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focus

China's Economic Challenges:

From the Tiger's Roar to a Lingering Cold

China has long been a key driver of the global economy, but more recent headlines have depicted a less rosy picture. China's economy is grappling with some significant challenges, including slowing growth, a struggling property market, a potential debt crisis, and escalating trade tensions with the West. **Once considered an unstoppable force, China now faces an uncertain economic future.**

FORSYTH BARR

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China's economic transition

The spectacular growth rates that catapulted China to the forefront of the global economy are becoming increasingly elusive. Between 2000 and 2010, the Chinese economy grew by an impressive 9.5% year-on-year. However, as an economy matures and expands, sustaining such remarkable growth becomes a herculean task. While the Chinese government has set a more modest growth target of 5% for 2023, most economists view this as an upper limit in coming years, with expectations for a further deceleration ahead.

Property and debt dilemmas

A major reason behind China's economic shift is the downturn in its property market. In 2021, China's property sector was valued at approximately US$55 trillion, double the size of the US property market. Construction and real estate contribute as much as 25-30% of China's GDP, while property accounts for around 70% of household wealth.

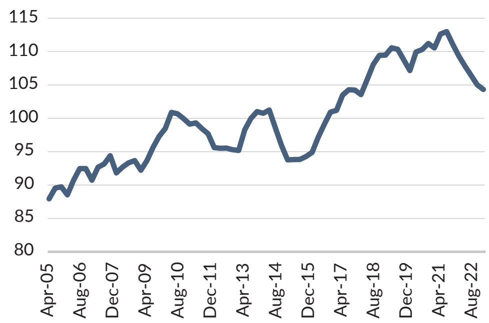
While concerns about the Chinese real estate market have been simmering away for some time, these issues came to a head in 2020, following changes in government policies aimed at curbing investor speculation and developers' risky debt levels.

Chinese households have one of the highest savings rates in the world. The challenge for households is where to put their money. Compared to other countries they have fewer investment options. Regulations make it hard to place money offshore. One obvious choice was property and investors flooded in. With property prices rising consistently every year many investors didn't even see the need to rent their properties out. Excess inventory built up to extraordinary levels. There are reports of around 65 million empty houses in China. To put that in perspective that's about 10% of all homes, equivalent to the total number of houses in Japan, the world's 11th largest country by population.

Unsurprisingly, the bubble has now burst (the surprise is actually how long it persisted!). Developers, who had borrowed heavily to meet demand, are now facing strife as demand cools and projects lie dormant.

Although official data suggests that the decline in property prices has been in single figures, private data suggests prices are down at least 15% in major cities. Chinese authorities are providing support to finish the work that is currently underway, ensuring people who have prepaid for housing aren't left high and dry. But equally, they do not want to reignite the bubble. It's a tough tightrope to walk.

CHINESE REAL PROPERTY PRICES (INDEX 2010=100)



Source: Federal Reserve Bank of St. Louis, Forsyth Barr analysis

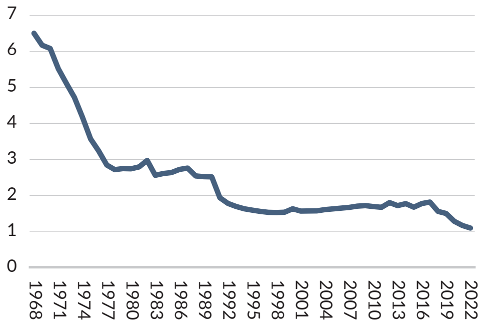
Trade tensions rising

Another factor putting pressure on China's economy is the increased tension around trade. While China has thrived for many years as the world's manufacturing hub (according to United Nations data it accounts for a massive 29% share of global manufacturing output), this model is starting to come under pressure. A number of factors are driving this change. As China has become wealthier and the population has aged, labour and other costs have increased, making alternative manufacturing destinations more cost competitive. COVID and China's strict zero-COVID policies exposed the risks of overreliance on supply from a single country. Furthermore, growing trade tensions between China and the West are encouraging companies to either re-shore (bring manufacturing back home) or friend-shore (manufacture in a country that, at least, isn't a geopolitical rival). Countries such as Vietnam, Malaysia, India, Bangladesh, Taiwan, and Mexico are benefitting (in the first half of 2023 Mexico overtook China as the US's largest trading partner, the first time since 2005).

Population problem

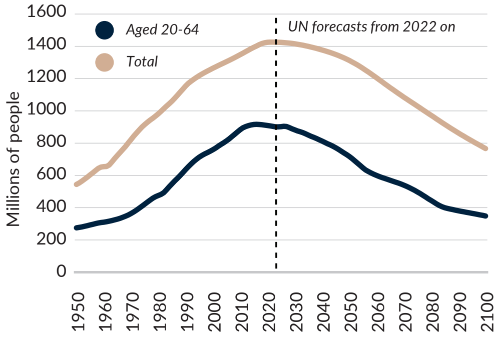
While slow moving, China faces a significant structural long-term headwind from demographics. The nation's fertility rate, estimated to have declined to 1.09 in 2023, falls well below the 2.1 needed for a stable population. China's working-age population has likely peaked and is now declining. An ageing population means less workers, and in turn a smaller percentage of the population supporting a higher proportion of dependents. China's total population is forecast to roughly halve by the end of the century, putting additional pressure on a property sector already burdened by overcapacity.

CHINA'S FERTILITY RATE



Source: World Bank, Forsyth Barr analysis

CHINA POPULATION FORECASTS



Source: UN, Forsyth Barr analysis

Pop guns versus bazookas

Unlike in previous economic downturns, Chinese officials have been very hesitant to jump in, guns blazing, with fiscal stimulus and instead have been drip-feeding out small sector-specific policies. This is a conscious decision to try and step back from using construction, fuelled by rampant credit growth, to prop up the economy. However, the piecemeal measures they have delivered to date (mild interest rate cuts, easing lending standards, encouraging more consumption, and lowering childcare costs) have yet to produce substantial changes in economic activity. If the economy continues to tumble, it remains to be seen how long government officials will hold off unleashing larger stimulus programmes.

China's chills will be broadly felt

Earlier this year, the International Monetary Fund (IMF) projected that China would contribute about 35% of global economic growth in 2023, with the Asian region, which is heavily dependent on the Chinese economy, providing over 67%. A weaker Chinese economy will have a flow-on effect to the rest of the world and notably to countries such as New Zealand and Australia, both of which are major exporters of goods and services to China.

On the flip side, the US remains the world's biggest economy and has fared much better than expected over the past six months. The US, however, is a relatively self-sustaining economy and New Zealand sends about 30% of all exports to China, versus around 11% to the US. New Zealand, like many other nations, has closely tied its economic fortunes to China which is our largest export destination for dairy products, meat, forestry, and horticultural exports. Our tourism sector has also benefitted from Chinese visitors who, pre-COVID, were some of our most valuable tourists. Cooling consumer confidence and cautious spending habits among Chinese citizens are negatively impacting demand for New Zealand's food exports, while Chinese tourism remains about half what it was pre-pandemic.

...China will remain an economic giant, second only to the US ...

Looking ahead

China's growth rates have been on a downward trajectory for some time. While the Chinese government is targeting a 5% growth for 2023, most economists predict lower figures in the coming years. Nevertheless, even 3% or 4% growth in a large economy like China's still represents significant expansion.

Financial markets have priced in a pessimistic outlook for China. In the near-term there may be room for upside surprises and improved sentiment. If really needed, Chinese officials have the capacity to unleash greater stimulus. But it is unclear whether they will choose to go down this path — they've been cautious to date. Long-term, China will remain an economic giant, second only to the US in economic output, and will continue to be important to New Zealand. But looking forward, we don't expect China will play as big a role in driving global economic growth as it has in recent decades past. China's economic challenges serve as another reminder of the value of a well-diversified investment portfolio. The current juxtaposition of a weakened Chinese economy and a resilient US economy, an unforeseen scenario at the start of 2023, underscores the uncertainty and importance of adaptability in navigating the global financial landscape.

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If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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