China needs to Rethink their Growth Playbook

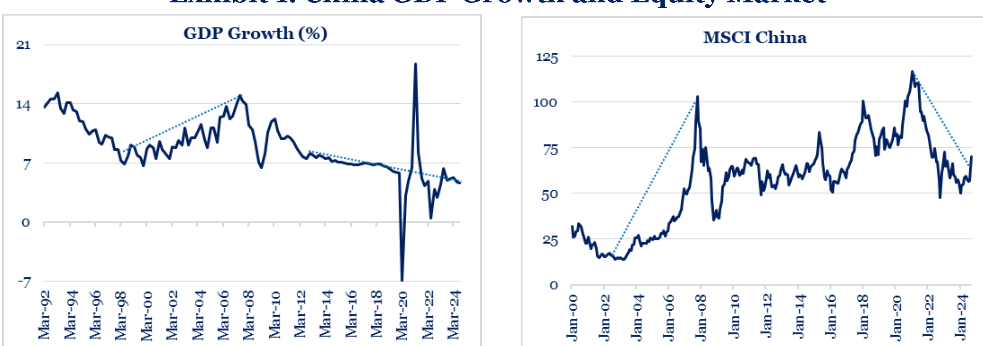
In a surprise move last month, China's politburo announced an array of stimulus measures to promote economic growth back to the target 5% rate and stabilize the capital markets as well as the property sector. The People's Bank of China (PBOC) cut reserve requirement by half a per cent and also reduced the benchmark interest rate on seven-day reverse repurchase agreements from 1.7% to 1.5%. The PBOC unveiled $114bn in funds to boost the stock market by lending to asset managers, insurers and brokers so they can buy equities as well as to companies for them to buy back their stocks. Beijing plans to double or triple the plan if these schemes work and is also mulling a "stock stabilization fund".

In addition, China plans to issue approximately 2 trillion yuan ($284bn) in special bonds. Of this, half will be used to increase subsidies for a consumer goods replacement program and for business equipment upgrades. The other half will be used to reduce debt at the local government level.

The politburo pledged to stabilize the real estate market. Tier 1 cities Shanghai and Shenzhen are planning to lift key home purchase restrictions in coming weeks removing the limit on the number of houses that the Chinese can buy. Under the new plan, homeowners will be able to renegotiate terms with their lenders before January and if necessary, refinance their loan with a different bank. Furthermore, the minimum down payment for a second home will be reduced from 25% to 15%, which is the same amount as for the first home.

Many have referred to these measures as the biggest bazookas triggered by Beijing and the PBOC to bolster economic growth and an equity market that has languished for the last 5 years (Exhibit 1). Chinese GDP growth slowed to 4.6% in the latest quarter, which is below the government target of 5%. And the Chinese stock market has been one of the worst performers in the last few years, lagging most developed and emerging equity markets.

Exhibit 1. China GDP Growth and Equity Market



Sources: Bloomberg, MSCI

This raises the question of whether these measures initiated by the Chinese government are enough to pull China out of its doldrums. And a bigger question is whether or not they can change China's growth trajectory, putting the economy on a higher growth path.

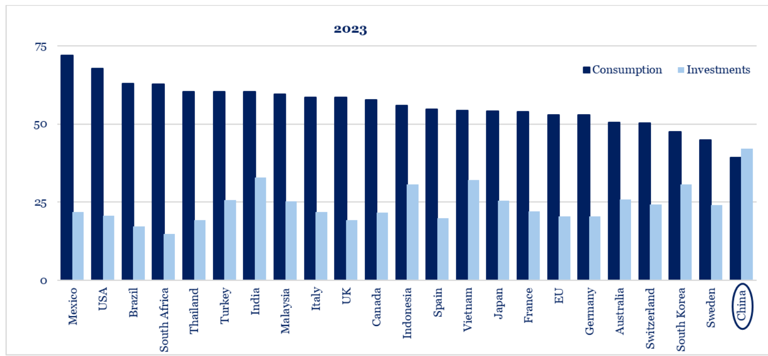
In Exhibit 1, we present Chinese GDP growth going back a few decades. In the early part of the 1990s, GDP growth tracked in the teens driven by fixed asset investment in the form of infrastructure spending. In 2001, China entered the World Trade Organization, which helped reaccelerate growth back to the teens from high single digits. However, the Global Financial Crisis interrupted this steady growth, and the Chinese government stimulated the economy with a 4 trillion-yuan (13% of GDP at the time) package to invest in national infrastructure projects such as high-speed rail, which successfully increased GDP growth to 10% by 2009.

In 2013, President Xi Jinping launched the Belt and Road Initiative, which was referred to as the New Silk Road. The goal of this massive infrastructure project was to develop and link Asia, Europe, Oceania and Latin America by creating a vast network of infrastructure such as railways, energy pipelines, highways, port developments, etc. In addition, in 2015, Prime Minister Li Keqiang launched Made in China 2025, an initiative whose objective is to reduce China's reliance on foreign technology imports and modernize China's industrial capability.

Again and again, China's strategy has been to go back to its old playbook to boost fixed asset investment to stimulate GDP growth. This has led to investments being the biggest component of GDP as presented in Exhibit 2. Between 2013 and 2019 when consumption as a percentage of climbed from 35.6% to 39.1%, there was some hope that this trend would persist putting China on the path of rebalancing its economy from investment-led to that driven by consumption. Alas, that has not been the case so far.

In sharp contrast to other economies, China remains dependent on investments for GDP growth (right chart, Exhibit 2). While this ratio is down to 42.1% in 2023 from 46% in 2013, it is still one of the highest. Thus, in our view China has reached the end of the road on fixed investments and can no longer continue to rely on investments to drive GDP growth.

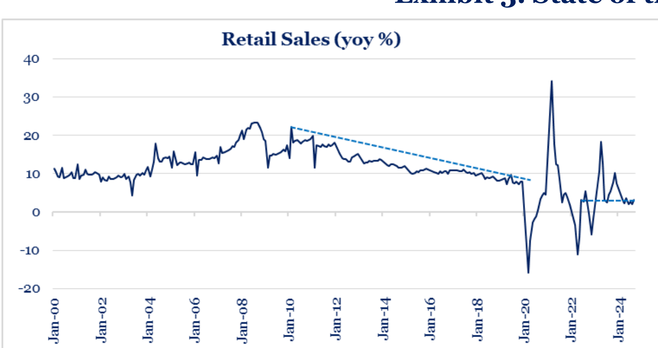
Exhibit 2. GDP Components: Consumption versus Investments (%)



Source: CEIC Data

It is encouraging to think that the objective of China's "common prosperity" policy has been exactly this - to rebalance the economy away from investments and towards consumptions and domestic demand. However, these policies are designed more to redistribute income to poorer households and to be a wealth transfer mechanism from the rich to the middle class. Government crackdowns on private industries such as the tech, property and tutoring sectors have led to a stall in economic growth. The middle class is facing slow income growth as there have been reports that some professionals are being forced to repay bonuses awarded several years ago. The number of companies founded in China in 2024 is down 99% to just 260 from 2018, when 51,302 companies were founded. The number of startups in 2023 was just 1,202. Growth in retail sales has fallen to less than 4% in 2024 (Exhibit 3, left chart), which means consumption as a percentage of GDP is likely to decline again in 2024. Meanwhile consumer confidence remains depressed (Exhibit 3, right chart).

Exhibit 3. State of the Chinese Consumer



Source: CEIC

According to Vice Finance Minister Liao Min, the recent stimulus plan is centered around lifting domestic demand to achieve 5% annual target growth rate. That would be a welcome change to the Chinese growth playbook. In a report, Rhodium estimates that if China's consumption share were similar to that of the EU or Japan, its annual household spending would be $9 trillion instead of $6.7 trillion – a difference of $2.3 trillion. But we will have to wait and see whether the Chinese consumers respond as the government expects to the recent stimulus package and whether common prosperity is redefined to promote consumption by everyone, both the rich and the poor.