China Matters

What Comes Down Must Go Up

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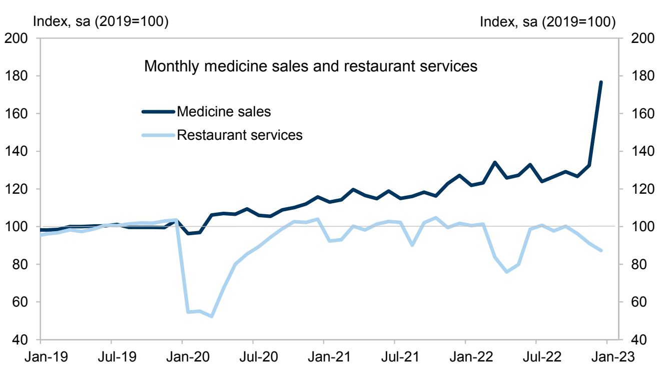
- China's December activity and Q4 GDP data were big upside surprises. While many patterns in the detailed data make intuitive sense (e.g., sharply rising medicine demand amid surging Covid cases), the monthly and quarterly headline numbers appear stronger than high-frequency data and other official measures. Nonetheless, we recently adjusted our 2023 real GDP growth forecast to 5.5% (from 5.2% previously) after incorporating the Q4 official data and benchmarking to the faster-than-expected reopening process.
- Consumption and property are the two areas where the post-Lunar New Year (LNY) recovery path is most uncertain. On consumption, our 8.5% real household consumption growth forecast this year originates mainly from the fact that household consumption was extremely depressed (on par with 2020Q1 during the national lockdown) on the eve of reopening in 2022Q4. Our baseline projection takes into consideration potential scarring effects of the pandemic and does not assume households tap into their "excess savings" in 2023.
- On property, we assume an "L-shaped" recovery. The emphasis of property policy has clearly shifted from developer deleveraging in 2021 to preventing the property slowdown from further damaging the economy and imposing systemic risks. If the post-LNY recovery were to disappoint, we believe policymakers will stand by and ease more. However, the objective is to manage the multi-year slowdown rather than to engineer an upcycle given the challenging long-term demand outlook, as evidenced by the first population decline in 60 years in 2022.
- The policy tone has been unmistakably "pro-growth" of late. But pro-growth in this cycle means easing industry-level policies (e.g., property and internet) rather than further monetary and fiscal loosening. On the contrary, we expect monetary and fiscal policy to gradually normalize as reopening boosts consumption and services activity in 2023 after being very accommodative in 2022.
- Structurally the Chinese economy still faces multiple challenges, including demographics, debt, and decoupling. Cyclically, however, we believe reopening is in the driver's seat for Chinese economy and markets in the coming quarters.

What Comes Down Must Go Up

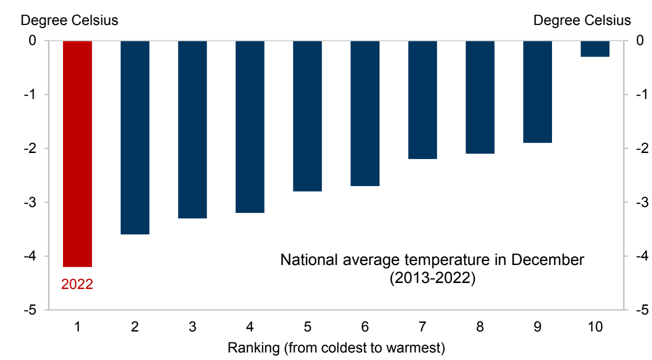
The Q4 GDP and December activity data released by the government this week paint a surprisingly resilient picture of the economy during China's abrupt reopening. Some supportive factors revealed by the data appear intuitive. Medicine sales jumped in December, consistent with the surging Covid cases and soaring demand for fever-reducing medicine and treatment drugs. Restaurant services, on the other hand, continued to slide (Exhibit 1). Power generation contributed notably to industrial production, consistent with the coldest December in a decade (Exhibit 2). Auto sales increased as buyers accelerated purchases ahead of the year-end expiration of certain government subsidies and tax cuts, whereas auto production fell, presumably because a large number of workers fell sick.

Exhibit 1: Medicine sales jumped while restaurant services slid during the "exit wave"



Source: CEIC, Goldman Sachs Global Investment Research

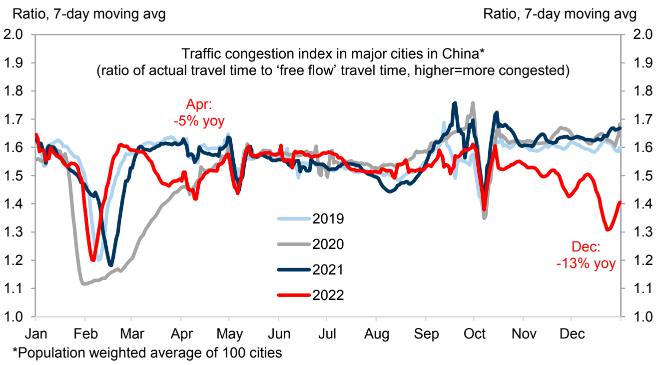
Exhibit 2: 2022 had the coldest December in a decade



Source: Haver Analytics, Goldman Sachs Global Investment Research

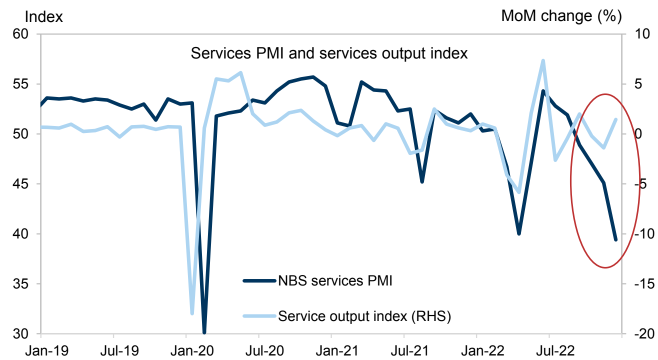
But the much better-than-expected headline data still seem at odds with high-frequency trackers and other official measures. For example, the 100-city traffic congestion index shows that December mobility was 13% lower than a year ago, but retail sales only declined 1.8% yoy. In April during the Shanghai lockdown, national retail sales plunged 11% yoy when 100-city mobility was only 5% lower than a year ago (Exhibit 3). Sharply rising medicine sales only added 1.5pp to December year-over-year retail sales growth by our estimates. Additionally, the December official services PMI released three weeks ago plummeted to below 40, weaker than it was in April. By contrast, the official services output index – which measures private services production in real terms and is a key input of quarterly GDP – showed a surprising uptick in December (Exhibit 4).

Exhibit 3: Mobility dropped more in December than during the April Shanghai lockdown



Source: Wind, Goldman Sachs Global Investment Research

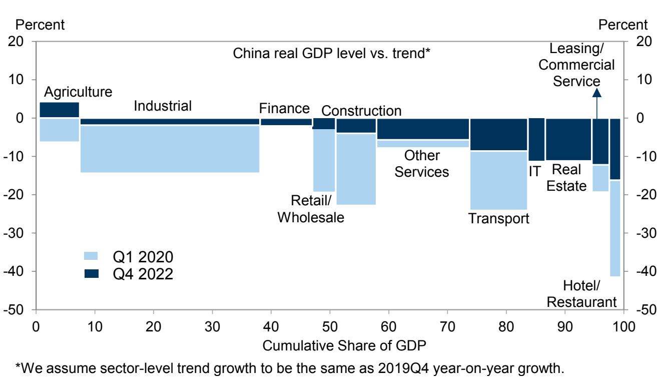
Exhibit 4: Service output index increased in December while service PMI plunged



Source: NBS, Haver Analytics, Goldman Sachs Global Investment Research

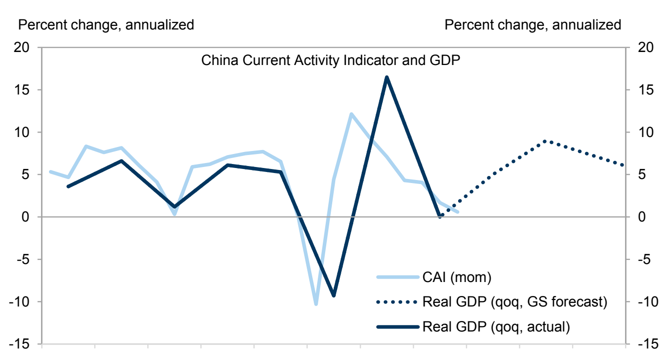
Although the December/Q4 data showed the largest positive surprise in years, as indicated by our proprietary MAP score, investors have largely moved on from 2022 data and the focus is squarely on the strength and sustainability of the post-LNY recovery. We recently adjusted our 2023 GDP forecast higher from 5.2% yoy to 5.5% yoy after onboarding the official Q4 GDP and benchmarking against the faster-than-expected reopening process. For example, at the January 17th press conference, National Bureau of Statistics (NBS) officials stated that domestic flights had recovered to 80% of the 2019 levels. Our core view of a consumption and service driven rebound post-reopening remains the same. As shown in Exhibit 5, many services industries face sizeable output gaps at the end of 2022. If zero-Covid policy was the main reason why a large share of the economy is operating significantly below potential last year, then reopening should lead to meaningful cyclical growth acceleration even on a partial recovery. This is why we expect growth to accelerate sharply in H1 and real GDP to grow 6.5% yoy in 2023Q4, more than a full percentage point above consensus expectations (Exhibit 6)[1].

Exhibit 5: Significant slack in many services industries



Source: Wind, Goldman Sachs Global Investment Research

Exhibit 6: We expect a sharp growth acceleration in H1

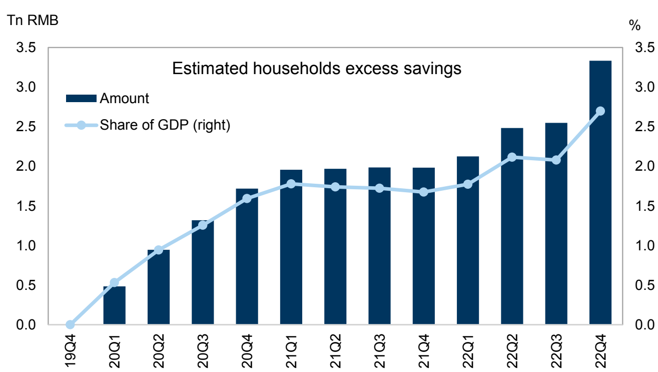


Source: NBS, CEIC, Goldman Sachs Global Investment Research

[1] Our China Current Account Indicator (CAI) measures annualized growth rate using monthly official statistics (see here for more details). The stronger-than-expected December activity data feed into CAI and translate into the better-than-expected CAI shown in Exhibit 6.

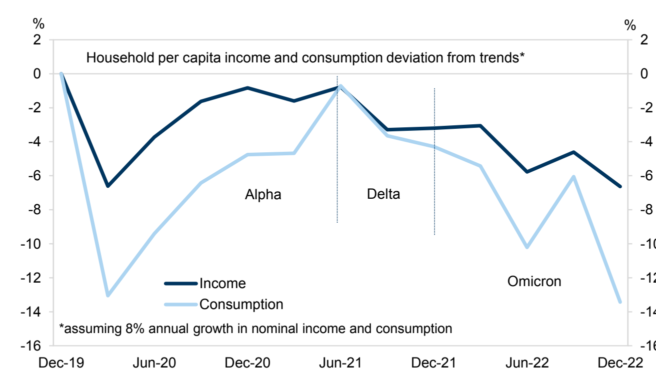
Even a partial recovery in household consumption would imply a notable growth acceleration this year. As explained in our latest consumption deep dive, our 8.5% real household consumption growth forecast for 2023 takes into consideration lingering scarring effects of the pandemic. It also assumes that households will not tap into the RMB3.3tn "excess savings" this year – which is defined as household savings above and beyond implied by pre-Covid trend in savings rate – accumulated over the past three years (Exhibit 7). The key reason behind the projected rebound is the fact that household consumption is far below its trend level on the eve of reopening. We estimate that the gap between actual household consumption and the trend level in 2022Q4 was almost as wide as in 2020Q1 when the initial Covid-19 outbreak triggered a national lockdown (Exhibit 8).[2] Admittedly, there remain considerable uncertainties regarding how quickly the labor market can recover and how long Covid fears may persist within certain segments of the population. But our scenario analysis suggests real household consumption should grow 7-10% this year, with the potential deployment of excess savings representing an upside risk (see "China post-reopening consumption recovery: Large potential, lingering scars", Asia Economics Analyst, January 18, 2023 for more details).

Exhibit 7: We estimate RMB3.3tn excess savings accumulated by Chinese households over the past three years



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 8: The gap between actual consumption and trend level in 2022Q4 was as wide as in 2020Q1



Source: CEIC, Goldman Sachs Global Investment Research

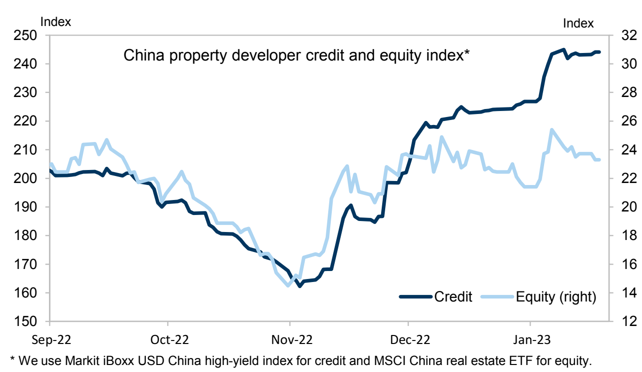
Another area of the economy whose forward recovery path is highly uncertain is property. As our China Property team discussed, the policy tone on the property sector has turned decisively more dovish since November. While the focus was on reining in developer leverage in 2021, the emphasis has shifted to preventing the property sector from further damaging the real economy and causing systemic financial risks. In his speech at the World Economics Forum in Davos on January 17th, Vice Premier Liu He stressed the importance of the property market: 40% of bank lending, 50% of local government revenue, and 60% urban households' assets. Broader economic recovery would be very difficult without the property sector stabilizing. It is clear to us that, if the property market does not show signs of improvement, policymakers will likely stand by and continue easing. In other words, the "left tail" of potential outcomes has

[2] In 2019, nominal income and consumption per capita in the NBS quarterly household survey grew 8.9% and 8.5%, respectively. In Exhibit 8, we assume a trend growth rate of 8% per year in subsequent years. It is possbile that trend growth rate was below 8% in 2020-22 in which case the gap between trend and actual income/consumptoin in 2022Q4 would not be as large as shown in Exhibit 8.

diminished. Market reactions in the past month seem to agree: developers' bonds rallied more than their equities, suggesting fading downside risks (Exhibit 9).

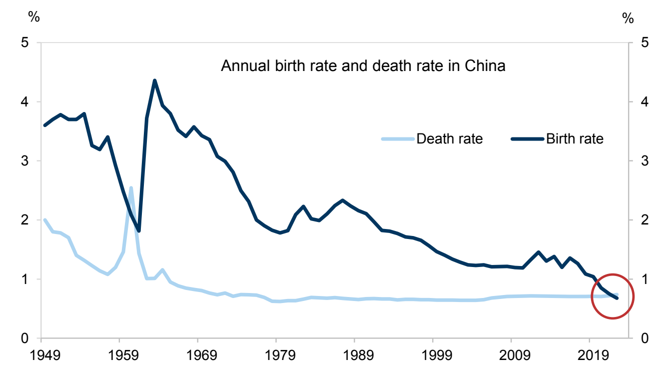
That said, our base case remains an "L-shaped" recovery in the property sector given the long-term trend of falling demand. The newly released 2022 population data are a case in point. China's population declined for the first time in 60 years on falling birth rate (Exhibit 10). If annual demand for new properties is on a structural down trend, then the policy goal should be managing the pace of decline rather than sending new construction and new sales back to their 2021 peak. This explains the differentiated easing approach adopted by the government: on the demand side, only cities with declining house prices are allowed to lower mortgage rates beyond the national floor; on the supply side, only "quality" developers are receiving policy assistance. The head of the Ministry of Housing and Urban-Rural Development (MOHURD) Ni Hong said as much in early January: the government will vigorously support first-time homebuyers, reasonably support second-home demand, and not support purchases of third or more homes.

Exhibit 9: USD China property credit has rallied more than China property equities



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 10: Chinese population declined for the first time in 60 years on falling birth rate



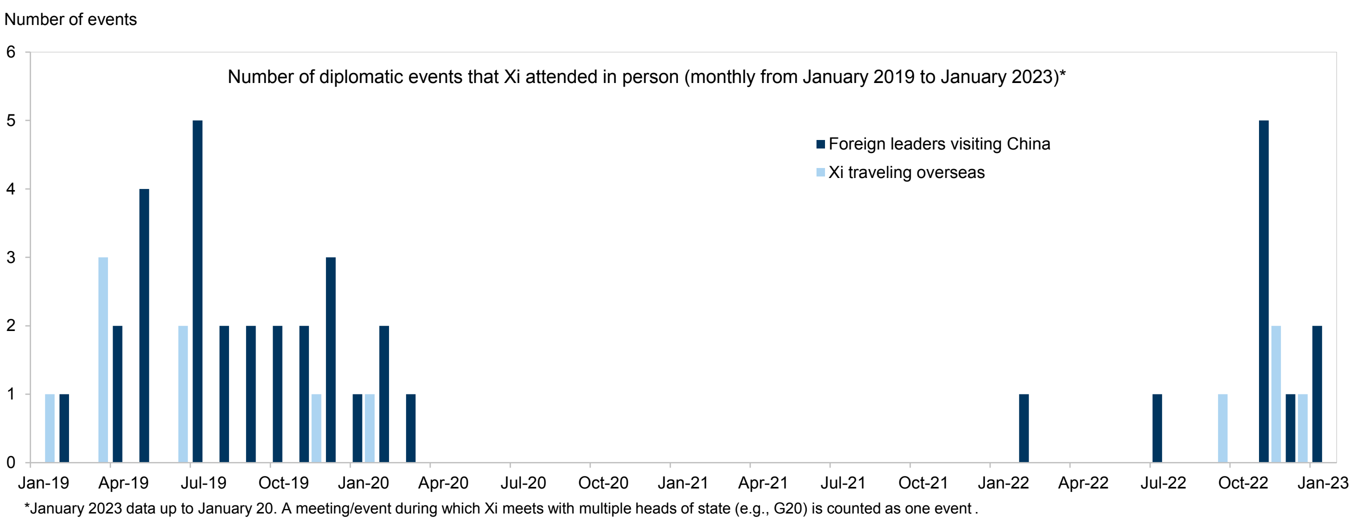
Source: Haver Analytics, Goldman Sachs Global Investment Research

Policy discussions since early December have sounded unmistakably pro-growth (see December Politburo meeting and Central Economic Work Conference for example). But "pro-growth" has different meanings in this cycle than in previous cycles. In the past, pro-growth typically implied more monetary stimulus via RRR and rate cuts and more fiscal stimulus via infrastructure building. However, with the exit of zero-Covid policy poised to boost consumption and services activity, we expect the interbank market rate to climb back to the 2% policy rate and augmented fiscal deficit to narrow 2pp this year after the 3pp widening last year. On the other hand, industry-level policies have eased materially, including property market and internet regulations. The tone toward private-owned enterprises (POEs), market economy, and opening to the rest of the world has become more market-friendly compared to the previous two years. These are the essence of the "pro-growth" message in the current cycle, not the traditional monetary and fiscal easing, in our view. Put differently, because reopening itself is likely to provide a large growth impulse, less stimulus is needed this year than in traditional recovery.

In our client conversations, market participants have continued to express concerns over China's long-term outlook, the fast and furious reopening rally notwithstanding. The sudden exit from the zero-Covid policy raised questions about policy predictability. The declining population has dampened investors' sentiment on China's long-term growth. The much stronger-than-expected Q4 GDP data revived doubts in investors' minds on whether official statistics are becoming less reliable. President Xi stated in his New Year speech on December 31st that "China's GDP is expected to exceed RMB120tn in 2022." On January 17th, the NBS printed RMB121tn for China's 2022 GDP on the back of an upward revision to 2021 growth rate and the largest upside surprise to quarterly GDP forecast in years.

While we are sympathetic to some of the structural concerns, we also think it is important for investors to recognize the power of reopening cyclically. Many aspects of the Chinese economy and society will be normalizing over the coming quarters after three years of zero-Covid policy. Some of these normalizations may be faster than others, and the large number of in-person meetings President Xi had with other heads of state over the past two months is a good example (Exhibit 11). Although demographics, debt, and decoupling will be influential to China's growth outlook and probably remain top of mind for China investors for years to come, in the next few quarters, reopening is likely to be in the driver's seat for Chinese economy and markets.

Exhibit 11: Chinese leadership re-engages with the rest of the world in person



Source: Ministry of Foreign Affairs, Goldman Sachs Global Investment Research

Appendix

GS China GDP forecasts

		2019	2020	2021	2022	2023F
GDP	**% yoy**	**6.0**	**2.2**	**8.4**	**3.0**	**5.5**
Domestic Demand	pp	5.2	1.6	6.4	2.5	6.5
Consumption	% yoy	6.2	-0.4	9.4	1.8	7.5
Household Consumption	% yoy	6.4	-1.8	11.9	0.5	8.5
Government Consumption	% yoy	5.9	3.0	3.6	5.0	5.0
Gross Fixed Capital Formation	% yoy	5.2	3.2	2.3	4.0	3.5
Net Exports	pp	0.7	0.6	1.7	0.5	-1.0
Exports of Goods (nominal USD)	% yoy	0.5	3.6	29.6	7.0	-1.0
Imports of Goods (nominal USD)	% yoy	-2.7	-1.0	30.6	1.1	5.0
Inflation						
CPI	% yoy	2.9	2.5	0.8	2.0	2.2
Core CPI	% yoy	1.7	0.7	0.8	0.9	1.4
PPI	% yoy	-0.5	-1.8	8.1	4.1	-1.5
Other						
Current Account	% GDP	0.7	1.7	1.8	2.3	1.5
USDCNY (eop)	level	6.96	6.53	6.35	6.98	6.50
OMO 7-Day Repo Rate (eop)	%	2.50	2.20	2.20	2.00	2.00
TSF Stock Growth (eop)	%	10.7	13.3	10.3	9.6	9.5
Augmented Fiscal Deficit	% GDP	12.0	17.2	11.3	14.3	12.3

Source: Haver Analytics, Goldman Sachs Global Investment Research

GS China macro policy forecasts

Type	Instrument	2022	GS 2023F
Monetary	RRR	Large bank avg: 11.0% Small/med bank avg: 8.0%	Large bank avg: 11.0% Small/med bank avg: 8.0%
	DR007 (20dma)	1.80% (eop)	2.00% (eop)
	7-Day OMO	2.00% (eop)	2.00% (eop)
	MLF (1-year)	2.75% (eop)	2.75% (eop)
	LPR (1-year)	3.65% (eop)	3.65% (eop)
Fiscal	Effective on-budget deficit	5.8% of GDP	5.0% of GDP
	Augmented fiscal deficit	14.3% of GDP	12.3% of GDP
Credit	TSF stock	9.6% (eop yoy)	9.5% (eop yoy)
Housing	Housing policy	moderate easing	moderate easing
FX	USDCNY	6.98 (eop)	6.50 (eop)

Source: CEIC, Goldman Sachs Global Investment Research

Disclosure Appendix

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