THE CHANGING ASIAN LANDSCAPE – PART 3
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China Takes It Slow

The world may want higher growth, but Chinese policymakers are employing a balanced approach.

China continues to seek a "quality" expansion while addressing its real estate situation, tough demographics, reduced foreign investment and geopolitical tensions, among other issues. Given this complex backdrop, we continue our interview series on *The Changing Asian Landscape* with Puay Yeong Goh, Senior Economist, Emerging Markets Debt. From his desk in Singapore, Puay Yeong explores China's economic strategy and challenges, and explains why he believes investors should get used to the country's more gradualist path.

China is tackling an array of economic issues, most prominently the real estate slump. Can you explain the genesis of its recent efforts?

It's useful to consider the kind of economy President Xi Jinping inherited from his predecessors when he first took office in 2013. It was an economy that was growing very fast, but was starting to have major imbalances. So, throughout his first five-year term, the government tried to deal with some of these issues. They began with the industrial sector, especially in metals and mining back in 2013 and 2014 to address overcapacity issues, and shifted their focus to financial market reforms in 2017 – 18.

As there was never going to be a "good time" to do it, authorities began to focus on the property market and local government financing vehicles (LGFVs) toward the end of 2020. In China, local governments traditionally had limited avenues of direct taxation and instead relied heavily on land sales as a primary source of income. They encouraged the rapid growth of the real estate market, which fueled speculative investment over genuine demand and led to an overheated environment with unsustainable prices. The situation escalated financial instability, especially for developers and LGFVs, which became heavily indebted from aggressive expansion efforts. In this context, the national government felt that it had to act sooner rather than later to prevent the problem from spilling over to other parts of the economy.

STAYING ON TRACK

China is looking for quality, rather than maximum growth, but the real estate crisis and other issues have complicated that task.

The high-quality growth that China wanted involves boosting consumption, assisting high-tech private companies, encouraging foreign direct investment (FDI), expanding trade agreements, opening up the service sectors and more. That was the grand plan.

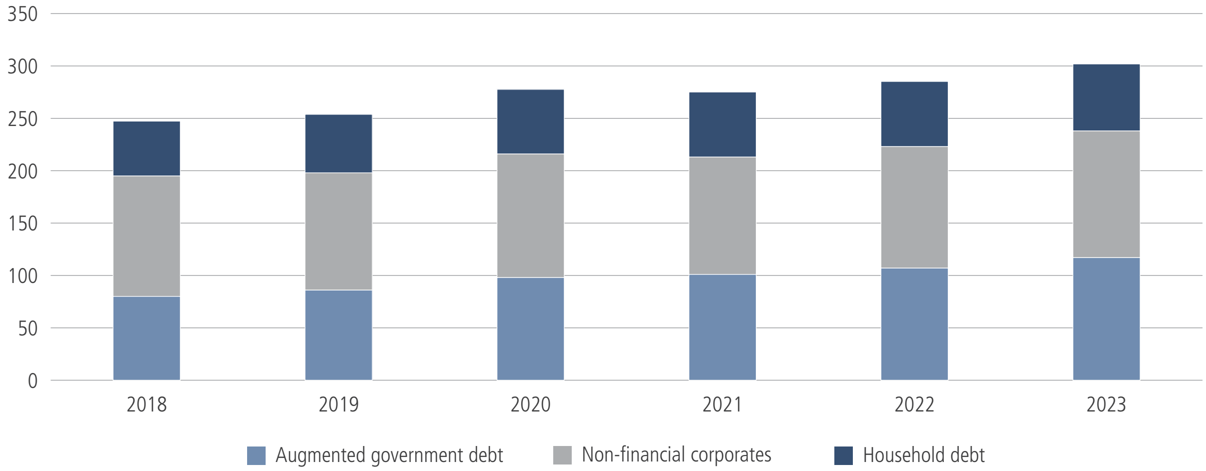
At the same time, they thought that this higher-quality growth would allow them to take on rising risk in the property sector and LGFVs. Unfortunately, in the midst of the once-in-a-decade political transition in 2022, implementation was not exactly seamless, and I think policymakers appeared to underestimate the scale of the issues they faced, and what would be required to fix them. High levels of debt, a sharp decline in local government revenues affecting their support for the local economy, and dampened consumer sentiment due to falling property prices are hindering efforts toward economic transformation. These intertwined issues are adding layers of complexity to the task of reshaping the economy.

Missing, it seems to me, has been a meaningful blueprint for the outcome they want to achieve, which is a departure from past reforms. There have been numerous rumors about potential approaches, including the use of the "Singapore model," where 85% of the populace lives in public housing. Within this framework, developers retain the ability to compete for business in both the private and public sectors, with local governments overseeing the process. Along these lines, authorities recently introduced a plan for local governments to acquire unsold homes and convert them to affordable housing. This might be an early sign of a major shift in addressing challenges in the real estate sector, particularly the issues of housing affordability and excess inventory. However, we feel the measures announced so far are insufficient to cause a meaningful turnaround in the sector. The focus of investors is now on the Communist Party central committee's "Third Plenum" meeting in July, when there could be further announcements.

Stepping back, the COVID pandemic has had an impact on reform efforts, as have geopolitical and economic tensions with the U.S. With the higher-value growth model, China has started to move into fields that both the U.S. and Europe have exposure to and are interested in, such as electric vehicles, green energy products and various electronics, among many others, and they've seen considerable pushback.

CURBING DEBT LEVELS IS A KEY TASK FOR POLICYMAKERS

Components of Chinese Debt (% GDP)



Source: IMF, as of December 31, 2023. Augmented government debt includes issuance from the central government, local governments, LGFVs and government funds. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Is “quality growth” still on track, and what are its implications?

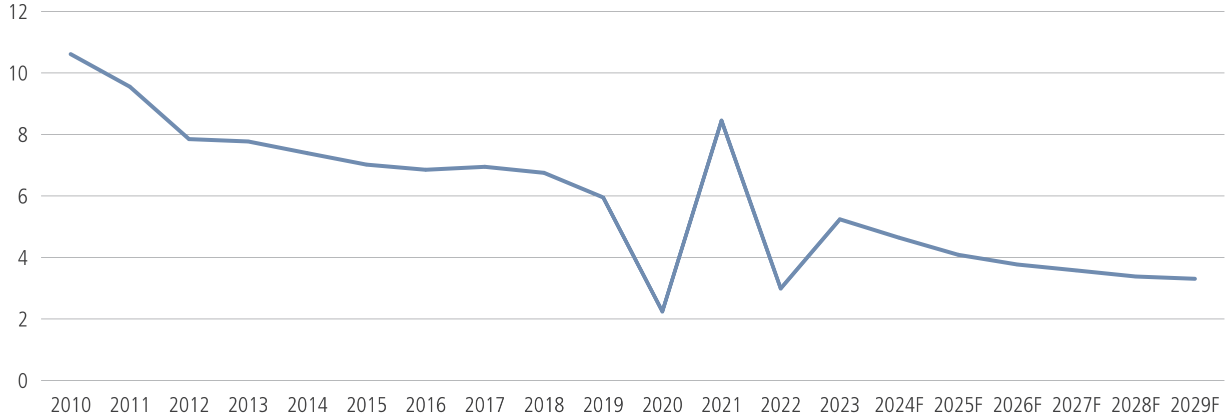
Overall, the strategy has seen rocky results, but I think it is still feasible. One aspect of the quality approach is that the growth rate can be lower than what was achieved since 2000. Instead of 6 – 8%, 4 – 5% is probably sufficient, given the potential for increased productivity.

Although this sounds respectable, the reduction would still have major implications, especially given the multiyear timeframe we are talking about. Even the China “miracle” took 10 years to meaningfully increase incomes, and the current transition may be harder. Unlike the clean balance sheets of the past, systematic debt (at the local and individual levels) is much higher; but the government won’t permit the kinds of market-driven adjustments that might happen in Western economies, which tend to experience more frequent boom-and-bust cycles. Instead, the process will be one where debt is slowly restructured over time, given that authorities want to avoid the potential for a deep recession that often follows those market-led adjustments.

This means that the world will likely need to get used to a slower-for-longer growth profile from China. At the same time, policymakers realize the need for a growth floor to aid that transition and avoid collateral damage from high debt levels. If growth dips below certain levels (or is at risk of doing so) they’ll tap, rather than step, on the accelerator to bring it back to what they deem acceptable levels.

CHINA’S NEW NORMAL

Real GDP Growth (%), Actual and Forecast



Source: IMF, as of April 2024. Annualized, constant prices in national currency. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

At the start of the year, China was looking for an official growth rate of 5%. How are things going on this and other targets?

In our view, the first several months of 2024 were reasonably strong. First-quarter real GDP was above expectations at 5.2%, with exports providing a positive surprise, and supporting industrial production. If exports remain healthy, that could help China meet its 5% growth target for the full year. This may be partly due to an inventory rebuilding cycle and continued expansion in the U.S. and certain other economies, so a slowdown in developed countries could strain the Chinese growth picture.

Unfortunately, domestic demand continues to soften; onshore sentiment remains quite fragile, and could get worse given wage trends. The government’s unemployment goal is 5.5%, and they seem able to achieve that figure on an official basis. However, more local surveys suggest that unemployment is actually a lot higher, with many young people, including recent college graduates, abandoning job searches. We remain cautious about the sustainability of the recent rebound, given ongoing challenges in labor and housing markets, and are expecting real GDP growth of around 4 – 4.5% in 2024.

On inflation, China continues to undershoot the mark, and we think that will continue. The current goal for CPI is around 3%, but with producer prices in deflation and a potential softening of food costs after the Lunar Year, the actual figure for CPI growth will probably hover in zero-to-negative territory.

Policymakers are aware of current economic weakness, but are aiming for a soft landing that facilitates systemic deleveraging. This means that property market and labor conditions will likely still exert downward pressure, contributing to an anticipated nominal GDP growth of about 4%. That's difficult for psychology because most people will think about their income and costs from a nominal perspective.

CONSUMERS, FDIs AND AGING

What can be done about consumer sentiment?

If they really want a boost, the government should execute more demand-based easing. For example, authorities are providing cash for auto trade-ins, and have been executing some tax cuts, but the scale is not large enough to make a real difference. And again, what's the point of artificially boosting growth in the near term if that worsens the debt issue you are trying to correct? In reality, it may just take time—and a bit of discipline—for the high leverage to fade to more acceptable levels, and for consumer confidence to return, as we saw in developed markets after the Global Financial Crisis.

Foreign investment has dropped meaningfully in China. Why?

Events during the pandemic had a significant impact on foreign direct investment flows, which ran at about $300 billion in 2021, but dropped to about $50 billion last year. Initially, companies were impressed by China's ability to keep its supply chain open. But the zero-COVID strategy changed all that, and managements now worry about potential for sudden interruptions in manufacturing. This has led to further exploration of "China plus one" strategies, which were already gaining momentum because of geopolitical issues. Now, instead of "just in time," the approach is to have a buffer, with higher inventories and capacity than before.

Moreover, currently slow Chinese domestic demand provides little incentive for investors to return. With finite available funds, why not place that money elsewhere? Eventually, when a trough becomes more evident, there should be more investment dollars, but that could take a few years.

One issue causing concern is China's aging demographics and population decline. What are the implications, and is there a way to deal with the issue?

The Chinese population has been shrinking since 2022—which is much earlier than the 2027 starting point that many people expected—and is projected to fall below 1.4 billion by 2040. This means that the dependency rate (measuring the number of seniors and children for every 100 working age people) will move up more quickly, reaching 60% well before 2040. This, in turn, will add to pension needs, which could become a huge fiscal burden for the country.

One way to offset a declining population is higher productivity, which may be addressed with further modernization of the economy, including the use of artificial intelligence, to foster the high-quality growth we've discussed. Another is to take care of economic problems like the property overhang now, before the population declines so much that they become even harder to solve.

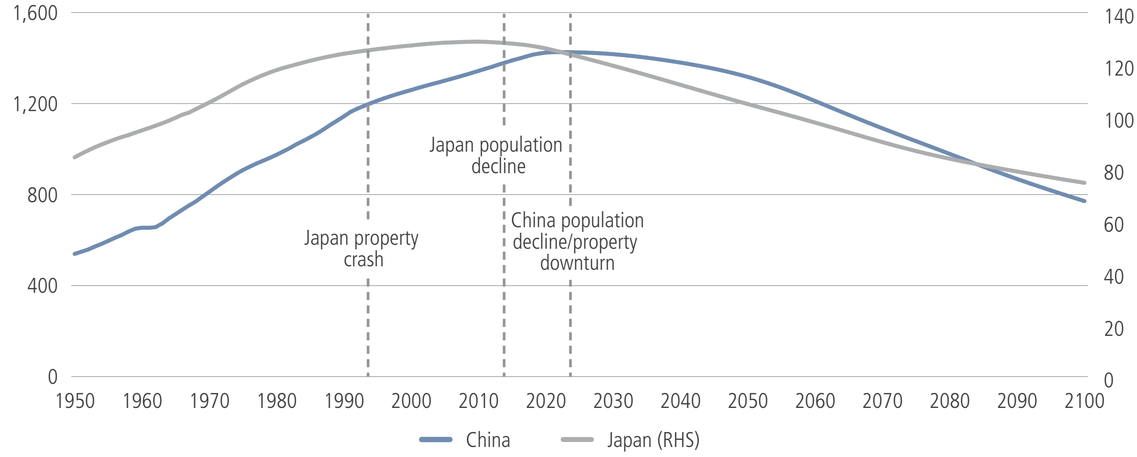
The press has focused a lot of attention on the flood of cheap goods from China. Is the increase a strategic move?

To be fair, I don't think it was a deliberate strategy, but more a consequence of China's industrial policy and a cyclical lack of domestic demand. Companies have been guided to invest in and run at higher capacity, but demand is currently quite stagnant, so they have been exporting the excess. To me, it shows one of the characteristics of industrial central planning: It's very easy to direct resources to achieve a result, but it becomes more difficult to course-correct.

In this case, the policy is driven by both economics and geopolitics. In the wake of the Russia-Ukraine war, the government has been concerned about the impact of potential sanctions by the U.S. and wants to build more self-sufficiency. This focus on self-reliance has led to investment in semiconductors, autos and much more, aided by subsidies and cheap loans, resulting in a continued increase in industrial capacity.

DEMOGRAPHIC PRESSURE: ECHOING JAPAN?

Population, Actual and Forecast (Millions)



Source: United Nations, World Population Prospects, 2022 revision. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

What are some key external impacts of China's slower growth?

China's current slow-growth trajectory and continuing difficulty in the real estate market provide natural dampers to prices on traditional commodities, including base metals. But as my colleagues have suggested, those involved in the energy transition, like copper, should continue to see healthy demand—a reflection of the broader climate story rather than China fundamentals. There are some other interesting wrinkles to the commodity story; for example, China's demand for iron ore remains relatively strong given its cost advantages in refinement.

More broadly, China is generally exporting its industrial deflation, which has helped limit the cost of goods across many countries. Depending on where you sit, this can be positive or negative: In Asia, markets that are export-oriented see more price competition and softer wage growth; for net importers of industrial goods, however, it can be a benefit to profitability and higher purchasing power for consumers. In developed markets, it is helping limit the cost of goods even as services inflation is strong. Still, the danger of countries reacting with protectionist measures is real.

HAZARDS: GEOPOLITICS, SLOWER RECOVERY

That leads us to the issue of risks. How would you view the geopolitical issues?

One problem with assessing the impact of these geopolitical relationships is that they can take a really long time to unfold, so it's hard to make concrete investment choices in advance of those trends. I think it is fair to say that those tensions will continue, sometimes to a lesser and sometimes to a greater degree.

Recently, we saw the Biden administration place tariffs on steel, aluminum, semiconductors, electric vehicles and other goods made in China, while Donald Trump has talked about high tariffs as well; and there is a U.S. directive that the social media platform TikTok change ownership. However, both sides have leverage, including the significant exposure of some U.S. companies to China. The truth is that the Chinese economy is intertwined with the U.S. and global economies, and those ties can't be unwound easily. This is in contrast to Russia, for example, where impacts have been primarily to energy prices. These relationships are complicated, and so you have conflicts, but also areas where the players can try to work together.

What other concerns do you have about China?

Let’s start with something that is *not* so worrisome to me, which is the prospect of a sudden deep recession. Because of the government’s control over economic levers, including the financial markets, you are very unlikely to see the kind of financial blowup that might occur elsewhere. They can also dictate the pace of price adjustments in housing and other economic sectors. This level of control is a double-edged sword. It provides short-term stability, but may create long-term distortions in the market.

Moreover, I think there is risk that the government misjudged the level of support needed to maintain the transition we’ve talked about. This could see growth fall to say 1 – 2% rather than a more comfortable 4%, which is a huge delta for a $20 trillion economy, and prolong the transition for five, seven or even 10 years. That would of course be negative for China, but also for other countries in the region and globally where it remains a key trading partner.

Finally, we’ve talked about China’s patient approach. How long will it take before investors become more confident about adding exposures?

The scale of the current task is significant, and as I’ve said, I don’t think it’s something that can be resolved quickly—it could take several years. In a sense, it’s reassuring that policymakers are not reacting to issues with the same stimulative mechanisms as in the past. So, if they can stick with it, it bodes well for China’s future economic outlook and for the broader global economy. As for investors, they will look for signs of greater stability in the debt situation, and once they’ve reached a psychological tipping point, I think you will likely see a shift back in fund flows anticipating improved fundamentals.

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