Trampled under Thucydides

Global economic outlook in the shadow of US-China struggles

2024

GLOBAL MACRO PANORAMA – PART 2: CHINA

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Executive Summary

- China has been going through an acute real estate crisis, which—coupled with disruptions from the pandemic—has depressed household income and consumption. Unlike a typical "Western" approach, however, the Chinese authorities have been far less willing to provide bailout or handout, instead implicitly tying demand-side recovery on supply-side improvement.
- Criticisms of China's inadequate stimulus typically cite its tepid rate cuts and its relative reluctance to expand fiscal spending. A peek under the hood, however, reveals that China is engaged in a "QE-like" operation, albeit one where the central bank's balance sheet expansion provides a direct boost for bank lending.
- Massive financing flows into manufacturing is dictated by a combination of (1) China's need to avoid monetary contraction and the ensuing debt-deflation cycle, (2) lack of appetite to lend to property and other tertiary sectors, and (3) the authorities' own strategic priorities amid its competition with the West.
- This financial boost has helped China make strong inroads into high-tech sectors, especially EVs and renewables—without which, the GDP would have only grown by 3-4% in 2023. For less complex and more labor-intensive industries, however, this wave of financing acts more as a large-scale subsidy scheme, to compensate for declining profits due to falling factory-gate prices.
- China's monetary expansion has inadvertently driven global disinflation, by spurring industrial output much faster than its domestic consumption growth. This supply-focused strategy can only be sustained through exports—making China's recovery contingent on continued strength of global demand and/or loosening of global liquidity.

This is part 2 of 4 in our Global Macro Panorama

** all data and forecasts are updated at least one week prior to the original publication date, on Feb 13th 2024*

Part 2
China

The great zag of China

- Another pivotal factor to the soft landing in 2023 was the unique trajectory of China's economic recovery, which leads to goods disinflation across the world. As it turned out, China's emergence from its COVID-19 lockdown late in 2022 did not really bolster global demand, but mainly amplified supply.
- China, of course, has been grappling with a real estate crisis, which greatly affects household finances. It also has substantial impact on infrastructure projects, which are traditionally financed by local governments in part via sales of land to real estate developers.
- A typically "Western" playbook in dealing with this might consist of rescuing institutions and making large fiscal and monetary stimuli to boost demand. However, China’s approach seems—at least superficially—more muddled.
- Debt restructuring for developers has been a protracted affair, while fiscal stimulus proceeds in fits and starts. Monetary support—consisting of 150 bps cuts or less to several key rates—is eclipsed in real terms by deflation, meaning that policy has actually tightened.
- Moreover, a big part of this stimulus is directed towards the manufacturing sector. The ensuing increase in production causes inventory to accumulate, given the weak domestic demand. Clearing these requires price discounts or exports (or both), which therefore leads to the global disinflation.

Running on empty

- Might the Chinese authorities have pursued an alternative path that would salvage demand? After all, previous real estate crashes in 2012 and 2015 did end in robust consumption recoveries.
- But the current crisis exceeds the previous ones in scale and is also made worse by the impact of the COVID-19 pandemic. The latter disrupted the service sectors, which were supposed to be key for China's shift away from its manufacturing- and export-centric economic model.
- Compared to the 2015 crisis, the current crisis has clearly caused a more profound reduction in household income growth. There was also a downward lurch in consumer sentiment in 2021, with little sign that things would turn around anytime soon.
- While retail sales are displaying strong growth due to low-base effect from 2022, consumption still falls short compared to pre-pandemic trends. This is even more apparent from mobility data, which show that Chinese tourism is no longer the force it was during the late 2010s.
- In theory, the Xi Jinping government could have provided for a bolder fiscal stimulus to make up for the slowing income growth. However, the Chinese authorities has often stated its aversion to providing "handouts"—making any demand-side recovery contingent on productivity improvement on the supply-side.

QE with Chinese characteristics

- Exacerbating the challenges are US efforts to restrict investment into China, which have caused sharp downturn in FDI and portfolio flows, as Western investors rush to "de-risk" from China.
- This has the effect of curtailing China's liquidity growth, leaving it with the unwelcome alternatives of deflation (which can make its already-high debt levels more burdensome) or devaluation of the Yuan (which may accelerate capital flight).
- The Chinese authorities have to thread the needle between these proverbial Scylla and Charybdis. They allow some CNY depreciation without succumbing to more severe pressures. Domestically, meanwhile, they try to stabilize aggregate financing growth in order to stave off debt deflation.
- However, with FX loans and equity financing limited by the outflows, the only route to drive up financing is by issuing more CNY bonds or loans. The former probably implies more deficit spending by the government (at either the central or regional levels), but what about the latter?
- Here we need to delve into an overlooked aspect of the Chinese stimulus. In recent years, the PBoC has actively expanded its balance sheet by lending to banks during times of liquidity stress, not unlike what the Fed did with QE. Indeed, this appears to be the PBoC's primary route for monetary stimulus, rather than the relatively tepid rate cuts.

- However, unlike the Fed which incentivizes banks to park this newly-minted liquidity by paying interest on excess reserves, there is scant evidence that the PBoC discourages banks from lending it out. China's commercial banks thus seem to act as conduits, channeling credit from the PBoC.
- This form of stimulus clearly enables closer alignment between credit allocation and the government's strategic priorities, particularly in the areas of technological, energy, and manufacturing competition against the US.
- And indeed, these may be the only logical recipients of these new financing, given the elevated risk in the property sector and weak demand elsewhere. In other words, they represent the exact point where China's grand strategy and its monetary stabilization needs overlap.

Great leap forward

- So how has this big financing push worked? By some measures, very well indeed. Fixed-asset investment in manufacturing has kept a healthy pace even as those in real estate slumps, and energy consumption is booming accordingly.
- Even more important than energy usage, however, is energy production. China is, by far, the leading nation in terms of renewable energy investment, —to the extent that without it (and the concomitant investment in EVs), its GDP in 2023 would have grown by 3 – 4% YoY, instead of 5.2%.
- Given the massive investment, it is unsurprising that China is in the midst of an EV production boom, while its lithium-ion battery output is revived after slowing down in 2022. Other advanced manufacturing such as robotics and semiconductor chips are also growing strongly, thanks to generous support from the authorities who see them as key in China's strategic competition against the West.
- China is also advancing in basic, upstream industries like metal processing and especially chemicals. The latter in particular seems to be related to the situation in Germany, whose chemical industries are losing competitiveness due to high energy prices in the aftermath of the Russia-Ukraine War.

Too much money many making too many goods

- In several other areas, however, China's industrial prowess appears to hit a wall. This is most obvious in industries like cement, steel, and heavy equipment, which rely on the previously-insatiable demand for construction.
- But there is also a steady, gradual erosion in the production of consumer goods and basic machineries which actually predated the pandemic. This is the result of two separate developments—(1) rising labor cost which begins to undermine the competitiveness of China's labor-intensive industries, and (2) the uncertainty arising from US tariffs since the Trump era, which drives some MNCs to diversify their sourcing.

- In an ideal world, China's move up the value chain (towards more complex products) would open up space for other EMs to participate in less complex manufacturing. This was, after all, what happened at the crest of Japan's and South Korea's industrialization, when they began to outsource the more labor-intensive areas to other (predominantly SE Asian) EMs.
- This, however, might be precluded by China's enormous scale advantage—including its demographics. The Chinese authorities probably still see these industries as important sources of employment, especially for its still-large contingent of migrant workers.
- Here, then, the PBoC-driven financing push serves less as stimulus or R&D funding, as it is a giant subsidy scheme. After all, most of China's industrial sectors are seeing margin compression from falling factory-gate prices.
- China's growing strength upstream is also a boost for the labor-intensive industries downstream, in terms of input costs. In the metals and textiles value chains, for instance, the upstream industries continue to produce at low prices and high volumes, regardless of the struggles downstream.
- The curious implication here is that China's monetary expansion is driving global inflation down, rather than up. But this is not that odd if we recall how the Fed's loose policies post-GFC caused an investment boom in areas such as shale oil and tech, also with little regard to short-term profits. These in turn pushed down global inflation via cheaper energy on one hand, and enormous consumer subsidies on the other.

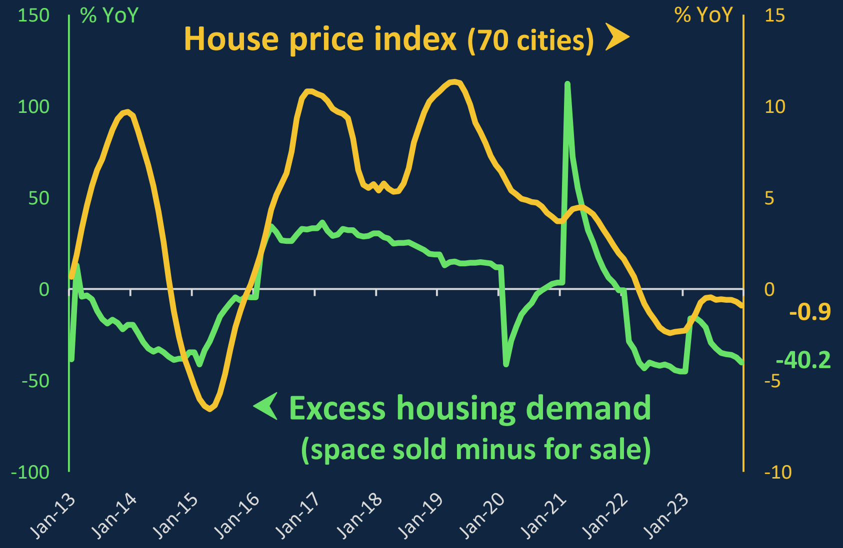
Not cutting the Gordian knot

- How long can China keep doing this? There are signs that the authorities are starting to wring out excess capacity and encourage industrial consolidation—including in key areas like steel, EVs, and renewables. Given its negative impact on growth, however, this will likely be a slow, protracted affair.
- The other limit to this strategy, of course, is global demand. And here the US still controls key lever, since prolonged tight policy from the Fed—or indeed a higher set of tariffs from a second Trump administration—could cause a further decline in the demand for Chinese-made goods.
- Here, then, lies the ultimate flaw of China's strategy. Even as it make noises about reforming the US-centric global economic system through BRICS+ or Yuan internationalization, its relentless focus on the supply-side only makes it more dependent on Western markets and the US Dollar.
- Its current account, which only grows more lopsided since the pandemic, is a testament to this interdependence. The only reason why its surplus somewhat narrowed in 2023 was payment for shipping, insurance, and patents, where it still greatly relies on Western firms.
- And of course, China's surplus continued to be employed—whether directly or indirectly—to finance US current account and fiscal deficits. The latter in particular, and the US economic situation in general, will be the focus of our ***Part 3***.

Third time unlucky

China's current real estate crisis has been more severe and prolonged than similar episodes in 2012 and 2015

Source: *Bloomberg, BCA Economist*



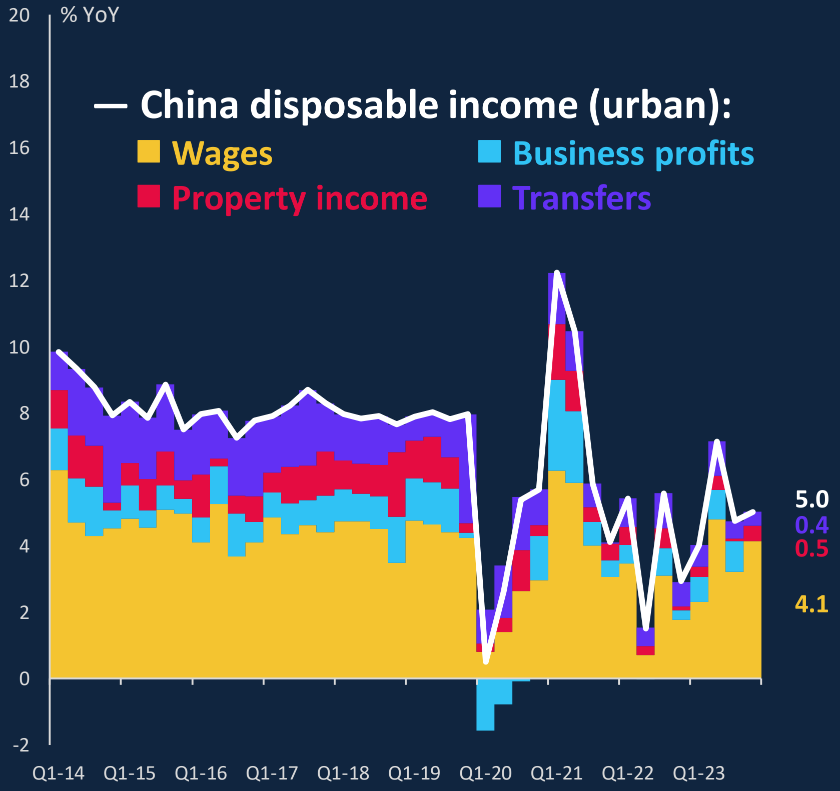
Source: *Bloomberg, BCA Economist*

Note:

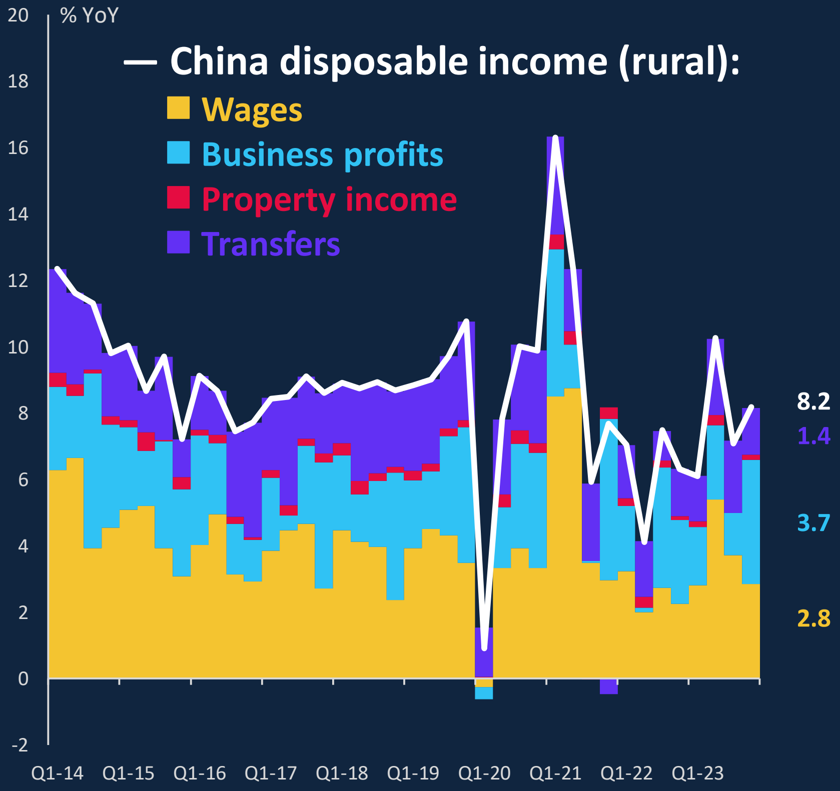
- Just as the current crisis was triggered by tighter regulations on the real estate market ("three red lines"), the crises in 2012 and 2015 was also driven in part by policy tightening, on top of the persistent over-investment. In both cases, the crises ended as policies were relaxed and financing flowed back to real estate—which might not be possible this time given the extent of the problem as well as the authorities' resolve not to re-inflate the bubble.

Urban blues

Income growth for urban households have slowed considerably—not just from property income but also from wages



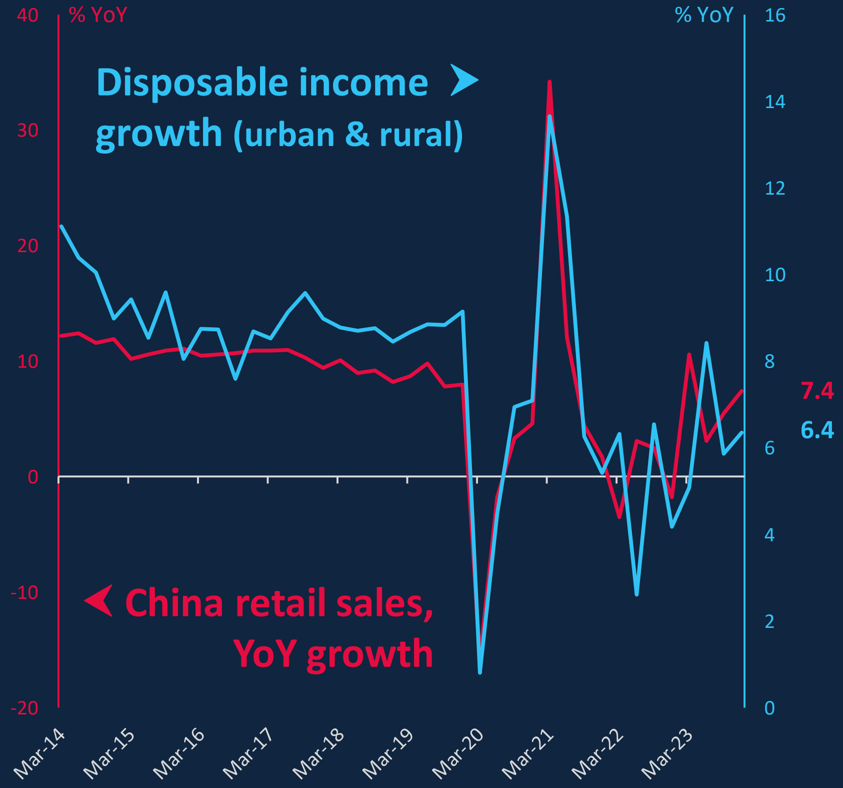
Source: *Bloomberg, BCA Economist*



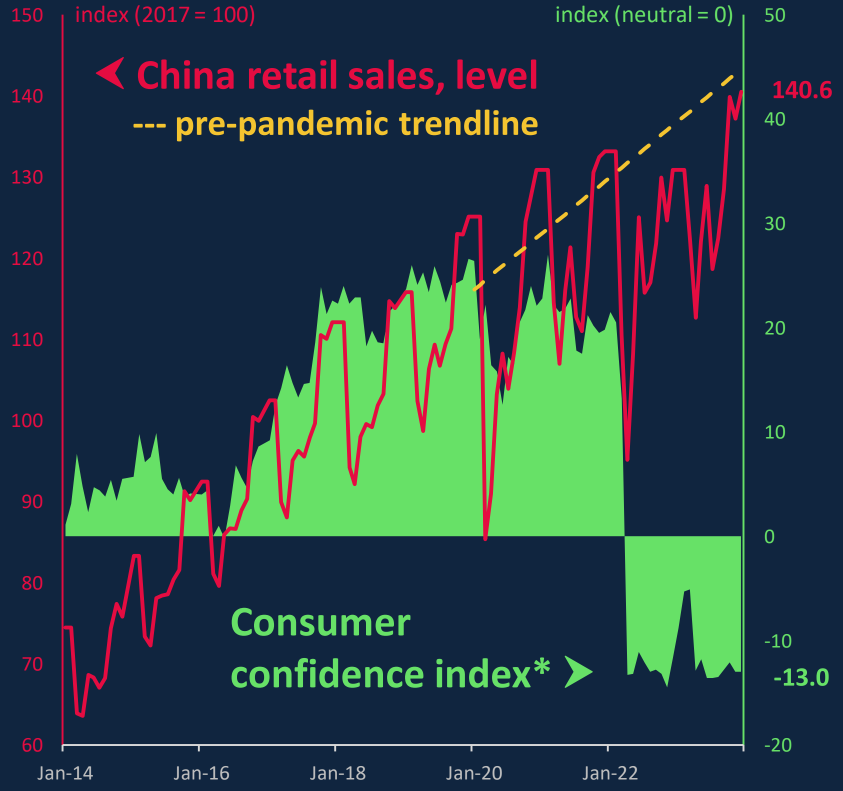
Source: *Bloomberg, BCA Economist*

A double blow

Weak income growth—and a seemingly-irreversible drop in consumer sentiment—has weighed down on China's domestic demand



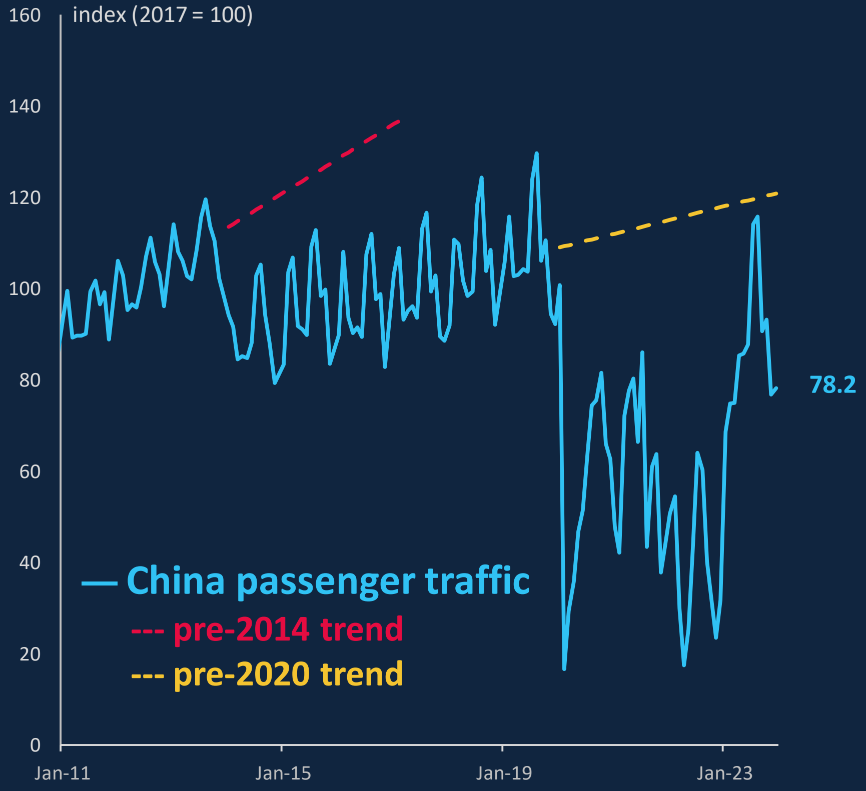
Source: *Bloomberg, BCA Economist*



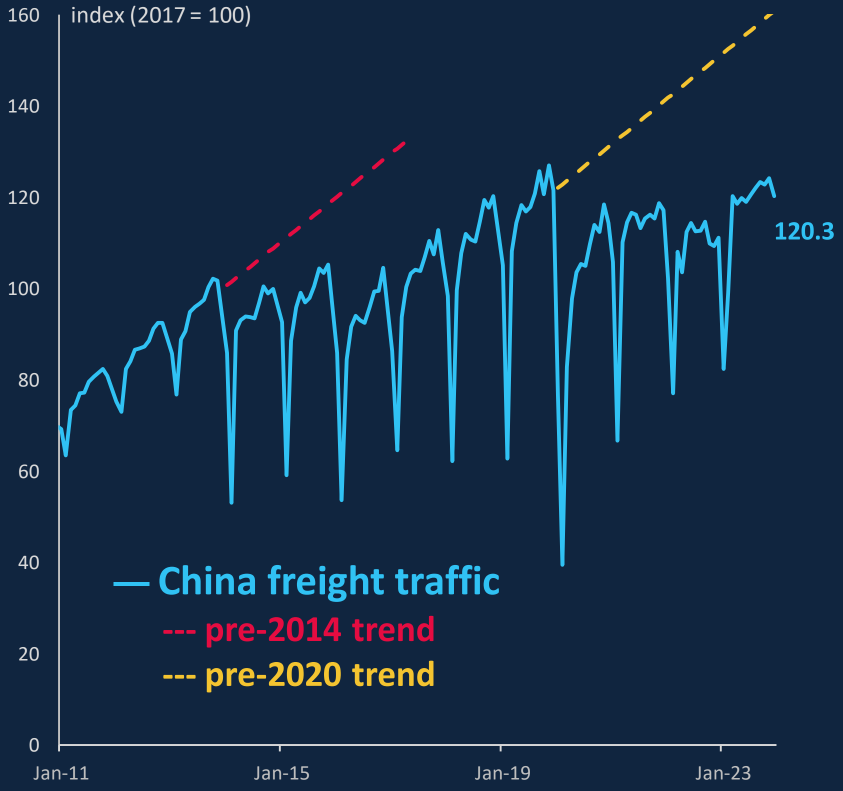
Source: *Bloomberg, BCA Economist* * *headline index minus 100 (normalized to 0)*

Roads less travelled

Mobility data might suggest even more severe decline in economic activities than what the headline data indicate



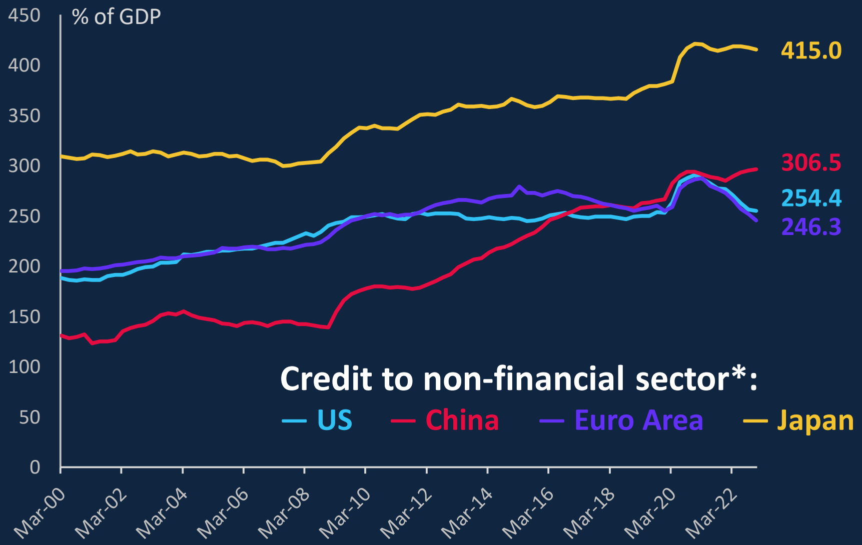
Source: *Bloomberg, BCA Economist*



Source: *Bloomberg, BCA Economist*

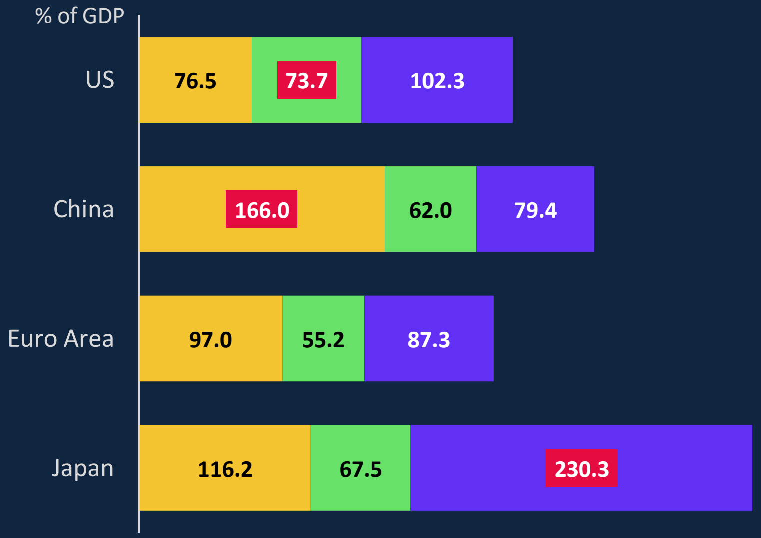
A burden for tomorrow

High debt levels in the world's major economies could stifle future growth, but China faces a complete opposite problem to the West or Japan



Source: *BIS, BCA Economist*

** held by public, at market value*



Source: *BIS, BCA Economist*

** held by public, at market value*

Note:

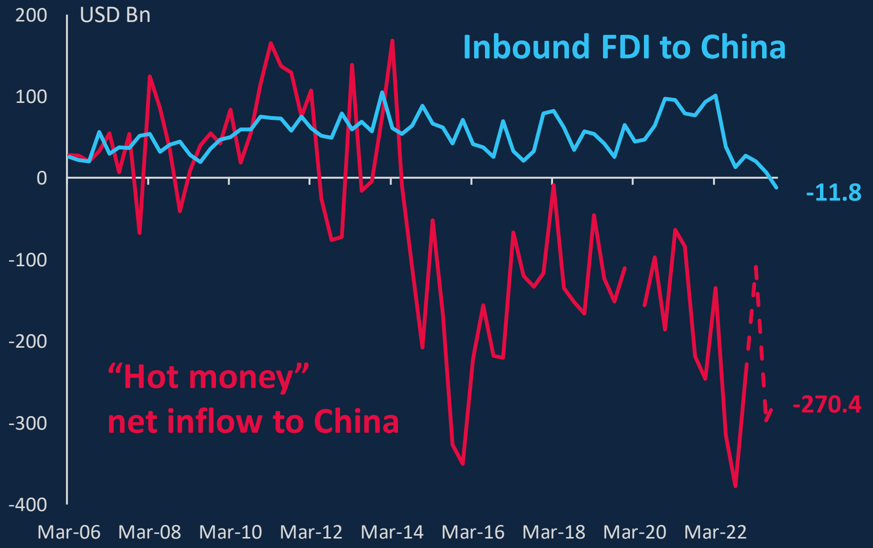
- China's central government debt is much lower (at around 20% of GDP) compared to regional government debt—and the latter might not include the "hidden" debt raised through local government financing vehicles (LGFVs).

Credit by sector*, Q2-23:

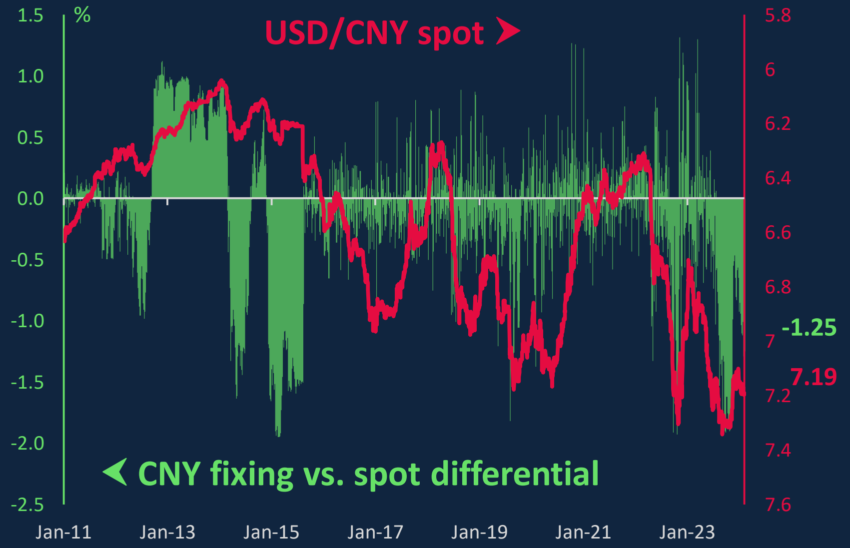
- Non-financial corporations
- Households
- General government

End of an era

China had been a major recipient of Western investment, but heating rivalry has led to capital pulling out, to the detriment of the Yuan



Source: *Bloomberg, BCA Economist*



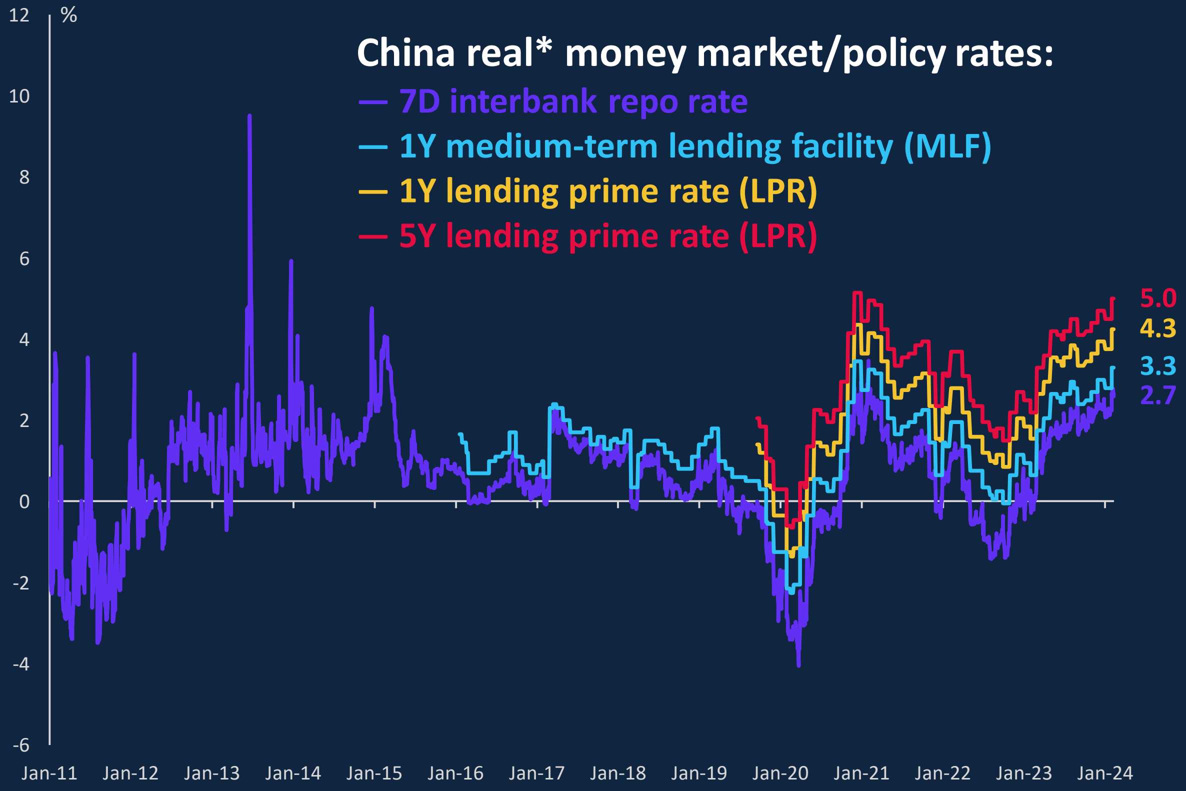
Source: *Bloomberg, BCA Economist*

Note:

- China’s current BoP pressures echo a similar episode in 2015-16, but with two key differences: (1) the current situation happens despite much bigger trade surplus, which means that the underlying capital outflows are also larger, and (2) the PBoC no longer intervenes as aggressively to defend the CNY. Instead, it has somewhat relaxed CNY spot movements, with occasional moral suasion/interventions to prevent more extreme depreciations.

Too little, too late

Rate cuts by the PBoC have been overtaken by deflation, meaning that monetary policy has actually tightened in real terms



Source: *Bloomberg, BCA Economist*

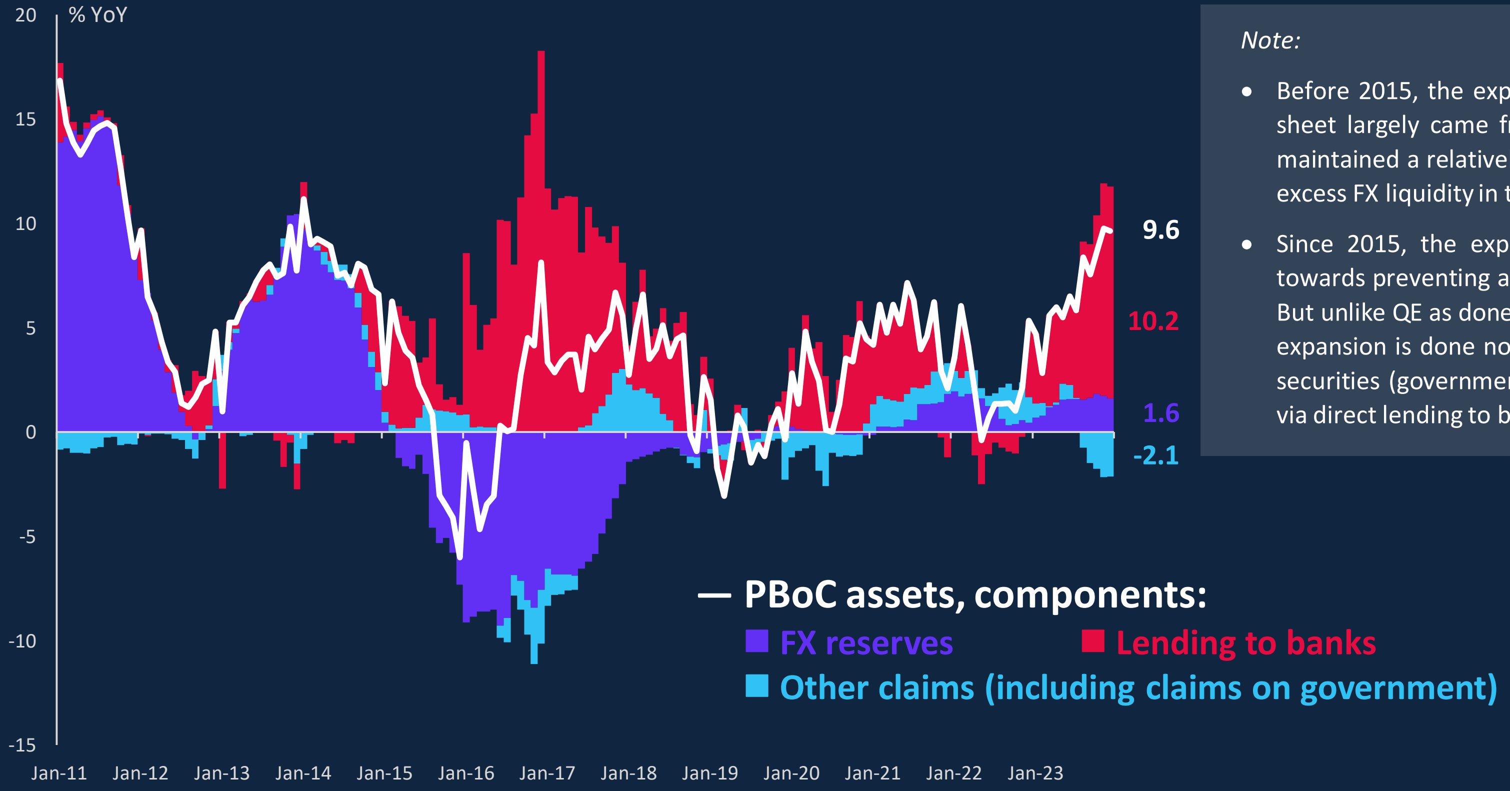
** minus CPI inflation*

Note:

- Previous spikes in real interest rates—in 2013, 2015, and 2021—were associated with subsequent issues in China's financial market and/or real estate sector.
- In addition to several funding and lending rates, the PBoC also controls the reserve requirement ratio (RRR), which has been cut from 11.5% to 10.0% since the start of the real estate crisis—the latest cut being in Jan-24.

QE with Chinese characteristics

The PBoC's balance sheet has seen periodic expansions in recent years, mostly in the form of liquidity injections to banks



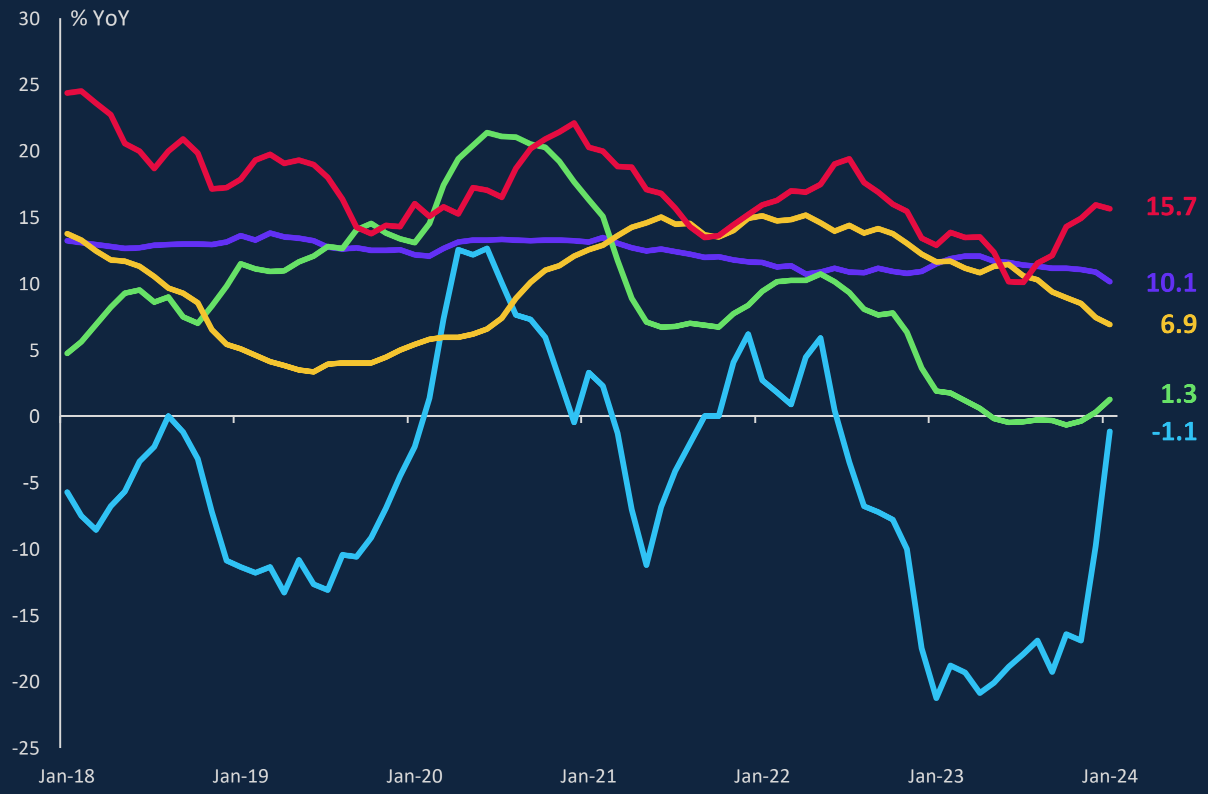
Note:

- Before 2015, the expansions in PBoC's balance sheet largely came from FX reserves, as PBoC maintained a relatively weak Yuan by absorbing excess FX liquidity in the market.
- Since 2015, the expansions are geared more towards preventing a domestic liquidity crunch. But unlike QE as done by the Fed or the BoJ, the expansion is done not through the purchase of securities (government debt or otherwise), but via direct lending to banks.

Source: *Bloomberg, BCA Economist*

Can we have more debt, please?

As market financing slumps, China needs to ramp up government bonds and CNY loans to prevent debt-deflation cycle from taking hold



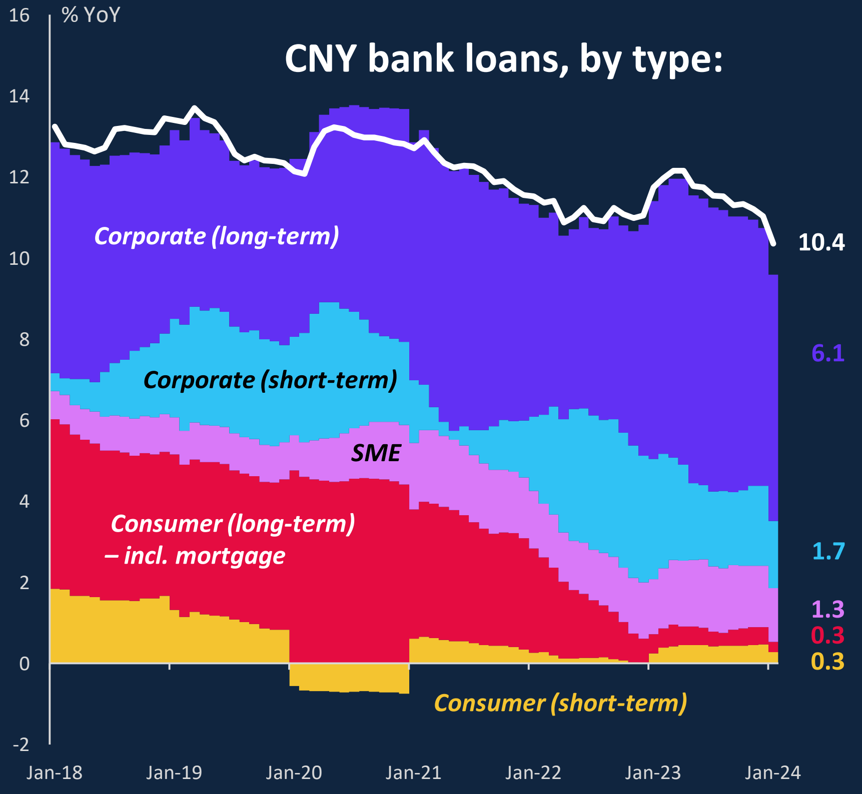
All-system financing, based on instrument:

— Government bonds
— Corporate bonds
— CNY bank loans
— FX bank loans
— Equities

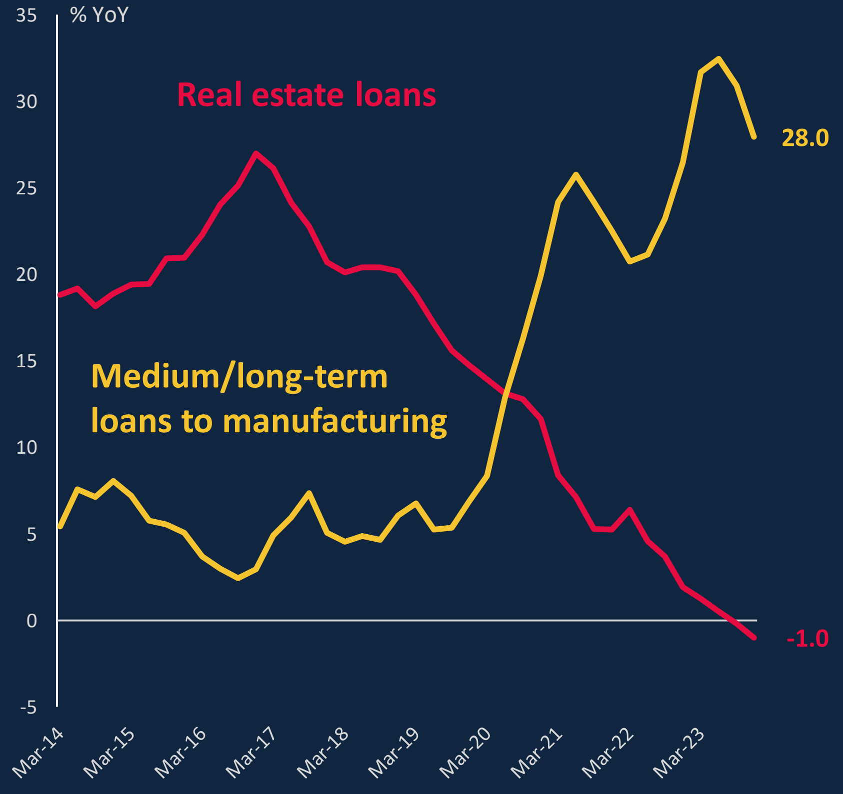
Source: *Bloomberg, BCA Economist*

All aboard the manufacturing train

Given the real estate crisis and weak consumer demand, manufacturing industries are the only logical recipient of new bank loans



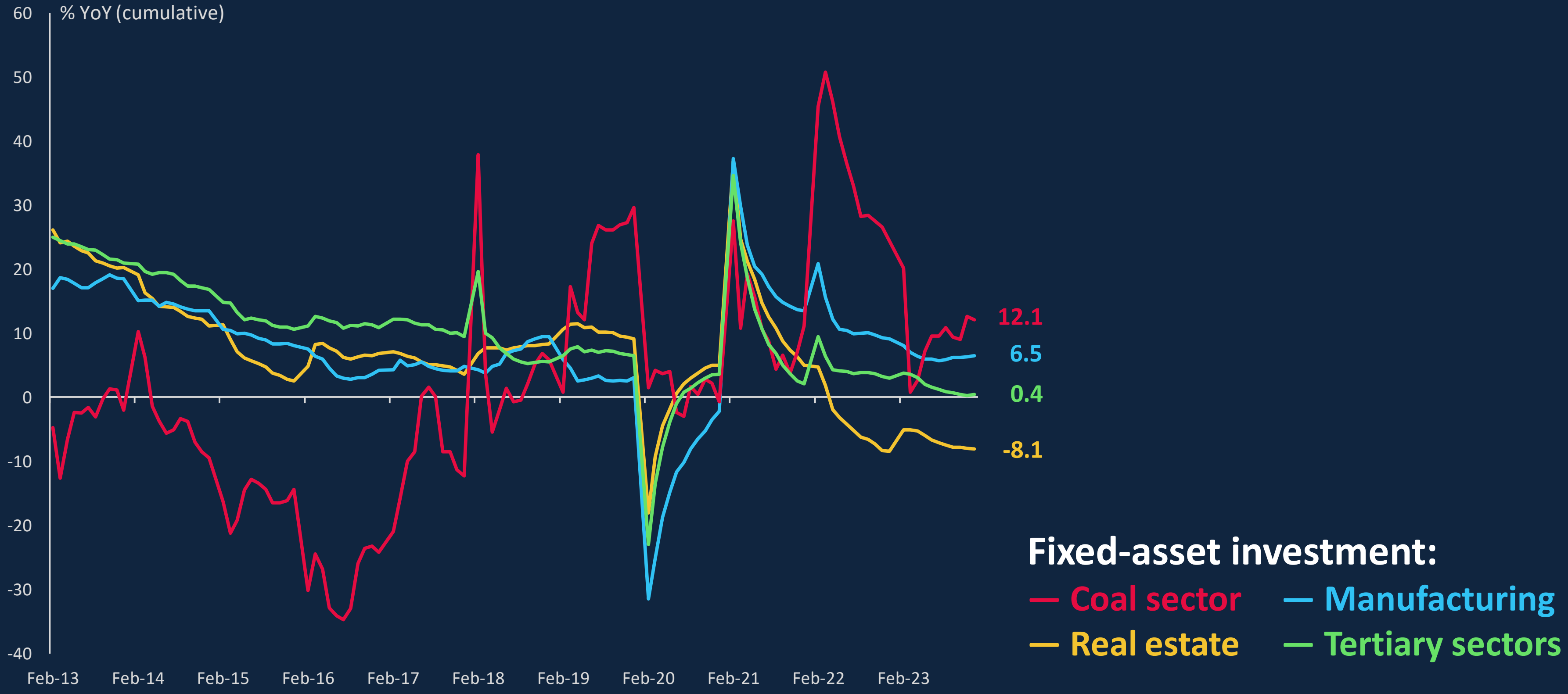
Source: *Bloomberg, BCA Economist*



Source: *Bloomberg, BCA Economist*

The great divergence

Investment into services and real estate has declined, as China redoubles its focus towards energy and manufacturing

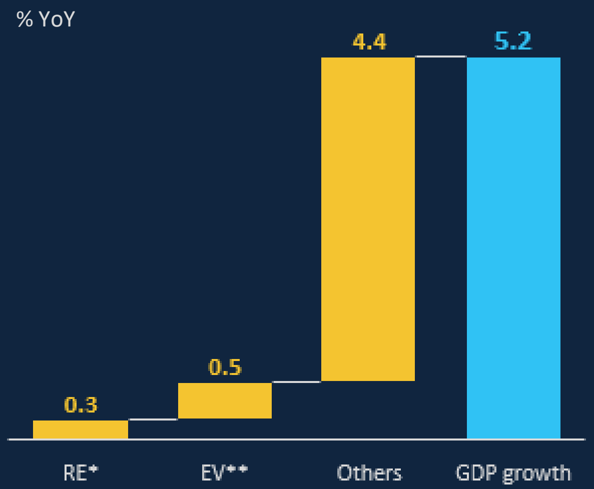


Source: *Bloomberg, BCA Economist*

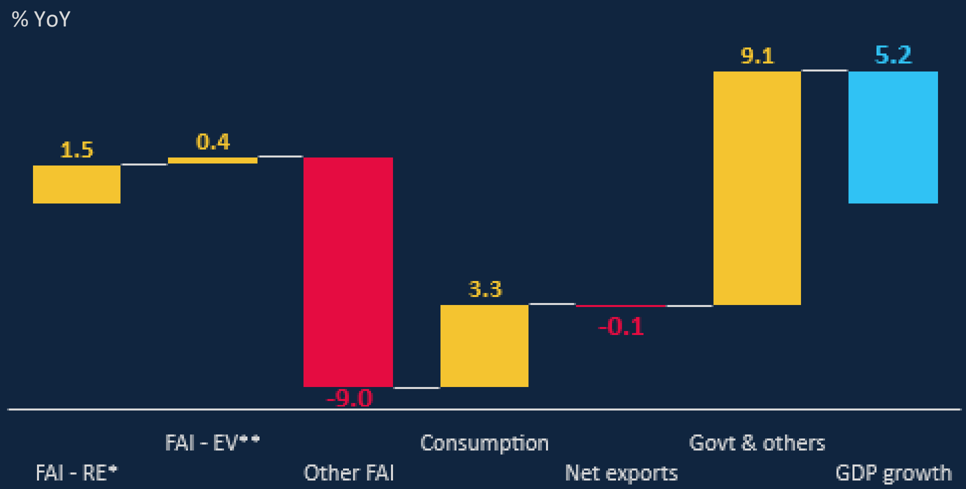
New energy

Without the massive growth in renewable energy and electric vehicles, China's GDP would have grown by only 3 – 4% YoY in 2023

GDP by Production



GDP by Expenditure



Source: *Center for Research on Energy and Clean Air, Bloomberg, BCA Economist*

** renewable energy (including storage and grid)*

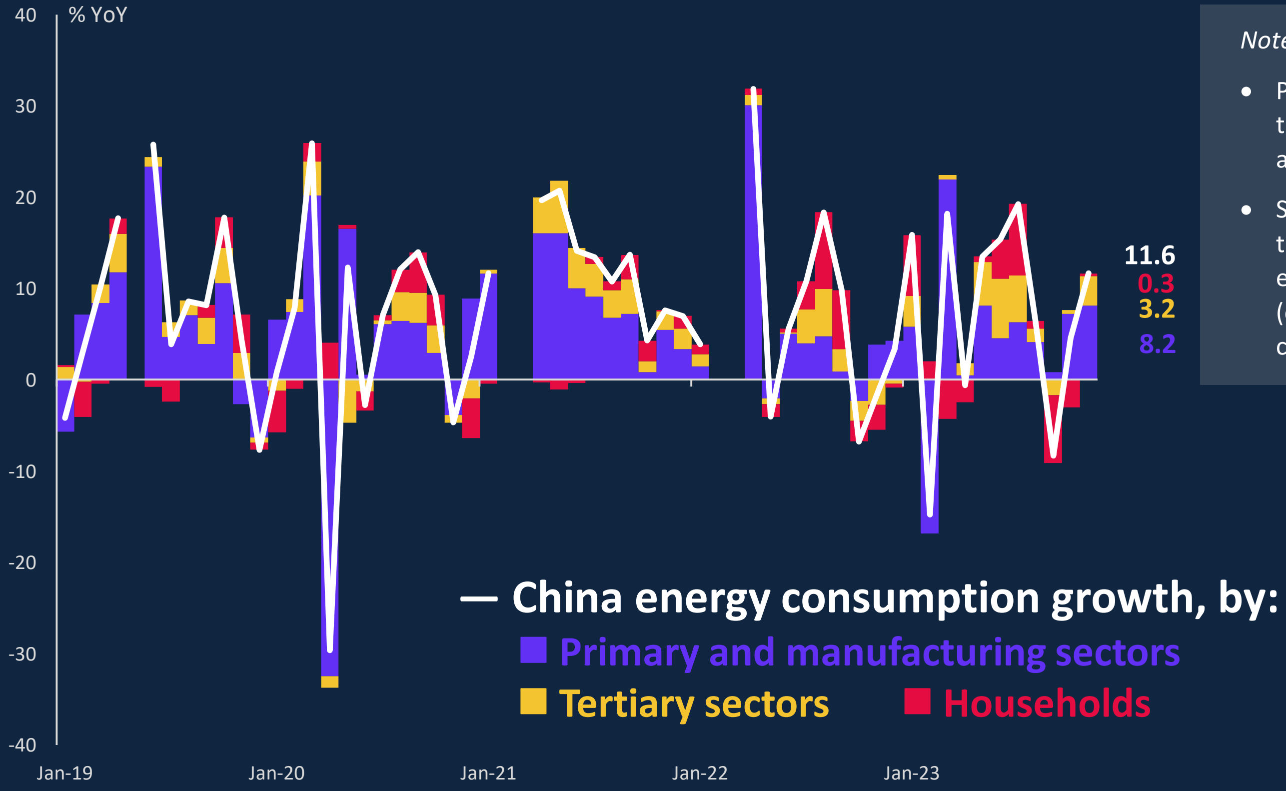
*** electric vehicles*

Note:

- Overall, the breakdown of China's GDP data shows that fixed-asset investment (excluding renewables and EV-related) did worse than expected, while fiscal stimulus is actually doing a heavier lifting than is often portrayed. Meanwhile, the relatively robust contribution from household consumption may be attributed largely to low-base effect, given that many Chinese cities spent large chunks of 2022 in lockdown.

Voracious appetite

The growth in China's energy consumption—during and after the pandemic—has been driven overwhelmingly by manufacturing



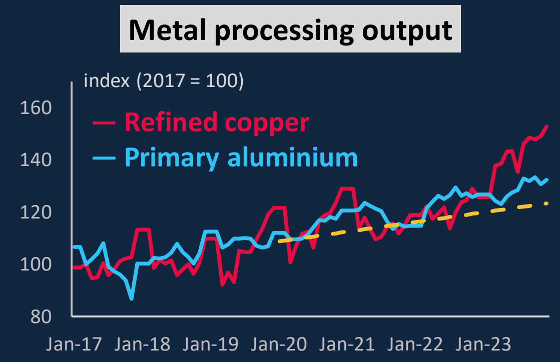
Note:

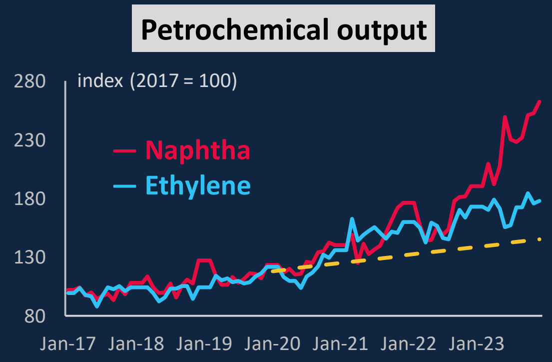
- Prior to the pandemic, China's energy consumption growth was driven more by tertiary sectors and households.
- Since 2021, however, energy consumption by these sectors has been slowing down, with the exceptions of low-base effect in certain periods (early 2021, early 2023) after lockdown protocols have been relaxed.

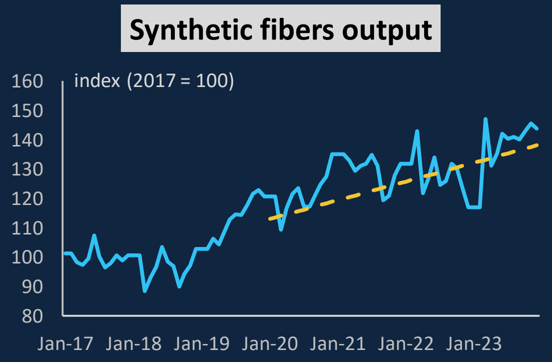
Source: *Bloomberg, BI, BCA Economist*

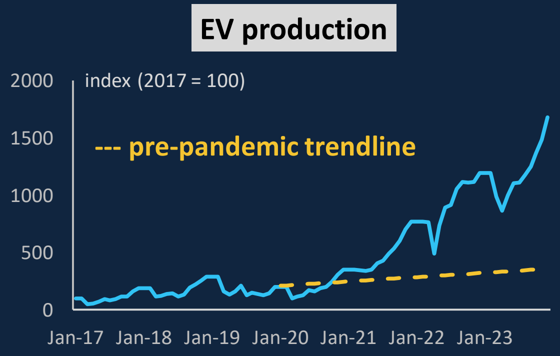
Glass half-full

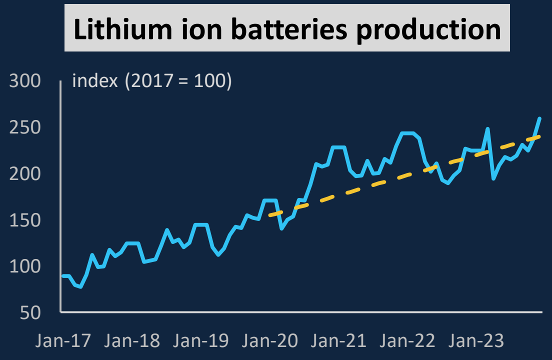
China is making massive strides in basic/upstream industries and cutting-edge manufacturing …

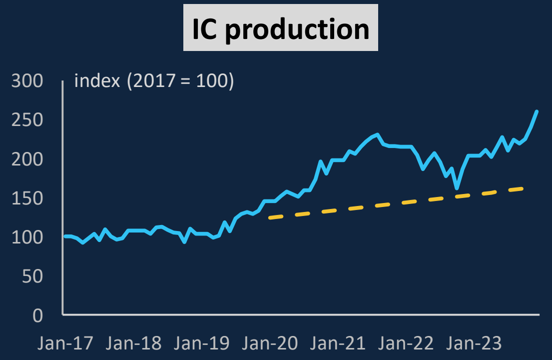










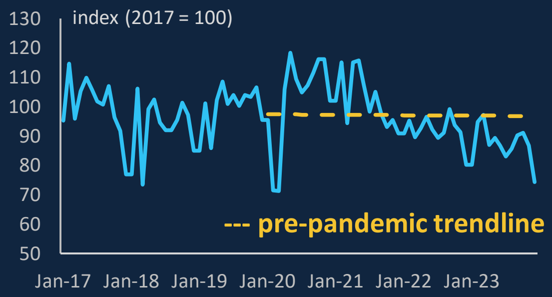


Source: *Bloomberg, BCA Economist*

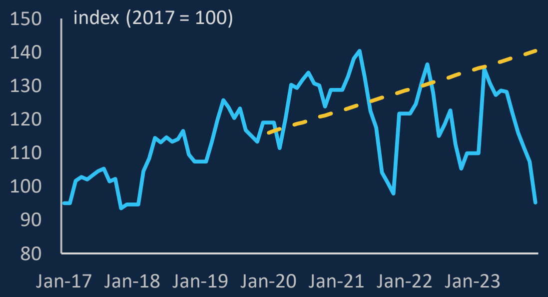
Glass half-empty

… but many other industrial mainstays are stagnating or even slumping, especially those related to construction or consumer goods

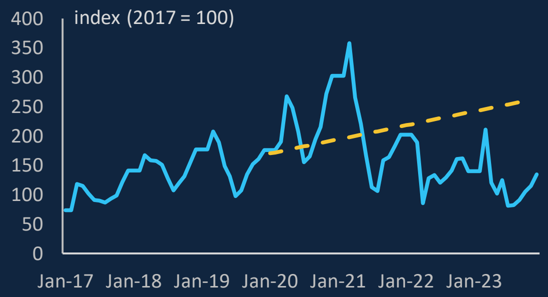
Cement output



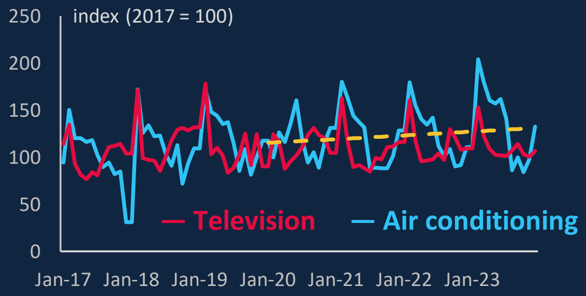
Crude steel output



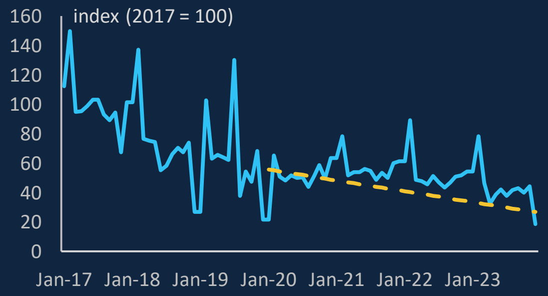
Exacavator production



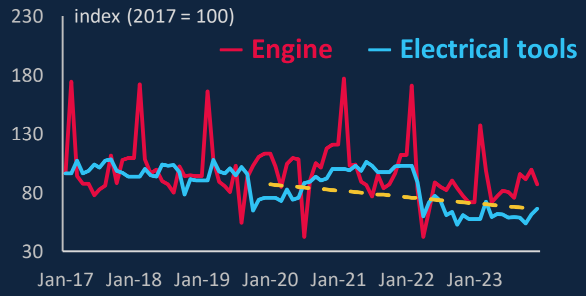
Consumer electronics output



Clothing production



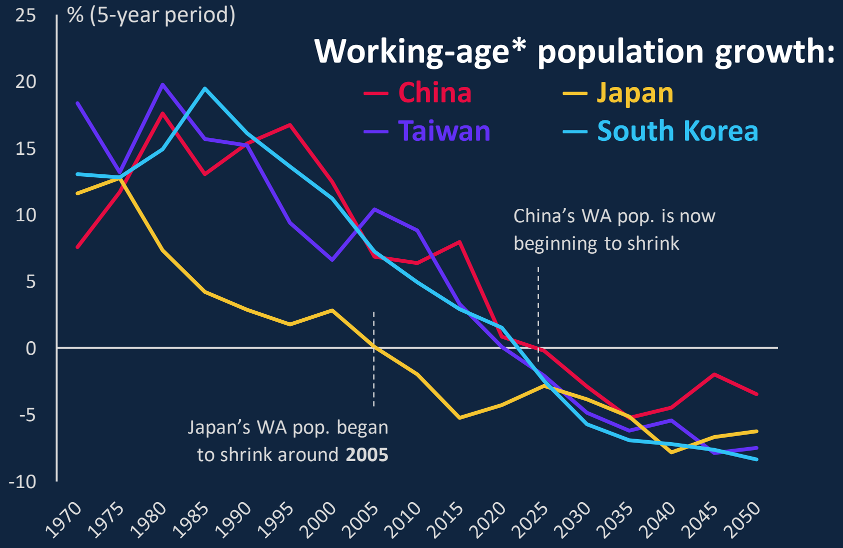
Engine production



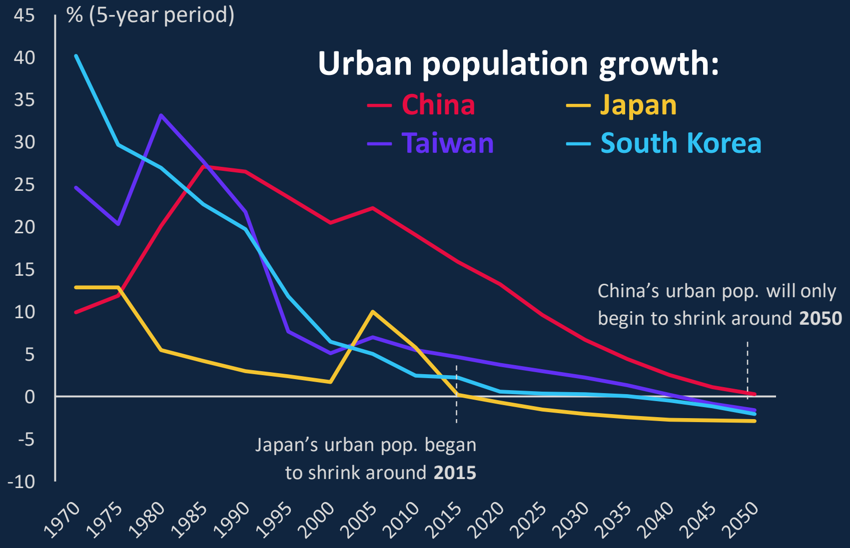
Source: *Bloomberg, BCA Economist*

Fresh blood

While China's workforce is shrinking, its urbanization continues apace—implying the need for continued job creation in labor-intensive sectors



Source: *UN World Population Prospects*, *BCA Economist* ** age 25-64*



Source: *UN World Population Prospects*, *BCA Economist*

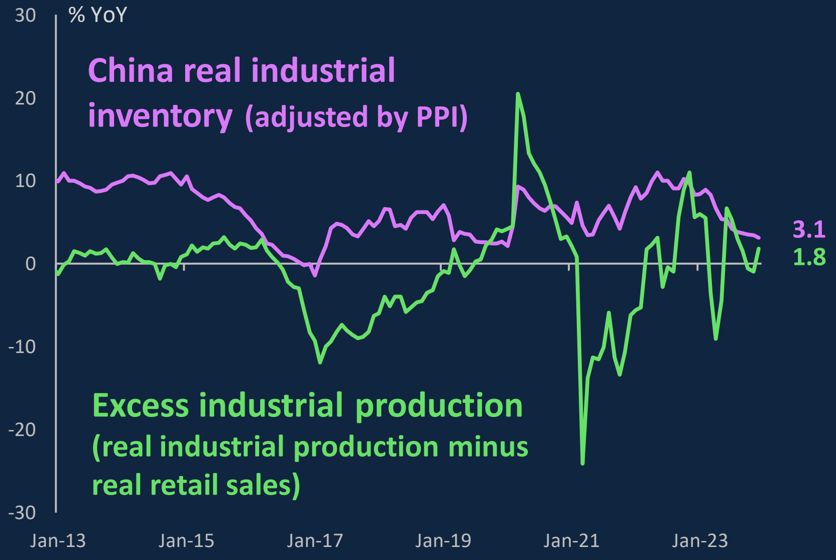
Note:

- China's urban population increases by around 15-18 Million per annum, and its share of urban population to total (around 64% in 2022) is still some way off the ~80% level where urbanization began to taper off in Japan, South Korea, and Taiwan. This implies continued migration of rural workers to urban areas, which has to be absorbed mostly in low-skill services and labor-intensive manufacturing sectors.

Keep piling on

China's inventories may continue to increase going forward, albeit possibly at slower pace compared to 2022-23

Source: *Bloomberg*, *BCA Economist*



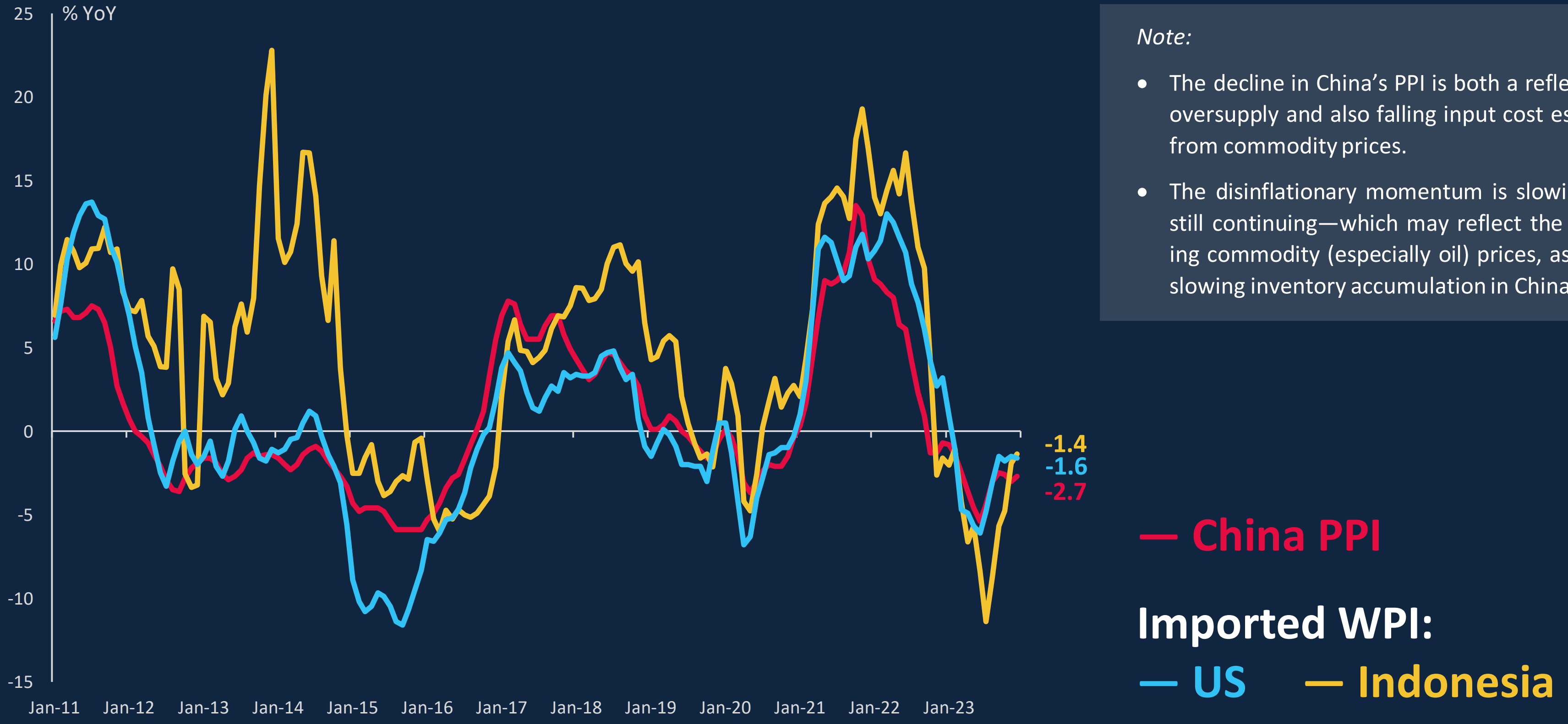
Source: *Bloomberg*, *BCA Economist*

Note:

- There had been episodes where Chinese industrial production substantially collapsed, during late 2016 and in 2021. There is no sign as yet that a similar decline is forthcoming, especially given robust financing support from the PBoC. Without a collapse in production, the only way to clear the inventory is through lower prices and/or higher demand, either domestically or via exports.

Exporting deflation

China's falling factory gate prices have translated to lower import prices globally



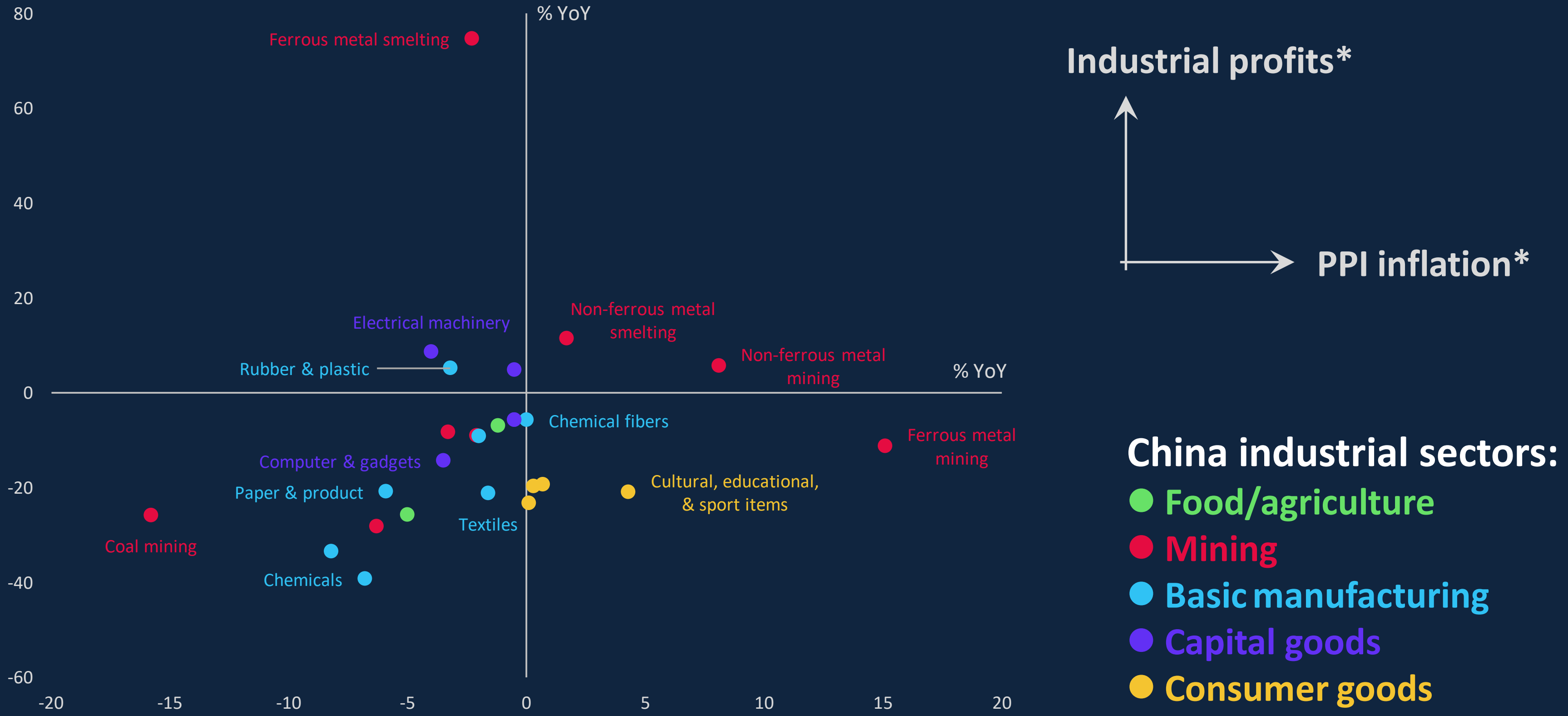
Note:

- The decline in China's PPI is both a reflection of oversupply and also falling input cost especially from commodity prices.
- The disinflationary momentum is slowing—but still continuing—which may reflect the stabilizing commodity (especially oil) prices, as well as slowing inventory accumulation in China.

Source: *Bloomberg, BI, BCA Economist*

The big squeeze

Most Chinese industrial sectors experienced modest-to-severe margin compression in 2023



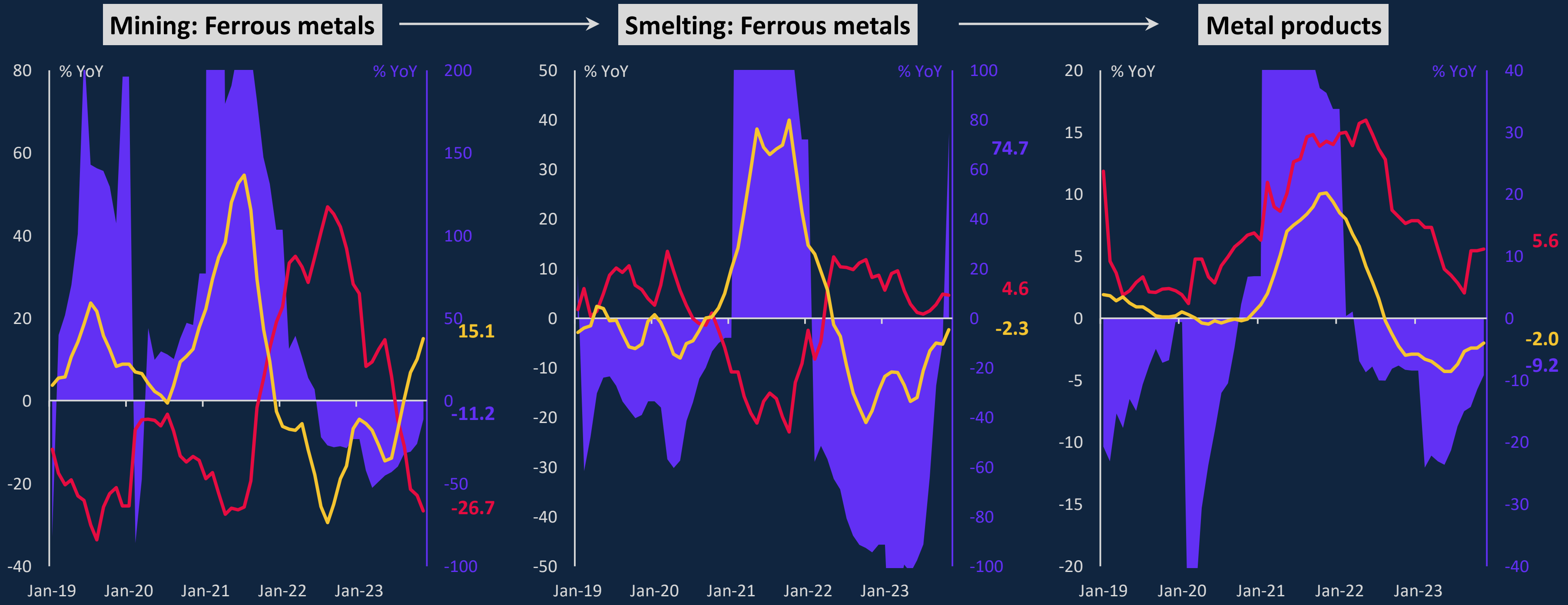
Source: *Bloomberg, BCA Economist*

** data per Nov-23*

Swimming upstream

Although metal products are still oversupplied, China's miners and smelters are starting to see a reversal in their fortunes

Sectoral indicators: — PPI — Real inventory* Industrial profits



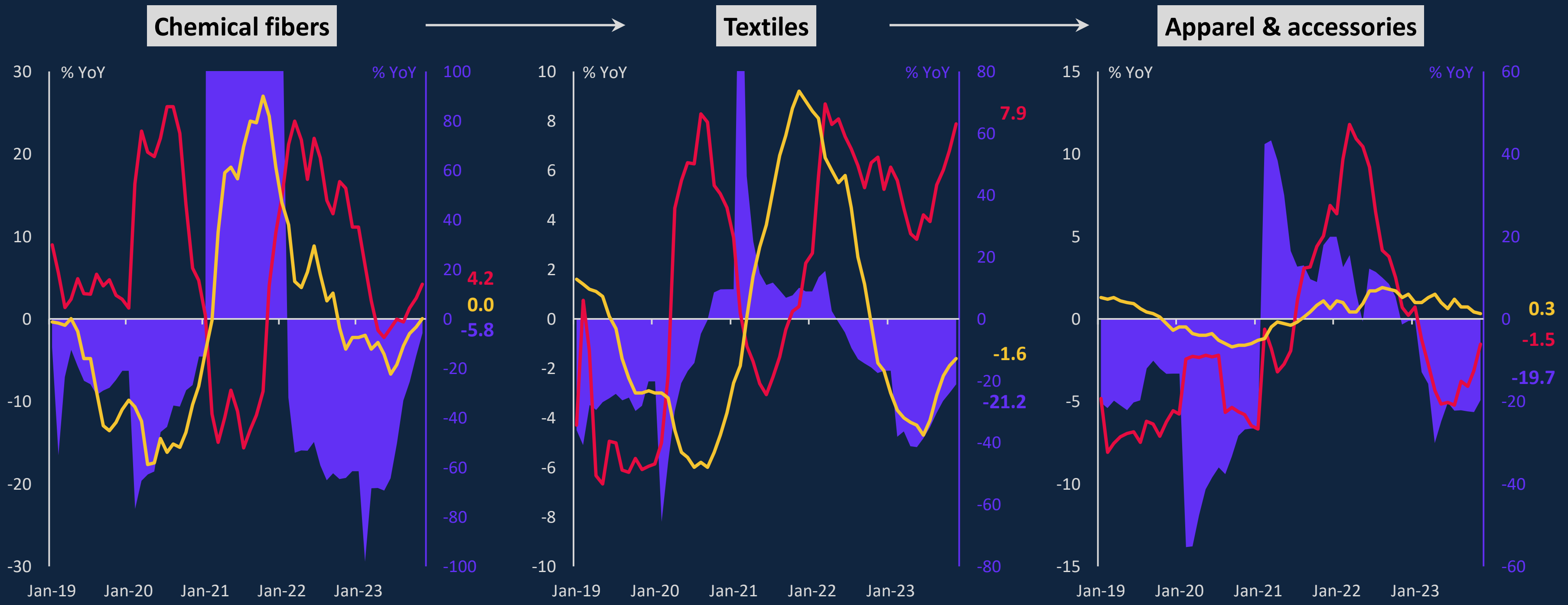
Source: *Bloomberg, BCA Economist*

* *adjusted by sector-specific PPI*

Pileup in the middle

While apparel inventories are clearing up, declining profits have reduced the downstream industry's ability to absorb intermediate products

Sectoral indicators: — PPI — Real inventory* Industrial profits

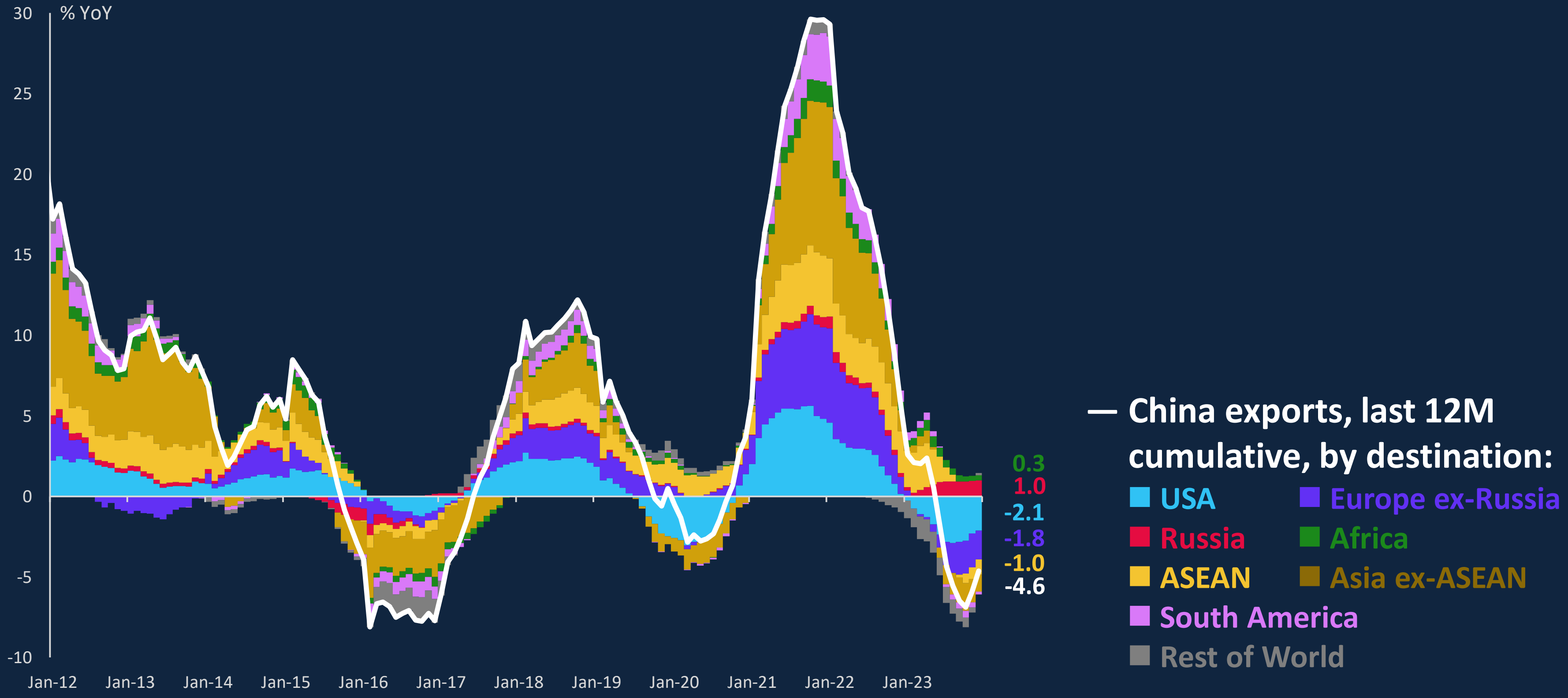


Source: *Bloomberg, BCA Economist*

** adjusted by sector-specific PPI*

Turning back on the West

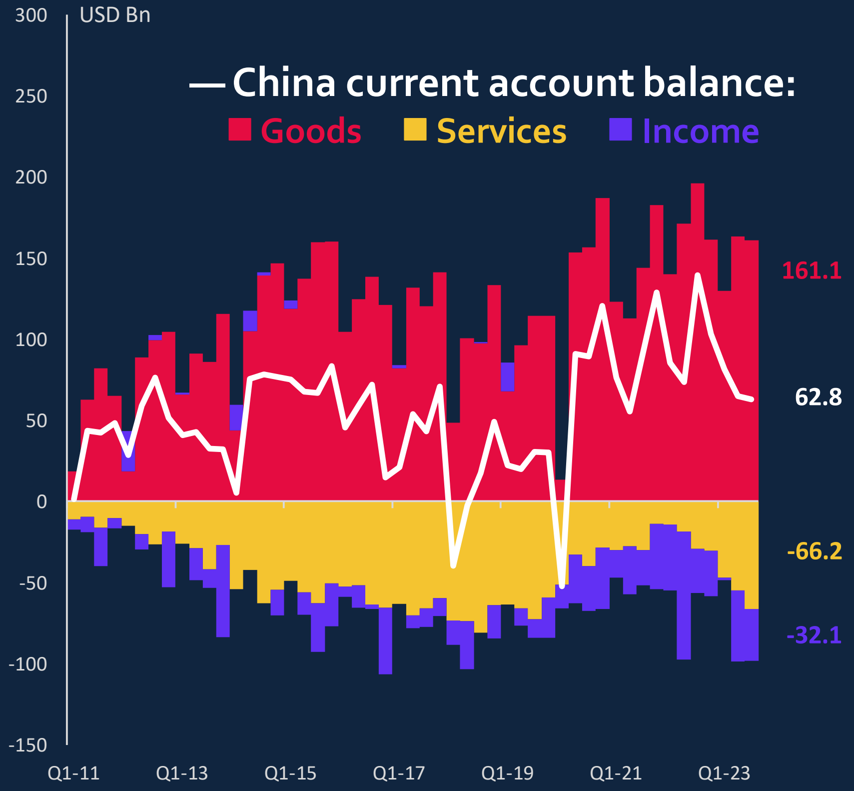
China's increased exports to Russia and Africa have not compensated for its declining exports to the US and Europe



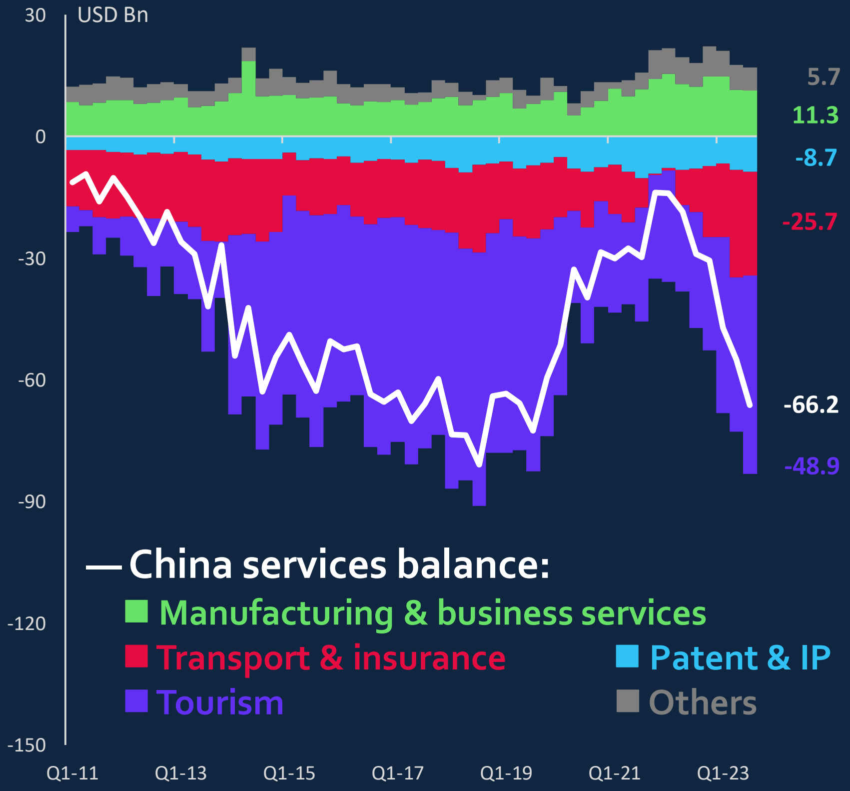
Source: *Bloomberg, BCA Economist*

Persistent imbalance

China has retained outsized current account surplus, only narrowing slightly due to the recent return of service imports



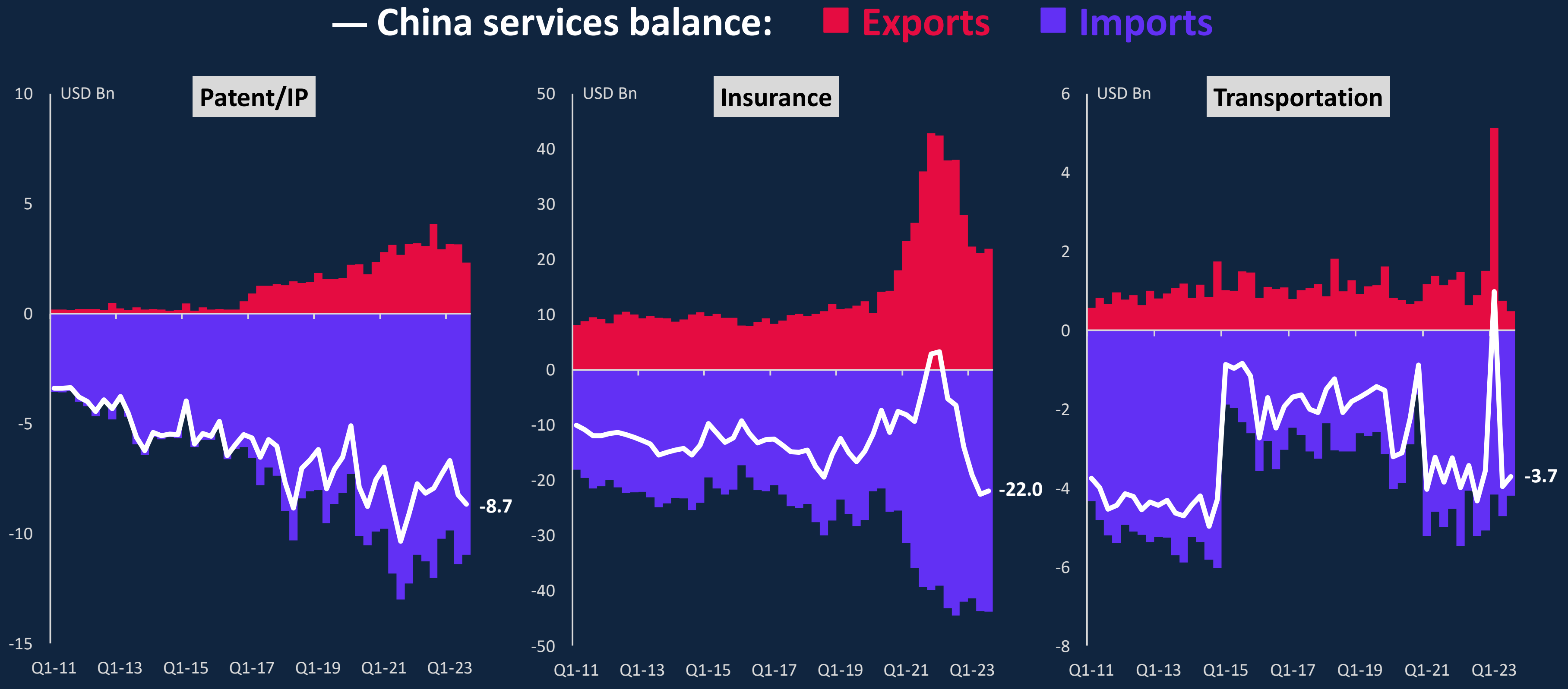
Source: *Bloomberg, BCA Economist*



Source: *Bloomberg, BCA Economist*

Umbilical cord still intact

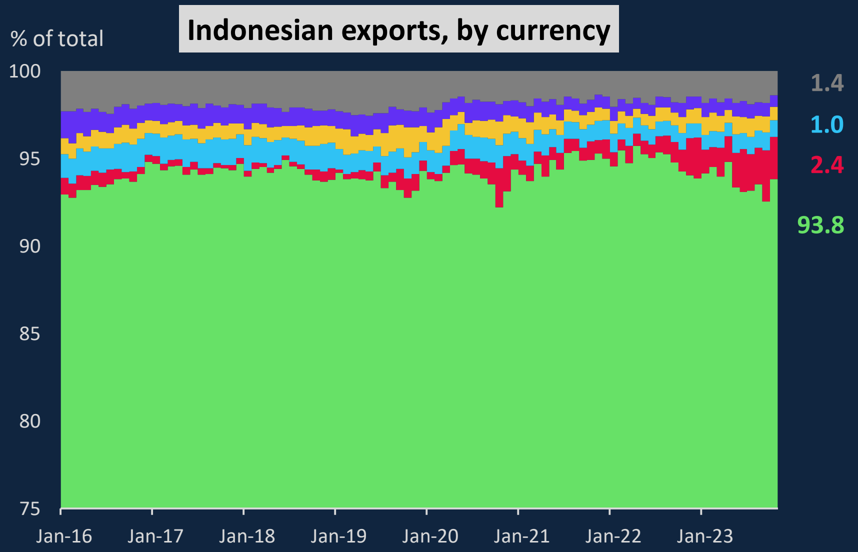
While China is making good technological progress, it remains highly dependent on Western patents, insurance, and shipping services



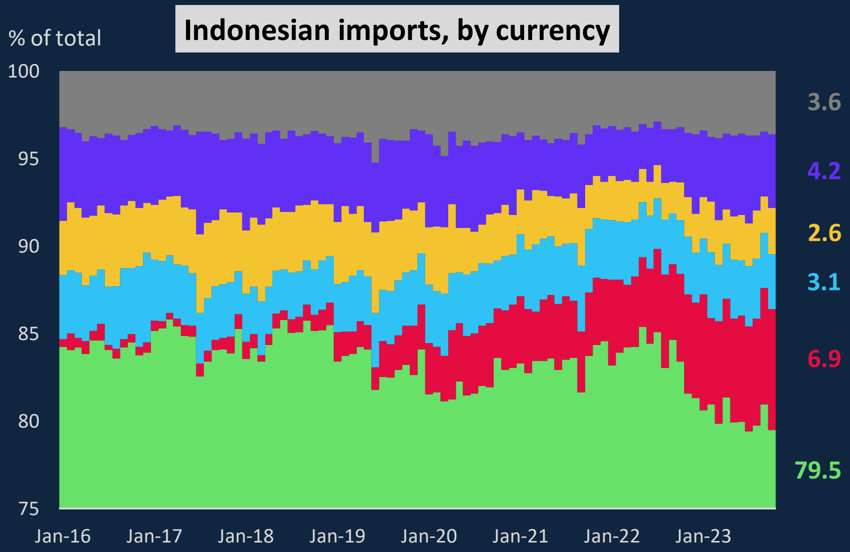
Source: *Bloomberg, BCA Economist*

One-sided gain

The Yuan has expanded its role in China's trade with other countries, but USD dominance in commodity trade presents a formidable ceiling



Source: *Bank Indonesia, BCA Economist*



Source: *Bank Indonesia, BCA Economist*

Note:

- China accounts for ~28% of Indonesia's imports, which implies that the CNY is now used in a quarter of such transactions. Meanwhile, Yuan's smaller gains on the other side is likely a byproduct of Indonesia's export structure, which is dominated by commodities.

USD CNY IDR
JPY EUR
Others or unclassified

Projections of macroeconomic indicators

	2019	2020	2021	2022	2023(E)	2024E
GDP growth (% YoY)	5.02	-2.07	3.69	5.32	5.04	**5.03**
GDP per capita (USD)	4,175	3,912	4,350	4,784	4,982	**5,149**
CPI inflation (% YoY)	2.59	1.68	1.87	5.51	2.61	**3.21**
BI 7-day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	**5.25**
10Y gov't debt yield (%)	7.04	5.86	6.36	6.17	6.45	**6.79**
USD/IDR exchange rate	13,866	14,050	14,262	15,568	15,397	**16,037**
Trade balance (USD Bn)	-3.3	+21.7	+33.8	+54.6	+37.0	**+32.6**
Current account balance (% of GDP)	-2.71	-0.42	+0.30	+0.98	**+0.08**	**-0.50**

Source : *BPS, BI, Bloomberg, BCA Economist estimates*

Notes:

- BI 7-day Repo Rate, 10Y yield, and USD/IDR exchange rate all refers to end of year position
- 10Y yield and USD/IDR exchange rate projections refer to fundamental values; actual market values may vary depending on market sentiment and technical factors

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