PICTET WEALTH MANAGEMENT

China 2023 Macro Outlook

Stronger rebound in second half following a messy re-opening

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FLASH NOTE

SUMMARY

- The Chinese government has finally started to change some of the policies that have inflicted massive pains on the economy over the past one and a half years. The recently announced financial support to property developers will likely lead to stabilisation in this sector in the coming months so that it may be less of a drag on the economy in 2023.
- The government has also swiftly pivoted towards re-opening after a wave of large-scale protests against stringent covid controls broke out across the country. This could be a messy process that lasts one to two quarters, but we expect a stronger rebound in the economy in the second half of 2023 after it has fully re-opened.
- Monetary policy will likely stay supportive with additional rate cuts, but the space for further fiscal easing may be limited.
- Our Chinese GDP forecast in 2023 stands at 4.5% and our forecast for headline inflation at 3.0%.

The Chinese economy has had a difficult 2022. Two main headwinds—the property slump and covid restrictions—have greatly weighed on growth, despite monetary and fiscal policy support that has mainly benefited the infrastructure sector. In 2023, we expect some stabilisation in the property sector. On the covid front, the country is finally heading to a re-opening. But the process will likely be bumpy and messy. In our base-case scenario, we expect the Chinese economy to expand by 4.5% in 2023 after about 3% in 2022.

PROPERTY WILL LIKELY BE LESS OF A DRAG IN 2023

The current slump in the property market is the most serious in Chinese history. Following a set of new regulations introduced in late 2020 to curb developers'

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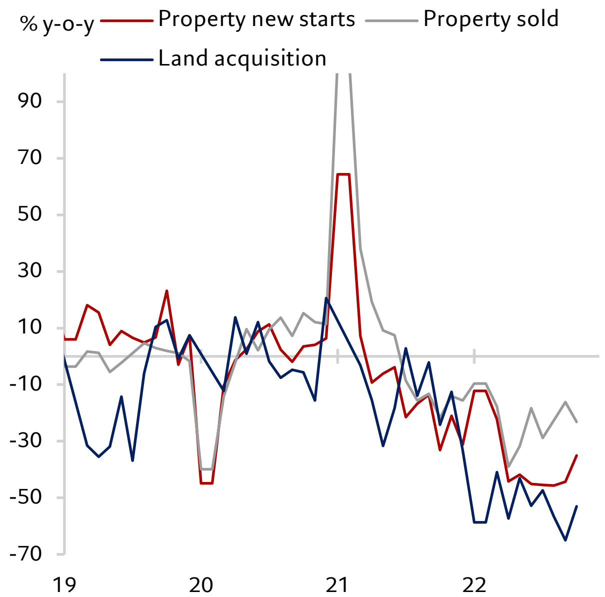
indebtedness, many property developers ran into liquidity problems, which, in turn, weakened home buyers' confidence. The frequent and wide-spread covid restrictions since the second half of 2021 has made the situation even worse as home sales have plunged.

In the first 10 months of this year, housing sales were down by 26.1% year-over-year (y-o-y), property investment by 8.8% and property developers' land acquisition by 53% *(Chart 1)*. The contraction in housing construction and the deceleration in related activities such as construction materials and real estate services have had a significant impact on headline growth in 2022.

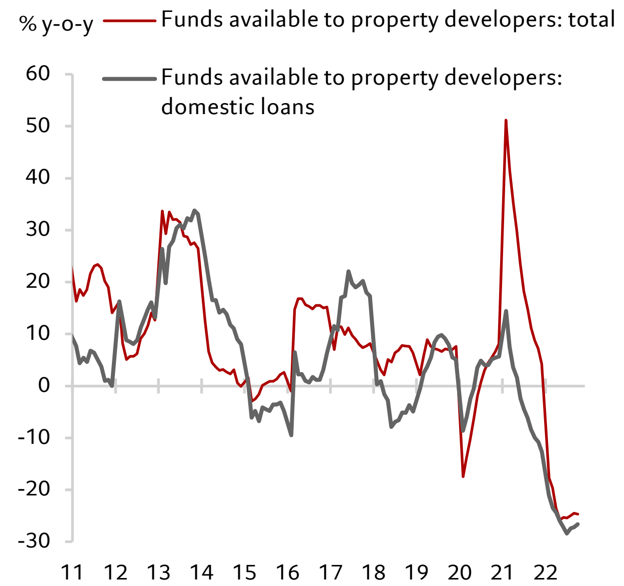
In mid-November, the People's Bank of China (PBoC) and the Chinese Banking and Insurance Regulatory Commission jointly issued a set of measures to support the property sector, many of which are aimed at providing credit to property developers. In our view, these are the most direct and the strongest policy support to the sector since the property crisis started more than a year ago and represent an important change in policy direction. If well implemented, financing conditions for developers could improve notably in the coming months, leading to stabilisation in the property sector *(Chart 2)*. On a macro level, this means that, unlike this year, the sector will likely cease to be a major drag in 2023 on a year-over-year basis.

Chart 1: Select property-sector indicators



Source: Pictet WM & CIO Office & Macro Research, National Bureau of Statistics of China, December 2022

Chart 2: Funds available to property developers



Source: Pictet WM & CIO Office & Macro Research, National Bureau of Statistics of China, December 2022

That said, for structural reasons we do not expect another major rebound in China's property sector. According to our estimate, the underlying demand for urban housing in China will likely cool due to the imminent peaking of the Chinese population and a slowdown in migration from rural areas. Supply could massively exceed demand if the former reverts toits trajectory before 2021 *(Chart 3)*. Hence, China's housing market probably will stay on a downward trend in the coming years before it settles into a new equilibrium.

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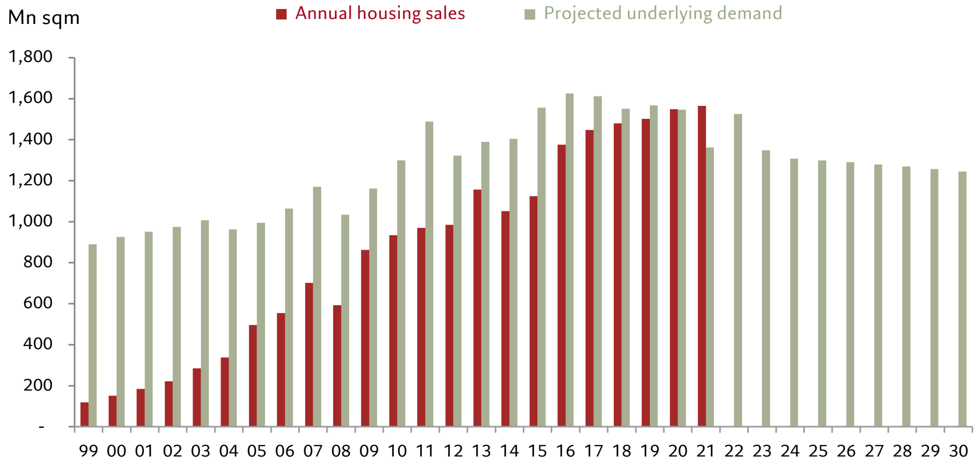
Chart 3: Annual housing sales in China and estimated underlying demand



Source: Pictet WM CIO Office & Macro Research, National Bureau of Statistics of China, December 2022

MESSY RE-OPENING TO CREATE NEAR-TERM HEADWINDS BEFORE STRONGER REBOUND

The other key factor for China's near-term outlook is the authorities' zero-covid policy (ZCP). After performing well in the first two years of the pandemic, the ZCP has become increasingly disruptive and costly to the Chinese economy due to the emergence of the highly contagious Omicron variant of the coronavirus. In addition to the economic costs, ZCP's social costs are also mounting, Repeated, increasingly intrusive covid restrictions and frequent mandatory PCR tests are wearing out people's patience.

A deadly fire in an apartment building in Urumqi (the capital city of Xinjiang Autonomous Region) on 24 November triggered large-scale protests in many cities against the ZCP, with excessively strict local covid restrictions seen as having contributed to the death. Protestors requested economic re-opening and a stop to unending covid restrictions.

The protests seem to have played a role in pushing the Chinese government to make rapid adjustments in its covid rules. In our view, **the re-opening process could accelerate in the coming months due to the public's evaporating tolerance for restrictions and the diffuse presence of the virus**.

But the re-opening process may be chaotic and messy. This is because it starts before the Chinese government and people are well prepared. Vaccination booster coverage in China lags significantly behind its Asian peers' *(Chart 4)*, an apparent policy mistake. The Chinese government's recent commitment to re-accelerate the vaccination campaign, especially among the elderly, will likely take time to have an effect and there are still questions about the efficacy of the current Chinese-made vaccines.

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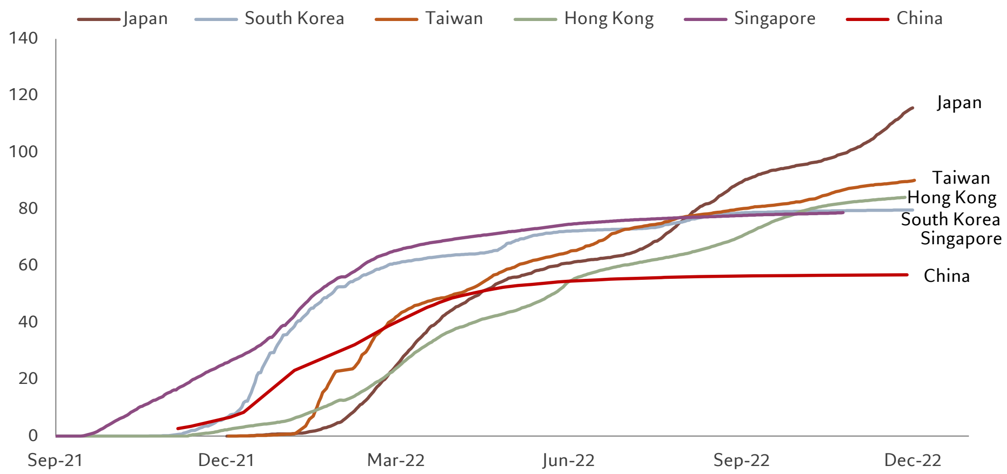
Chart 4: Booster shots administered per 100 persons in select Asian economies



Source: Pictet WM CIO Office & Macro Research, Wind, 5 December 2022.

In addition, the government needs to significantly strengthen the medical system and educate the population about the nature of the Omicron variant to avoid panic should infection cases surge, which seems inevitable. Official efforts on both fronts seem to have only just begun in response to public protests.

Consequently, it is highly probable that the medical system will come under severe pressure in the coming months, causing stress in parts of Chinese society. All these means that the economy will likely face more disruptions in the near term.

Our expectation is that Chinese economic growth may remain muted in the first half of 2023 before a stronger rebound in the second half. Our full-year GDP forecast stands at 4.5% for the time being.

MONETARY POLICY WILL LIKELY STAY SUPPORTIVE, BUT FISCAL SPACE IS CONSTRAINED

China's economic policies were desynchronised from other major economies' in 2022. While most major central banks have embarked on a steep tightening cycle with sharp rate hikes (with the notable exception of the Bank of Japan), the PBoC cut rates in 2022.

As the economy will likely stay weak in the first half of the 2023, we expect the PBoC to maintain monetary easing next year, with additional rate cuts, likely in H1. Also, the authorities may continue to rely on policy banks (e.g., China Development Bank) to provide financing to some sectors of the economy such as real estate.

Consumer inflation, which has been muted in 2022 (2.2% expected for the full year), may rise moderately in 2023 due to higher food prices, but the overall weakness of demand, both domestically and, increasingly, abroad as well, will likely ensure the rise in inflation is moderate. All in all, our expectation that **China's headline inflation will rise to an annual 3% in 2023** should not hinder the PBoC's monetary easing.

However, the space for further fiscal policy easing may be constrained. The current crisis in the property sector has greatly reduced local governments' revenues through a slump in land sales and other related tax receipts. The stringent covid

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control measures (such as frequent mass PCR tests) are very costly and have also worsened the finances of various levels of governments. While Chinese local governments' debt issuance grew by over 8% in the first 10 months of 2022, there was still likely a funding gap. Without a significant rise in the central government's fiscal deficit above its usual level of about 3% of GDP (2.8% in 2022), which is unlikely, the room for an increase in fiscal spending next year looks limited.

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