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Why China is struggling

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Allison Nathan: Downgrades. That's the word that pops into my mind when it comes to economic growth in China these days. The world's second-largest economy continues to struggle with a real estate downturn, slowing consumer spending, and geopolitical tensions. And that's raising doubts that the country can even meet its official growth target of around 5 percent this year. So, a lot of economy watchers have recently downgraded their Chinese growth forecast.

That made me curious about where our China economist stands on all of this. So, today I'm speaking with our chief China economist in Goldman Sachs Research Hui Shan, who's joining me remotely from Hong Kong. Hui, welcome back to the program.

Hui Shan: Thanks for having me.

Allison Nathan: So, let's get into it. Hui, we sat down only May of this year. So, only a handful of months ago. And when I think back to that conversation, the narrative went something like this: Chinese growth was much better than expected heading into 2024. Chinese equities were taking off. So, it was a very, in some ways, surprising upbeat conversation relative to our prior expectations. But today, it feels like a really different picture. Investor confidence seems to have waned. Obviously, Chinese equities have substantially underperformed of late. And we've seen a slew of global banks downgrading their growth forecast for the country. So, bring us up to speed on how we got here and how the narrative has changed, at least in my mind, so dramatically from only a few months ago.

Hui Shan: So, looking back in May earlier this year, at that time we just got the first quarter real GDP growth of 5.3 percent year-on-year, which it was above the government's goal of around 5 percent growth. And then around May, policymakers announced a set of easing policies on the property sector, destocking properties and trying to stabilize the largest part of the economy. And the combination of good data and policy easing measures got the market excited.

At the time, we were characterizing it not too good and not too bad, but rather a stable picture. And activity did slow down quite a bit from May to now we're talking in September.

If I think about what has changed, back in May, if you look at exports, they were pretty good. You look at property, pretty bad. But there were hopes of policy easing generating a boost to the sector. And consumption was holding up pretty well considering the housing bust we were in. But fast forward to today, what has changed? If anything, exports were even better than we thought. And the latest data showing export volume up 15 percent, one five, year-on-year from an already pretty high level.

If anything, the property numbers are even worse than we were expecting. We thought this year probably sales starts would be down 10 percent compared to last year. But it's on track for 20 percent decline year-on-year. And what really made the difference is consumption. It was stable, but now we're seeing for a few months consumption is slowing. Retail sales in the month of August only increased 2 percent from a year-ago levels.

So, when you have the good exports and the bad property, but coupled with softening consumption, that's really driven our view that the growth is going to be some distance away from around 5 percent growth target. We're expecting 4.7 percent growth this year.

Allison Nathan: Okay. Interesting. Do you think that that slowdown in the consumption side is really just the real estate sector trickling through? Or what do you attribute the weakness in the consumer to?

Hui Shan: I think the relationship between consumption and the housing market has a bit of ambiguity in there. In the longer term, if Chinese households no longer want to buy properties, they don't need to save a big down payment, if you give them the same income they can consume more. It's good for the consumption sector if housing is weak and people don't want to buy the second, the third, the fourth apartment.

But in the near term, a slowing property sector, a depressed housing market is going to translate into weak economy, fewer jobs, lower income growth, more uncertainty about the future. All of which are negative for consumption.

I think we're seeing that property sector decline, the weaker-than-expected property sector performance really weighing on income, on wages, and consumer sentiment.

And on top of that, I think a lot of the government policies, which were designed for other purposes, are inadvertently impacting consumption negatively. For example, the crackdown in the financial sector. A lot of the people working in the financial sector are being laid off or are facing significant salary cuts. That is going to translate into weak sentiment and consumption cutdowns, which combined with what's happened in the property sector, probably accelerated the softening in consumption.

Allison Nathan: Got it. If we dig into these property sector woes that we've been talking about for years now, where are we in terms of that cycle? Are we close to bottoming at all at this point?

Hui Shan: From the peak of the market in 2021, we're three years in. Are we at the bottom depends on which indicator you're talking about. The more leading indicators, such as land sales, housing starts, I think they're probably around the bottom after declining at least 70 percent from the peak.

But if you look at the total under construction, the floor space under construction or the construction activity, we don't think we're at the bottom yet because that stock of property under construction only declined around 20 percent. Right? So, if your start is down 70 percent, eventually the total under construction should also be down 70 percent. There's still some distance to go.

In addition, we're seeing property prices have not really bottomed. Latest data, continue to see declines sequentially in property prices. So, if there's a transmission from house price decline to household balance sheet deterioration to negative sentiment toward consumption, then that has not completely played out yet until we see stabilization in house prices. Let alone, the local government transmission mechanism where local governments don't have land sales revenue, short of cash, not really balancing expenditure versus revenue, and at the same time trying to delever from the debt accumulated in previous years. That negative feedback loop on the real economy will likely take a few more years to play out.

Allison Nathan: But we're basically dealing with an oversupplied physical asset. So, even though as you mentioned, the Chinese government has taken measures to address it, how much more can they really do to address this problem?

Hui Shan: I think they can do more. What is holding them back? I think there are a couple things. One is the mentality and the history, because in previous cycles whenever they eased the property market, prices started increasing, especially in the top tier cities. I see a little bit of dynamic here. They worry if they ease too much, then all the efforts that went into housing deleveraging would be in vain. So, they want to proceed cautiously and easing incrementally to see how that's working and adjust accordingly.

The other reason is their view that government money should not be used to bail out irresponsible real estate developers. Because if you think about addressing property market downturn, if you're dealing with developers, there are a limited number of developers, large developers. On the financing side, it should be logistically easier to implement policy easing versus dealing with millions, if not more properties. One apartment project is different from another. One city is different from another. If you're trying to ease from the demand side at this juncture, it's more challenging. But because of the mindset that we shouldn't be helping developers, those are the bad guys, we should only help homeowners, home buyers, and deal with individuals, it makes the problem even harder.

Allison Nathan: So, it sounds like that is going to hang over the economy for a while. But if we talk about the bright spot, you mentioned, of course, exports have been much stronger than expected. But if I look around the world, you know, growth is slowing globally. So, how much risk is there to that export strength that is really buoying the economy and maybe one of the only bright spots in the economy right now.

Hui Shan: In the near term I think Chinese exports can continue to grow and surprise us to the upside. Why is that? Because they're so competitive in terms of quantity and in terms of cost. You ask any purchasing manager, regardless of their political views and how they think of Chinese exports or Chinese overcapacity issue, if they were faced with the same product but 30 percent cheaper, it's very hard to say no. We're not forecasting global recession. Global growth is going to slow. But still quite resilient.

In this environment in the near term, we think Chinese exports can continue to be strong. But over the medium/long term. If you look at the history of a global imbalance, right, Chinese trade surplus has been as high as ever. We think that at some point it will hit a wall, and it will be difficult to continue that already very high global market share.

Allison Nathan: And then, of course, if we think about really the glaring threat to Chinese exports, the risk of tariffs following the outcome of the US election, of course no one knows what's going to happen with the election, and really no one knows what's going to happen with tariffs even once the election outcome is determined, but how might tariffs impact the outlook for Chinese exports and growth overall?

Hui Shan: You're right. We don't have a template. All we can do is look at the 2018/19, the US/China trade war experience and try to draw some lessons. Back in the 2018/19 US/China trade war, the United States imposed up to 25 percent tariff on over $300 billion of Chinese goods imported from China to the US. If we use the 2018/19 experience, we can learn a few things. One is that Chinese exports to the US did decline after US put tariffs on China. But if you look at the overall China's trade surplus with all trading partners, you know, right now China's trade surplus is the highest ever.

So, in a sense, bilateral trade will be impacted significantly by tariffs. But global trading will be rerouted and redirected. So, at the end of the day, China's trade surpluses may not decline as much.

We saw in 2018/19, Chinese growth took a hit. It wasn't really due to the trade channel alone. A lot of the growth shock came from the uncertainty channel. What that means is that you look at a company's capex, they were declining for companies with exposure to the US and the companies without exposure to the US. It's the environment when you're in the middle of a trade war, not sure how much longer it’s going to last or what's the final equilibrium we're going to reach, then all companies are going to cut back on capex. And that's going to impact growth more generally than the US tariffs on Chinese exporters alone.

And we also saw that the Chinese currency, the RMB, depreciated notably against the dollar. So, those are the few things we learned from the 2018/2019 experience. If I were to do a linear extrapolation, which probably won't be correct, but is a starting point to think about what would a 60 percent tariff on China do to Chinese growth and Chinese currency, we estimated that the growth impact might be two percentage points. And then the RMB may depreciate to above eight in terms of USD/CNY.

Allison Nathan: That's seems huge to me, Hui. And so, if that happens, wouldn't that be a catalyst for the government to react much more aggressively with fiscal stimulus, with other stimulus to try to counteract this type of big hit to the economy?

Hui Shan: Yes. I think in that scenario, trade tensions ratchet up significantly and growth impact as big as the 2018/19 experience, then that would translate into job losses. And at that point, I think the Chinese government would not be hesitating anymore and would introduce large fiscal stimulus combined with further monetary policy easing to cushion that blow from tariff increases.

Allison Nathan: Right. And one thing you can always say about the Chinese economy is they do have a lot of levers to pull and can pull them when they feel like they need to.

Hui Shan: I think a lot of the policy constraints today are self imposed. You know? The government may say that looking at government debt-to-GDP ratio, combining both central and local, implicit and explicit is already over 100 percent of GDP. But I don't see why that can't be 110 or 120 percent GDP. So, from that point of view, they have quite a bit of space to lever up the central government and conduct fiscal easing.

Allison Nathan: So, if the Chinese economy does slow as we expect it to, but obviously we've talked about some downside risks as well, what are the implications for the global economy at this point? Obviously, it's the second-largest economy in the world. So, how much will that impact growth around the world?

Hui Shan: If it was really the slowdown driven by housing and consumption, then the impact on the rest of the world would be pretty straightforward. Negative for iron ore imports by China from Australia and Brazil and less purchases of luxury goods from European countries by Chinese consumers. That linkage is relatively straightforward.

If the trade war is at the center of why the Chinese economy is slowing, then by our global economists' estimates, global growth will slow and global inflation will pick up, and the dollar will strengthen. So, that would have a very different set of implications on the global economy and markets.

I will also say that even in the scenario of a trade war with global growth slowing and global inflation picking up, the heterogeneity across countries might be interesting. Because if you think about the global supply chain reallocation, if the second trade war is generating accelerated supply chain rearrangement, then you can see some countries benefiting more versus other countries as multinational companies move into other countries outside of China. Or Chinese manufacturers want to strategically position themselves in other countries to avoid US tariffs.

And on the price side as well, I think you might expect some Chinese products facing US tariffs will have to find a market elsewhere. So, for those types of products, even though the overall global inflation may pick up, for these specific products, prices can go down and Chinese manufacturing activity could put downward pressure on these products.

And I think for global investors, if we see another trade war and then global investors want to rethink where to allocate their capital, then we can see global portfolio investment flows moving away from China into other countries. So, you can see there a several themes going on here and depending on what is the dominating factor driving China's growth slowdown, the impact will be different. And the impact on different countries will be quite different as well.

Allison Nathan: Hui, always a fascinating a conversation. Thank you so much for joining us.

Hui Shan: Thanks for having me.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Monday, September 16th, 2024. I'm your host, Allison Nathan.

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