China's recovery

Beyond a quick fix

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Economics - China

- The slowdown in economic momentum indicates the recovery needs more support to lift confidence…
- …but policymakers, while still in a pro-growth mindset, are unlikely to come out with a 'big bang' stimulus package
- Long-term 'quality' growth is still top of mind for policymakers; local government debt needs to be addressed

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China's economic recovery is showing signs of slowing down. The weaker April activity data and a slowdown in May PMI indices have made investors worried that this may be it for the recovery. We do not think so, but policymakers need to do more to revive confidence and get the economy back on track.

Beijing still has a pro-growth mindset… but this time appears different
We do not foresee a 'big bang' stimulus package as we saw during the GFC. Rather, we think policymakers will roll out gradual support to help prop up growth, which is our base case. We see a continuation of fiscal policy easing, with more focus on new infrastructure investments, such as building out data centres, EV charging stations, and upgrading power grids. Meanwhile, monetary policy is likely to stay accommodative as the inflationary environment remains subdued.

More clarity over where policy goes from here should come at key economic meetings this fall: the third Plenum (policy meeting) and the National Financial Work Conference. But long-term structural growth is likely to remain in focus. We see more policy support for new growth areas like consumption, manufacturing and green development.

What might move the needle for more policy support?
Financial stability is likely to be the key tipping point. Should there be broader downward pressure on the property sector or more widespread issues related to local government debt, we believe Beijing may be more proactive in its approach.

Local government debt faces structural challenges from its revenue sources alongside more bond payments coming due this year. Old sources of revenue, such as land sales, are likely to stay more muted, while the domestic economic recovery has yet to hit its stride. Meanwhile, we think unproductive debt assets will need to be properly addressed. Solutions we see as likely include debt restructuring, asset monetisation, and the ring-fencing of 'bad' assets.

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How much more support?

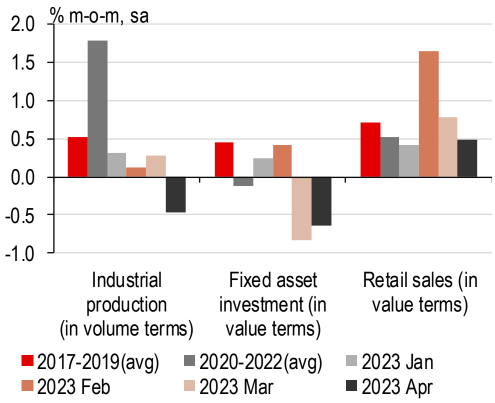
- Growth is showing signs of slowing, which means more policy support would be needed to revive confidence
- But policymakers are unlikely to provide big bang support, preferring to take a more cautious approach
- Long-term growth remains in focus, while challenges from local government debt still need solutions

After two months of poor data, we see increasing anxiety over whether China will roll out policy measures to ensure a stable recovery. We answer the most asked questions around this topic.

Consumption-led recovery is defining a different recovery path

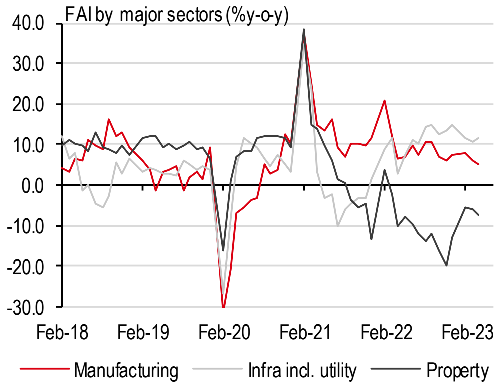
Is China's recovery losing steam? That is the question everyone is asking us, but the answer is not straightforward. To gauge the recovery momentum, the market is focusing on sequential growth. Because current y-o-y growth rates face a low base for comparison in 2Q22, (Shanghai was under a lockdown), this could easily paint a rosy picture. However, April activity data surprised to the downside: FAI and IP growth contracted sequentially (-0.64% and -0.47% m-o-m sa, respectively) even after seasonal adjustments, while the property sector showed renewed signs of stress. As such, it seems the effects of policy measures introduced since November 2022 are waning (given some policy support is expiring). For example, construction loans to developers and trust loans due within six months were extended in late 2022, and this has now come to an end. That said, we think it is premature to conclude the recovery momentum has stalled.

Chart 1: Economic recovery continues to be led by services and consumption



Source: Wind, HSBC

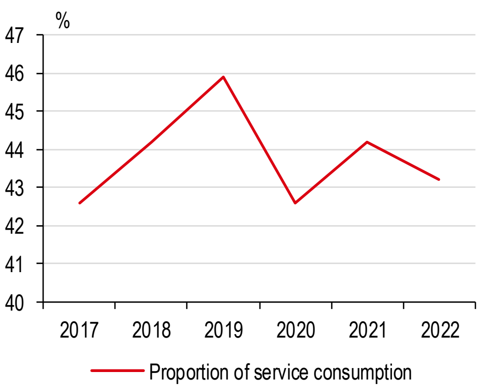
Chart 2: FAI growth has been supported by manufacturing and infrastructure



Source: Wind, HSBC

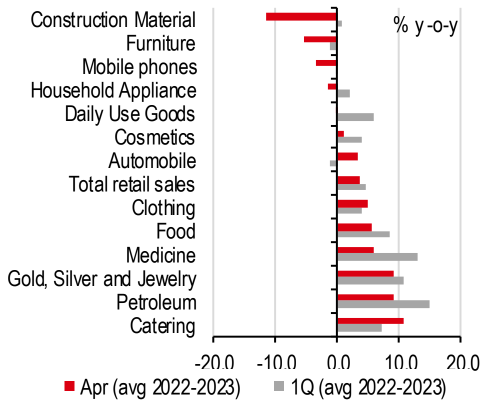
This time appears different as a consumption-led revival is driving the overall recovery path. Although sequential growth in retail sales (seasonally adjusted) in April appeared weaker than the historical average (0.49% m-o-m versus 0.76% m-o-m for the 2015-2019 average), the statistics may have underestimated the consumption rebound. Services consumption outperformed goods consumption, while only catering services (including restaurant dining), representing c30% of the entire services consumption sector, are included in retail sales. As service sectors continue to improve, more jobs and stable incomes could emerge, which – in turn – will further encourage consumers to buy. While excess savings may provide a source of dry powder, we see this more relevant for the higher income groups. For the several hundred million individuals in lower income brackets, we note a rebound in consumption will depend critically on improvements in the labour market.

Chart 3: Services' share of consumer spending dropped significantly during the pandemic



Source: National Bureau of Statistics, HSBC

Chart 4: Offline activity-based consumption outperformed after reopening



Source: CEIC, HSBC

So, will there be a large stimulus package in the near term? Unlikely, in our view. Investors may feel disappointed as they could be expecting the government to implement a range of measures to support the economy, relying on the same recipe that has worked in previous cycles. However, the current challenges may require more structural planning, rather than short-term quick fixes. Beijing has shown no appetite for another "mega" RMB4trn stimulus package, like that implemented during the GFC; local governments are limited in their ability to make substantial investments in infrastructure projects. Meanwhile, policymakers are also seeking to facilitate "quality growth" that may address structural imbalances in the economy, such as income inequality and fixing the local government debt overhang.

What could come next? Incremental policy measures in the next few months, and more clarity on the long-term economic policy focus after the 3rd Plenum and National Financial Work Conference could come next.

What's on the minds of policymakers?

Policymakers are at a crossroads

It appears policymakers are more patient this time: despite the sequential weakening in data since April, there is no "mega" stimulus is in sight. While acknowledging the cyclical challenges and reiterating its "pro-growth" stance, we note Beijing is placing greater emphasis on addressing structural imbalances to facilitate long-term "quality growth".

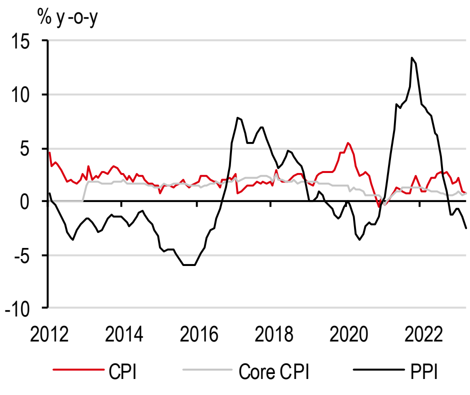
Some believe policymakers may feel relatively "relaxed" about the recovery, as the "around 5%" annual growth target for this year should not be difficult to achieve, given 2022's low base. However, we disagree. Challenges, such as the c20% record-high youth unemployment rate and low private investment, are keeping government officials busy. Indeed, Chinese officials at different levels, including top leaders and ministers, are carrying out extensive field research and studies (China Daily, 28 April 2023), following Premier Li Qiang's guidance. In his first press conference, Premier Li Qiang said, "my experience is that when you sit in the office, you see lots of problems; but when you reach out to the people, you see all kinds of solutions." (Xinhua, 13 March 2023). This may help reduce the risk of policy missteps, as sometimes macro- and micro-level evidence can be inconsistent.

What has kept policymakers from dusting off their trusty old toolbox? The old toolkit may not be as effective, and the policy space from this source is likely more limited, especially now that the primary challenge is "insufficient demand" stemming from weak confidence. Moreover, we note the old investment-driven growth model is incompatible with the goal of achieving long-term sustainable growth. As such, the pursuit of quick fixes could exacerbate existing structural imbalances.

Still room for monetary easing, but effectiveness to be balanced against potential costs

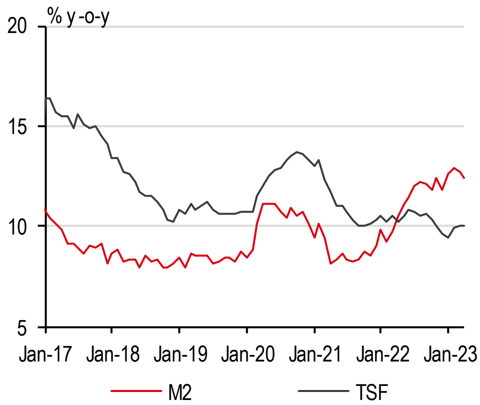
When it comes to monetary easing, there is still policy room, given muted inflationary pressure (Chart 5). However, the PBoC has reinstated its prudent policy stance (*Financial Stability report*, 19 May). The effectiveness of monetary easing will need to be carefully evaluated and balanced against potential costs, such as inflation, asset bubbles, or both. Indeed, overall liquidity conditions are still ample. For example, M2 growth has continued to see strong double-digit growth, while short-term interest rates continue to trend near the policy rate. Still, new bank lending weakened significantly in April, indicating inadequate demand for credit. In particular, household lending contracted y-o-y, even though average mortgage rates have dropped 1.28ppts over the past year (1Q23 versus 1Q22). Similarly, infrastructure investment has continued to sustain double-digit growth this year, but private investment is contracting. If confidence is the problem, the efficiency of monetary easing is compromised.

Chart 5: Liquidity conditions remain ample in recent months



Source: CEIC, HSBC

Chart 6: M2 has been experiencing double-digit growth since 2022



Source: CEIC, HSBC

Supportive liquidity conditions should incentivise banks to issue more loans to the real economy. But there will likely still be concerns regarding excessive liquidity amounting to 'flood-like' stimulus and, in turn, fuelling bubbles in unproductive assets and higher prices. In China, inflationary pressures remain low due to the continued gradual domestic demand recovery and a fall in the prices of some volatile items like fuel and food. But the risk of overstimulating the economy (which leads to upward price pressures, as seen in other economies) will likely remain in the back of policymakers' minds. Overall, we see a continued cautious approach to monetary easing being taken.

Infrastructure investment has remained buoyant…

Limited room for significant infrastructure investment

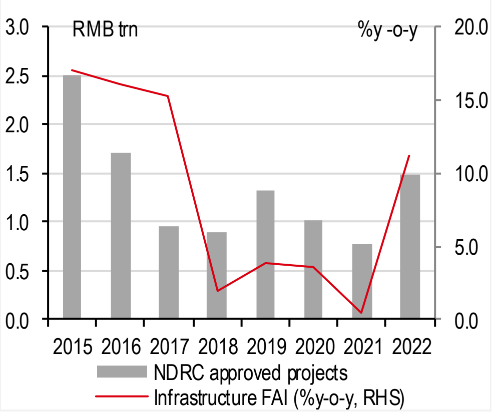
Although the activity data have been softer than expected overall, infrastructure investment continues to serve as a counter-cyclical buffer: as of this April, infrastructure investments (including utility) increased 11.3% y-o-y YTD, much faster than manufacturing investment (6.4% y-o-y YTD) and property investment (-6.2% y-o-y YTD).

We think this is important as infrastructure spending is often a key channel for feeding through the policy support. We saw an “all-out infrastructure push” launched in 2022. Last year, the National Development and Reform Commission (NDRC) approved 109 major FAI projects with a total investment of RMB1.48trn for 2022, nearly twice as much as the value in 2021 (Chart 7). As a result, infrastructure investment ramped up by 11.2% in 2022 (versus an average of 2.5% in 2018-2021), a key growth stabiliser for that year.

This year, the central government budget report highlighted that it is necessary to strengthen the overall planning of fiscal funds and expand the scale of fiscal expenditure. As such, RMB27.5bn in general public budget expenditure was planned, an increase of 5.6% from last year, and largely consistent with the 5% GDP growth target. Together with the balance of government management funds, the broadly defined budget deficit will stay elevated at 7.5% of GDP in 2023, the second-highest level when compared to historical levels. Against this backdrop, we believe infrastructure investments could still deliver solid growth of 5.6% in 2023, albeit slowing somewhat from the high pace of 2022.

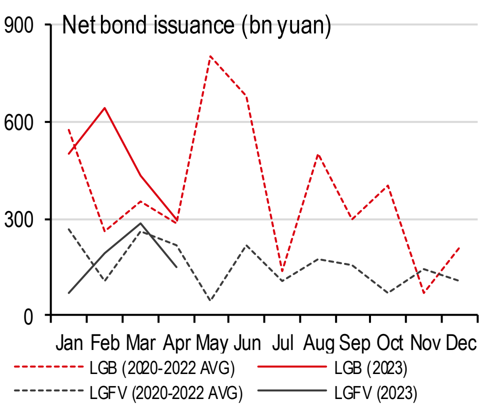
At the local level, the importance of infrastructure was also highlighted during the 2023 local “two sessions”. As of 1Q23, about two-thirds of China’s provinces have announced their spending plans on major projects, totalling more than RMB12.2trn, or up 17% compared to 2022 (Bloomberg, 11 April 2023). Local governments front-loaded special purpose bond issuance to kick-start the year with strong investment growth. According to Wind data, a total of RMB1.87trn new local government bonds were issued during the first four months of 2023, which is above the average of the past two years. Accompanied by that, net issuance of local government financing vehicle (LGFV) bonds also reached close to RMB700bn, up 5% from the same period in 2022 (Chart 8). In the near term, they will help expand infrastructure investment and drive total social financing demand.

Chart 7: NDRC-approved projects in 2022 were double the amount in the prior year



Source: Wind, HSBC

Chart 8: New issuance for LGB and LGFV bonds were front-loaded so far this year



Source: Wind, HSBC

…but we think it's better described as supportive rather than stimulating

That said, we do not think this is anywhere near the well-known RMB4trn stimulus package designed to mitigate the sudden external shock of the Global Financial Crisis (GFC) and facilitate a V-shaped rebound. One can argue this time around that headwinds come from multiple directions, including declining exports, albeit less acutely, and a sluggish domestic housing market. However, there is a limit as to how far infrastructure investment can go. After years of effort, China now ranks 36th in overall infrastructure quality (out of 141 countries; WEF Global Competitiveness Report 2019). There is a risk that aggressive public investment in traditional infrastructure projects could crowd out private investment, rather than achieving the intended crowd-in effect.

Local governments are limited in their ability to make aggressive infrastructure investments

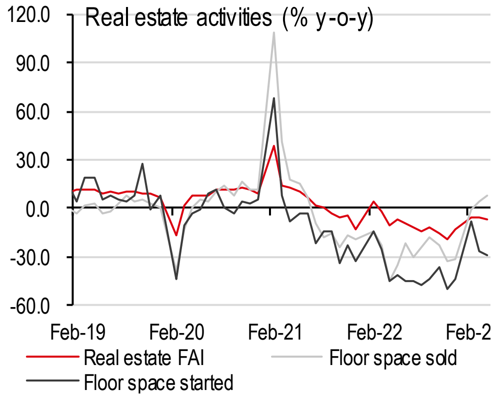
Feasibility is also a concern. A relatively large fiscal deficit suggests that while policymakers aim to preserve the economic recovery momentum, the chance of launching another major stimulus package is limited. Given infrastructure projects are primarily planned and funded at the local level, the financial sustainability of local governments and their debt overhang are major constraints.

Financial sustainability is undoubtedly a thorny problem to tackle, particularly given the still soft property market recovery. Land sales are the primary source of revenue for local governments, making up an average of 35% (calculated, by us, based on government budget statistics) of augmented local government revenues, which includes both general budget revenue and government-managed funds, in 2017-2022. In 2023, local government-managed fund revenue is only budgeted to increase 0.4%, compared to an average of 10% annual growth between 2017 and 2022. This flat revenue growth projection compares to a low base of a RMB2trn decline in land sales revenue in 2022 (Chart 9), reflecting policymakers' cautious view on the land market this year. Instead, the central government planned to increase fiscal transfers to local governments by RMB10trn, a 3.6% increase in gross terms, or 7.9% y-o-y if the one-off transfer in 2022 was taken out.

Chart 9: Land sales revenue declined by about RMB2trn in 2022

Source: Wind, HSBC

Chart 10: Floor space has continued to contract, pointing to muted land sales



Source: CEIC, HSBC

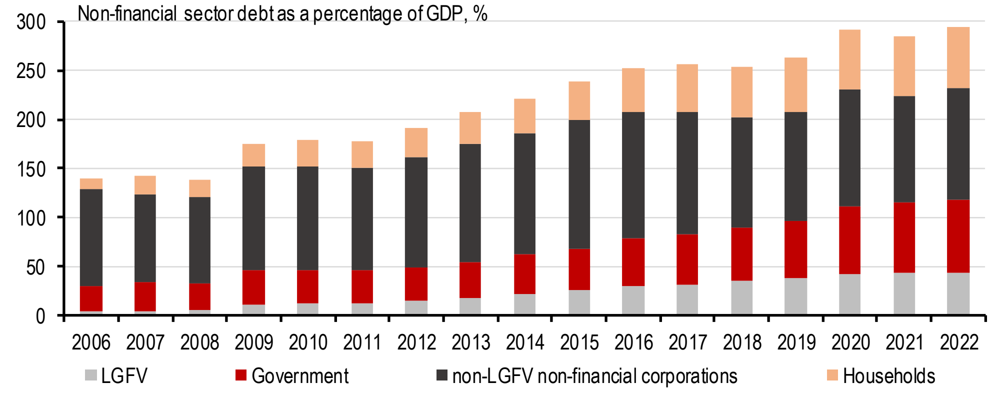
The property market has yet to stabilise. Land sales revenue is still in a deep contraction, declining 21.7% y-o-y YTD as of April, not much different from -23.3% in 2022 (Chart 9). Lacklustre performance in the property sector, particularly weak new home starts (Chart 10), may put more pressure on regions that have been relying heavily on land sales revenue. Even if the property market finally bottoms out, it is more likely to settle at a lower level of equilibrium as China no longer has such high housing demand. Policymakers have also pledged to shift away from an investment-driven model. Alternative revenue streams are critical for local governments.

There is also the problem of the debt overhang: not just the on-balance sheet debt, but also implicit debt borrowed via local government financing vehicles. Chart 11 updates the analysis.

When the LGFV debt is included, China's government debt (grey bar) increased substantially. As of 3Q22, total government debt stood at c120% of China's nominal GDP, of which local governments accounted for the majority.

We think it's fair to say that keeping local government implicit debt under control has been successful as it has remained relatively stable in relation to nominal GDP during the pandemic, though conceivably the imperfect definition of LGFVs that the data vendor Wind and bank regulator use may have understated the problem. However, there is a significant divergence across regions. On the one hand, Beijing and Guangdong managed to eliminate all local government implicit debt (Yicai, 16 January 2023); on the other hand, some LGFVs have just experienced near-default incidents.

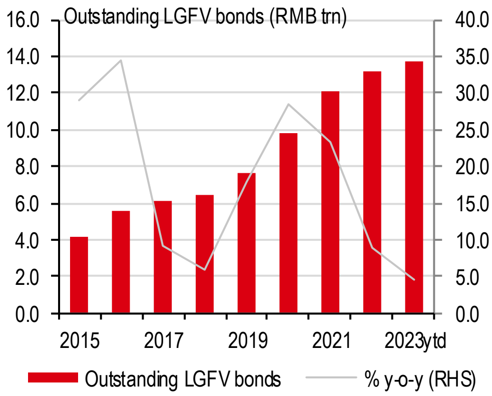
Chart 11: Local governments owe 60% of total government debt (c120% of GDP)



Note: Macro-leverage is defined as the non-financial sector debt to GDP ratio, where core debt, basically interest-bearing liabilities, is used as the numerator. For LGFV debt, we use interest bearing liabilities of LGFVs currently with bonds outstanding to proxy.
Source: BIS, Wind, HSBC estimates

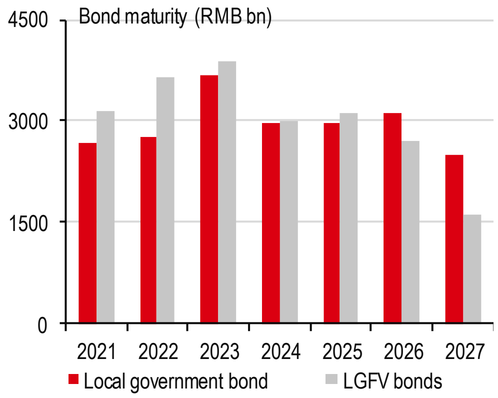
The Ministry of Finance continues to prioritise fiscal discipline, indicating a commitment to reducing implicit debt (Yicai, 21 March 2023). As a result, there may be limited opportunities for raising funds through off-balance sheet channels − illustrated by the decelerating growth in LGFV bond issuance in recent years. Yet, local governments are facing a significant increase in bond maturities in 2023: RMB3.88trn of LGFV bonds are going to mature this year, the highest level in recent years (Chart 13). A holistic solution is needed to address "the elephant in the room".

Chart 12: LGFV bond issuance has slowed amid tighter management



Source: Wind, HSBC

Chart 13: Local governments and LGFVs are facing elevated bond maturities in 2023



Source: Wind, HSBC

What might move the needle?

Financial stability is likely to be the red line, which, if crossed, would change the preference for a gradual approach. If the property sector was to experience the start of a disorderly downturn or local government debt repayment issues grow to more than a few isolated cases, then we see policymakers likely stepping up their stimulus package to prevent a hard landing.

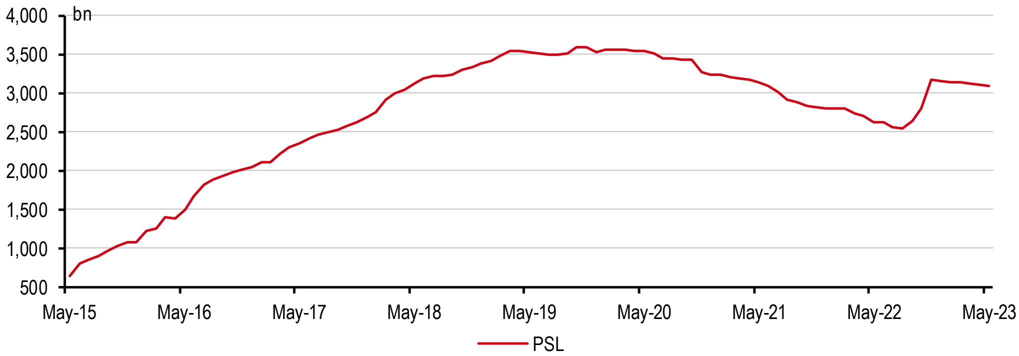
What's in the toolbox for incremental support:

1. **More monetary easing** to prevent a downward spiral in confidence, including further liquidity support through RRR cuts, increased re-lending quotas, and increased issuance of medium-term lending facility and open market operations

2. **More support for the property sector:**

   Quasi-fiscal policies by policy banks to support the housing sector, such as increased issuance of pledged supplementary lending (PSL) to provide funding to developers, or to local governments to purchase oversupplied homes in lower tier cities. PSL was the "secret weapon" to fund monetisation of the shanty town renovation and eventually fuel the housing market rally. Beijing does not appear to have the appetite to fuel a nationwide housing market rally, but we note PSL could be used more prudently to stabilise the housing market.

Chart 14: Outstanding balance of PSL increased cRMB600bn in August 2022-March 2023



Source: Wind, HSBC

   Top-tier cities also have room to further relax home purchase restrictions, including raising the purchase quota per households, reducing down-payment ratios, and easing eligibility requirements for home purchases. Already, Beijing is reported to be considering a new basket of measures to stimulate demand, including "reducing the down-payment in some non-core neighbourhoods of major cities" and "further relaxing restrictions for residential purchases under the guidance of the State Council" (Bloomberg, 2 June 2023).

3. **Restructuring of LGFV debt into longer tenors, lower interest rate bank loans:** There are already precedents on such measure. For example, a distressed LGFV in Zunyi, the second largest city in Guizhou Province, restructured its RMB15.6bn debt into 20-year bank loans, reducing the interest rate for over 3ppts (Yicai, 5 January 2023).

Structural reform

Different focus of public investment to promote new growth drivers

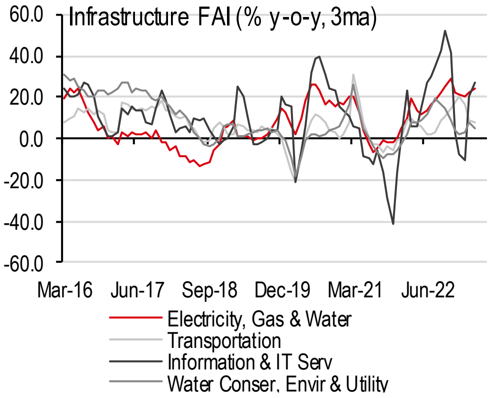
While we may have to wait until the fall for concrete economic policy measures targeting structural changes, we think it is reasonable to anticipate a focus on cultivating new growth drivers, such as domestic consumption, green transition, and manufacturing upgrading. As a result, we expect public investment to support these areas.

Particularly, public investment will focus on inclusive growth, such as ensuring social safety nets and increasing human capital support through areas like education, to help long-term growth. Meanwhile, new areas of investment will be directed at new infrastructure, such as those related to Information and Communication Technology (ICT) development, as well as green goals.

Based on Wind data, the scale of special bonds allocated to new infrastructure is still small. As of 1Q23, it amounted to less than RMB9bn (or 0.6% of total new SPB issuance), but there is substantial room to grow as the policy turns more supportive of new infrastructure areas such as 5G, AI, Industrial Internet, and IoT. As such, investments in information transmission, software and IT services increased by about 26% during the first four months of the year, on top of an already strong 22% growth rate in 2022. The new energy sector represented by power production has also shown no signs of slow down. Investments in electricity, gas, and water production as well as supply accelerated further to 28.7% y-o-y in January-April 2023, up from 17.1% growth in 2022 (Chart 15).

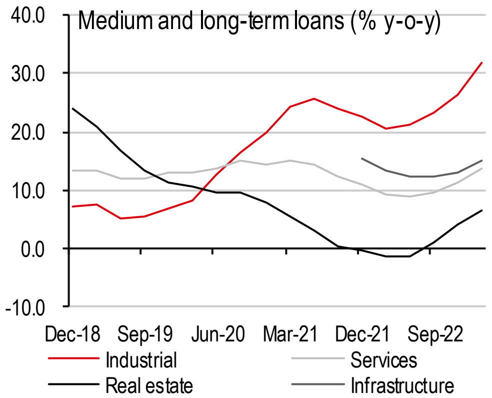
In addition to SPB allocation, structural monetary policy tools represent another key channel to fund new energy and technology upgrade projects, supporting their expansion in the coming quarters. According to the PBoC's Governor Yi Gang, the central bank lent more than RMB300bn via relending tools to support clean energy since November 2021; this has helped commercial banks make RMB600bn in loans to green projects. Overall, green loans increased 38.5% in 2022. In January, the PBoC announced it will extend three structural monetary tools. Among which, a 'clean usage of coal' relending facility (a specific policy tool that provides cheap funding for banks that lend to companies engaging in clean and effective use of the coal business) and a carbon-reduction relending facility will continue to be implemented until the end of 2023 and 2024, respectively.

Chart 15: Growth in new infrastructure and new energy sectors picked up further



Source: CEIC, HSBC

Chart 16: Growth trends for the major infrastructure investment areas



Source: CEIC, HSBC

A holistic solution on local government debt

Resolving the local government debt overhang will likely take time, and we see the debt restructuring measures mentioned earlier as, at best, a temporary solution. Essentially, the measures appear to be shifting burdens from local governments to banks and buying time. So, what can be done? We see the following solutions:

- For existing assets, the model used to restructure China's banking sector around the turn of the millennium might be worth considering. That is basically a good bank-bad bank model where 'bad' assets could be separated from LGFVs and assigned to designated entities to operate. Here 'bad' assets refer to those without sufficient cash flows to cover expenses in the near future. Capital support from the central government to operating entities may be essential for this step, as the state-owned distressed asset managers may not have sufficient capital to do so. The 'good' assets - those with commercial operability – could be retained by LGFVs, which may become ordinary local SOEs after reform, or partially sold to strategic investors, or sold off completely. The key is to prevent a large-scale default in LGFV space and preserve investor confidence.
- For new ones, local governments could benefit by financing future infrastructure projects in a more transparent manner, using sources, such as fiscal reserves, explicit debt, or future revenues.
- In the longer term, local governments would benefit by finding alternative revenue to replace the shortfall in land sales revenue. The Temasek model is gaining attention again, where local governments could learn from Temasek's success in managing diverse portfolios of investments across a range of sectors.

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