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China's great transition

From construction to capex and consumption

China's decades-long boom in real estate and infrastructure, a major source of economic growth, is coming to an end

To pick up the slack, investment is already rotating to higher-end manufacturing and green projects

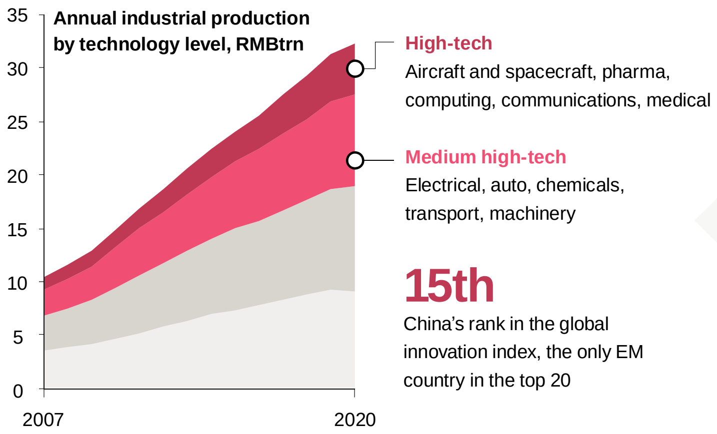
The middle class is also set to expand, making consumption a bigger growth driver in the coming years

This is an abridged version of a report by the same title published on 09 November 2021. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

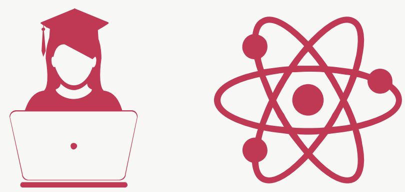
China's new growth drivers

Investment in medium to high-tech manufacturing

Higher-end manufacturing investment will grow by over 12% y-o-y in the next five years



15th
China's rank in the global innovation index, the only EM country in the top 20

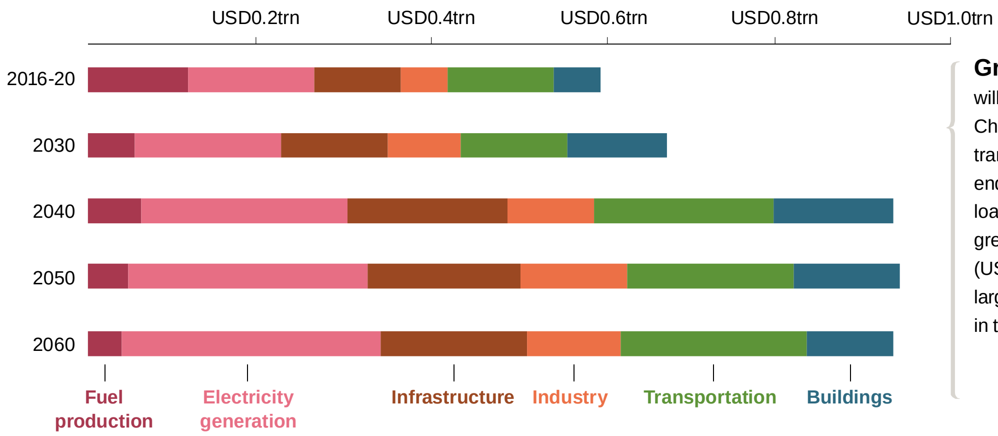


50m
Graduates set to enter the workforce over the next five years

20m
Are science, technology, engineering and maths (STEM) graduates

Green investment will be the second growth engine

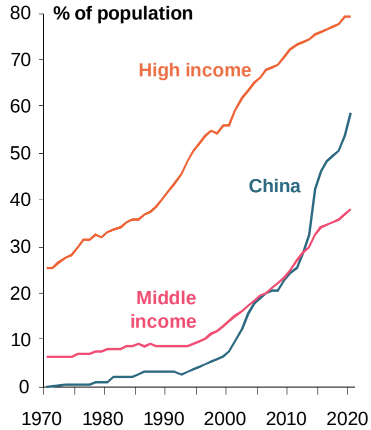
Annual investment to surpass RMB5trn on average between 2020 - 2060, mostly in electricity generation



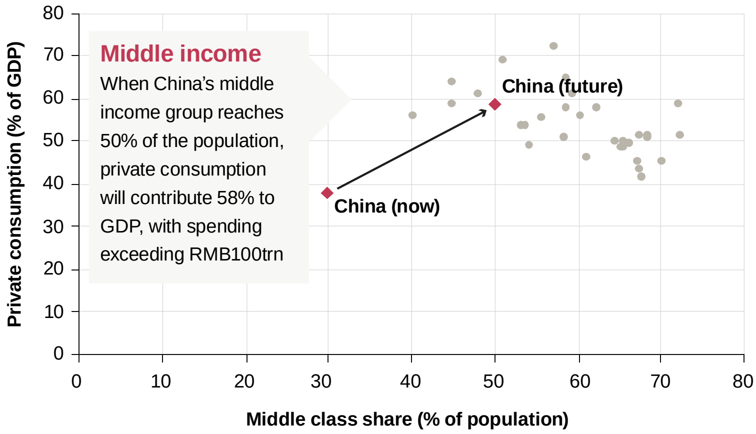
Green finance
will be an accelerator for China's green transformation. As of end-2020, China's green loans (USD1.8trn) and green bonds outstanding (USD125bn) were the largest and second-largest in the world

A rapidly growing middle class will make private consumption a third new driver

China's tertiary enrolment ratio has soared



Expanding the middle income group to boost consumption



*Urbanisation rate for 2020 is for China, for other countries, data is for 2019
Note: The "middle-income" group is defined by population share with household disposable income between 75% and 200% of the national median. Incomes are disposable incomes, corrected for household size, following OECD (2019).
Source: OECD, CEIC, IEA (2021), World Bank, HSBC estimates.

China's great transition

Evergrande's debt crisis underscores a fundamental change to China's economy: a decades-long construction boom is coming to an end. But investment isn't standing still and, instead, is shifting towards higher-end manufacturing and green projects. Combined with a rapid expansion of the middle class, this points to a major shift that will likely lift productivity and help sustain around 6% economic growth in the coming years. Such a transition will have significant spill-over effects both domestically and externally.

The country can no longer rely on the real estate sector to drive the economy forward

China's recent measures to cool the housing market have been much tougher than previous attempts. Hence, it's not very surprising to see highly leveraged property developers such as Evergrande struggling with heavy debt loads. But the more important question is why Beijing is now more determined than ever to tame the rampant property market? We believe it's because policy makers know that after a more than two-decade long housing boom, the country can no longer rely on the real estate sector to drive the economy forward. By looking at a range of key measures, it soon becomes apparent that the housing market is reaching its limits:

- Property investment has surged by an average 18.2% per year since 1997, 1.6 times nominal GDP growth in the same period, and lifting property investment's share of fixed asset investment and nominal GDP to a record high of 25% and 10% respectively. That's higher than the ratio in Japan during its 1980s property boom.
- Home ownership has surged from 47% in the mid-1990s to over 80% in recent years, much higher than developed economies such as the US, Japan and South Korea. About 40% of households now own at least two apartments.
- Residential living space per person has doubled since 2000 to around 40 square metres, higher than many developed economies in Asia and Europe.

All this doesn't necessarily mean property investment is going to collapse, especially with millions of villagers still moving to towns and cities each year, and a need to renovate the stock of old houses. Rather, it implies that property investment is likely to slow substantially in the years ahead. And it's not alone as investment in infrastructure may also slow after being on a tear over the past decade. Doubtlessly, there is still a need for more investment in 5G networks and other IT infrastructure facilities, but the days of making massive investments to ease crucial bottlenecks in manufacturing or transport are behind us. Combined, investment for property and infrastructure make up 22% of the economy, and the slowdown will lower demand for commodities and building materials in the years ahead.

However, the focus of this report is exploring what new engines of growth can pick up the slack. With so much more capital being freed up, this can all be reallocated into other areas.

Over the last four quarters growth, as bank lending to the real estate sector has slowed, growth in credit to the manufacturing sector has accelerated. This credit reallocation has reinforced the rotation in investment away from construction to spending on manufacturing, especially in the medium and high-tech sectors. We expect this rotation to gain momentum for these reasons:

- China's manufacturing sector is climbing up the global value chain while some 9-10m college graduates per year (more than the US, German, Japan, Korea and ASEAN combined) provide support for expanding further into higher technology manufacturing.
- China's ranking in the global innovation index has been rising, and is now the only emerging market in the top 15, a move which will likely drive industrial upgrading.
- China's 14th Five-year Plan (FYP) outlined concrete steps towards developing technology, which if implemented well could also add fuel to industrial upgrading.

As a result of all this, we expect the medium to high-tech sectors to account for over 60% of total manufacturing by 2030 (vs. around 45% in 2020). Such a shift would partially offset the slowdown in real estate and infrastructure investment. More importantly, reallocating capital from real estate to more productive manufacturing sectors will likely fuel productivity growth and therefore keep the potential growth rate above 6% in the years ahead. As the experiences of Japan and South Korea show, moving up the global value chain is a proven pathway for China (as a middle income economy) to graduate into a high income one.

Along with faster growth in loans to the manufacturing sector, more credit is also being gradually channelled into green and low-carbon projects. About USD65bn of green bonds have been issued so far this year, already some four times the amount in full-year 2020. The State Council last week published new guidelines to ensure carbon emissions peak by 2030, especially for the energy and industrial sectors which account for the bulk. But it will come at a cost as the International Energy Agency (IEA) estimates China needs to invest more than RMB200trn (equivalent to 200% of GDP in 2020) in the next 40 years to achieve carbon neutrality. Some estimates from a government think tank put the number as high as RMB500trn. Still, funding should not be an issue as China's high level of savings (one of the highest in the world) could be channelled into such projects. The key challenge though is accelerating financial reforms to open up more channels to reallocate the funds to green projects. Based on the IEA estimate, total green investment needs to top RMB5trn a year, i.e. c5% of 2020 GDP, beating the one-off post-Global Financial Crisis stimulus of RMB4trn trillion. This will help to not only offset the slower growth in construction investment, but also develop green technology and make economic growth more sustainable.

All of these initiatives will create more high-skilled jobs. Combined with Beijing's policy support for small and medium-size enterprises, this should provide opportunities for the 9-10m college graduates and around 5m vocational school graduates per year in the coming years. This will enable this cohort to transition into middle-class consumers, driving growth in consumer spending, especially for new products and services. This, in turn, should create demand for medium to high-tech manufacturing businesses in China, creating a positive feedback loop between the rise of the middle class and medium to high-tech manufacturing business. Moreover, we expect Beijing's common prosperity initiative to also drive growth in the middle class as it will accelerate "hukou" (household registration) reforms to give 286m migrant workers equal opportunities. By giving this cohort equal access to social welfare in the coming 10-15 years, we estimate that this will likely raise their propensity to consume and therefore lift annual GDP growth by 0.6% in the coming years.

This is an abridged version of a report by the same title published on 9-Nov-21. The full note covers why the construction boom is ending, the rise of medium and high-tech manufacturing, kick-starting green investment and doubling the middle class. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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