China: Headwinds to fade, but ride to remain bumpy

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- **Exit from Zero-Covid could be a bumpy ride, as the authorities face a difficult balancing act**
- **Beijing doubles down on property support, but restoring trust is key and may take time**
- **Growth should profit from these major policy shifts, but some downside risks remain**
- **All in all, we expect annual growth to pick up from 3.0% in 2022 to 4.8% in 2023, and 5.2% in 2024**

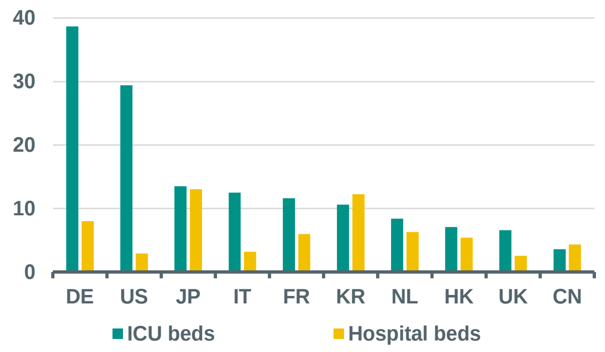
In 2022, China's economy faced major headwinds, some of which are self inflicted: Zero-Covid, the property sector slump, a slowdown in global growth and the flaring-up of tensions with the US on tech and Taiwan. Going forward, we expect some of these headwinds to fade, and annual growth to pick up from 3.0% in 2022, to 4.8% in 2023 and 5.2% in 2024.

Exit from Zero-Covid could be a bumpy ride, as the authorities face a difficult balancing act

Although Zero-Covid helped to keep the death toll extremely low, it has proven less effective in dealing with the highly contagious Omicron and related variants. Moreover, this policy had a large macro impact, depressing confidence and domestic demand, while adding to supply bottlenecks from time to time (particularly during the initial Covid-19 shock and the Omicron slump in early 2022). There is also a huge social impact, evidenced by unprecedented protests in late November. Although Beijing quickly stepped in to contain these protests, the sense of urgency to prepare for a relaxation of Zero-Covid has increased, even as new cases remain high (albeit falling). Both central and local authorities have started 'optimising' testing, quarantine and vaccination policies. With herd immunity still a distant prospect, the key to engineer an orderly exit is boosting the vaccination of the elderly while strengthening ICU capacity. Also crucial is a shift of Beijing's overall narrative and the launch of education campaigns to prepare the population for a different approach. Bolstering vaccination efficacy by developing or importing mRNA vaccines may also be needed, but using foreign vaccines remains politically sensitive. All in all, we expect Beijing to aim for a gradual but steady approach towards relaxation, aiming for an orderly exit without overburdening the public health sector. Still, the risk of a more disorderly outcome is high, with a bigger impact on public health that may backfire on the economy, and lead to renewed disruptions to both the supply and demand side.

China's vulnerable public health system

ICU beds per 100.000 people / Hospital beds per 1000 people



Source: Various (pre-pandemic numbers)

Zero-Covid has driven consumer confidence to record low

Consumer confidence index, 100 = neutral

Source: Refinitiv

Beijing doubles down on property sector support, but restoring trust remains key, and may take time

The property slump, initially triggered by tighter policies ('three red lines') and aggravated by Zero-Covid, intensified over the past year due to a vicious cycle of financing problems for developers leading to more projects being unfinished, depressing confidence and new home sales, even resulting in a mortgage boycott. The government's response was initially cautious, as it wanted to contain overall leverage and moral hazard. Still, in line with our expectations, support measures have been stepped up over time. A more direct support package was announced in November, including a PBoC relending programme, more room for property lending by banks, easier restrictions on shadow-bank and equity financing, government bond guarantees, and the extension of payment deadlines, with a wave of debt maturities due in the coming months. This policy is aimed at avoiding further defaults amongst property developers, with specific funds allocated to help finishing construction projects. These measures, together with a relaxation of Zero-Covid, should help to break the vicious cycle, but it may take a while to restore homebuyers' trust and revive property sales – particularly if the exit from Zero Covid is disorderly.

US-China tensions to remain, but Biden-Xi meeting last November should help to keep the situation under control

US-China tensions flared up over the summer after China responded with unprecedented military activity in the Taiwan Strait to Nancy Pelosi's visit to Taipei, and with the US imposing export restrictions on advanced chips and related machines. Some calm has returned after the first face-to-face meeting ever between Biden and Xi at the margins of the November G20-summit in Jakarta. Both leaders agreed to restart some working-level communication channels that were suspended, on climate and other areas. US Secretary of State Blinken will visit China in early 2023. That said, risks remain, also depending on political developments in the US and Taiwan (with presidential elections coming up in both countries in 2024). Meanwhile, there are more signs that multinational firms are diversifying their supply chains following geopolitical tensions and pandemic disturbances (from 'just in time' to 'just in case'), but this will be a gradual process given the interests at stake.

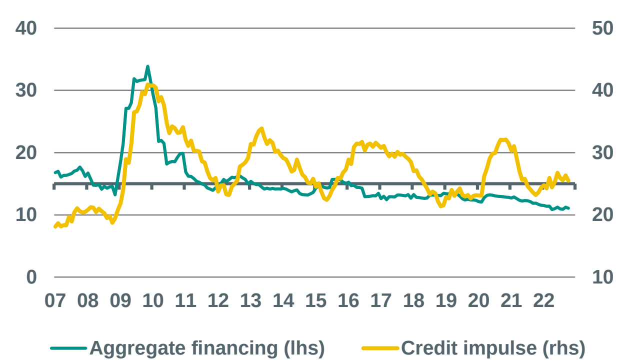
Inflation still relatively low, giving the PBoC room for manoeuvre

China does not face the same (largely energy-driven) inflation spikes as major developed economies. In line with our expectations, consumer price inflation has picked up in the course of 2022 (partly driven by pork prices), averaging around 2% yoy in 2022 (2021: 0.9%) . However, core inflation has fallen to 0.6% yoy in recent months, reflecting weak domestic demand and the lack of pipeline pressures – with producer price inflation even turning negative in Q4 2022. We expect headline (and core) inflation to pick up again in 2023, as domestic demand stabilizes, but to remain below the PBoC's 3% target. All of this means that the PBoC still has some room for manoeuvre in terms of piecemeal monetary easing. We anticipate modest additional cuts in banks' reserve requirement ratios and targeted mini cuts of specific policy rates (such as the 5-year Loan Prime Rate, which is used as a benchmark in mortgage lending). We do not anticipate a major monetary easing campaign, partly also for FX stability reasons (given further rate hikes expected in developed economies in early 2023). Indeed, the main shift in China's policy stance will come from the expected relaxation of Zero-Covid, and the more direct support of the property sector. These shifts will likely support a further turn in the credit cycle as well.

Growth should profit from Zero-Covid exit and property support, but some of the downside risks remain

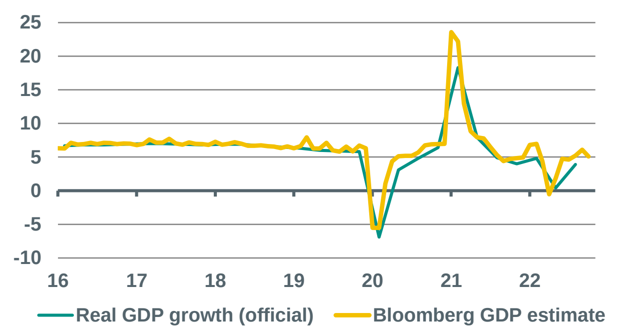
What does all this mean for the growth outlook? We expect the impulse from the Zero-Covid exit and more property sector support to materialise in the course of 2023, driving a rebound in consumption and private investment. However, after years of volatile quarterly growth numbers due to recurrent lockdowns, China's growth trajectory could remain bumpy in 2023, as the exit from Zero-Covid may well prove disorderly. Meanwhile, recent foreign trade data show that China's export strength is fading, reflecting the sharp slowdown in global growth and the rotation in global demand back to services. In addition, it will likely take some time before the property sector adds to growth again. All in all, we expect sequential growth to pick up particularly in the second half of 2023 and annual growth to rise from 3.0% in 2022 (revised down following the intensification of pandemic headwinds in Q4, as reflected in for instance the PMIs), to 4.8% in 2023, and 5.2% in 2024.

Turn in credit cycle has further to run



Source: Bloomberg

Real GDP growth volatile due to recurrent lockdowns



Source: Bloomberg

Key forecasts for China

	2020	2021	2022e	2023e	2024e
Economic outlook (% yoy)					
GDP	2.2	8.1	3.0	4.8	5.2
CPI inflation	2.5	0.9	2.1	2.5	2.5
Unemployment rate (urban areas), %	5.6	5.1	5.6	5.2	5.0
Interest and exchange rates (eop)					
1-Year Loan Prime Rate	3.85	3.80	3.65	3.60	3.60
USD/CNY	6.54	6.37	7.00	6.70	6.50
EUR/CNY	8.00	7.24	7.35	7.24	7.28

Source: ABN AMRO Group Economics