China Economic Spotlight

Why GDP growth will likely bounce a little next year

Free to View
Economics - China

- Targeted policy easing, plus slower pace of regulatory tightening, should cushion the slowdown
- An upturn in manufacturing investment is likely to be sustainable, helping offset the real estate weakness…
- …as should a spike up in green investment

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We share the view that the GDP growth is likely to slow markedly to the 4-5% range in the rest of the year amid multiple headwinds. Yet we disagree with the bearish call for growth to stay below 5% into 2022 and beyond, as we expect Beijing to introduce more targeted easing measures in the coming months that should help cushion the growth slowdown. Meanwhile, manufacturing investment (accounting for over 40% of total fixed asset investment) has also been bottoming out and will likely accelerate into next year thanks to high levels of profit growth, increasing credit support and the pandemic-induced digitalization and automation. In addition, green investment has started to pick up following about a decade's preparation work for funding and pipeline projects. All this points to a moderate bounce in GDP growth to around 5.6% in 2022.

On the policy side, accelerated special bond issuance will likely go some way towards plugging the holes caused by weaker land sales in local government revenues, and support a moderate pick-up in infrastructure investment heading into 2022. In addition, we expect more tax incentives and subsidies to be devoted to promoting innovation and tech upgrading, as well as green investment in the coming months. Meanwhile, we expect more targeted credit support for green investment, small businesses and manufacturers, as a way to anchor liquidity expectations and stabilise credit growth. Instead of outright key policy rate cuts, we believe the PBoC will still prefer more selective liquidity management tools such as targeted RRR cuts and new liquidity facility for green financing. For the property sector, we believe the government has made it clear that it wants to avoid a collapse in the property market or a systemic liquidity crunch. While there is unlikely to be a U-turn in the overall tightening stance to reverse the slowing momentum, we believe more measures will be rolled out to increase credit access for healthy property developers and homebuyers.

Meanwhile, Beijing's push on technology sufficiency and green campaign will likely provide a longer-lasting boost to both manufacturing capex and new infrastructure spending in the coming years. While the ongoing "dual control" on energy consumption may cause some disruption to the industrial sector, policymakers will likely take a more flexible and orderly approach to reaching the green development goals in 2022. Policy support for digital and green investment such as tax exemptions and favourable credit treatment will also likely be carried over or even beefed up further next year. We thus expect manufacturing investment growth to become a key growth driver in 2022.

This is an abridged version of a report by the same title published on 13-Oct-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Targeted policy easing to cushion the slowdown

No U-turn in property policies, but marginal adjustments may restore some order
The slowdown in the property sector and its impact on the broader economy no doubt remains the biggest risk on China's growth outlook. As Beijing focuses on "cross-cyclical" strategy and pursuit for "common prosperity", it is willing to tolerate slower short-term economic growth momentum for its longer-term development goals. Therefore, a U-turn in the tightening stance over real estate seems unlikely.

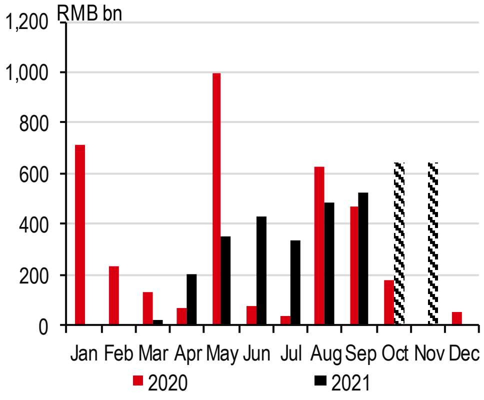
Having said that, recent communications by the government suggest it wants to avoid a collapse in the property market or a systemic liquidity crunch. To prevent the sector-wise deleveraging from developing into a systemic concern, there have been some early signs of government intervention. PBoC's 3Q policy meeting minutes released on 27 September briefly mentioned "to maintain the healthy development of property market and to safeguard the consumers' rights". Meanwhile large state banks received regulatory guidance to accelerate disbursement of approved mortgages, likely in order to prevent property market disruption due to overly tightened mortgage conditions.

We believe more measures will be rolled out to increase credit access for healthy property developers and homebuyers. While these measures are unlikely to reverse the slowing growth momentum in the sector, it can mitigate the pressure on struggling property developers and anxious buyers, and facilitate normalisation of land acquisitions to plug the potential hole in local governments' revenue.

Stronger special bond issuance to support a moderate pick-up in public investment
Special bond issuance has picked up pace in the recent months, which will likely support a moderate pick-up in infrastructure investment growth. As shown in Chart 1, local government special bond issuance has speeded up in recent months after Beijing gave it a nudge at the Politburo meeting in late July. As an important funding source for public investment on infrastructure, faster special bond issuance has been a key counter-cyclical tool that Beijing wields to cushion economic growth slowdown. Now as Beijing encourages more special bond quotas to be used on digital infrastructure, it can also serve the "cross-cyclical" policy goals of industrial and technological upgrading in the economy. This is thus the most likely way for the government to boost its overall fiscal spending heading into 2022.

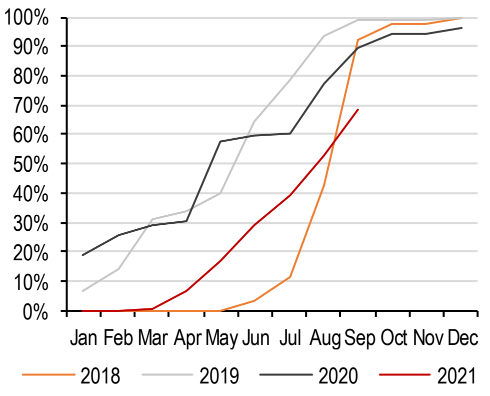
According to the latest media report (21st Century Business Herald, 30 September), local authorities are now required to finish all special bond issuance by the end of November

Chart 1: We expect high levels of special bond issuance in Q4 2021 compared to a low level in the same period of 2020



*HSBC estimates for October and November 2021
Source: CEIC, HSBC

Chart 2: Year-to-date special bond issuance as a share of the full-year quota



Source: Wind, HSBC

Net issuance of local government special bonds will further rise to RMB642bn on average in the next two months, compared to RMB523bn in September.

(compared to the previous announcement of leaving some quota for issuance in December). This means that net issuance of local government special bonds will further rise to RMB642bn on average in the next two months, compared to RMB523bn in September. This would mean a rather high special bond issuance in Q4 this year, unlike in the previous years when local governments mostly used up the issuance quota by the end of Q3 (see Chart 1 and 2). It will help partially offset local governments' loss in land sale revenues due to the recent weakness in the property sector, and bode well for a moderate pick-up in infrastructure investment growth in early 2022, especially on the back of a low base.

In addition, we expect more tax incentives and subsidies to be devoted to promoting tech upgrading and green investment in the coming months. We think the government can further increase tax cuts and exemptions for manufacturers' R&D activity, equipment upgrading and green transformation. Favourable policy treatments for small businesses rolled out in the recent two years such as a VAT rate cut from 3% to 1% may be again rolled over to next year as well.

Liquidity support to continue in a targeted manner

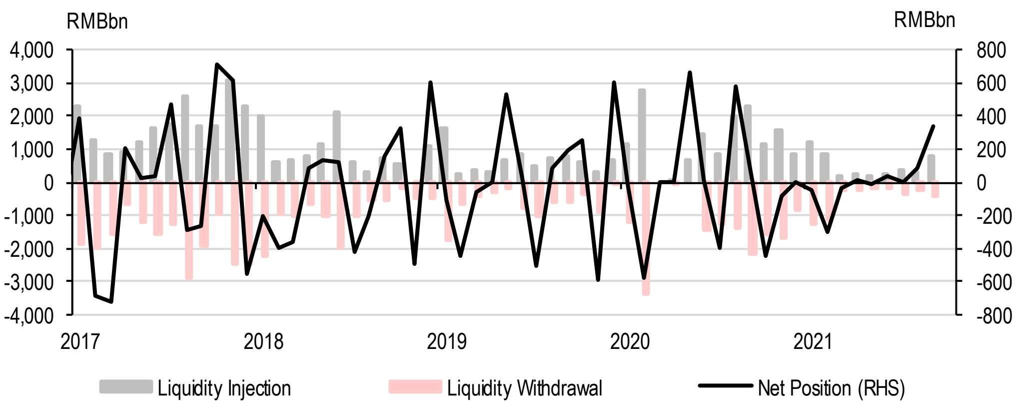
On monetary policy, the PBoC has also put out some low-profile and targeted policy support to increase liquidity supply in recent months, including the following:

- Stepping up net liquidity injection through open market operations (see Chart 3);
- Adding another RMB300bn to the relending quota in early September with a cap on bank lending rate;

We expect two targeted RRRs and other liquidity facilities to ensure easier access to credit for green financing, small businesses and manufacturers.

In addition, a 50bp across-the-board reserve requirement ratio (RRR) cut in July is also seen as a proactive measure to cushion the following rather swift regulatory tightening across sectors. Going forward, targeted credit support will likely continue as a way to anchor liquidity expectations and stabilise credit growth amid a continued tightening stance over carbon emission and the property sector. We expect the central bank to continue to rely on quantitative liquidity management tools. This will likely include two targeted RRRs and other liquidity facilities to ensure easier access to credit for green financing, small businesses and manufacturers. As such, together with faster local government special bond issuance, we expect credit growth to see a moderate rebound from an estimated 10.1% at the end of Q3 to around 11% heading into 2022.

Chart 3: Continuous net liquidity injection over open market operations in recent months



Source: CEIC, HSBC

Manufacturing investment to become a key demand driver

Smart manufacturing to fuel an upturn in capex

Policymakers will likely take a more flexible approach to reaching the green development goals next year.

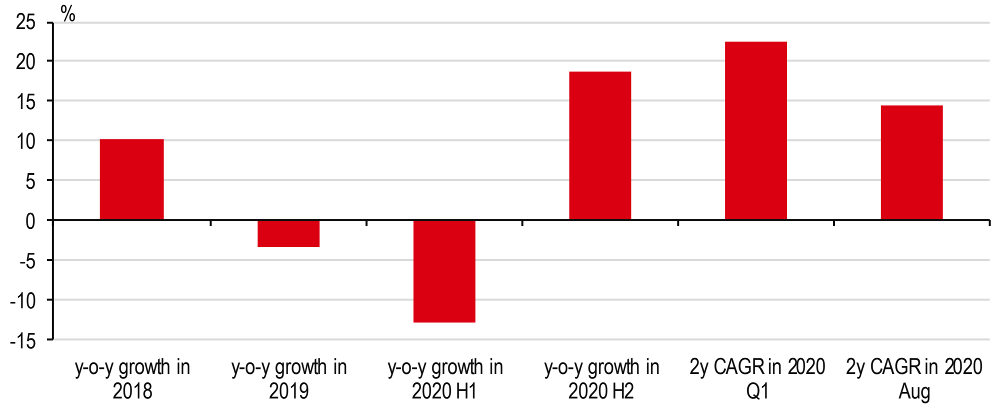
The "dual control" of energy consumption has raised concerns on whether a new round of supply-side reforms will disrupt industrial production and capex growth in a long lasting manner. We believe this concern is overplayed for two reasons. Firstly, policymakers will likely take a more flexible approach to reaching the green development goals and may be less aggressive about power reduction in the coming months, as they are likely to be wary of the compounding effect of power cuts on an already slowing economy, combined with a slowing property sector.

Secondly, and more importantly, we think there are still both cyclical and structural factors prompting manufacturers to plan more capital spending:

Despite the slowing momentum, industrial profit growth has stayed well above the pre-pandemic level.

1. Accumulated profits, together with favourable credit policy, will likely continue to fuel manufacturing capex, especially when regulatory adjustments come in at a more moderate pace next year. Despite the slowing momentum, industrial profit growth has stayed well above the pre-pandemic level this year after a quick rebound in H2 2020. The 2-year CAGR of industrial profits was nearly 15% in August, notably higher than the average y-o-y growth rate seen in 2018 and 2019 (Chart 4).

Chart 4: Industrial profit growth slows down in the recent month, but remaining notably higher than the level seen in 2019 during the trade war

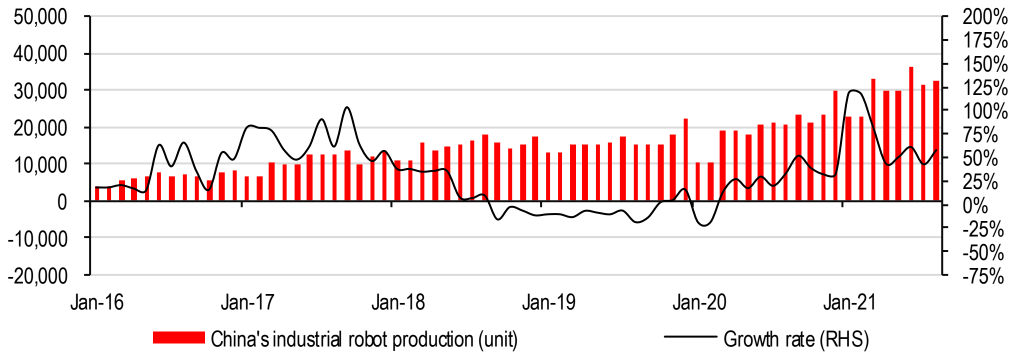


Source: CEIC, HSBC

2. Beijing has further increased credit support to manufacturers this year, with growth in mid and long-term manufacturing loans reaching 41.6% in H1 2021, 24.8ppt higher than the growth of overall mid and long-term loans. We expect favourable credit policy for manufacturers to continue in 2022.

3. The pandemic-induced acceleration in digitalisation and automation will likely fuel stronger manufacturing investment in the years ahead. We note that there is still huge potential for China to play catch up with developed economies in smart manufacturing. Beijing will also likely double down on policy incentives to promote digitalisation and automation in the coming years as they are key components of China's technology self-sufficiency strategy, including further tax cuts and exemptions for manufacturers' investments in technology upgrading. Moreover, an anticipated policy push under the 14th Five-Year Plan to develop smart cities and other digital infrastructure will also generate more demand for domestic high-tech equipment manufacturing, and lay the foundations for a faster digital transition by manufacturers in more sectors and regions.

Chart 5: Industrial robot production remains at a robust level

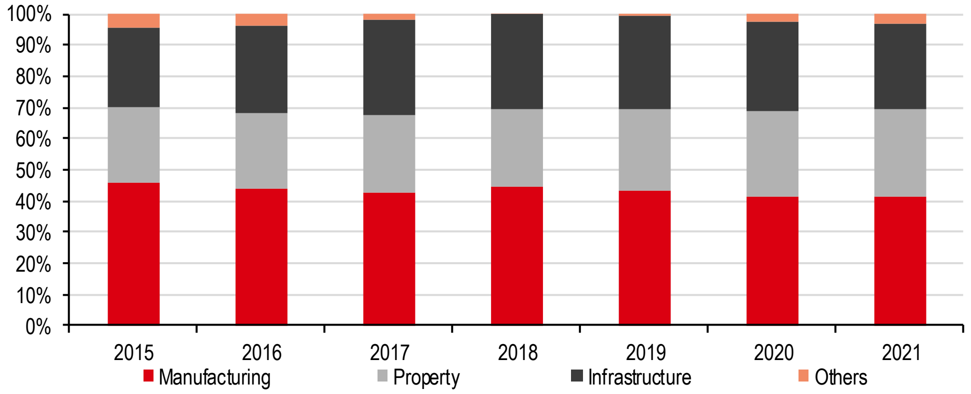


Source: CEIC, HSBC (see *Asia Automation Indicators: Non-mainland China names outperforming by Helen Fang et al.*, 29 September 2021)

Manufacturing investment accounts for around 40% of total fixed asset investment (FAI) and 47% of total capital formation

All this will likely provide some boost to manufacturing investment growth in the coming years. We believe the 5-year compound annual growth rate (CAGR) of manufacturing investment can improve to over 8% under the 14th Five-Year Plan from 3.8% during the last five years. Considering that manufacturing investment accounts for around 40% of total fixed asset investment (FAI) and 47% of total capital formation (calculated as FAI minus land purchases), more robust manufacturing capex growth on the back of digital and green transformation will provide a robust buffer to offset the negative shock from slowing property activity.

Chart 6: Breakdown of fixed asset investment (FAI)



Source: CEIC, HSBC

Kick starting green investment

The recent power crisis suggests that China cannot rely solely on cutting coal production to achieve its environmental targets. Investing in energy and industrial transformation is essential, in our view. In order to achieve more effective and secure energy distribution, the government will need to invest more in the upgrading of grid infrastructure and the development of energy storage systems. For the industry sector, to meet the government's carbon emission goals, both local authorities and manufacturers will need to plan more capital spending on green transformation of production and operation.

A massive amount of investment is needed on the path to decarbonisation.

This suggests a massive amount of investment is needed on the path to decarbonisation. For example, the International Energy Agency (IEA) estimates cUSD33trn for new investment from now to 2060[1]. Decarbonisation can thus become a key driver for both manufacturing and infrastructure investment in the coming years. We believe Beijing and local authorities will roll out more proactive policies to support development of new infrastructure and innovation of frontier technologies. A new regulatory framework (e.g. on ESG disclosure on investment) and incentives (such as varied risk weighting) may also be introduced to encourage financial institutions to beef up support for green financing.

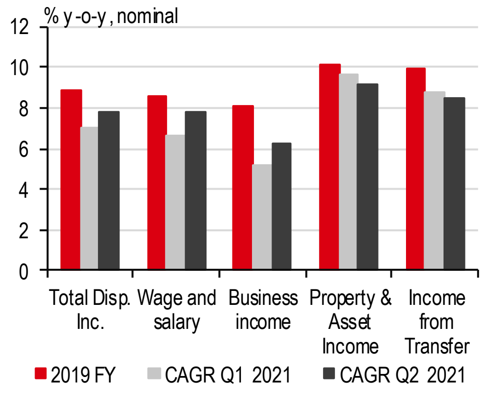
Consumption recovery hitting speed bumps, but unlikely to stop

The recovery in retail sales has been a difficult uphill battle, and it is now hitting more speed bumps. Regional COVID-19 resurgence continues to put a drag on service activity. Data from the Ministry of Culture and Tourism shows that during China's weeklong National Day holiday at the beginning of October, only 515 million domestic trips were made, down 1.5% from a year earlier and c30% from the pre-pandemic year of 2019. Moreover, regulatory tightening across property, tutoring, tech and other sectors may bring more labour market pressure.

Two-year CAGR of total disposable income reached about 90% of the pre-pandemic pace in 2019 by the end of Q2 2021.

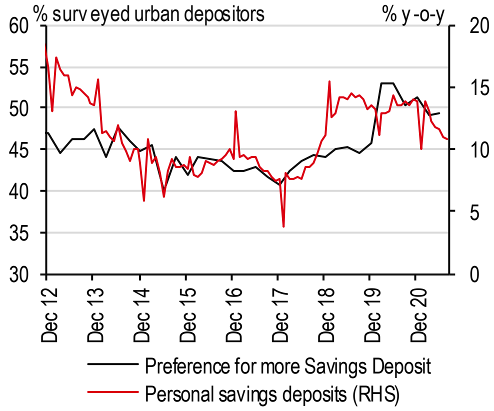
Having said that, the ultimate drivers of a further recovery in retail sales will still come down to further improvements in the labour market. There has been a notable recovery in total disposable income growth since Q2 2020, with the two-year CAGR reaching about 90% of the pre-pandemic pace in 2019 by the end of Q2 2021. It has mostly rebounded, reaching about 90% of pre-pandemic levels by the end of Q2 2021 when looking at the two-year CAGR compared to 2019 growth levels (see Chart 7).

Chart 7. Income growth has mostly recovered



Source: CEIC, HSBC

Chart 8. Households are starting to unwind some savings



Source: CEIC, HSBC

Going forward, tailwinds for the economy stemming from manufacturing investment, strong export growth, and infrastructure investment may continue to provide some support for income growth in related sectors. The improvement in income growth has in turn helped to reduce some precautionary behaviour as the preference for increased savings has dipped down from its peak in 1Q20 (Chart 8). The personal savings deposit data have also shown a fall in the growth rate from the levels seen in pre-pandemic and pre-trade tension times (2018).

[1] IEA, 2021, "An energy sector roadmap to carbon neutrality in China," *CC BY-NC 3.0 IGO*, September.

We expect consumption may not fully recover until at least 2022, with growth reaching pre-pandemic levels of 6.5% y-o-y.

Taking this all together, it will likely mean the path for a consumption recovery will continue to face challenges, and the road towards a full recovery will be longer than we previously expected. We expect consumption may not fully recover until at least 2022, with growth reaching pre-pandemic levels of 6.5% y-o-y.

All in all, we expect GDP growth to bounce back moderately in 2022 to 5.6% y-o-y (from 4.8% y-o-y in H2 2021). After a slowdown in H2 2021 on the back of stronger policy response and new investment drivers under the 14th Five-Year Plan. This is in line with the central bank's estimated potential growth rate of 5.0-5.7%. Considering the government is heading towards the quinquennial personnel changes in the 20th Party Congress in 2022, policymakers will likely ensure that real GDP growth will at least trend close to the potential level in the coming quarters.

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