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China outlook 2023

A year of change and challenge

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- **The Chinese government will insist on remodelling the heavily indebted property sector and avoid a full-blown stimulus. This will lower the risk of an eventual "hard landing", although at the expense of a swifter and stronger recovery.**
- **To manage the gap in the public finances, the central government is expected to raise borrowings at its own level and discuss fiscal arrangements that work in the long term, including the levying of a capital gains tax.**
- **Despite a dim trade outlook, Chinese exporters will capitalise on Europe's rising production costs and intra-bloc frictions. This will be especially the case for Chinese makers of clean energy equipment.**

It will be a year of change and challenge for China in 2023. Although the country has lifted the most disruptive "dynamic zero-covid" restrictions, the path towards normalisation will be bumpy as authorities navigate surging infections and pressures facing the healthcare system. The convention-breaking new leadership team that took power in October will inherit an economy facing pressing and lingering issues, including the aftermath of campaign-style reforms in property and technology.

EIU forecasts that China's real GDP growth will pick up to 5.2% in 2023, with a recovery in domestic demand helping to offset a dim outlook for exports. The growth pattern of China, however, will differ in important ways compared to other major economies. Lacking household-focus stimulus, the recovery of private consumption will be much milder. To lift market sentiment and consumer confidence, the government will suspend the economically disruptive policies in technology regulation, property, decarbonisation and income redistribution. We also expect the authorities to announce expansionary fiscal measures—supported mostly by bond insurance and a wider fiscal deficit—and to front-load its spending in 2023, stimulating the economy and financing the treatment of covid-19.

Property: expect a remodeling, not just a rebound

We do not expect government support to the struggling property sector to expand into a full-blown stimulus in 2023, in contrast to the administration's previous responses to economic downturns in 2009-10 and 2015-16. The bottom line for authorities is not to meaningfully loosen purchase restrictions or offer deep discounts to mortgage rates in the largest "first-tier" cities (Beijing, Shanghai, Guangzhou and Shenzhen), where prices are already elevated, even as similar measures have been widely adopted in their smaller peers. Neither will they rescue distressed developers indiscriminately for fear of creating moral hazard, which risks undermining efforts to curb speculation in the market.

Having ruled out blanket bail-outs, policymakers are keen to "remodel" the debt-stricken sector while avoiding a "hard landing" that would implicate banks. To that end, they have, in principle, divided stressed developers into "stronger" and "weaker" ones based on their indebtedness, credit history and governance, although no clear definition is given. The authorities will direct most of their expanding support to a few stronger developers—whose bankruptcies could trigger wider financial contagion

How China's government will support the property market in 2023

	The government will:	The government will not:
Demand	• Ease purchase restrictions in first- and second-tier cities, especially targeted at first-time buyers and multi-children families • Cut benchmark mortgage rates, especially in smaller cities that have witnessed continued price declines • Loosen household registration (hukou) require-ments in most cities • Buy unsold projects for use as affordable housing • Step up renovation of old neighbourhoods	• Allow for extremely low or zero down payment • Offer steep discounts (like 30% or above) to mortgage rates for homebuyers • Expand the property tax pilot programme for now • Support purchase of a third or fourth home by a single family • Substantially loosen purchase restrictions in first-tier cities (for example, scrapping hukou requirements for home purchase)
Supply	• Expand financing access for "stronger" private developers • Adopt reprieves or exemptions to the "three red lines" restrictions on developer leverage • Deliver troubled projects through project-by-pro-ject financing support or brokered acquisition • Encourage state-owned developers to acquire more land plots in government auctions	• Revoke altogether the "three red lines" require-ments • Bail out smaller and "weaker" developers even if they are on the brink of bankruptcy • Roll out a massive shanty-town renovation campaign financed by the central bank, similar to what happened in 2015-18

Source: EIU.

in China—by encouraging bank lending, bond issuance and equity financing. With better prospects of survival, we expect these developers to maintain a sizeable presence after the Chinese property market stabilises and liquidity stress ebbs.

A turnaround of the weaker ones will largely be a forlorn hope, however, as official support will not extend beyond existing efforts to deliver troubled projects. Their lack of access to a government-designated bail-out plan forebodes more defaults and restructurings, leading some to quit the market. Others may be fortunate enough to continue as a going concern with private funding, but will nonetheless contract in size and retreat from nationwide expansion.

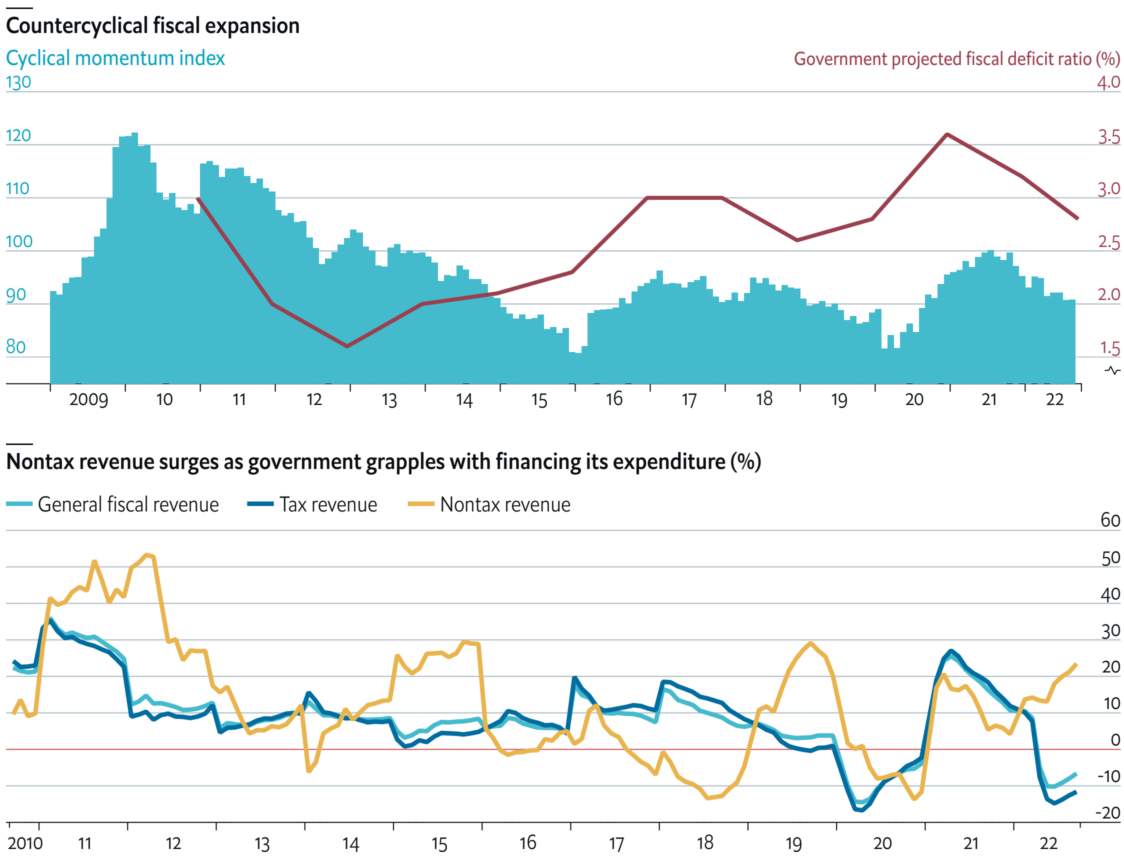
We expect the market to stabilise by mid-2023, when China's economy gains a firmer footing after the relaxation of zero-covid protocols, unleashing the pent-up demand accumulated during lockdowns. However, the supply of new homes will be tight; a halving of new land acquisitions in 2022 will preclude a construction boom and lead to a shortage of available projects for pre-sale. Moreover, spurious bids by state-owned enterprises, which participated in land auctions simply to shore up market confidence, are unlikely to translate into actual development activity. Consequences of this will include subdued levels of investment and new home transactions; price rises in some "hot spot" cities caused by undersupply; and limited improvement to the balance sheet of developers from sales proceeds.

Starting from 2023, the property sector will play a more diminished role in fuelling broader Chinese economic growth, particularly when benchmarked against trends evident over the past decade. Instead, a new era will be ushered in. Leverage constraints for both developers and households will provide stability, but also put a cap on that sector; this will have far-reaching implications for upstream (such as steel and cement) and downstream industries (such as furniture, home appliances and property services). The state will assume a far bigger role, as state-owned enterprises fill the vacuum left by private players and the government steps up the construction of affordable housing.

Government finances: persistent shortfalls call for sustainable solutions

The lack of a property bounce-back is one of the reasons why a fiscal strain is set to affect all levels of governments for another year. The year 2022 has been one of fiscal revenue miss, with an economic slowdown and tax rebates eroding a large chunk of budgetary revenue and income from land sales plummeting. To make up for the shortfall, local governments instead sought extraordinary income based on state asset disposal, amercement and forfeiture (rising by 23.2% year on year in January-

Target deficit to edge up in 2023



Sources: Wind; EIU.

October)—the latter two are controversial measures that risk hurting business sentiment. Covid-related volatility and the anticipated developments in the property sector will keep a cap on revenue in 2023.

This will also limit the government's spending power in 2023. The challenges are amplified by the fact that authorities will have fewer fiscal resources available, with several one-off buffers (including the

China has Rmb5trn of "structural monetary policy tools" outstanding*

Instruments	Areas supported	Interest rate	Balance (Rmb bn)
Agriculture relending	Agriculture	2%	540.4
SMB** relending	SMBs and private businesses	2%	1,399.7
Rediscounting facility	SMBs, farming businesses and private enterprises	2%	614.5
Inclusive and SMB-targeted loans supporting facility	SMBs	2%	4.4
Pledged supplementary loans	Shanty-town renovation; underwater pipeline; waterworks; other infrastructure projects	2.80%	2,620.3
Decarbonisation supporting facility	Clean energy and carbon emission reduction	1.75%	182.7
Special relending for clean and efficient use of coal	Coal development and use; clean coal technologies	1.75%	35.7
Science and technology innovation relending	Innovative enterprises	1.75%	0
Inclusive eldercare relending	Pilot eldercare programmes	1.75%	0
Special relending for transport and logistics	Road transport; express delivery	1.75%	0

*As at end of June 2022

Source: People's Bank of China.

**Small and micro-sized businesses

Rmb500bn, or US$71.6bn, in unused local government special bond quota, and a large part of Rmb1trn, or US$143bn, in central bank profit transfer) set to be exhausted in 2022. Spending on healthcare will still be prioritised, as authorities navigate an anticipated surge in caseloads following policy easing. Funding will become a bigger issue for infrastructure investment, which remains important in the growth agenda at a time when other drivers (such as exports) are forecast to flag.

Although we do not expect fiscal consolidation in 2023, given the challenging economic environment, maintaining a level of expansion similar to 2022 (when we estimate the broad fiscal deficit to have widened to 8.6% of nominal GDP) will be difficult. We therefore expect the central government to raise the general budget deficit (a narrower gauge) to up to 3.3% of GDP (from an estimated 2.8% in 2022), which is equivalent to more than Rmb500bn in additional funding and will allow it to increase transfers to struggling local governments. That would, however, be insufficient to meet the growing spending requirements, and much of the gap will be financed by an expansion in local government special bond issuance; a moderate support from the rainy-day budget stabilisation fund; increased profit transfers from state-owned enterprises; and indirect borrowings from the central bank in the name of "structural monetary policy tools", which now play an increasing role in supporting various government priorities.

That said, the fiscal strain risks evolving into a chronic issue, especially as the property-sector correction squeezes related tax revenue and land-based finance, and an ageing population add to the burden. This, along with considerations over other objectives such as income equality, will prompt serious discussion over sustainable long-term fiscal arrangements in 2023. These could include the adoption of a more progressive income tax system, as well as the levying of redistributive taxes on, for example, capital gains and wealth. Talks on property taxes could gain traction again, but any expansion of related pilot programmes is unlikely in 2023.

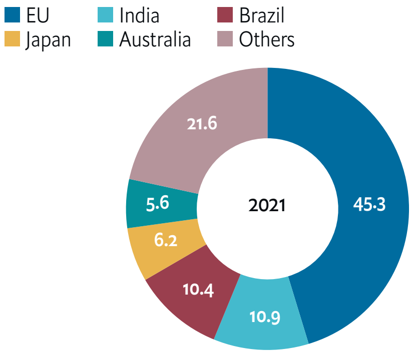
Trade: China will capitalise on Europe's rising costs and intra-bloc frictions

We have an overall pessimistic outlook for China's exports in 2023, given anticipated deterioration in global demand. However, there will be pockets of resilience, with producers of green equipment and, to a lesser extent, energy-intensive industries, set to benefit from Europe's ongoing energy crisis.

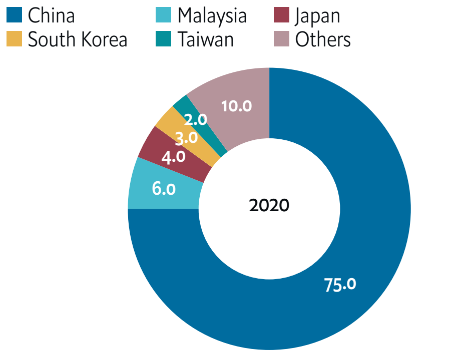
Solar power equipment is a bright spot in China-EU trade

(%)

Chinese export of solar modules by destination



EU import of solar power products by destination

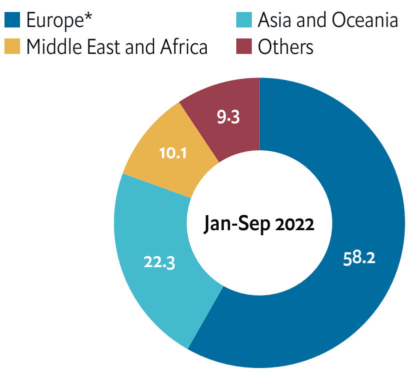


Sources: Eurostat; China Chamber of Commerce for Import and Export of Machinery and Electronic Products.

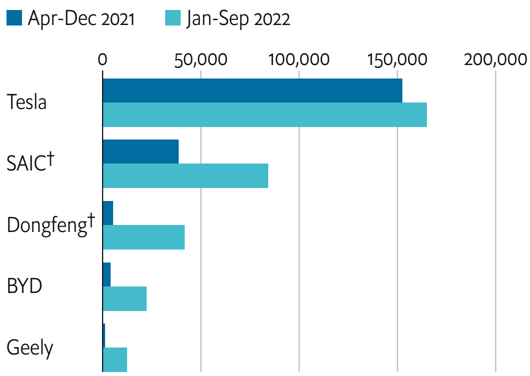
China's green energy equipment supply chain will profit from Europe's accelerated green transition. Despite the continent's unease about reliance on Chinese trade, China has a dominant position in solar panels, batteries and different critical materials. Europe's demand for made-in-China renewable energy equipment will remain high in 2023, although some Chinese manufacturers may also plan to install new production capacity in Europe for tariff avoidance or market entry reasons.

Made-in-China NEV models are increasingly popular in Europe

China's global exports of NEV passenger cars by destination
(%)



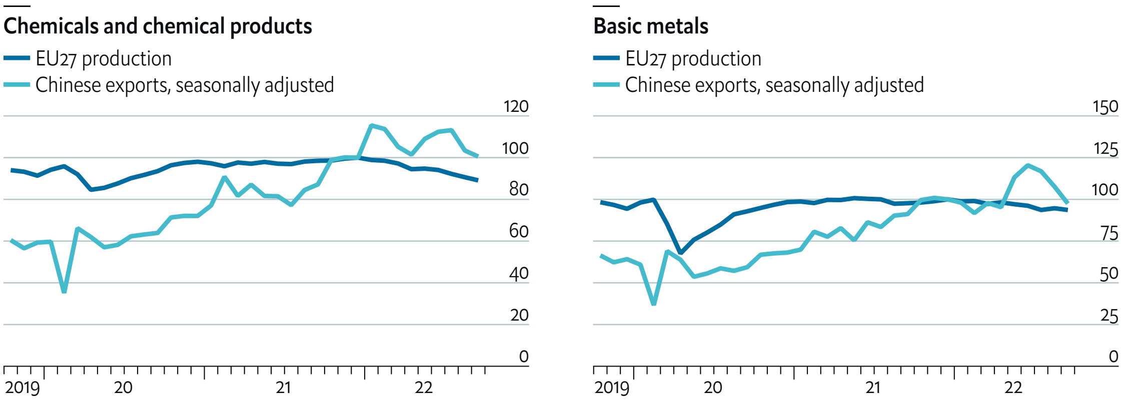
China's global exports of NEV passenger cars by brand



Sources: China Passenger Car Association; EIU.

*Including the EU, the Schengen area and the UK.
†Including sub-brands; data for models that are produced in China.

European chemicals and metals production declined, while Chinese exports recorded gains—but they were not immune from the global downturn
(Dec 2021=100)



Sources: Statistical Office of the European Communities; China Customs; EIU.

In addition, the EU-China automotive trade flow will begin to reverse, as years of Chinese industrial policy start to pay off. Exports of Chinese new energy vehicles (NEVs, a term reserved for both electric vehicles and plug-in hybrids) have skyrocketed in 2022, with Europe being the top destination. Chinese companies are also making a foray into automotive components previously dominated by foreign suppliers.

Opportunities are also present for China's energy-intensive businesses, like metals and chemicals, as their European counterparts lose competitiveness. Producing in Europe is increasingly unprofitable, as energy costs for the industrial sector will remain high in 2023 and for years to come. By contrast, China-based production benefits from relatively stable and cheap energy supply (while also providing the allure of accessing the Chinese market). Germany's BASF, the world's largest chemical producer, is a case in point. BASF plans to permanently downsize its operations in Europe while continuing expansion in China, serving both local and global demand. In 2023 these dynamics will probably be more evident in fixed asset investment than in export growth, not least because global demand for heavy industrial products will be weak until 2024.

In the long term, trade disputes can arise from China's growing competitiveness (vis-à-vis Europe) in green energy equipment and energy-intensive industries. The EU will adopt its carbon border adjustment mechanism in January 2023, which envisages taxing high-carbon imports, including iron and steel and electricity, to prevent carbon leakage (although full implementation will occur gradually until 2027). Europe's push for strategic autonomy is also gathering pace—manifesting in industrial policies aimed at shoring up domestic manufacturing competence spanning semiconductors to critical materials—and the long-term outlook for China-EU ties is pessimistic.

Diversifying imports of green equipment like solar panels will, however, take time. Short-term economic and energy challenges will, ironically, increase the continent's reliance on China. China will also attempt to exploit divisions within the EU, both between Brussels and EU member states and among European countries (such as between France and Germany), to deter the formation of a US-led "anti-China" coalition.

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