Marketing Communication

NATIXIS INVESTMENT MANAGERS

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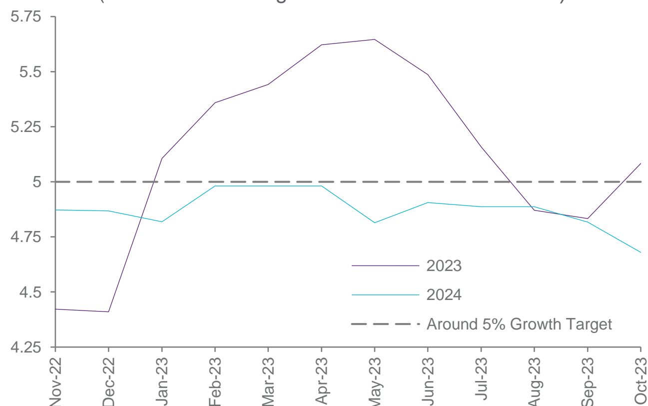
Unravelling China's Structural Challenges

When the Chinese authorities decided to lift Covid-related restrictions at the end of 2022, we warned against excessive expectations about China's economic prospects. This reservation was not rooted in any historical precedent, but in a contemporary shift in the country's economic priorities as it faces fiscal challenges, and its investment-led growth model is coming to an end. Unlike in previous crises, when local governments were able to drive growth through aggressive infrastructure investment, the central government now seems reluctant to reuse this strategy. While at first glance China's debt levels would suggest that the country has room for manoeuvre due to a low ratio of central government debt to GDP, when local government debt is considered, the picture is less rosy, with an estimate of around 142% of GDP in 2022[1], the situation being even more worrying when also considering private debt. Therefore, a likely unsustainable trajectory marred by excess capacities and rising debt levels needs to be rectified to converge towards a more sustainable growth model. Consequently, as we moved into 2Q23, optimism about the economic recovery began to wane, as neither investment nor consumption data echoed the expected rebound (see Fig. 1).

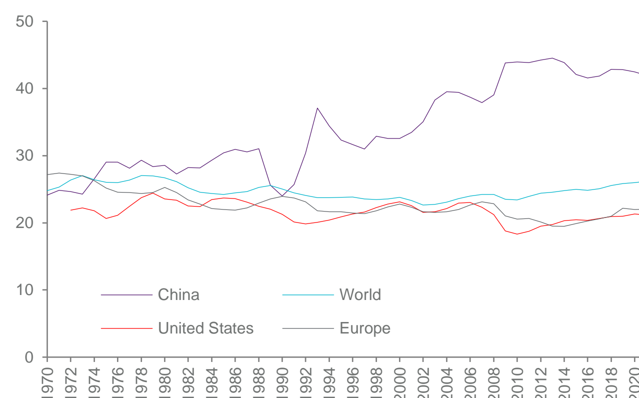
Fig. 1: Expectations for China's average real GDP growth
(Source: Bloomberg Consensus & NIM Solutions)



China's Excess Capacity Story

In recent years, the Chinese economy has shown signs of mounting stress in the manufacturing, construction, and infrastructure sectors. This is probably related to the unprecedented increase to over 40% of its GDP being invested in fixed capital over since 2008, a figure considerably higher than in the United States and Europe (see Fig. 2).

Fig. 2: Gross fixed capital formation (% of GDP)
(Source: World Bank & NIM Solutions)



Manufacturing: Overproduction in China has become a major concern, and the country's electric vehicle (EV) sector exemplifies broader manufacturing problems. Aggressive investments driven by government subsidies has led to a proliferation of EVs and EV batteries in excess of domestic demand, which is also declining due to reduced subsidies to EVs' consumers and overall weak internal demand. At the same time, China faces increasing trade barriers to EV exports, especially to the US and Europe, which complicates and threats EV makers' international expansion plans.

Construction: The real estate sector stands out as the most pressing concern, as highlighted by the financial problems of Evergrande, China's leading real estate developer. Evergrande's liquidity crisis highlighted the significant indebtedness of the entire sector, which is alarming considering that real estate activity (construction and services combined) accounted for 25.4% of China's GDP in 2021[2]. The situation is exacerbated by the large number of vacant properties, with an estimated 12% home vacancy rate[3]. China's declining population is an additional challenge to this oversupply of housing, as additional homes will become available over time while the potential buyer base shrinks. To further compound these problems, other major real estate

[1] Source: Bank of International Settlements
[2] K.S. Rogoff and Y. Yiang (2020), NBER Working Paper 27697
[3] Beike Research Institute – Survey, August 2022

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entities, such as Country Garden, and the large asset management company Zhongrong International Trust, which is linked to shadow banking activities, have also faced liquidity problems. This highlights the potential systemic nature of the problem given that the consequences of the problems in the real estate sector are unlikely to be limited to the real economy.

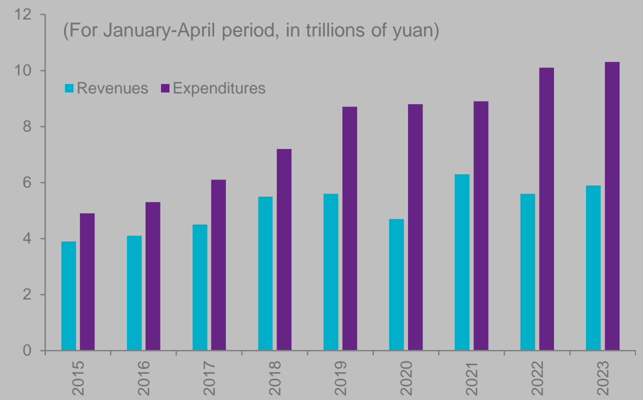
Infrastructure: China's robust economic growth in recent decades was based in part on significant infrastructure investment, much of which was financed through local government financing vehicles (LGFVs). However, there are growing concerns about the sustainability and prudence of such investments. Some provinces, despite limited financial resources, have indulged in the construction of a wide range of infrastructure, from bridges to airports, which has led to an increase in regional debt. For instance, one of the poorest provinces in the China, Guizhou, with a GDP per capita below USD 7200 in 2022, has 11 airports, which is more than those of the country's four biggest cities combined. This propensity to over-invest has swollen China's non-financial sector debt, now nearing 300% of its GDP[4].

China's LGFVs Strategy: A Double-Edged Sword

Following the fiscal system reforms of the 1990s, Chinese local governments came to rely on land sales as a crucial source of revenue. As a result, local governments were incentivised to bolster land values through robust infrastructure development, which in turn required substantial capital to drive local growth. LGFVs are an off-balance sheet financial mechanism that was established to raise capital for these ambitious projects and to purchase state-owned land. By the end of 2022, the debt held by local governments totalled 80% of China's GDP, of which two-thirds (about USD 8.9 trillion) was held in LGFVs, dwarfing the on-balance sheet debt of USD 4.8 trillion[1].

Moreover, these state-led increases in investment were used as counter-cyclical measures during economic downturns. Of note were the periods of 2008-09, 2012 and 2016. However, the central government, in its eagerness to improve China's growth model, enacted the "three red lines" in 2020, aimed at limiting the leverage of real estate developers. This precipitated a sharp fall in real estate prices, which significantly reduced China's fiscal room for manoeuvre due to lower revenues from land sales. Thus, local governments were forced to take on even more debt to sustain their economies, and many cities now face rising interest-to-fiscal capacity ratios as LGFVs have increased their interest-bearing debt while returns have been low. Add to this the financial burdens induced by Covid, and a plausible explanation for the absence of any meaningful fiscal support is offered (see Fig. 3).

Fig. 3: Public Finances of Chinese Local Governments (Source: China's Finance Ministry & NIM Solutions)



Beyond what looks like an impending restructuring of local debt to prevent the debt crisis from worsening, it seems imperative for the central government to reassess the role of local government investment in China's future growth model.

Current challenges in the manufacturing, construction and infrastructure sectors warrant a critical assessment of its growth prospects. While China's economic rise in recent decades is commendable, it is becoming increasingly clear that China may not be the main engine of global growth in the short and perhaps to medium term. To move successfully to a more sustainable growth model, China needs a process of deleveraging and the absorption of excess capacities.

China and Japan: Paralleling Economic Narratives?

Recent developments have fuelled comparisons to Japan's prolonged economic stagnation that began in the late 20th century. It is true that several similarities between both countries can be found. China and Japan have exhibited growth models characterized by an exports-oriented industry, high savings, and aggressive investment. This development strategy has resulted in capital misallocation and excessive capacity expansion, especially in real estate, that were followed by stark price corrections due to inflated valuations. However, China does not appear to be on the verge of a household "balance sheet recession"[5] like the one Japan faced after the bursting of its asset bubble in the 1990s. While, as mentioned above, China's non-financial sector debt to GDP ratio is close to 300%, household debt is not particularly high at around 61% of GDP when compared to 68% in Japan. In addition, Chinese households maintain a savings rate of over 45%, higher than Japan's 31% throughout the 1990s (see Fig. 4). In fact, Chinese households are net savers, while the corporate sector is a net borrower. The opposite was true in

[4] Source: Bank of International Settlement
[5] A balance sheet recession occurs when high levels of private sector debt cause individuals or companies to collectively focus on saving and paying down debt rather than spending or investing, causing economic growth to slow or decline.

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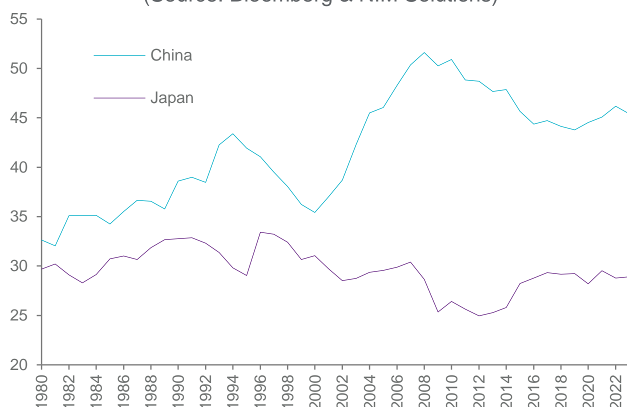
Japan during the 1990s, when households were net borrowers and Japanese firms persistently accumulated cash.

Fig. 4: National savings rate (% of GDP)
(Source: Bloomberg & NIM Solutions)



In our view, it is China's weak domestic sentiment, especially around the property sector, that continues to weigh on the country's economic outlook. High consumer savings are justified by the belief that negative economic events are in the horizon, especially next year with the US White House Race, and even more so if households feel that the country's social security system might not adequately cover their needs in a context of an ageing population. Since China's structural problems can only be addressed gradually, policy should focus on what is feasible in the short term. The property sector crackdown has severely weakened overall confidence, so the Chinese authorities need to focus on restoring confidence to allow consumption to recover and savings to decline.

What comes next?

For the time being, the Chinese authorities seem intent on pursuing the long-term strategic goals and migrate to a new and more sustainable growth model. But the balancing act between restructuring their economy and ensuring the country's short-term stability will require policy to focus in supporting the underwhelmed consumer confidence while minimizing contagion effects in other sectors as much as possible.

In the short term, the end of the rate hike cycle in developed markets, combined with deflationary trends in China, should provide some relief to the People's Bank of China (PBoC) and the yuan. In this context and given the local government debt situation, the PBoC is likely to continue to support the economy through an accommodative monetary policy, especially as the scope for a substantial fiscal package remains limited. As we had expected, Government spending has failed to increase in any substantial way and it has been targeted fiscal initiatives, such as the recent measures to improve housing affordability for first-time homeowners, what has been preferred to offset the weak levels of consumer confidence while ensuring economic stability while addressing the country's structural problems.

For China to move successfully to its new growth model that prioritises investment, such as "ABCDG"[6] technologies, structural reforms are needed. One of the main reforms should be a complete overhaul of the tax system towards a more consumption-based economy, which could include the introduction of new taxes targeted at households and consumers. Equally crucial is addressing the looming local government debt crisis, which requires both immediate debt restructuring and preventive mechanisms against future runaway borrowing. Moreover, as revenues from property and land sales, on which local governments rely heavily, decline, the central government must redefine revenue-sharing models, possibly by expanding domestic consumption taxes or taxing emerging sectors such as data-related services. In addition, as China's working-age population shrinks, the social security system will need to be reformed to meet future challenges such as population ageing. This difficult outlook is likely to force monetary policy authorities to keep rates at low levels or even to cut them further to accommodate the lower levels of economic growth that will result from the country's structural slowdown. But it will not be until these reforms are implemented that Beijing will cease to find it difficult to manage its business cycles while moving towards its long-term strategic goals.

[6] The "ABCDG" technologies stand for artificial intelligence, blockchain, cloud computing, big data centres and 5G infrastructure.

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