HSBC Global Research

16 December 2021

China in 2022

Five key macro themes

Free to View
Economics - China

- To shore up the slowing economy, Beijing will likely step up monetary and fiscal easing, fine-tune property lending, and slow the pace of regulations
- Growth in both higher-end manufacturing and green investments is set to quicken; property investment to bottom
- We expect GDP growth to recover gradually to around 6% y-o-y into H2 2022, but core inflation will likely stay muted

China's slowing economy in recent months has prompted Beijing to step up policy easing to shore up growth. How and when will these measures kick in and help drive a recovery? As a guide to next year, we highlight five key macro themes:

More easing. We expect the PBoC to cut the reserve ratio for banks and increase relending (banks given funds to lend to customers) to boost cash available for higher-end manufacturing, green projects and SMEs. The central government is also set to increase spending on technology and allow local governments to borrow more to bolster investments in new infrastructure like 5G. Meanwhile, Beijing will also likely slow the pace of regulations to mitigate the negative impact on growth.

Manufacturing investment is set to quicken. Despite softer global demand, investment in mid to high-end manufacturing is set to gain momentum next year thanks to improving profitability and high capacity utilisation rates. Indeed, manufacturing capex spending has already picked up, reaching a two-year CAGR of over 6% since August, higher than 2019's growth of 3.1%. More generous tax incentives and other policy support for technology upgrading should also add fuel to the upturn in manufacturing investment, which will likely grow by double digits.

Kick starting green investments. After rolling out detailed plans for de-carbonising the economy, Beijing is ready to jumpstart green investments next year. Given the massive amount of spending needed to achieve its longer-term climate goals, there is ample room for front-loading of projects and lifting growth in green investments to above 30% p.a. in the coming years.

Property investment to bottom out gradually. Beijing has already started, and will likely continue, to fine-tune its property lending policies. Combined with anticipated easing in general financial conditions as well as local administrative measures, this should help put a floor on the property downturn next year.

Core inflation to stay muted. We expect core CPI to stay below 1.5% next year considering the absence of supply-chain bottlenecks and a modest recovery in GDP growth.

Main risks. More-than-expected cases of COVID-19 at home, especially in light of new variants like Omicron, may hinder the consumption recovery. Geopolitical tensions could also weigh on business sentiment.

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China in 2022: A year of easing

- Beijing is likely to ease monetary and fiscal policy further and slow down the pace of regulations
- A pick-up in green and higher-end manufacturing investment will lead the recovery; property investment will bottom out gradually
- We expect GDP growth to recover to around 6% in H2 2022 and core inflation to stay muted

Beijing will step up policy easing to shore up growth

The key message from Beijing in recent months has been clear: supporting growth is now the key priority. But why is there this new determination to prop up the economy? Because officials worry about the rising threat to the stability of the labour markets amid headwinds stemming from the "triple pressures": demand contraction, supply shocks and weakening expectations. We expect more easing measures on four fronts into 2022: Monetary, fiscal, property lending and regulations.

Proactive fiscal policies to do the heavy lifting

Fiscal measures will take the lead in supporting the economic recovery, especially as Beijing has vowed to front-load policy stimulus. While the official budget deficit next year is expected to remain in line with this year's, at 3.2% of GDP, the broadly defined fiscal deficit is likely to increase by at least 1.0ppt to 7.3% of GDP (up from 6.3% of GDP in 2021e). These fiscal measures will likely include the following:

- Rollout of tax cuts and fee reductions.
- Direct funding support and loan guarantees for new growth drivers
- RMB1trn in sovereign green bond issuance for green projects
- Speedier project approvals for new infrastructure projects
- Quota issuance of special local government bonds[1] likely to see a modest increase, with front-loading of part of the quota prior to the National People's Congress in March 2022.

While infrastructure investment has been a relative underperformer, we see fiscal support likely accelerating infrastructure investment given increased special local government bond issuance in second half of 2021 and an expected pick up in 2022. Special local government bond issuance will benefit from both front-loading and an increased quota. Moreover, if the global commodity price rally comes to an end and more focus is put on ensuring sufficient production domestically, the construction industry could benefit. Alongside some policy adjustments around the property sector, a ramp-up in public housing development, as well as increased acceleration in infrastructure project approvals could help bring infrastructure investment growth up.

[1] Special local government bonds have certain restrictions on their use compared to general local government bonds. They can only be repaid by revenues from their projects as opposed to fiscal reserves. They are typically used to finance infrastructure projects.

That said, Beijing will still be keeping an eye on local government debt risk. That means, local governments will find it difficult to add leverage via implicit debt, while at the same time the cooling land market will continue to weigh on their balance sheets. We expect that Beijing will increase transfer payments to local governments next year amid the continued headwinds.

Monetary easing to focus on increasing credit support for targeted sectors

In terms of monetary policy, there was a noticeable change of tone at the Central Economic Work Conference (CEWC) this month: the wording on controlling macro leverage was dropped, a sharp contrast to the previous tone, i.e. deleveraging between 2016 and 2018, and stabilising the macro leverage in 2019 and 2020. That leaves room for more accommodative monetary policy, especially as inflation is unlikely to be a constraint. Consistently, at the CEWC Beijing refrained from mentioning a statement about targeting total social financing growth to be in line with nominal GDP growth.

We expect the PBoC to keep the policy rate unchanged as it aims to steer a structural change in the so-called cross-cyclical policy adjustment (which takes into consideration policy continuity over the medium term).

Instead, policymakers will rely more on quantity tools such as reserve requirement ratio (RRR) cuts, green and SME relending and some rollover or new issuance of medium-term lending facilities. These tools will facilitate a flexible and appropriate monetary easing, and should in turn lead to a modest pickup in total social financing growth. Moreover, such structural easing can also engineer a rotation in the credit allocation away from property development, and towards new growth drivers such as green investments and technology innovation. We expect policymakers to roll out re-lending facilities in targeted areas (SMEs, manufacturing and innovation, green development) with preferential rates to facilitate more activity.

Adjusting property lending policies to cushion the slowdown

In recent months Beijing has already been fine tuning its property lending policies, leading to an improvement in both lending to developers and home loans. We expect the regulators will continue to selectively loosen restrictions on property lending into 2022. Local governments will also likely make adjustments to policies based on their regional conditions to ensure there is sufficient credit to meet real housing demand and maintain stability in the property sector.

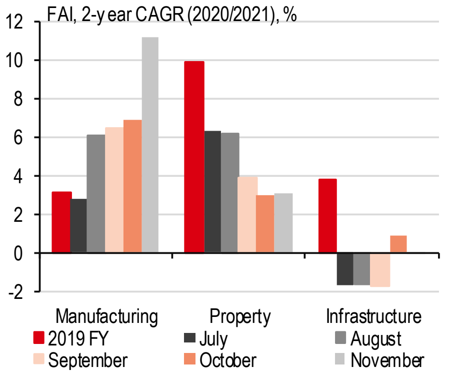
Slowing down the pace of regulations

We also expect the authorities to implement regulatory changes at a slower pace and in a more transparent manner. This can help to reduce the uncertainty faced by businesses and improve sentiment, particularly in industries with a larger impact on the economy as policymakers want stability in the labour market. Policymakers will also aim to strike a balance between striving for longer-term carbon reduction goals and maintaining sufficient energy and production security. Policies around “dual control” (which targets reducing energy consumption and intensity) are likely to be more pragmatic in meeting targets, in our view.

Capex to accelerate for mid to high-tech manufacturing

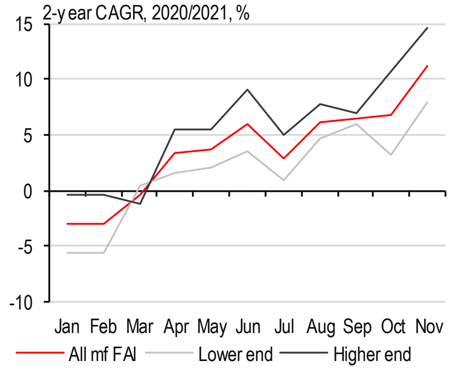
The investment rotation from construction towards manufacturing has already started and been picking up over the last three quarters. Following the astounding growth in exports, a strong rebound in profits and high capacity utilisation rates, manufacturing investment has rebounded to double-digit y-o-y growth so far this year (13.7% year-to-November), though part of the strength also stems from a low base. Looking at the two-year CAGR, manufacturing investment rebounded to above 6% since August 2021, and most recently to 11.2% in November, well above the pre-pandemic level of only 3.1% in 2019.

Chart 1: An ongoing rotation in investment drivers



Source: CEIC, HSBC

Chart 2: Mid and high-end manufacturing investment is leading the recovery



Source: CEIC, HSBC

But with growth headwinds mounting, there is the question of whether continued strength in manufacturing investment will persist. In our view, manufacturing investment is likely to continue towards double-digit growth in 2022. For one, mid to high-tech manufacturing will continue to climb as China is moving along the industrialisation pathway towards more technology-intensive manufacturing and away from lower-end manufacturing such as textiles. Furthermore, support from improving the innovation capacity, a large and talented human capital pool, and a highly adaptive domestic consumer market are all supporting factors for manufacturing's continued development up along the global value chain in the coming years.

Medium to high-tech manufacturing investments are already leading the recovery. Looking at the two-year CAGR, we note it has rebounded to over double-digit growth in October and November 2021. This momentum is likely to continue and even accelerate considering the stronger policy tone supporting the industry, enabling it to become a key growth driver in the coming years.

Certainly, there are some downside risks to our forecasts stemming from slower momentum in global demand given a rotation towards services amid continued re-openings and a high base from 2021. However, softer export growth is unlikely to reverse the momentum towards higher-end manufacturing development. The strong domestic conditions and policy support will likely push mid to high-end manufacturing investment growth to above 15% y-o-y in 2022. In all, this should help support manufacturing investment growth to reach double digits in 2022 at around 10% y-o-y (compared with the latest two-year CAGR of 4.7% year-to-November 2021).

Jump-start green investment

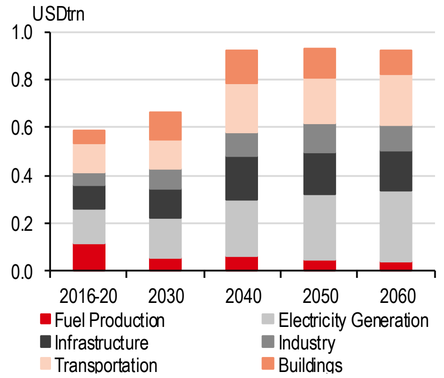
With China's climate pledge and the "1+N" framework (one key policy goal with many action plans to achieve it) released to map out its roadmap towards its green targets, it's clear that green investments will be a theme for decades. Hundreds of trillions of renminbi will be needed for China's green transformation: the International Energy Agency estimated that at least RMB200trn in investments is needed from now to 2060. China's own Green Finance Committee suggested RMB487trn of investments is needed in the next 30 years to reach the climate goals.

Why jumpstart?

We expect Beijing to jumpstart its green investments next year for the following reasons. First of all, the green transformation is a formidable task, but not mission impossible if China starts now. Although many factors may have contributed to the widespread power shortages this autumn in China, insufficient investment for the green transition is certainly one. Beijing now upholds the principle of "build first, then break" (先立后破), meaning clean energy solutions need to be built before society fully quits fossil fuels.

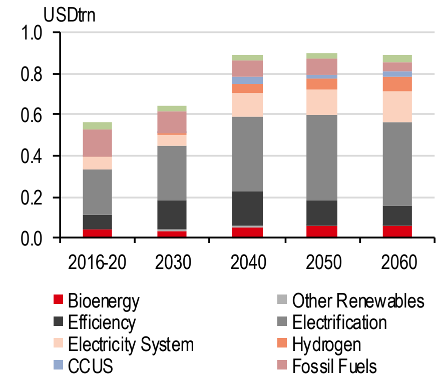
Second, plenty of low hanging fruit (in the sense of tech readiness) can be seized at the early stages of China's green transition. As the top two emitters, the power and industrial sectors are first in line awaiting investments (Charts 3 and 4). In particular, projects likely to kick off include building renewable energy bases, upgrading power grids to transmit green electricity, growing energy storage capacity, as well as boosting the energy efficiency in industrial sectors.

Chart 3: On average, over RMB5trn pa is needed between now-2060…



Source: IEA (2021)

Chart 4:…mostly in electricity systems and industrial electrification



Source: IEA (2021)

Last but not least, green investment can also act as a buffer to the economic slowdown in the short-term. Some green projects, such as renewable energy bases and power grid upgrading, bear the characteristics of infrastructure investment: significant economies of scale (the larger they are the more efficient), capital intensive (e.g., each ultrahigh voltage transmission line costs RMB20bn), a long lasting lifetime (e.g. a pumped hydro-electric storage system has a lifetime of between 30 and 60 years), and serving broad public goals (climate targets in the case of green investments). As such, green investments can be used as a countercyclical stabiliser.

In this sense, green investment can not only deliver a needed short-term boost to the economy, but also facilitate the long-term structural transition, the perfect policy under the new "cross-cyclical" strategy that Beijing has been emphasising since the summer (*Xinhua*, 22 August 2021).

Green investment to grow over 30% per annum in the years to come

Many signs point to the acceleration of green investment. The "1+N" framework is devised to steer investment towards specific technologies and sectors. For example, the goal to increase the installed capacity of wind and solar power to 1200GW by 2030 implies cRMB1trn of investments in renewable energy and at least RMB500bn in electricity transmission and distribution as well as energy storage capacity. Back in October, President Xi announced that the first 100GW of projects were already under construction. Now Beijing is reportedly preparing for the second batch, which will likely be larger than the first batch, with construction starting in 2022 and finishing by 2023 (*Bloomberg,* 6 December 2021).

Various policies are in place to facilitate financing for mega green projects. For example, in November, the PBoC announced a new green relending scheme, where banks can take qualified green loans extended at market rates benchmarked to the going LPR (3.85% for one-year) and then apply for 1-year funding from the PBoC to cover 60% of the loan principal with an interest rate of 1.75%. Shortly after, the State Council announced RMB200bn of quota for clean coal relending facilities (*Reuters*, 17 November). We expect a strong take-up for these schemes because loans to finance large green projects are usually extended to state-owned enterprises, and are considered high credit quality projects. The new relending schemes will accelerate the already rapidly growing green loans (at 22% CAGR over the past four years).

Besides loans, green bond issuance and green PE/VC funds have also mushroomed, albeit they are much smaller in terms of their absolute magnitude: in the past three years, green loans account for c95.6% of total financing to green projects. Putting the funding from loans, bonds and PE/VC bonds together, the outstanding balance is cRMB15.5trn.

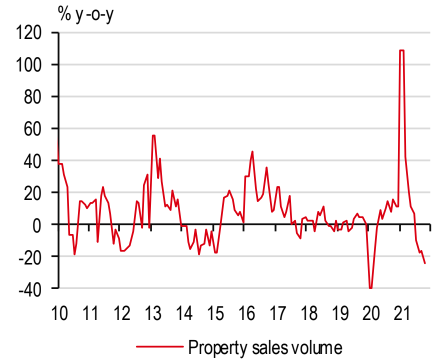
Property investment to bottom out gradually

Policy fine-tuning gives distressed developers some room to breathe

The property sector has experienced a significant policy-induced shock in 2021. As Beijing rolled out broad-based tightening measures on property financing, the property sector has seen a rapid deceleration in recent months alongside major credit events that have taken a heavy toll on business sentiment across different sectors. Considering the property sector accounts for c10% of GDP directly, and around a quarter of GDP should the whole industry chain be taken into account, a hard landing of the sector would drag the whole economy down into a very difficult situation.

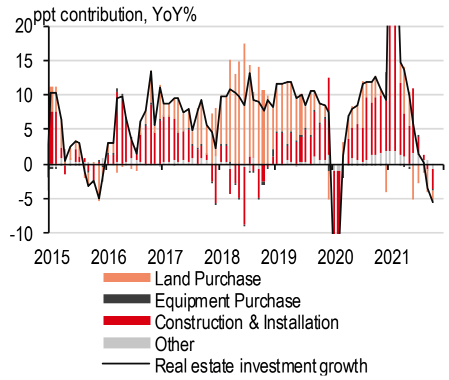
In recent weeks, it has become increasingly clear that Beijing is making policy adjustments to avoid a hard landing in the property sector. Regulators now urge banks to clear up the backlog of mortgage loans and resume lending to healthy developers. The government also appears to be preparing to engineer acquisitions of projects of distressed developers by state-owned enterprises. This kind of policy fine-tuning has helped stabilise overall financing conditions in the sector. October and November data suggests that the amount of new mortgages and developer loans have started to recover sequentially. Net bond issuance by real estate developers saw a rebound in both sequential and year-on-year growth in November.

Chart 5: Property sales plunged



Source: CEIC, HSBC

Chart 6: Property investment decelerated



Source: CEIC, HSBC

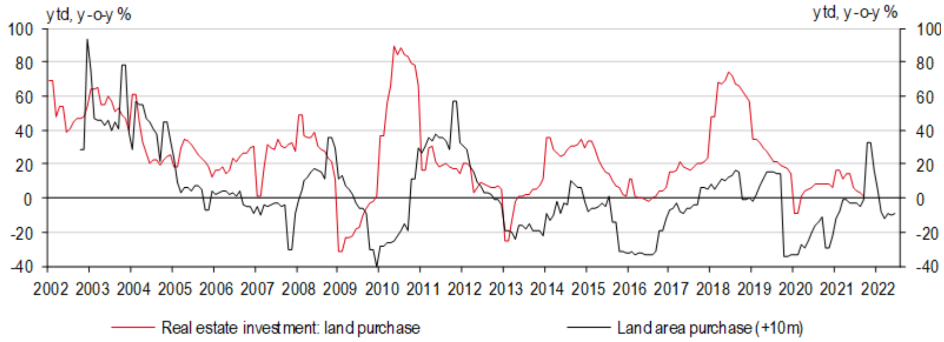
But this does not mean that the property sector is out of the woods yet:

- The overarching policy stance remained hawkish for the sector, with strict financing curbs in place such as the Three Red Lines policy;
- Developers will face high offshore debt repayments in 2022 of around RMB356bn, with nearly RMB100bn in both Q1 and Q2;
- The roll-out of property tax trials in more cities may put another damper on property sales, which have been the largest funding source for developers. HSBC equity analysts expect a 5% contraction in property sales in both volumes and value terms in 2022.

Property investment to trough in Q1, but the rebound is set to be gradual

We expect property investment to trough in Q1, but the rebound in the sector is set to be tough and a gradual process. On an annual basis, the tighter financing conditions, together with a 5% contraction in property sales, are likely to result in a contraction in floor space starts. Meanwhile, the ongoing lacklustre land transactions imply weak property investment in the pipeline. Data on land auctions serves as a good leading indicator for land purchases under property fixed asset investment (FAI) because developers purchase land first and then make payments to the government. Considering the leading indicator has been contracting on a y-o-y basis for about half a year now, we expect a downward trend in land purchases under property FAI in the coming months.

Chart 7: Shrinking developers' land purchases this year will translate into weak real estate investment in 2022

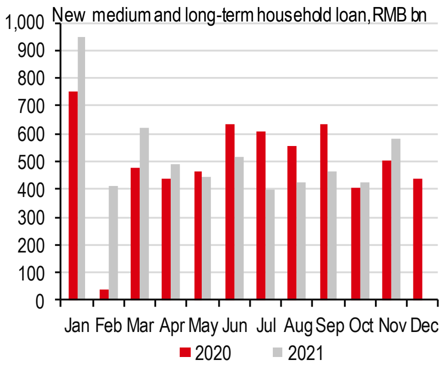


Source: CEIC, HSBC

Having said that, Beijing's priority for delivering pre-sold/under construction apartments will likely support floor plan construction in 2022. As Beijing is most concerned over homebuyers' losses in the property sector saga, we believe regulators will encourage healthy developers to take over and complete unfinished construction from their distressed peers. We thus expect investment in property construction to maintain a low digit growth in 2022.

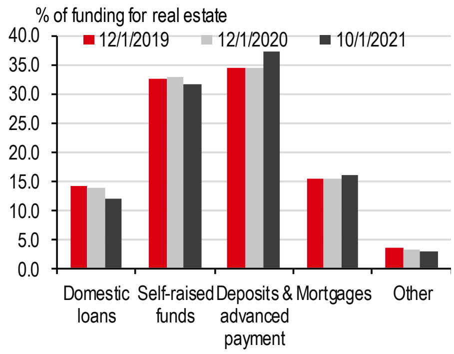
An upside risk may come from Beijing's pledge on building affordable housing to allow for actual housing demand to be met. Shanty town renovation played a key instrumental role in accelerating property sales and supporting housing investments in tier three and four cities during the 13th Five-year Plan (covering 2016-2020). However, investment on affordable housing has slowed notably in the last two years, with its share in total property investment falling from 10% in 2019 to an estimated 5%. Beijing's recent communication suggests that it is likely to shift the focus from shanty town renovation to construction of public rental housing, but the key question remains on the source and scale of funding for new projects. Should Beijing intend to quicken affordable housing to provide a floor for property investment, it may rely on a more generous fiscal bill or monetary policy tools such as Pledged Supplementary Lending facilities.

Chart 8: New medium and long-term household loans in Oct and Nov started to exceed the level seen last year



Source: CEIC, HSBC

Chart 9: Property sales account for about a half of funding for real estate investment



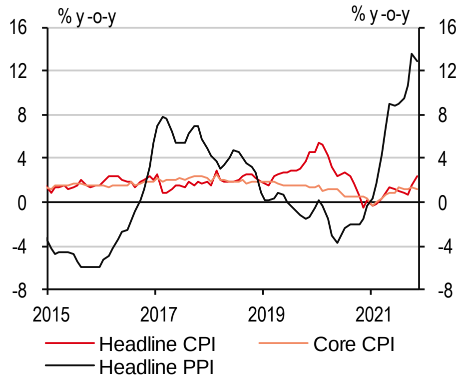
Source: CEIC, HSBC

Core inflation to stay muted

CPI inflation to follow a different path from developed economies

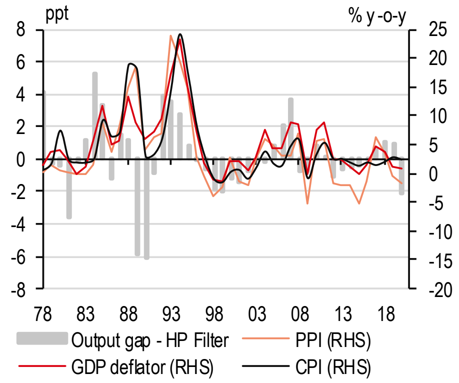
China's headline inflation has climbed up in the past couple of months from the ultra-low level of 0.7% y-o-y in September to 2.3% y-o-y in November. Going into 2022, headline CPI figures may be pushed up further by food and energy prices, but we expect it to remain under 3%. Domestic pork prices may bottom out and become less of a drag, and even contribute to y-o-y CPI inflation. Energy prices may also see some upward pressure as the energy crunch grips the world. But both transportation fuel and utility prices are controlled in China so they will be much less of a swing factor for inflation.

Chart 10: Despite the elevated PPI, the pass-through remains limited…



Source: Wind, HSBC

Chart 11: …as the negative output gap weighs on CPI inflation



Source: CEIC, HSBC

If we focus on core inflation instead, it has stayed low and will remain so in 2022. The key anchor is the negative output gap (Chart 11). The "scarring effect" (i.e. persistent impact on activity) from COVID-19 is lingering which is manifested by the sluggish consumption recovery so far. We expect to see a gradual recovery of GDP growth supported by accommodative monetary and fiscal policies in 2022 against the backdrop of "triple pressures", namely, "demand contraction, supply shocks, and weakening expectations".

China's inflation profile is in sharp contrast to that of developed economies. Many factors have contributed to such a divergence. For one, the PBoC stood out from peers in its monetary policy stance: out of concerns around asset price appreciation, the PBoC started to control liquidity in the market as early as the summer of 2020, while the major central banks were still in the loosening cycle. For another, China's stimulus package has targeted enterprises, so there is a lag on the filter-through effect to households, and hence on the consumption recovery. Developed economies, on the other hand, channelled cash directly to households, leading to a rapid pick-up in consumption.

We see China's CPI inflation, especially core, staying muted in 2022e and below 1.5%, paving the way for PBoC's expansionary policies to buffer the downturn.

Main risks to our outlook

While we expect the recovery outlook will improve in the coming year, there are still a number of risks to consider. For one, COVID-19 uncertainty persists. China has mostly been able to contain cases to local areas, but a more wide-spread wave of COVID-19 or emergence of new variants could mean the government will continue to implement strict measures on a wider scale to limit mobility and which would keep consumer sentiment low. This would hold back the consumption recovery, particularly in services. The geopolitical environment may also continue to face tensions, particularly with the US, and should there be a significant escalation, this could impact business sentiment and external demand.

Conclusion

Seeing the economy is slowing more sharply than expected, policymakers have shown more determination to prop up growth. Following the recent cut in the required reserve ratio, China's top policymakers made it clear at last week's Central Economic Work Conference that the policy focus will shift from de-risking towards supporting growth. With core inflation staying muted, we expect more easing measures in monetary and fiscal policy, a marginal relaxation in property lending and more transparent implementation on regulations in the coming quarters. These measures will likely add fuel to the ongoing upturn in higher-end manufacturing and provide a floor to the property slowdown. Combined with an anticipated jumpstart in green investment, this should help engineer a modest recovery in GDP growth to above 5.5% ahead of the 20th Party Congress next year.

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