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Economic Research:

China's Slowdown--This Time Is Different

January 31, 2019

Key Takeaways

- China's slowdown continues. Our proprietary tracker suggests growth is now at its lowest since early 2016, a period when hard landing concerns prevailed in financial markets.
- This slowdown is different. The demand drivers in 2016 were property investment and exports. Recently, they have been infrastructure investment and consumption.
- The slowdown until now has been domestic policy driven. Global trade and investment tensions have yet to show up in a meaningful way in the data. That may change but we see trade and investment tension as more of a long-term challenge for growth.
- Policy giveth and policy taketh away. The policy response, too, is different this time with a more careful easing. As a result, we expect growth to slow to 6.2%. Questions remain, though, on whether policy effectiveness is weaker in this cycle.

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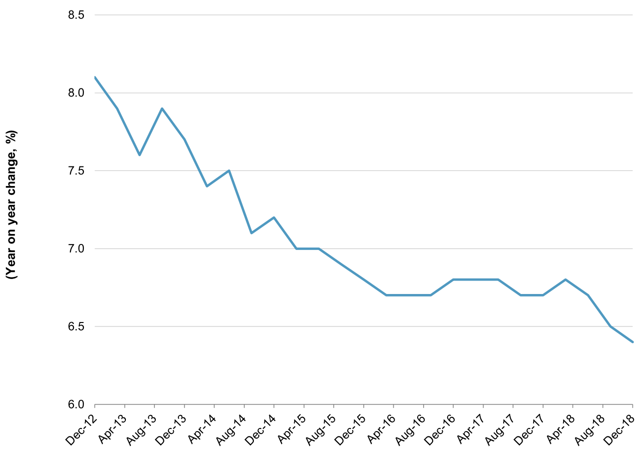
China is slowing again. That much is obvious but there is still uncertainty as to how much it is slowing. S&P Global Economics' proprietary activity indicator suggests that growth is heading back toward the lows of early 2016. When we calibrate our indicator against official real GDP growth, this suggests the economy is expanding by somewhat less than 6.5%. However, coming up with an alternative to the official data is hard so we use this mainly as a guide to the cycle rather than a second reading on the level of growth.

Chart 1

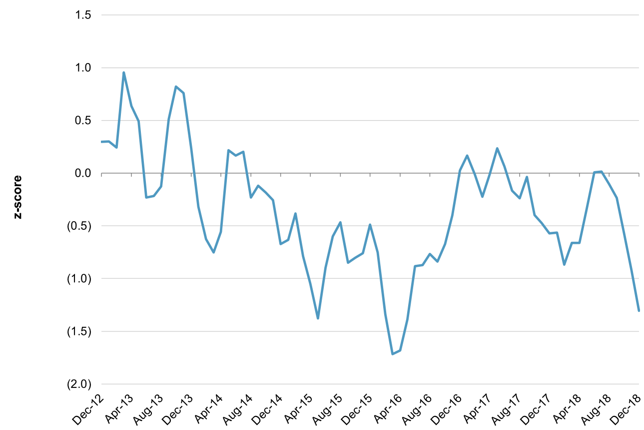
China's Real GDP



Source: CEIC.

Chart 2

S&P Global Current Activity Indicator



Note: The current activity indicator is the first principal component from a set of 32 real activity indicators measured on a 3-month annualized percent change. Sources: CEIC and S&P Global Economics.

Early 2016 was a rocky period for financial markets. Fears of a Chinese hard landing intensified and there was a sense that, following the stock market interventions and capital outflows of 2015, the government was running out of policy space. Similar concerns have begun to emerge recently. Before assessing whether this is a valid concern, it's worth comparing these two downturns.

Different Demand Drivers

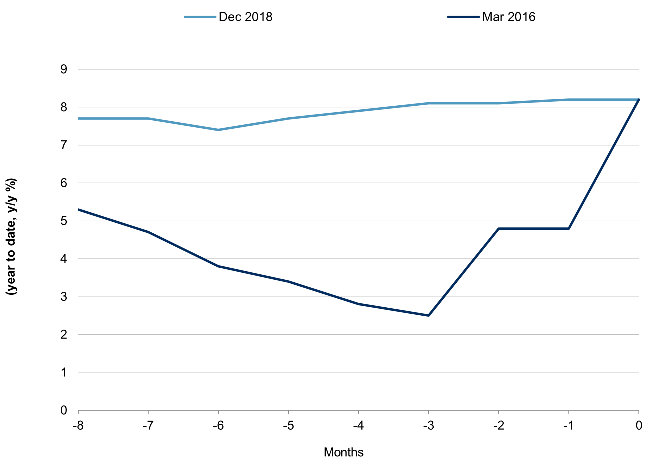
The demand drivers of this slowdown are different. Understanding what is causing the slowdown and where its effects are largest are important for the macro credit story. It can help us assess what policies can work to prevent the economy tipping into a downside scenario. It can also help identify where across the credit spectrum we should expect to see stress emerge or resilience maintained.

By early 2016, China had experienced a substantial slowdown in both the property market and exports, traditionally two important drivers of growth. Excess housing inventory in lower-tier cities caused investment growth to fall severely. This in turn affected the property supply chain, especially raw material demand that weakened prices for steel, cement, and other commodities produced upstream. Land sales also fell, which cut revenues for local governments.

Export growth had also collapsed as the global trade cycle sustained a large downturn--the 2015-2016 downturn was not just about China. Of course, China is too large and domestically driven for exports to move the macro needle much but trade downturns tend to also work through manufacturing investment. As firms see less demand but also suffer weaker cash flows today, they tend to invest less for tomorrow. Manufacturing investment was also weak in 2016.

Chart 3

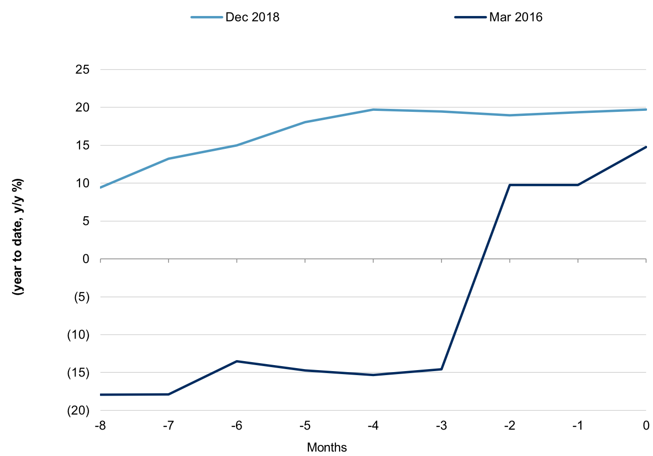
Real Estate Fixed Asset Investment



Sources: CEIC and S&P Global Economics.

Chart 4

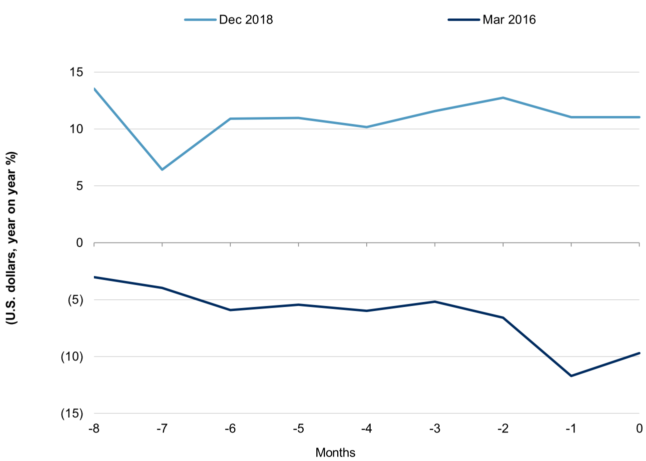
Residential Floor Space Starts



Sources: CEIC and S&P Global Economics.

Chart 5

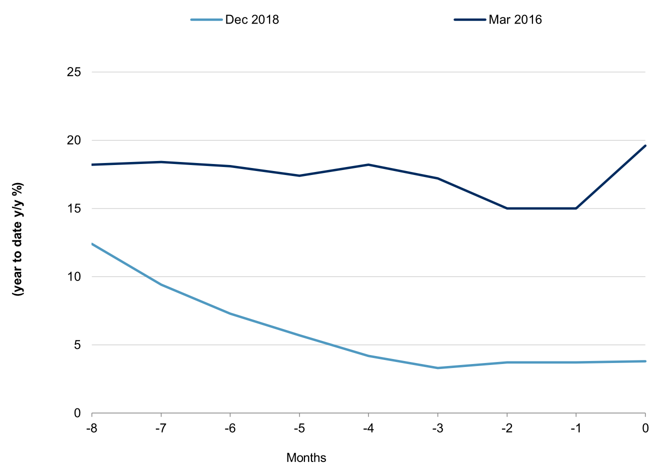
Exports



Sources: CEIC and S&P Global Economics.

Chart 6

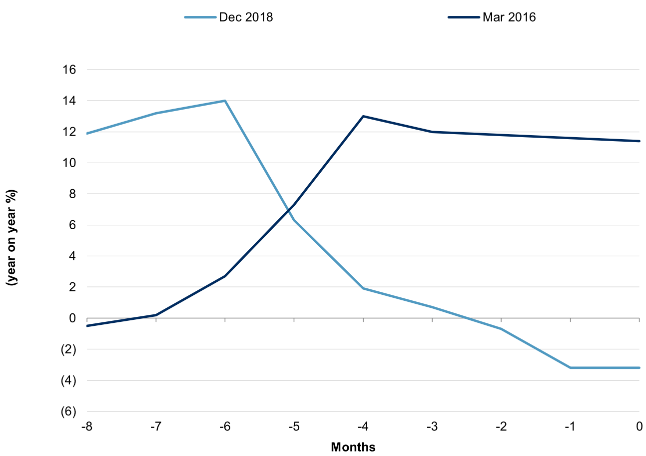
Infrastructure Fixed Asset Investment



Sources: CEIC and S&P Global Economics.

Chart 7

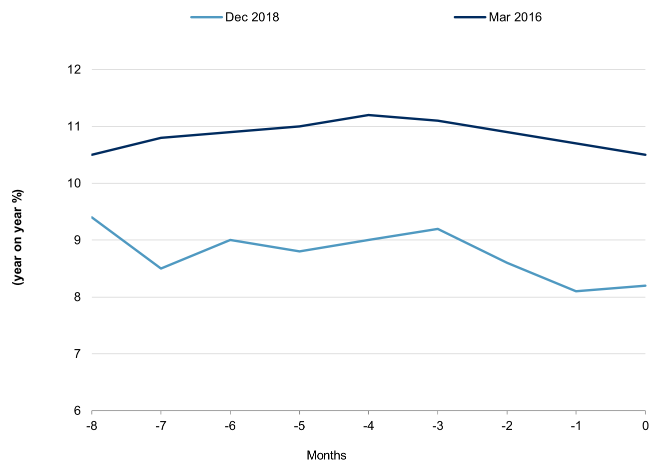
Automobile Industrial Value Added



Sources: CEIC and S&P Global Economics.

Chart 8

Retail Sales



Sources: CEIC and S&P Global Economics.

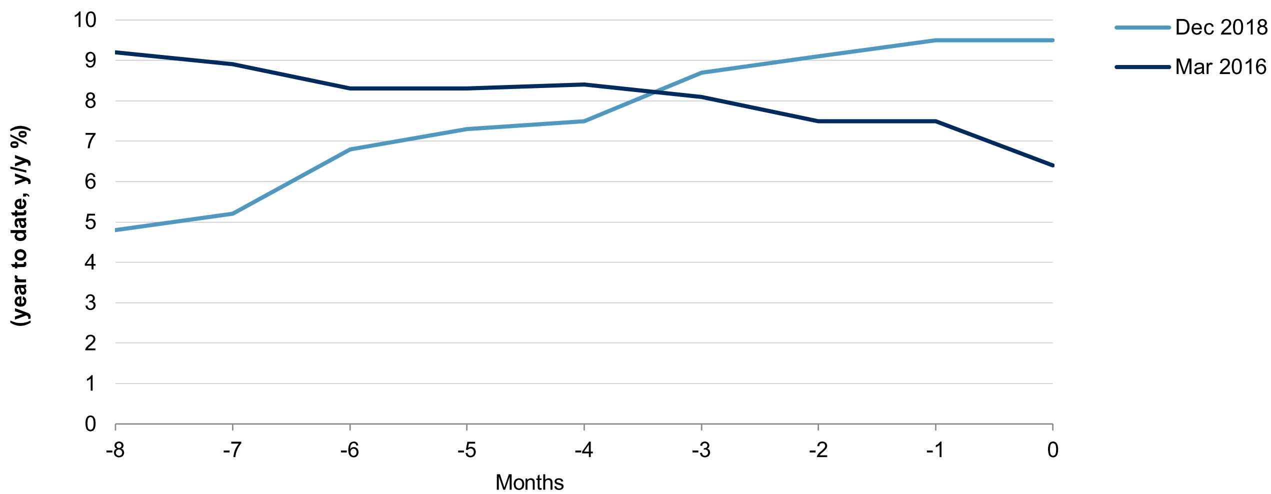
More Resilient Property And Export Sectors In This Cycle (So Far)

In contrast, property investment and exports have been resilient in this cycle. Property investment, which accounts for about 30% of overall fixed asset investment, has grown by about 8% during 2018. One implication is less pressure on upstream overcapacity industries such as steel and cement, which supply the property industry. These industries have also benefitted from previous supply-side reforms. One macro lens for viewing this is producer price inflation, which correlates closely with upstream profit growth. Although producer price inflation has fallen recently, it has only just retreated back to zero in contrast to the persistent deflation experienced in 2014 and 2015. In turn, we have not yet seen the intense stress on overcapacity sectors we saw then.

A second implication is resilient manufacturing investment, which roughly accounts for 30% of fixed asset investment. This is true across most categories of manufacturing but especially in technology sectors, including electrical and computing equipment. This is especially noteworthy given the stories about the private sector, which tends to dominate manufacturing, lacking access to credit. These are sectors that should also be more exposed to trade and investment tension.

Chart 9

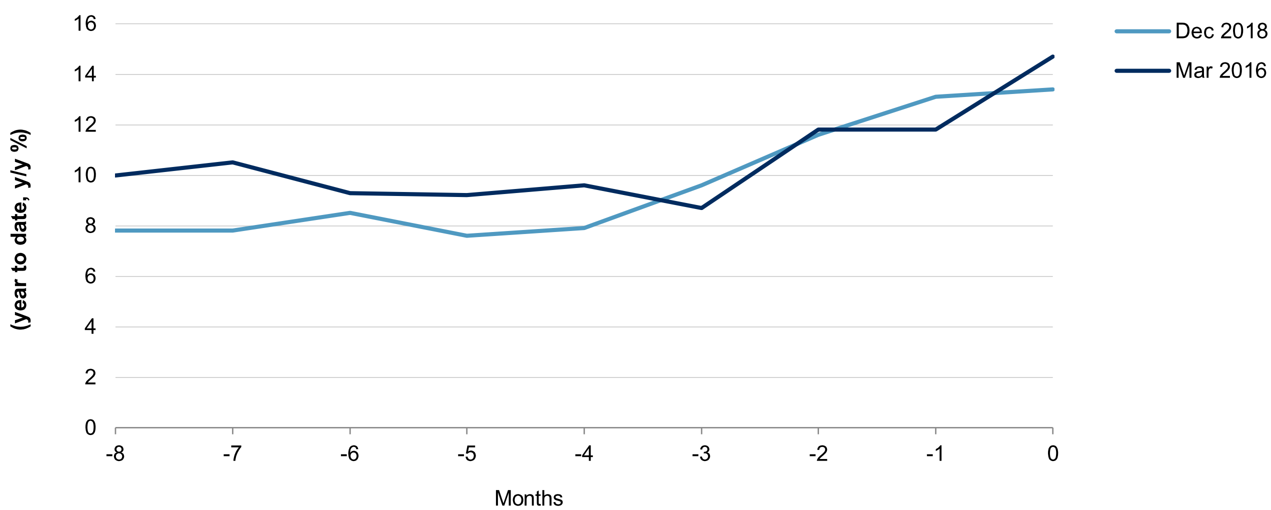
Manufacturing Fixed Asset Investment



Sources: CEIC and S&P Global Economics.

Chart 10

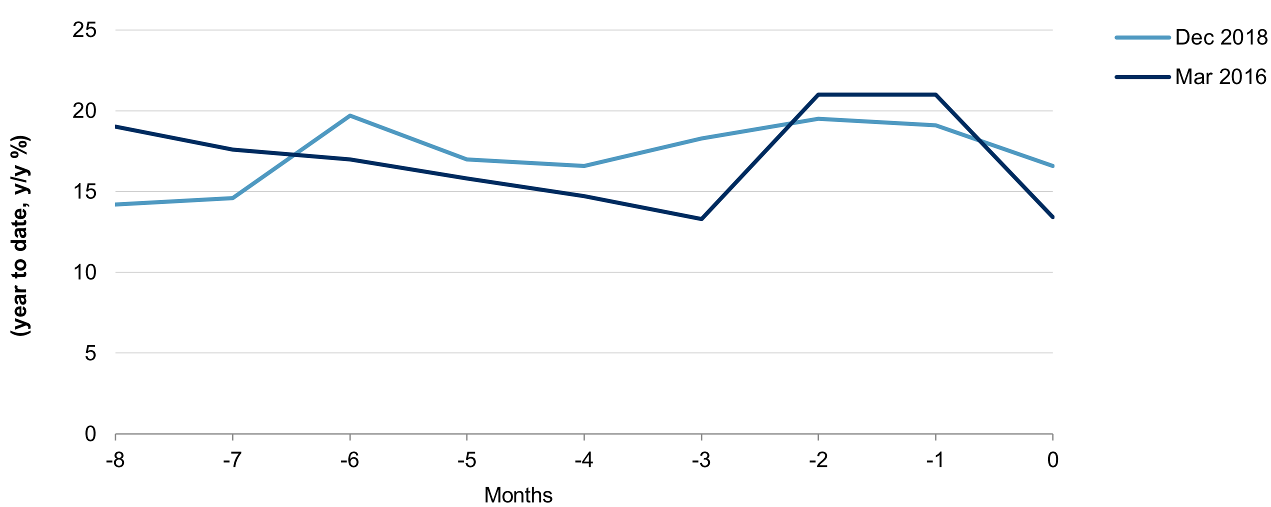
Electrical Equipment Fixed Asset Investment



Sources: CEIC and S&P Global Economics.

Chart 11

Computing Equipment Fixed Asset Investment



Sources: CEIC and S&P Global Economics.

Yet To See Much Trade Tension In The Data

It should be evident by now that trade tensions have not really shown up in the data yet. Undoubtedly, exports have benefitted from the frontloading of shipments by U.S. customers looking to beat the tariff hikes that became effective on Jan. 1. This should unwind during the first half of this year. At the same time, we expect export growth to slow in any case. Global demand growth has peaked and we are seeing signs of a turn in the global electronic product cycle. Disentangling the trade tension effects will not be easy.

One key variable to watch, though, is manufacturing investment. This is not just because it tends to have a larger arithmetic impact than exports on growth. More importantly, it offers an indication on how trade tensions are affecting confidence and expectations of companies in the real economy, not just financial markets. Manufacturing investment also affects not just short-term demand but also medium-term supply and productivity.

Still A Policy Driven Slowdown

Our view remains that domestic policy, specifically the broad attempt to reduce risks in the financial sector, has been the main reason for the slowdown until now. This shows up in the data in a few ways.

First, infrastructure investment growth has plummeted. In early 2016, this was running at 15%-20% year on year while by the end of last year, it had declined to about 4% (all on a year-to-date basis). Efforts to constrain off-balance-sheet financing for local governments have clearly depressed their ability to invest in in utilities, roads, airports, and metros.

Second, and less obviously related to policy, is weaker consumption growth. Back in early 2016, consumers seemed impervious to the slowdown happening around them and kept on spending--retail sales at the time were still growing 10%-11%. In contrast, retail sales growth is now expanding at about 8%. Although that is still quick by most economies' standards, this is a chunky slowdown for China.

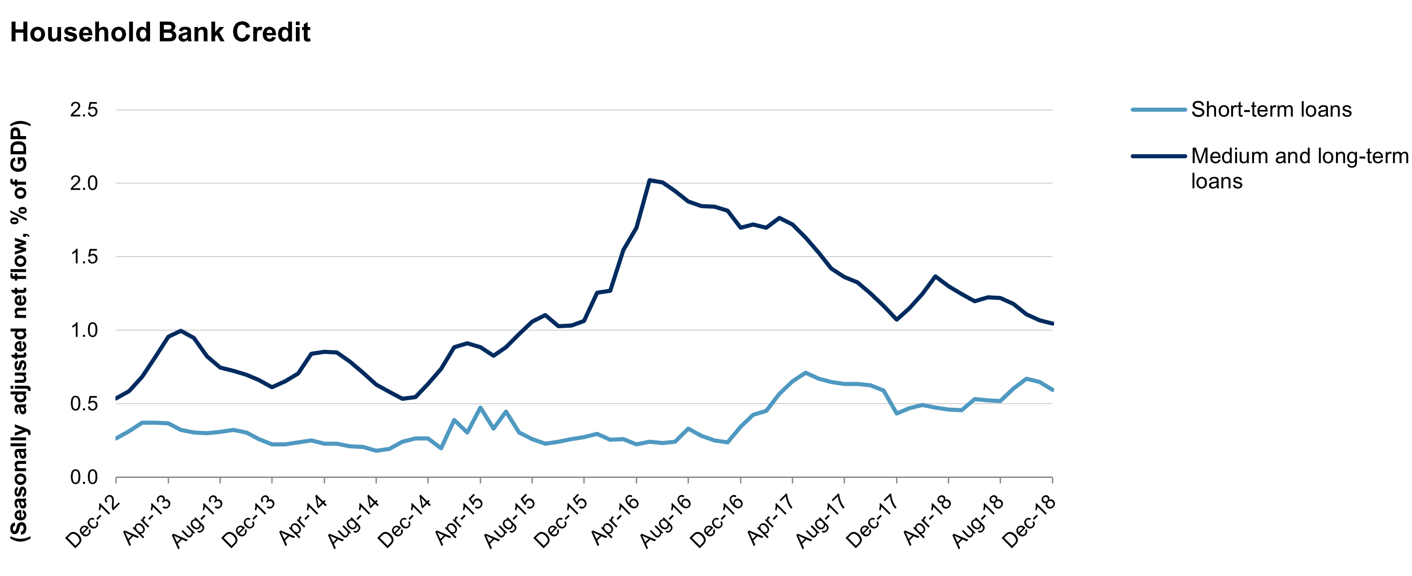
Some observers take comfort that the consumption slowdown appears to be concentrated in autos and cell phones but big ticket, less essential items are always likely to feel a slowdown first. Housing-related purchases are weakening also as property sales have begun to slip. On balance, there seemed to be a strong expectation that Chinese consumers had embarked on a long-term upgrading cycle, rebalancing remained on track, and this could offset difficulties elsewhere in the economy. This expectation is now being questioned.

The Policy Link To The Consumption Cycle

We think the policy driver for consumption can again be linked back to financial conditions but also housing policies. Back in 2015-2016, there was a clear easing in the access to credit for households as banks, encouraged by policymakers, switched their preferred exposures from over-indebted corporates to less leverage households. Chart 12 shows that the three-month flow of new long-term credit, mainly mortgages, to households jumped about 1½-2 percentage points of GDP in just a few months. Short-term credit flows, including auto loans and credit cards, also rose.

At the same time, the government was easing housing policies, which boosted demand from investors as well as owner-occupiers. In response, households bought more property (and related items such as household appliances) and cars. The government also cut taxes on car purchases, which helped to further juice demand.

Chart 12



Sources: CEIC and S&P Global Economics.

In our view, the result is mild indigestion. Banks got a big bump in their consumer exposures and have begun to tighten their consumer credit conditions following guidance from the regulators. Consumers' access to peer-to-peer credit, which although not huge was still material, was blocked after a crackdown by regulators. Finally, consumers themselves probably only want or can afford a certain number of properties, autos, and air conditioners. When a sudden easing in credit conditions brings purchases forward, we should always expect some payback in the future.

We should not downplay the deterioration in consumer confidence and a possible weakening in the labor market as contributing factors to softer consumption. Until now, though, we believe these factors themselves have been affected by deleveraging policies, tighter financial conditions, including some impact of higher household debt and mortgage and consumer lending rates on disposable income.

Demand Drivers To Shift Again In 2019

If 2018 was tough for some parts of the economy, then 2019 promises to be tougher. The areas of resilience that make this cycle, until now, quite different from the last one--property and exports--are likely to start weakening in the months ahead.

The property cycle appears to have turned, led by a marked softening in sales. Together with tighter financial conditions for developers, evident in part by the high coupons recently paid on the issuance of offshore debt, this is hitting land sales. S&P Global Ratings' property team does not expect a collapse in activity but more of a cyclical slowdown. At the macro level, we think this means real estate fixed-asset investment growth could drop from about 8% in 2018 to the low single digits this year.

We assume no major breakthrough or resolution in trade and investment tensions although we may see some progress by the March 1 deadline. Still, trade and investment tensions should start to show in exports and manufacturing investment. Most importantly, as corporate cash flows from the synchronized global upturn start to wane and businesses focus more on the potential impact of a sustained period of U.S.-China friction, we could see manufacturing investment growth fall from almost 10% in 2018 to below 5% this year. If capital expenditure also weakens more than expected in other economies, this would amplify what looks to be the start of another downswing in the trade cycle.

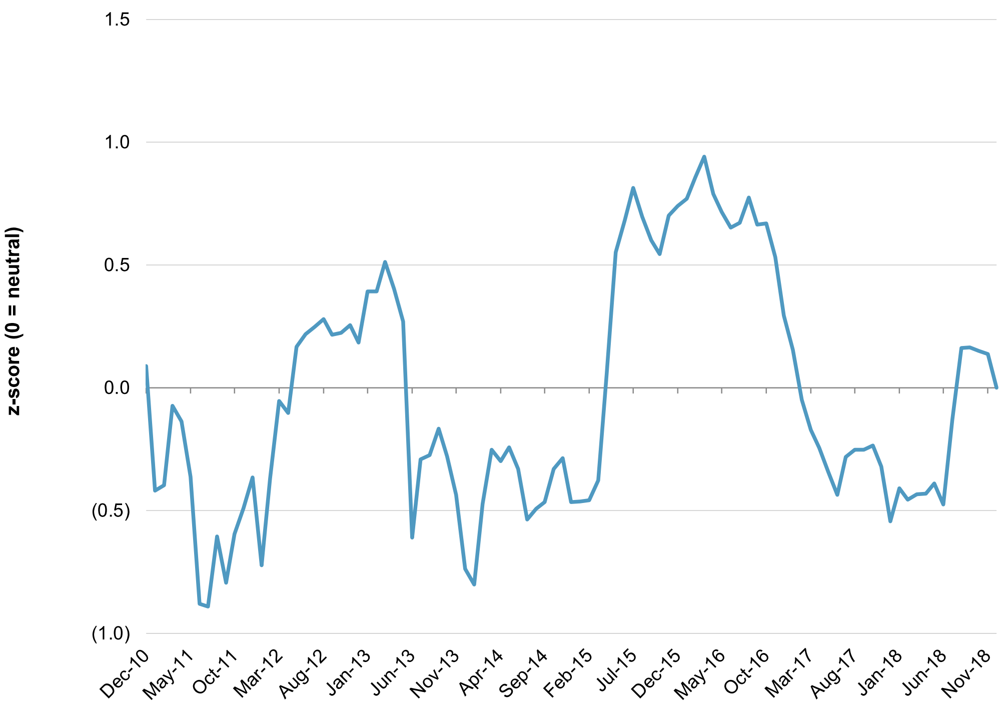
Overall, however, we see trade and investment tension as more important for China's long-run potential growth rather than a major short-term issue for demand. Specifically, if this tension causes firms to reevaluate their Chinese supply chains and slows China's burgeoning technology and new economy sectors, the impact is likely to be felt gradually, but substantially, over time. Moving supply chains, especially in sectors with complex eco-systems, is hard and costly, but the impact on potential growth could be large.

Policy Has Eased Modestly But Transmission Is Delayed

One way we track the broad policy stance is through a Financial Conditions Index (FCI). This index summarizes the information from 27 different interest rate, credit, and qualitative variables that are important for financial conditions in China. This complements popular but narrower measures such as the credit impulse. We find that changes in our FCI lead changes in growth, measured by our proprietary index, by two to three quarters. Our FCI shows the clear inflexion point in policies in mid-2018. The FCI moved from tight to neutral and has remained there in recent months. From this, we would make two points.

Chart 13

Financial Conditions Index: Tight To Neutral



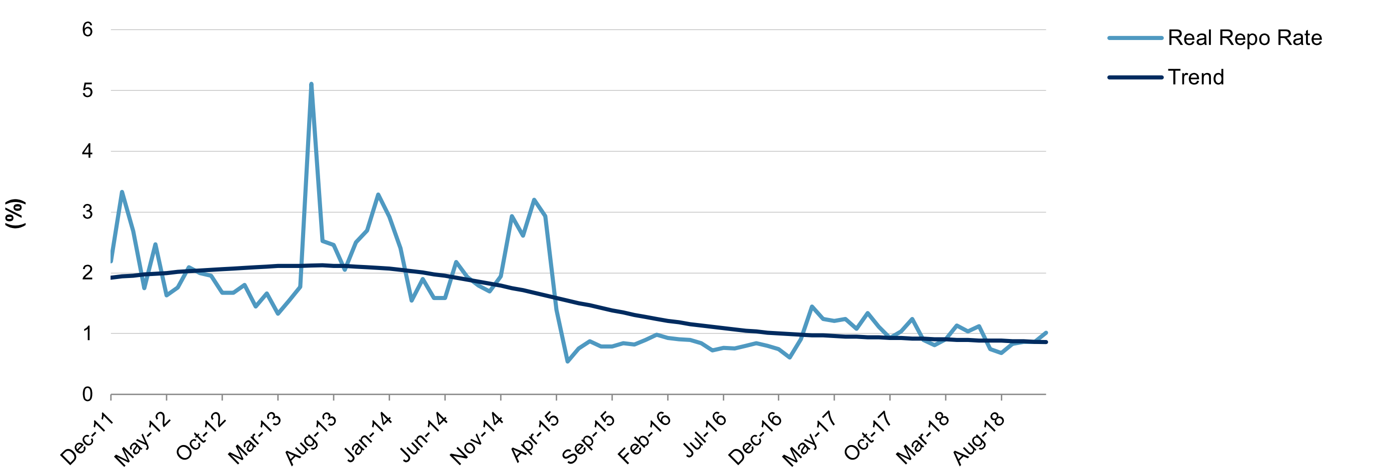
Source: S&P Global Economics.

First, policymakers are easing but carefully. The move in the FCI is a good bit smaller than in previous cycles, suggesting a desire not to over-stimulate but also a healthy tolerance for slower growth. This would be consistent with reports that the 2019 growth target may be lowered to "between 6%-6.5%." When the government says that it is not "opening the floodgates," then this is borne out by simple measures of the policy stance like the FCI. Deleveraging has paused, not (yet) reversed.

Second, the impact of an easing in the FCI may be weaker and more delayed in this cycle. In fact, we believe the major domestic risk now facing China is a lack of policy traction. For example, much of the easing in the FCI reflects a decline in real market interest rates, including de facto policy rates such as the seven-day repo. However, effective borrowing rates for the real economy remain stubbornly high. Greater interbank liquidity has also yet to show up in a recovery in credit flows, measured as a share of GDP.

Chart 14

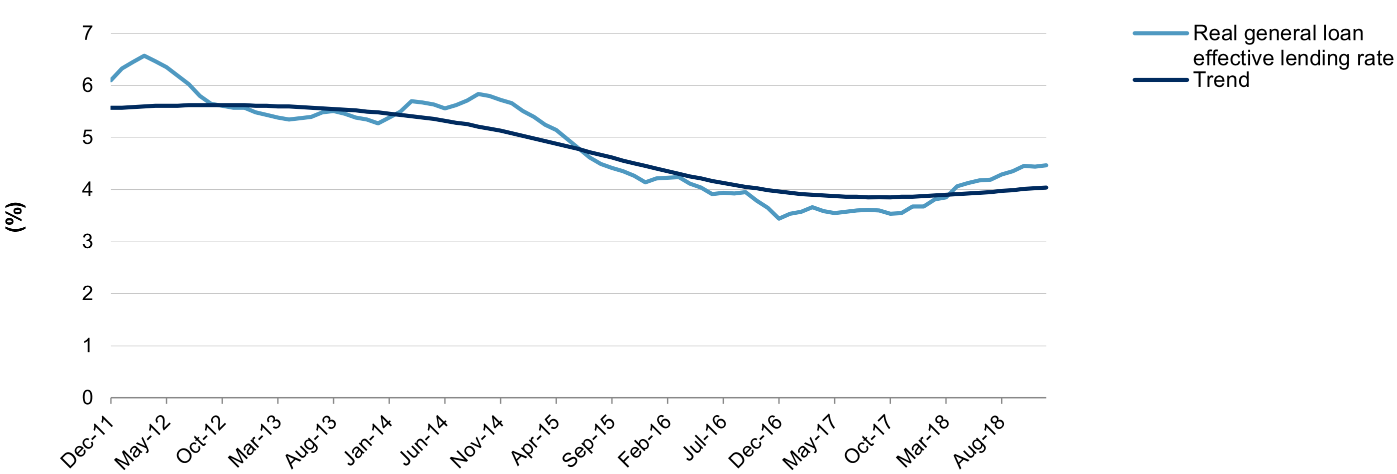
Real Repurchase Interest Rate



Note: Real repo rate calculated as repo rate deflated by core CPI inflation. Sources: CEIC and S&P Global Economics.

Chart 15

Real General Loan Effective Lending Rate



Note: Real rate calculated as general loan effective lending rate deflated by core CPI inflation. Sources: CEIC and S&P Global Economics.

Deleveraging Has Changed Policy Transmission (Mostly In A Good Way)

In our view, delayed transmission is due mainly to earlier deleveraging measures. For example, banks are reclassifying some of their off-balance-sheet credit and this is crowding out other types of bank lending. Demand for bank loans is also likely to have risen, despite a slower economy, as shadow bank finance has become harder to access following the regulatory tightening. Both these developments are likely contributing to keeping rates high. Meanwhile, local government officials may also be a bit more reluctant to start new infrastructure projects after all the emphasis on de-risking since 2015.

Slower transmission is no bad thing--in fact, it may help China to avoid the stop-go cycles of recent years. However, it does make policy calibration a bit harder in this cycle and that raises the risk that policy is eased too little, too late, even if a moderate slowdown is healthy.

More Easing May Be Needed

Our initial point is that this cycle is different and, until now, is mostly driven by domestic policy tightening. Policy has been eased carefully and is now in a "data dependent" mode. More moderate policy easing could be in the pipeline and we should expect even more if the slowdown intensifies.

First, we should expect some easing on local government financing constraints to support infrastructure investment growth. This has already been signaled by the decision to accelerate local government project bond issuance this year. We should also expect higher issuance quotas and, according to S&P Global Ratings' infrastructure team, some supportive measures to public-private partnerships. We'll know more about this after the budget is released at the "Two Sessions" (annual meetings of the national legislature and the top political advisory body) in March.

Second, the one big lever of macroeconomic policy that has yet to be pulled is housing policies, reflecting a desire to control risks. These policies remain fairly tight and the government has also scaled back its financing for shantytown (low income) housing redevelopment. Some municipalities have tweaked policies to support property markets but the guidance from the top--led by the National Development and Reform Commission--has not changed. Years of research show that housing policies work in China. This is the policy lever, which, if pulled hard, would likely arrest a slowdown that in the authorities' eyes has gone too far.

Unlike easing monetary and financial conditions, the lag of the effects of property market policies has tended to be much shorter. Referring back to chart 2, it is clear that the combination of easing housing policies and shantytown redevelopment had an almost immediate impact on the recovery of real estate investment, and eventually overall activity. However, we remain cautious about the potential side effects on credit and growth quality if such policies were to be unleashed in full force this time.

China Still Has Policy Space--For Now

A perennial question is whether China still has space to ease policies. In the short term, we think the answer is still yes. In large part, this is because capital outflows have subsided and pressure on the exchange rate has eased. Reinforced capital account measures and market expectations of a more dovish Federal Reserve have helped. In particular, this gives policymakers more room to run an accommodative monetary policy and ease more if needed without worrying about destabilizing capital outflows.

There is a trade-off though--more policy easing now, less space in the future. Stimulus can add to debt-related vulnerabilities, as it does when the growth target is too high and the policies are "second best" (too much infrastructure investment, not enough support for consumers). Our sense is that this is understood by policymakers, hence their careful easing in this cycle.

S&P Global Economics Baseline Still Expects 6.2% Growth For 2019

Our baseline assumes only a moderate further easing, mainly through local government infrastructure investment. We may also see some measures to help consumption. We believe both of these are enough to moderate, but not reverse, the slowdown by the second or third quarter and deliver full-year growth of 6.2%. This would be on the low end of the assumed 6%-6.5% target range. If the slowdown intensifies and official growth looks like it might test the 6% lower bound for 2019, housing policies are likely to be back on the table.

This report does not constitute a rating action.