China: an unexpected package that matters for the short run

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Chinese authorities have finally decided to "go big" on providing support to their ailing economy. Signs that growth was weakening further from an already subdued pace increasingly made the official 5% GDP growth target unrealistic, and the risk of the economy slowing below stall speed was becoming real.

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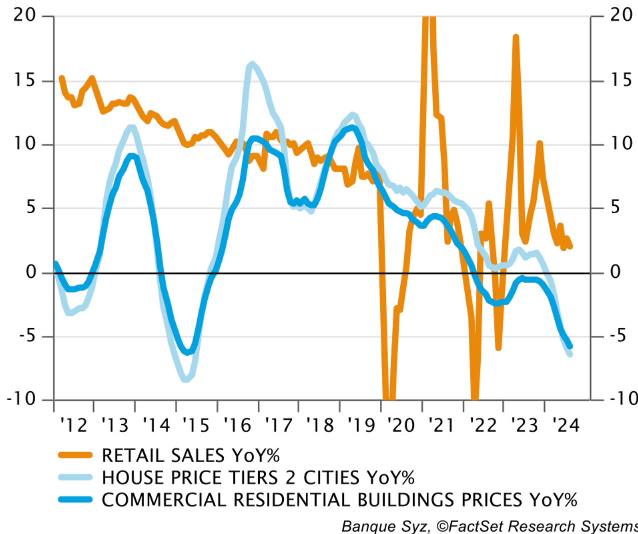
Time to act as growth keeps slowing down

Economic momentum has been worryingly deteriorating over the summer. Domestic consumption was below expectations again in August, with retail sales up a meager 2.1% from a year ago. The continuous and seemingly endless drop in real estate prices is weighing heavily on households' sentiment and spendings, in a context of labor market deterioration.

Domestic consumption is too weak, dampened by the fall in real estate prices



Industrial production is losing steam as well and slowed down again in August, fading the encouraging rebound witnessed earlier this year. If the trade balance continues to show elevated surpluses, it is mostly because of the weakness of domestic demand as imports into the Chinese economy have barely risen over the past three years. And the depressed demand has led to deflationary pressures taking hold in China since the pandemic, bucking the global trend.

Until recently, Xi Jinping and Chinese authorities gave the impression of accepting those weak economic performances as the price to pay for strengthening China's long-term growth prospects (see our Focus note "China has its eyes on long-term strategic objectives, not on current weak economic growth." 19 July 2024). Investors had long been hoping for "stimulus plans", only to be disappointed each time limited and targeted measures were announced.

However, recent data appear to have raised a sense of emergency by Chinese officials, who have this time surprised by unveiling a package of economic measures designed to kick-start domestic activity and reverse the downward trend of the equity market.

The size of this package is significant, and the coordinated decisions regarding credit conditions, support to the real estate and equity markets, along with a probable fiscal stimulus to domestic consumption, are likely to have a visible impact on the economy in the coming months. In fact, they already rapidly had a strong effect on the Chinese equity market.

It remains to be seen whether those measures will be sufficient to reach the 5% GDP growth target set for 2024, but they are at least likely to reverse the recent downward trend and fuel a rebound in economic activity during the fourth quarter of the year.

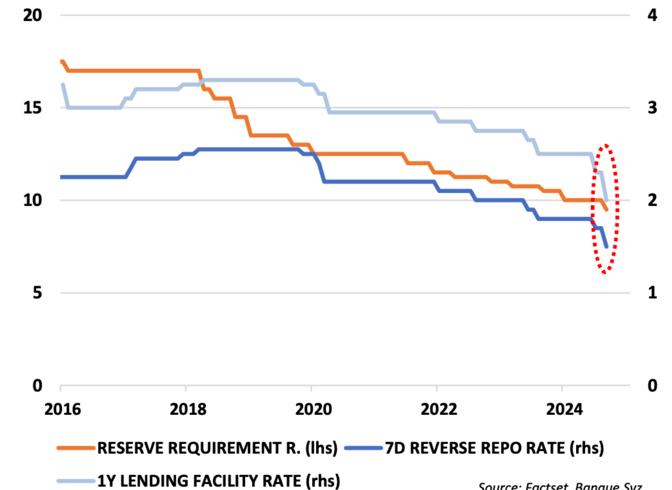
A significant package of measures for the economy and the markets

During what was a decisive week for Chinese economic policies, a number of announcements were made to foster domestic demand and bring the 3-year continuous decline of the residential real estate market to an end. Most of those measures were "supply oriented" measures aiming at facilitating access to credit and lowering the cost of mortgages and home purchases. Hints of pending fiscal support for households were also sent to address the "demand side" of the growth equation.

Monetary policy easing to foster credit growth

- The People's Bank of China announced a reduction of its benchmark short term rates: the 7-day reverse repo rate was lowered by -20bp to 1.50%, and the 1-year lending facility rate was reduced by -30bp to 2.00%., both to new lows
- In parallel, a 50bp reduction of the RRR (Reserve Requirement Ratio) to 9.50% of commercial banks, was also announced, bringing it to its lowest since 2007. This reduction will release about CNY 1 trillion of liquidity in the banking sector, helping banks to increase the supply of credit and thus support domestic spending.

A simultaneous cut in PBoC key rates and RRR



A simultaneous cut in the RRR and in interest rates had not happened since 2015. This time, it was combined with the announcement of a recapitalization of the six largest commercial banks, aimed again at fostering their capacity to supply credit. Those announcements signal a clear willingness to stimulate credit growth after it stagnated for four years.

Real estate

- A reduction in the rates of existing residential mortgages will be implemented, on average by 50bp. This measure will benefit around 150 million people, lowering yearly interest payments by CNY 150bn.
- The minimum downpayment for second home purchases will be lowered to 15% (from 25%).
- In addition, conditions will become more attractive for lending to entities that buy unsold inventories from property developers.

The residential real estate market has been on a continuous slump since 2022. Once a strong tailwind for domestic consumption, it has now become a major factor undermining households' sentiment and spending. To have a chance of seeing domestic consumption regain some momentum, the decline of the real estate market must be stopped.

Equity markets

Since 2021, China's equity markets have significantly underperformed other large equity markets. Since 2021, and until the latest announcements, the Chinese market index was down -30% while the World index was up +50% and the US market +60%. In order to revive a positive trend for the domestic market, large liquidity facilities will be created in order to support demand for Chinese stocks:

- A liquidity facility at the PBoC will be available for investment firms, insurance companies and listed companies to purchase stocks on the market, for a total amount of CNY 500bn (USD 70bn equivalent)
- A liquidity facility will also be available for companies that want to buy back their own shares, for a total amount of CNY 300bn (USD 45bn equivalent).
- There are also talks of a market stabilization fund that would invest directly on the equity domestic market.

Along with those sets of "supply-oriented" measures designed to ease and facilitate credit conditions and real estate investment, hints have been given of a coming fiscal support directed to households, especially low-income households. This type of measures, possibly financed by the issuance of new long-term government bonds, will likely be needed to stimulate demand and ensure the effectiveness of the easing on the supply side.

The package announced during the fourth week of September, although already significant, can be expected to be complemented in the weeks or months to come. After this initial large move, the Chinese authorities will likely fine tune and adjust their policy tools depending on developments in the economy and in markets.

A package to prevent an economic crisis, not to boost growth over the medium term

The economic measures announced at the end of September are unambiguously positive for the Chinese economy and its equity market. They appear sufficiently large and broad based to act as a positive shock for Chinese households and investors and reverse the depressing trend at play so far.

However, two important elements must be kept in mind before getting carried away by those announcements.

- This package of measures has been announced because economic growth and market dynamics were worryingly deteriorating. They are emergency policy adjustments designed to avoid a further deterioration, or even a full-blown economic crisis. They are not intended to engineer a sustainably higher level of economic growth going forward.
- This package of measures aims at addressing immediate pain points that undermine the current level of economic activity. But the medium- and long-term challenges facing China remain and will not be addressed by any of those measures.

Indeed, those challenges remain important and will continue to shape China's economic future.

- Unfavorable demographic dynamics limit the growth potential going forward, even if some measures such as the increase in the retirement age that will come into effect in 2025 will help contain their impact.
- Households' sentiment has been severely damaged by the succession of blows in the past four years. It will likely need time to recover durably, a necessary condition to see domestic demand bringing a larger contribution to total GDP growth.
- Businesses and investors' sentiment has equally been damaged by the succession of regulatory crackdowns and antibribery campaigns. This has weighed heavily on the evolution of the equity market, with the perception that the authorities were not interested in the level of equity prices. In that respect, the latest announcements are an encouraging sign for domestic and foreign equity investors, but certainly only a small first step in rebuilding the confidence and sentiment toward Chinese listed companies.
- Trade barriers have already increased for China's exports to the US and Europe. This trend is unlikely to reverse in the future, and the prospect of Donald Trump being elected as the next US President carries with it the risk of punitive US tariffs on Chinese imports that would likely shake global trade dynamics and hit the Chinese industrial sector. The contribution of exports to China's GDP growth might be constrained by a less favorable environment for global trade in the coming years.

In this context, the resolute policy actions announced at the end of September are clearly positive as they will likely prevent growth to deteriorate further in the world's second largest economy. But they do not improve China's medium-and long-term growth prospects significantly.

Source : Reuters

For further information

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