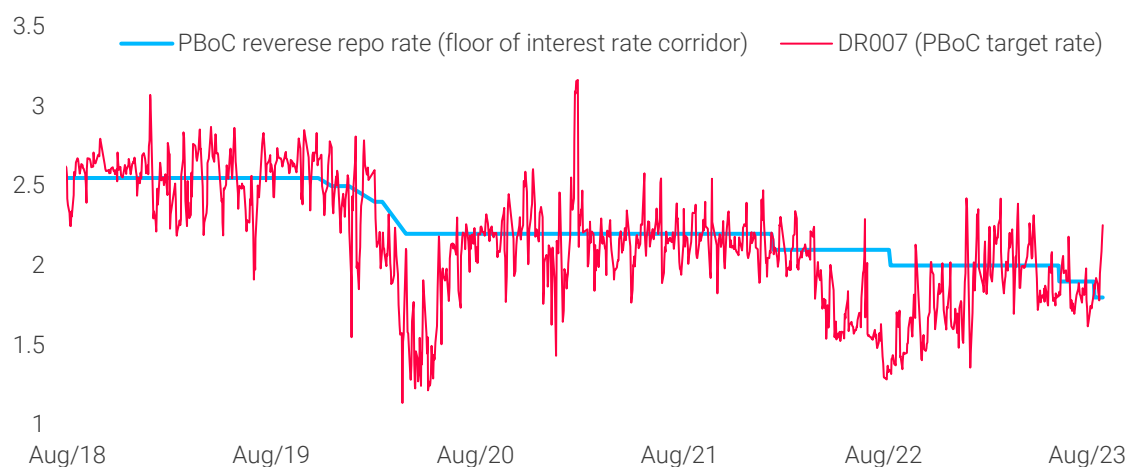
Chart 1: Mortgage cut to help consumption at the margin



Sources: BBG, PBoC, GlobalData TS Lombard.

A new higher pain threshold. Since 2016 the stimulus reaction function of policymakers has been evolving at the same time as cyclical and structural factors have been making traditional tools less effective. The Party now favours more gradual targeted easing and has a much higher pain threshold, especially for real estate-related economic difficulties. The new policy outlook is a direct product of the most ideologically driven leadership in 20 years. President Xi is clearly attempting to reshape the political economy and growth model in an attempt to deliver “Chinese-style modernization”. National security and related technology innovation have joined growth – now more narrowly defined as “high-quality growth” – as core CCP objectives. Although the relative importance of economic expansion has declined, it is still a major objective. Even for Xi, who is more steeped in Mao than Mises, it must be clear that a slowing China will struggle to compete with the US.

Chart 2: Short end rates have tightened in 2023



Sources: PBoC, TS Lombard.

If growth is still a priority, albeit a lower one, then the recognition of current economic difficulties may be the hurdle to more forceful stimulus. It seems that going into 2023 Beijing thought activity would recover easily without stimulus and that there would be opportunity to use reopening-driven growth to address longer-term structural issues related to local government debt. Those issues were cited at the Central Economic Work Conference last December and the NPC in March. The PBoC, for its part, was extremely concerned about the prospect of surging inflation when China lifted zero Covid: the bank cited it as a worry in its Q1 monetary policy report, published in April. Changing the Party view on economic activity has taken time, with Beijing acknowledging only at the end of July that the recovery was increasingly “torturous” and likely to come in “waves”.

Another factor complicating the stimulus reaction function is real estate. This time around is different for property – a fact the PBoC acknowledged in July and noted more forcefully in its Q2 monetary policy report, which says “the long-term supply and demand fundamentals of real estate have changed”. The pre-sales model is broken and consumers are heavily scarred and, if not overleveraged (second-home deposit rates are 30%), massively overexposed to the sector. In previous cycles, the fairly modest steps taken in H1/23 would have been sufficient to trigger a broader stabilization in sales. But it has not been enough this year, and the current trajectory – absent stronger intervention – will cause a second, more damaging round of financial spillovers.

But does Xi know? And does he [even] care? Famously, Xi believes “housing is for living in, not speculation” and real estate should not be used as a “short-term stimulus tool”. The longer-term

direction is clear and policymakers have tolerated a great deal of property pain, attempting to take a structural view that near-term suffering is necessary to rebalance China's economy. However, it appears even central authorities are acknowledging a need for greater easing. Neither of the aforementioned Xi aphorisms on housing was included in the July Politburo statement, and this paved the way for the broader easing measures announced earlier this week. Although, these moves are positive, it is likely that policymakers are still underestimating the severity of slowdown and related financial stress and overestimate their ability to manage more severe economic spillovers. The goal will be to do just enough to stabilize the sector and avoid reinflating a bubble.

Alongside property easing, policymakers have increased intervention across a broad array of markets in the past couple of weeks. It is worth emphasizing that in line with Beijing's hitherto rosy economic view, the coming infrastructure stimulus, property measures and rate cuts are the first round of meaningful stimulus this year; and they come after all three of our triggers – unemployment, financial contagion and growth-target risk – started to flash warning signs last month. For instance, bank lending rates in Q2/23 were down just 5 bps compared with last year, the PBoC's target market rate is 65bps higher than in December 2022 (partly owing to some seasonal liquidity tightness). At the same time, fiscal spending has been more restrictive, contracting ytd and on track to register the lowest deficit in a decade.

Chart 3: General budget deficit on track for rapid contraction



Sources: NUS EAI, NBS, CEIC, GlobalData TS Lombard.

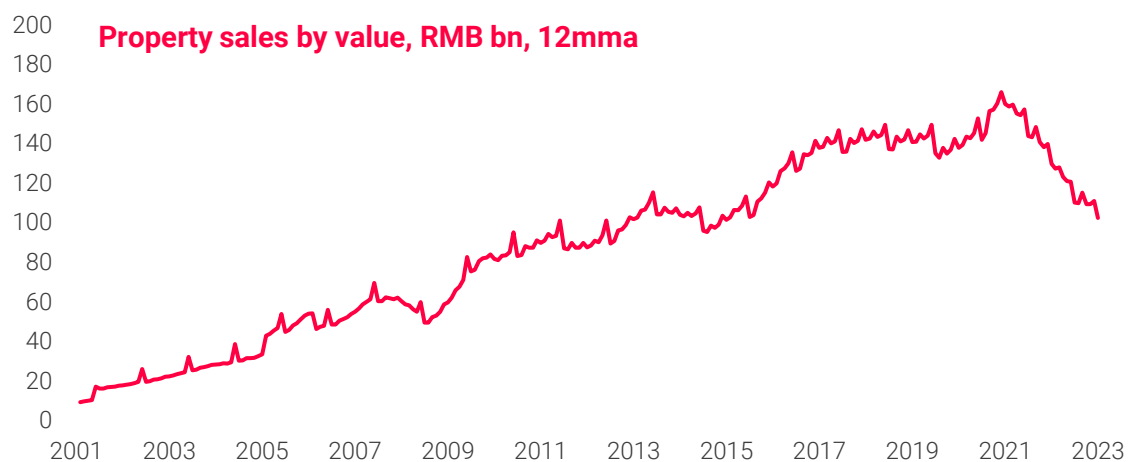
Stimulus is just beginning – and more will be needed. Although the first national-level property easing since Covid is a strong positive signal, its impact on home sales is likely to be limited. The reduction in minimum deposit rates for first-time buyers (from 30% to 20%) and second-time buyers (from 40% to 30%) may help purchases in Tier 1 and 2 cities, but the bulk of the market – the weakest part, namely Tier 3 and below – was already at those limits. The reduction in mortgage rates will help address the ongoing policy debate of whether cash handouts should be tried out in China? The cut amounts to a modest increase in income to homeowners (admittedly at the expense of savers – banks have cut deposit rates to maintain NIM). The average mortgage rate will fall by ~80bps, equivalent to an increase in spending power equal to 0.24% of GDP. However, with confidence low and income growth weak, it is likely that a large part of the increase in income will go to savings rather than spending. We think only 60% of the 0.24% of GDP will, in fact, be spent. **Much more will be needed to stabilize property sales (chart 4).**

Fiscal will be the main driver, with a contractionary stance turning expansionary. Beijing is stepping up easing via local governments, largely through the infrastructure channel, where

investment is likely to average ~10% yoy in H2/23. The Politburo statement signalled more fiscal fire power via measures to “resolve” local government debt issues and facilitate existing bond issuance. This suggests greater spending capacity for provincial cadres in H2/23. The method to “resolve” financial constraints of local governments is still unclear, for now; we think an ad-hoc province-by-province approach is more likely than a major national-level solution, with banks pressured to extend/roll over maturing debt. On the revenue side, officials have been told to draw on their remaining bond quotas by the end of this month and spend the proceeds by the end of October. Rapid issuance and temporarily less central government pressure on financial sustainability will mean much more revenue going directly to investment, and this will be the key government driver of activity in H2/23. Meanwhile, monetary policy is in supporting mode. We forecast a 10bps cut to policy rates and a 25bps reduction in RRR this quarter aimed at boosting property and fiscal easing measures.

The belated start to stimulus is welcome but will be insufficient to revive household confidence and property transactions. Data are set to decelerate further in Q3/23 and Beijing will need to do more to stabilize activity. The property investment growth rate will remain negative for at least the next couple of quarters – sales by volume will be weak as well – meaning an “L-shaped” economic growth path from Q4 onwards. For markets, the risk reward on China equities is becoming more attractive as assets near a cyclical nadir on sentiment, followed by either economic stabilization or more forceful government action.

Chart 4: Much more needed to halt property decline



Sources: NBS, CEIC, GlobalData TS Lombard.

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