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Chinese economic slowdown: this time is different

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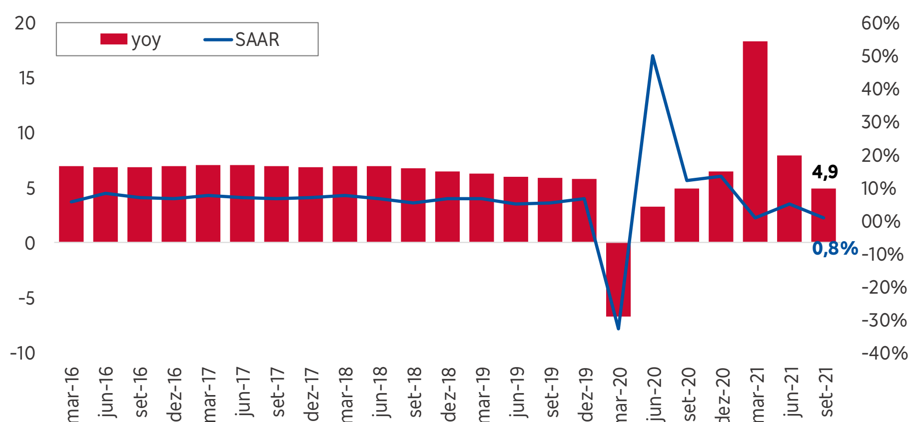
The signs available thus far suggest a structural change in the Chinese development model. By bringing together the different actions and measures adopted especially since the end of last year, we highlight new priorities that can be divided into four major agendas, which often intersect each other. They are as follows: reduction of systemic risks (such as financial and data control risks); geopolitical issues; common prosperity (with an emphasis on reducing income inequality as a means of strengthening domestic consumption and other social issues); and medium-term growth drivers (technology and the environment). These are pillars for a new growth model, based on quality and sustainability and not necessarily on quantity, as observed for many years.

In this context, the slowdown in the Chinese GDP's growth rate in the third quarter of this year deserves attention. The expansion of 4.9% in relation to the same period last year was slightly lower than expected and well below the 7.9% increase seen in the second quarter, on the same comparison basis. When compared to the immediately preceding period, growth was only 0.2%, which translates into an annual rate of 0.8%. Finally, the last useful comparison is against the average of the third quarters of 2019 and 2020, in an attempt to discount the effect of the pandemic, when the upswing was also 4.9% (coming from 5.5% in the second quarter, on the same comparison basis). It is definitely a low growth rate.

Chart 1: China's quarterly GDP in real terms
YoY and margin changes, seasonally adjusted and annualized



Source: CEIC

Based on these results, there are 5 questions that will help us detail the scenario for the rest of 2021 and 2022:

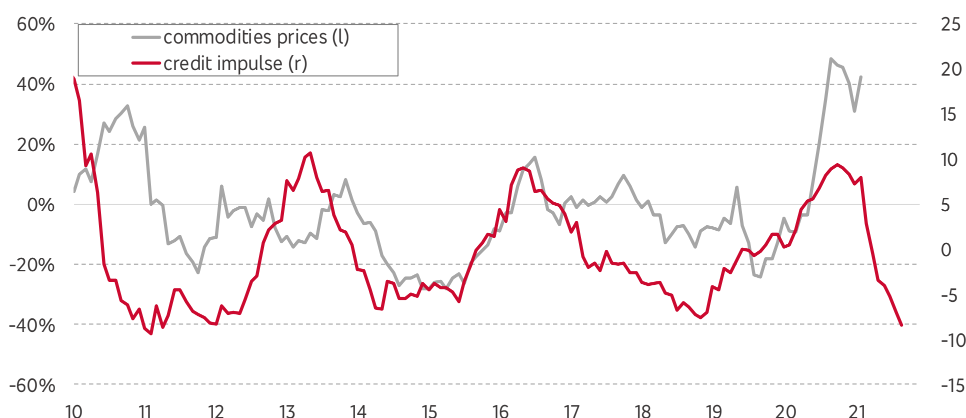
1. What are the vectors driving this deceleration?
2. What can we expect for the housing sector from this point forward?
3. What will the economic policy reaction look like?
4. How will commodity prices respond in this cycle?
5. What considerations should be made to counterbalance this more challenging scenario that is being confirmed?

1. What are the vectors driving this deceleration?

We can separate this slowdown into two fronts: the post-pandemic normalization and that induced by various measures. Part of the cooling was expected in the aftermath of the pandemic with a reduction in exports and industrial production, moderation in demand for real estate, and withdrawal of stimuli, since activity would return to normal. The credit cycle is worth noting, as total stock grew as much as 14% at the peak of the pandemic and today shows expansion close to 10%, as illustrated below in the credit momentum, which helps explain a good part of China's economic cycles. Such vectors pointed to growth between 7 and 6 percent, a pace recorded in 2019, for example.

Chart 2: Credit momentum and commodity prices

12M change in credit momentum as a ratio of the 6M anticipated GDP to the commodity price index



Source: Bloomberg, Bradesco

However, we must add two decisive elements that have accentuated this already expected trend, which currently indicate expansion between 4% and 5%. These are measures to contain the leverage of the housing sector (with a significant reduction in the supply of credit to construction companies) and cuts in energy production to meet pollutant emission targets. These two actions were induced by the government. In other words, this choice was made even knowing it would mean less growth. In addition, between July and August, in the face of a worsening pandemic, the government adopted severe mobility restriction measures across much of the country.

2. What can we expect for the housing sector from this point forward?

The housing sector represents approximately 15% of the GDP, considering the national accounts as well as the contribution of construction and related tertiary activities. It represents something on the order of 20% of urban jobs and 30% of the bank credit portfolio, adding loans to construction companies and especially to families. Both in absolute and relative terms (compared to other countries), the Chinese economy definitely relies heavily on the housing sector, especially residential real estate.

Furthermore, this sector ends up connecting various parts of the economy, in addition to the direct effect on economic activity. Real estate ownership turns out to be one of the main assets of Chinese household wealth. Naturally, the reduction in prices has a direct impact on wealth, especially in the higher income brackets, who usually accumulate several properties. In addition, land concession – still state property, even though urban properties have been privately owned since 1998 – is an essential source of income for local governments (which are faced with a significant mismatch between expenses and revenues, and the funds raised in the land auctions help to meet the different commitments). Land, as well as real estate, is probably the most important collateral for loans. Thus, many products distributed through the capital market – called shadow banking – have the housing sector at one end of the operation, both in funding and lending.

The construction companies, therefore, are an important player in this arrangement. In turn, they have had increasing leverage over the past few years. The government, understanding this as a high risk scenario, adopted measures to address these issues in late October last year (3 red lines), which ended up leading to a significant reduction in access to credit. To reduce real estate prices, in a more socially oriented agenda, the government has been controlling the supply of land and holding back the supply of credit for families. In addition, some Chinese cities will undergo a pilot program to adopt a property tax as a way to curb speculation and rising prices. These actions are in line with the government's intention to reduce the dependence of the Chinese economy on the housing sector under a three-year timeline. It seems quite strong and the various indicators confirm that this movement is already underway, most notably since the turn of the second to the third quarter. Taking into account the government's signals, we should also not expect a change in the trend.

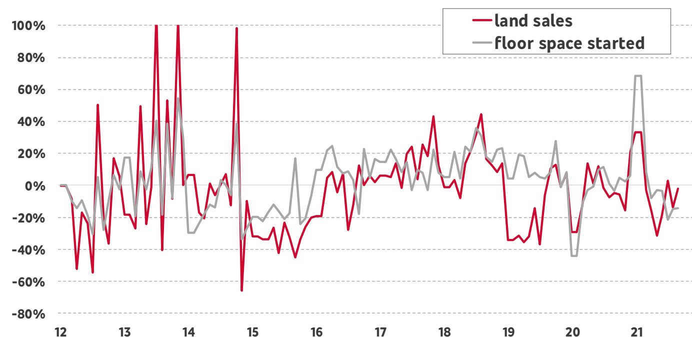
This is reinforced by the financial situation of the companies in the sector. The case of Evergrande is the most emblematic. About this case, our assessment is that we are not facing a systemic risk, from the banking point of view. The outcome of the financial situation is not clear and we understand that there will be questions in the months ahead. Still, our assessment is that part of the debt will be paid and part should remain in default. There will be a broad restructuring of the company and the government should inject liquidity into the system, through the banks. A possible solution is mixed: apartment owners (families), suppliers, and workers should have their commitments honored. But holders of the financial products linked to the company, Chinese banks and financial institutions, as well as foreign bondholders should expect at least a partial default. There are also many other construction companies that are struggling to make their payments.

It seems insightful to compare the current cycle with the one observed between 2014 and 2015, whose deceleration also stemmed from government measures to contain the formation of bubbles. In the following charts, we have selected some indicators that show how prices, new starts, and sales have behaved. In that cycle, prices fell more than 5%, sales dropped about 10%, and new starts took a downturn of more than 15%. In this scenario, we consider that a 10 p.p. deceleration in investments and sales would lead to a loss of close to 1 p.p. of the GDP.

We still have to consider a more extreme risk of an eventual stronger price drop. This can happen, for example, because builders, in order to make cash, will have to sell inventories at lower prices. In addition, the new property tax may be the trigger for a change in household behavior, with the liquidation of their assets, which can be converted into other investments; this may be another trigger for more accelerated sales at reduced prices on the secondary market and/or reduced demand for new properties, especially those used as savings.

Chart 3: Residential Real estate prices
YoY change

Chart 4: Land sales and investments
YoY change



Source: CEIC

3. What will the economic policy reaction look like?

This time will be different: we should not expect broad stimuli to offset this slowdown, especially considering that it was largely induced. In recent history, we have seen a reaction of more stimulus when the Chinese economy entered a problematic phase. The cutting of the bank reserve requirements in July, for example, gave the impression that China would inject more stimuli. However, in our assessment, there will be no significant reversal of monetary policy, there is little fiscal room (given the high indebtedness of local government finances) and infrastructure will not be the variable of choice at this time. Still, we understand that some calibration or smoothing can be expected on the sectoral measures. In other words, an easing of coal production (especially for heating purposes and not for industrial power generation), a slight increase in the supply of credit for small businesses and a relaxation of the 3 red lines are more feasible than an interest rate cut.

Still on infrastructure, it is worth mentioning that the supply of local government bonds for new projects has been growing (taking advantage of the annual bond issuance quota), but we understand that this amount is not enough to expand works to the point of compensating for the cooling of the housing sector. More important than this is to keep in mind that infrastructure is not necessarily road and rail projects (as in the past), but rather works focused on urbanization, sanitation, and technology. These are less commodity intensive and several projects have undergone very strict scrutiny to be approved.

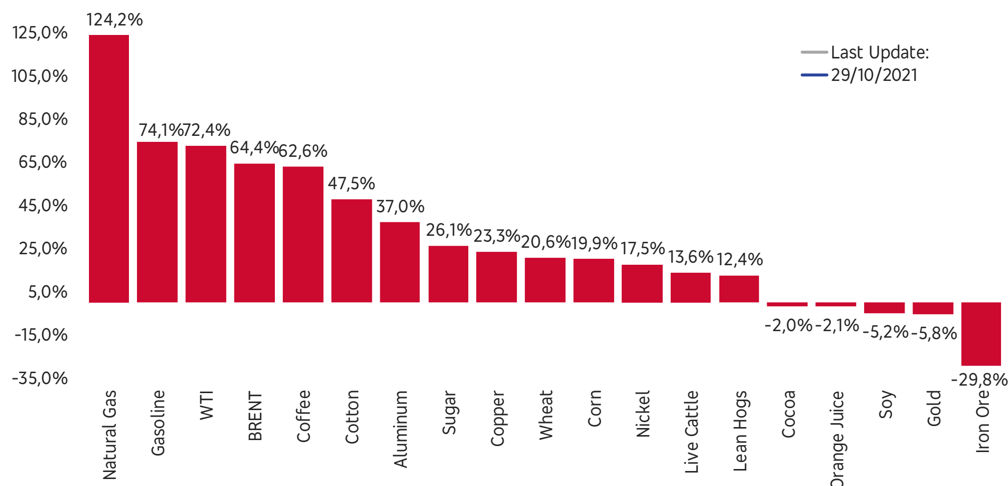
4. How will commodity prices respond in this cycle?

Unlike in other Chinese economic slowdown cycles, the downward correction of commodity prices has not been observed for the time being. There are several reasons, although we recognize that the iron ore price was the exception, having already returned to its fundamentals. First, the supply and demand cycle for key commodities has been global, as the pandemic led to a shift in demand from services to goods, accentuated by the extraordinary stimuli, which impacted production chains on a global scale. The expansion of liquidity, risk aversion, and the accumulation of savings boosting the housing sector, with an increase in real estate prices, is a worldwide phenomenon.

Added to this, much of the slowdown in the Chinese economy originates from supply constraints. Production has been reduced to curb the emission of pollutants, especially of metallic inputs such as steel and coal. It is also important to remember that we are now entering peak seasonal demand for heating in the northern hemisphere. Thus, prices have been and will continue to be pressured, in the face of supply shortages that are more intense than the loss of pace in demand. This explains why most metal and energy commodities remain at high or accelerating levels.

Chart 5: Commodity prices

Cumulative change year-to-date



Source: Bloomberg

However, we should see these prices fall over the next year as the supply of industrial inputs rebalances (inventory rebuilding concomitant with the accommodation of demand for goods), demand for energy for heating declines, and the cooling of the Chinese housing sector continues – even though energy production cuts will remain in place. The credit cycle in China also reinforces this expectation, as in the indicator presented, and the government continues to signal its discomfort with high raw material prices.

For agricultural commodities, however, supply conditions are the determinants for price dynamics. In fact, the expansion rate of the Chinese economy has historically had little explanatory power over the short-term behavior of food prices. This, however, does not mean that Chinese demand does not affect prices. In this sense, it is important to keep an eye on the evolution of policies aimed at increasing and distributing income, within the scope of the common prosperity agenda. If successful, this should maintain China's growing trend for food worldwide.

5. What considerations should be made to counterbalance this more challenging scenario that is being confirmed?

We maintain our growth forecast below 5% from here on out. Still, we should ponder some factors that may hold back a more intense deceleration of the economy, especially in the coming year. Domestic consumption, including services related to reopening, will continue to recover, especially when considering the good job market conditions. Exports should cool down, but still grow above the historical pattern, which implies strong performance by industry and logistics. Investments in the manufacturing sector are also slowing down, with significant inflows of foreign direct investment. It is worth noting that, for the time being, there have been no regulatory measures and no restrictions on the consumer goods and technology industry.

We also foresee smoother adjustments, as some members of the government have been signaling. We believe that we are close to that point of stabilization of measures, which does not mean overall relief. We expect an advance in real estate financing for families; the injection of liquidity has been increasing (to a large extent to enable the issuance of special local government bonds, mainly focused on infrastructure); part of the indebted construction companies will find a solution for restructuring (although some are expected to end up in default); the regulatory measures on the technology sector may have peaked and an increase in coal production for heating is expected. Stability and pragmatism should still not be discarded from Chinese economic policy management.

In summary, we are facing a very challenging period, with changes to the rules of the game: increased regulation, reduction of monopolies, improved income distribution, and a focus on environmental issues. It is uncomfortable to be faced with the lower participation of the housing sector, without compensation; domestic consumption and new industries are not ready to deliver immediate growth. Right now, the concern is with instability coming from financial risks and social inequalities. It is not instability resulting from less growth. Relief, on the other hand, will be a function of the political, and not the economic, calendar: the Winter Olympics and the Party Congress, respectively in February, October and November of next year. For now, stimulus seems less urgent and the risk becomes asymmetric for less growth.

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