Special Report

China's Economic Slowdown: The Property Crisis as a Drag on Growth

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December 2023

Contents

Executive Summary

- China, the world's second-largest economy and the main driver of global growth, has been facing multiple challenges that slowed its economic expansion.
- The pandemic, zero-tolerance policy, property market collapse, debt crisis, demographic decline, and deteriorating relationship with the West are some factors that contributed to China's economic slowdown.
- The slowdown had significant implications on the global economy, trade, investment, and innovation, as well as for China's domestic stability and development goals.
- The property sector, which accounts for about a quarter of China's GDP, has been hit hard by the government's "three red lines" policy, which aimed to contain the high leverage of property developers. This well-meaning policy landed developers — including some of the largest in the country, such as Evergrande — in a liquidity crunch against the backdrop of already-slowing domestic demand.
- The property sector crisis spilled over other sectors of the economy such as the financial, industrial, and consumer sectors. The financial sector faced the risk of contagion and systemic instability, as the property sector accounts for a large share of bank loans, bonds, and shadow banking products. The industrial sector faced the risk of overcapacity and deflation, as the property sector is a major source of demand for steel, cement, and other materials. The consumer sector faced the risk of low confidence and spending, as the property sector is a major component of household wealth and expectations.
- China's zero-tolerance policy toward COVID-19 exacerbated the economic slowdown and property sector crisis, which disrupted the normal functioning of the economy, especially the service sector, leading to unemployment and reduced income growth during the period.
- Recently, the Chinese government pledged that they would focus on strengthening macro policies, alongside its ongoing proactive fiscal policies and prudent monetary action to promote economic recovery in 2024. The plan is to spur local demand, tackle the nation's spiraling real estate crisis, resolve local government debt issues, and attract and channel foreign investments for the development of strategic sectors.
- In this report, the causes for the China's economic slowdown as well as property market crisis and its impact on the markets and different asset classes and the path forward are discussed.

Timeline of economic highlights in China (2013–23)

2013
China accounted for over 10% of global trade to become a trading superpower.

2014
According to data from the IMF, China surpassed the US to become the largest economy in the world on a purchasing power parity basis. The Chinese yuan overtook the Australian and Canadian dollars to enter the top five global payment currencies, with a record-high share of 2.17%

2015
The Chinese market crashed in 2015. The Shanghai exchange plunged almost 40% in one month from record high levels that began from the surge in 2014. The PBOC devalued the yuan three straight times, with the first devaluation being the biggest fall since 1994.

2016
China experienced another stock market crash, which led to its market declining about 18% in the first half of the month. Further, the yuan touched its lowest level since March 2011.

2019
The growth of the economy slid further to 6.1%, its lowest in 30 years. Chinese authorities implemented a slew of growth-promoting policies due to slow demand, amid growing trade pressure from the US.

2020
The Chinese economy, despite experiencing one of its worst economic results due to COVID-19, was one of the best-performing major economies, whereas its counterparts posted an economic contraction.

2021
The economy registered a growth of 8.1%, which was the best in a decade, driven by substantial exports. The property sector, however, started posting sharp contraction.

2022
The economy fell short of its GDP growth target, expanding 3% relative to the expected level of 5.5%. It was one of the poorest economic performances of the nation and a significant decline from the growth rate in the previous period.

2023
China ended its Zero-COVID policy, which boosted economic optimism. However, the nation struggled due to problems in the real estate and the finance sector. The government implemented a series of stimulus measures, which provided marginal relief.

Understanding the causes of the slowdown – (1/3)

The growth of Chinese equity has been more affected by domestic reasons rather than external/global issues. These unfavorable domestic events had a ripple effect on the economic state of the country. Below are some major causes of the slowdown:

Zero-COVID Policy

- An international public health measure that was put into place during the COVID-19 outbreak with China being the last countries to remove the policy in January 2023.
- Its primary goals were to contain and suppress COVID-19 as much as possible and to take all necessary steps to stop the virus from spreading.
- Although the policy was beneficial in halting the virus's spread, it also had unfavorable effects on China's economy, including strained exports, weak retail sales, and disruptions to the supply chain.
- The anticipated post-liftoff economic growth did not appear to materialize because decline in investments and sluggish consumer spending persisted.

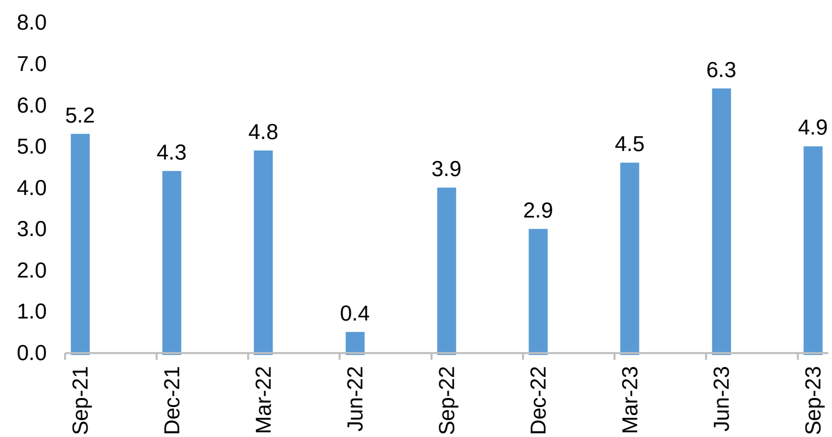
Poor Consumer Spending

- In comparison to other countries, China has historically had some of the lowest household consumption rates as a percentage of GDP. The pandemic slowed consumer spending even further.
- The lifting of the zero-COVID policy was intended to boost household consumption. In the end, this rise in consumer spending would benefit the whole economy.
- Unlike other developed markets, the Chinese did not adopt the "revenge spending" mechanism resulting in the household consumption continuing to be sluggish.
- The bleak household consumption is a consequence of many factors, such as rising unemployment, decreasing industrial production, and deflation.
- With the worsening youth unemployment rate, households are expected to park their savings in time deposits instead of spending on consumption, leading to further deterioration in consumption in coming months.

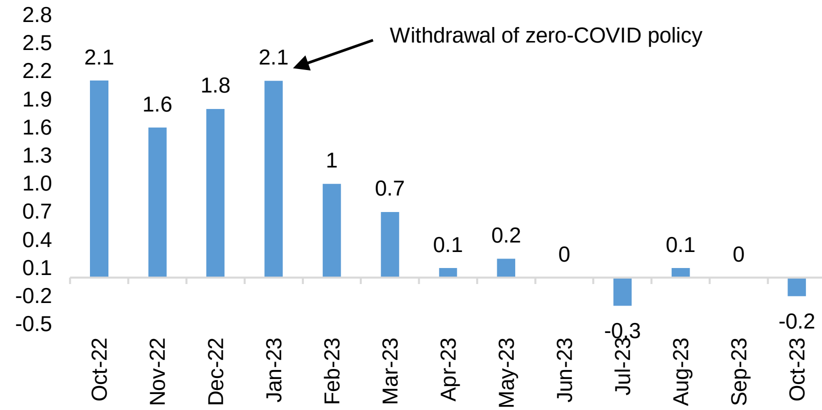
Understanding the causes of the slowdown – (2/3)

Key Parameters Reflecting the Impact Of Zero-COVID Policy and Poor Consumer Spending

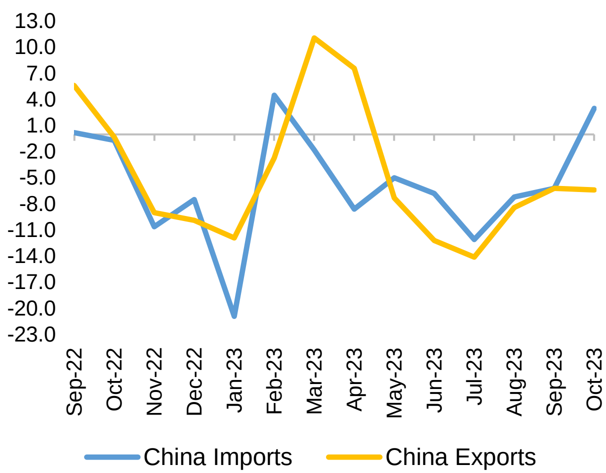
China GDP growth (%)



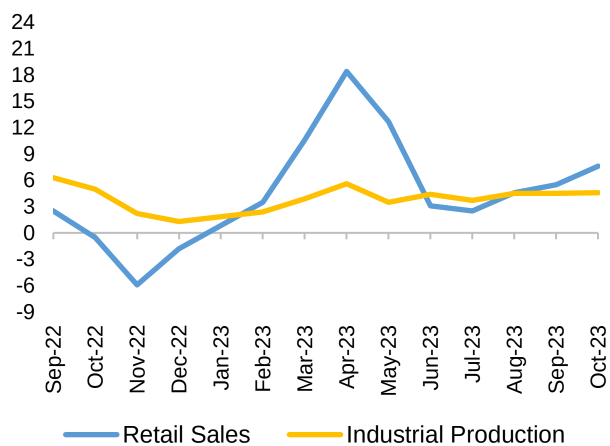
China Inflation Rate



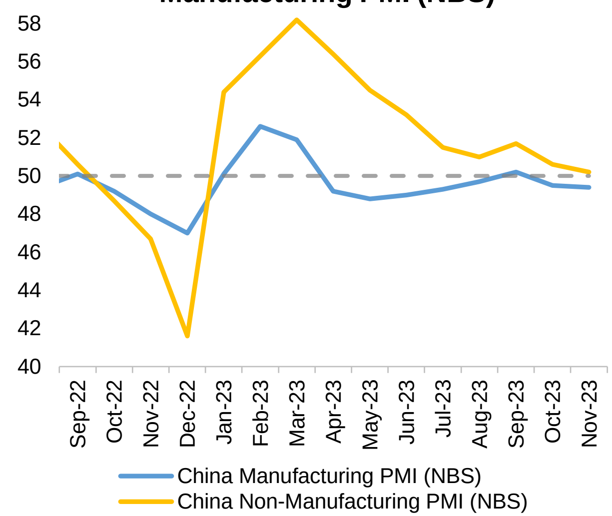
China Imports and Exports



China Retail Sales and Industrial Production



China Manufacturing and Non-Manufacturing PMI (NBS)



Source: *Refinitiv Eikon*

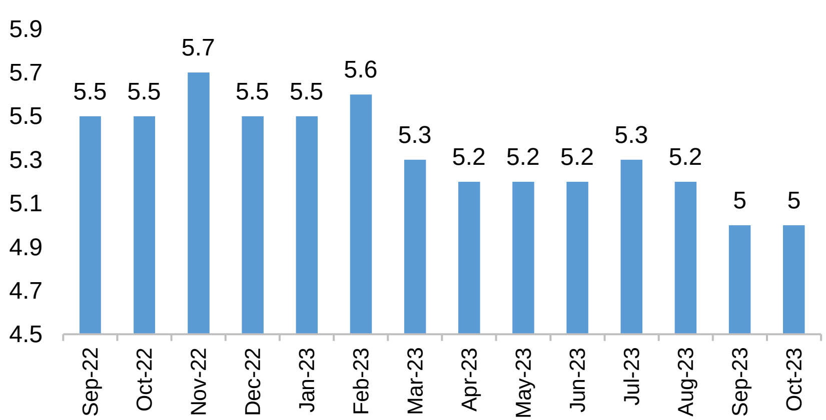
Understanding the causes of the slowdown – (3/3)

Increasing Unemployment Weighs Negatively On The Chinese Economy

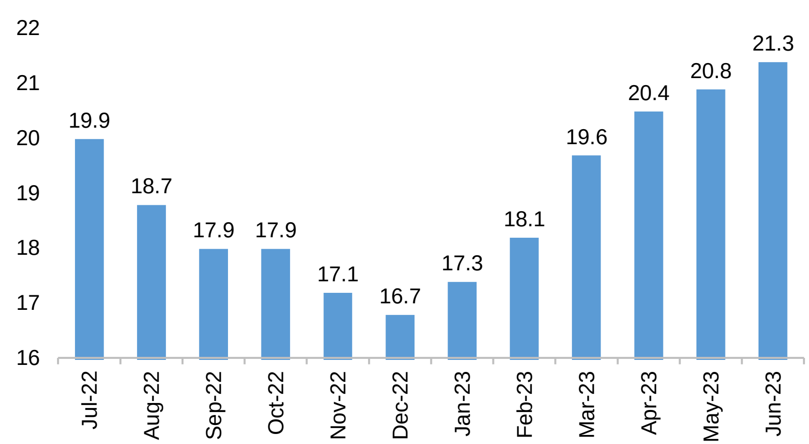
Rising Youth Unemployment

- The youth unemployment rate, which measures the unemployment rate among the population of 16 to 24-year-olds in urban areas, hit 21.3% (record high) in June and has been rising yearly.
- The youth unemployment rate almost doubled in the last four years, including the zero-COVID phase. During this phase, the mobility of the people was close to zero, attributing to one of the primary reasons for unemployment.
- However, various other factors, such as weak global demand, low industrial production and the vast layoffs in the property sector, contributed to the ever-increasing youth unemployment rate.
- The Chinese officials have stopped publicly disclosing the youth unemployment data, citing that the "mechanism to collect data needs to be further improved and optimized."
- The rising youth unemployment is expected to weigh negatively on the Chinese economy.

China Unemployment Rate - Urban Area (%)



China Youth Unemployment Rate (%)



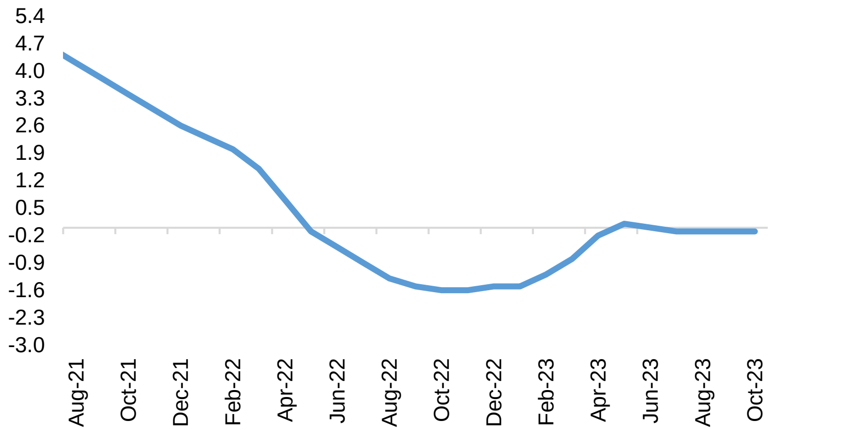
Source: *Refinitiv Eikon*

China property market crisis – (1/4)

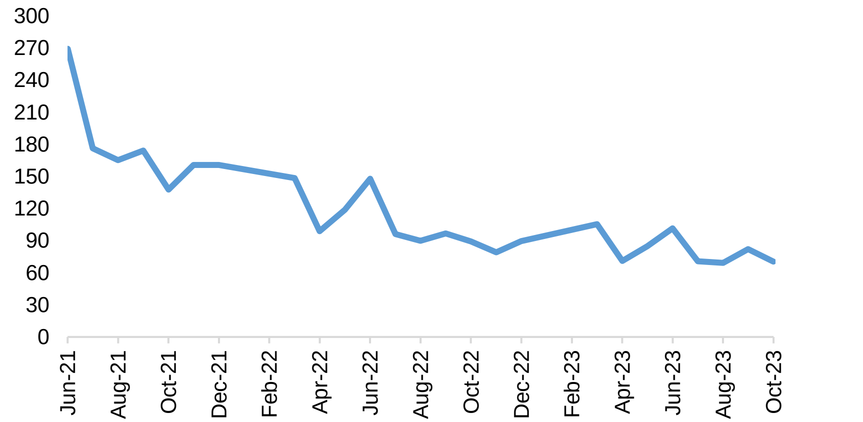
The Boom And Slump Of The Heavily Leveraged Chinese Sector

- Nearly 30% of China's GDP and 80% of household wealth are derived from the real estate industry.
- The Chinese government prioritized infrastructure investment when addressing the immediate problems during the 2007–08 financial crisis, leading to a dependence on the rapidly increasing value of land even though substantial debt was accumulated to finance these ventures.
- To rein in the heavily indebted real estate market, the government introduced the "three red lines" rule in 2020, which marked the beginning of tightening regulations in this area.
- This rule restricted the developers' borrowing and controlled the amount of leverage they used based on three metrics: debt-to-assets, debt-to-equity, and debt-to-cash.
- Due to its high level of leverage in the previous years, this rule had a significant effect on the borrowing of significant real estate developers, including China Evergrande Group, the country's second-largest property developer.
- The Zero-COVID policy further fueled the slump in the property sector, this is one of the major reasons for the slump in the entire Chinese economy.

China House Prices



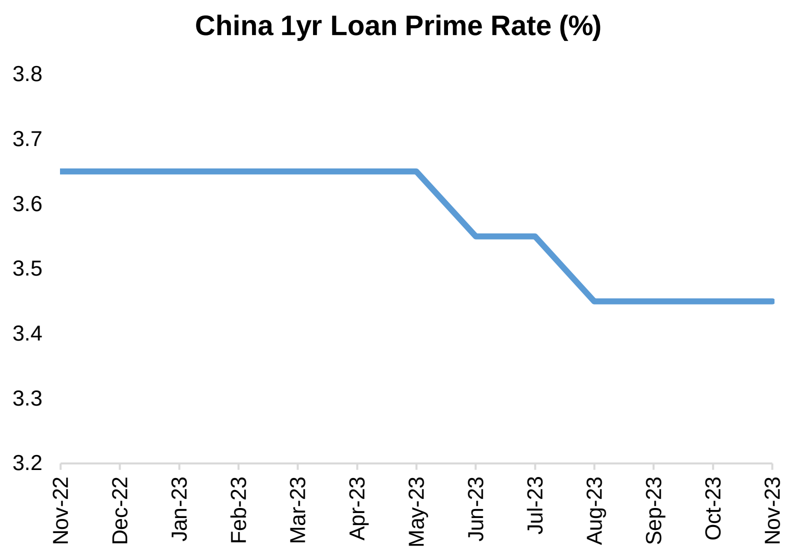
China Property - Floor space of houses newly started

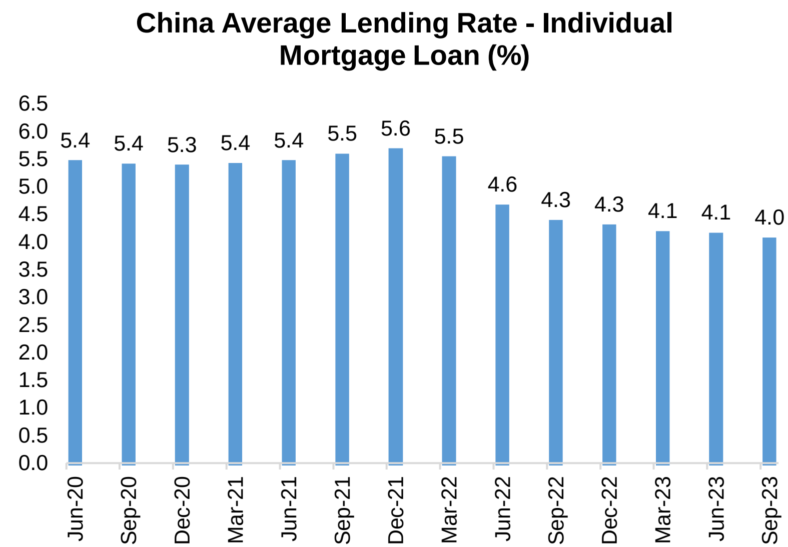


Source: *Refinitiv Eikon, Bloomberg*

China property market crisis – (2/4)

Decreasing Lending Rates to Aid the Slumping Property Sector





- The Chinese government decided to step in to support the sector by promoting banks to raise the financing for the property sector.
- A "whitelist" of 50 developers may be eligible for banks to offer unsecured short-term loans. These include the state-backed China Vanke and the troubled real estate behemoth Country Garden.
- The developers potentially will not have to back the loans with land, property, or other assets, which will aid the companies in the form of additional capital that can be used to repay their debt.
- According to Nomura economists, earlier this month, if authorized, the steps will be the largest implemented by Beijing to address the 3.2 trillion Chinese yuan, or $451 billion, financing shortfall needed to complete approximately 20 million incomplete pre-sold apartments across China.

Source: *Refinitiv Eikon*

China property market crisis – (3/4)

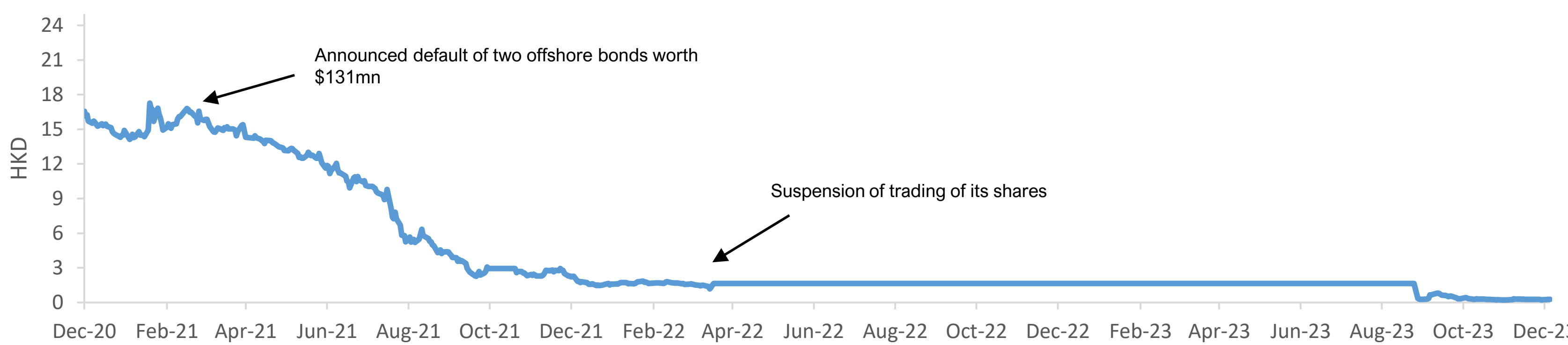
China Evergrande Group – The Face Of The Chinese Property Sector Downfall

Evergrande Group, founded in 1996, has over 1,300 projects in more than 280 cities in China. Owing to government support between the years 2008–20, Evergrande became one of China's biggest companies by borrowing more than $300 billion to fuel its land acquisition and launch newer real estate projects.

In 2021, Evergrande Group announced that it missed two offshore bond coupon payments, adding to $131 million. This default ignited the crisis in the property sector and had effects on the wider economy as well. During the first quarter of 2022, Evergrande revealed the suspension of trading of its shares, citing the inability to publish its audited results before March 31 and an investigation of the property management division in which the banks seized 13.4 billion Yuan deposits.

Since the beginning of 2023, Evergrande has been attempting to implement a government-supervised debt restructuring, standing at $328 billion. It had unveiled a multi-billion-dollar plan to make peace with its international creditors that gives its creditors a basket of options to swap their debt into new bonds and equity-linked instruments backed by the group and its two Hong Kong-based subsidiary companies. In August 2023, the group filed for bankruptcy in New York to protect its US assets while working on the multi-billion-dollar deal with creditors.

China Evergrande Group Share Price



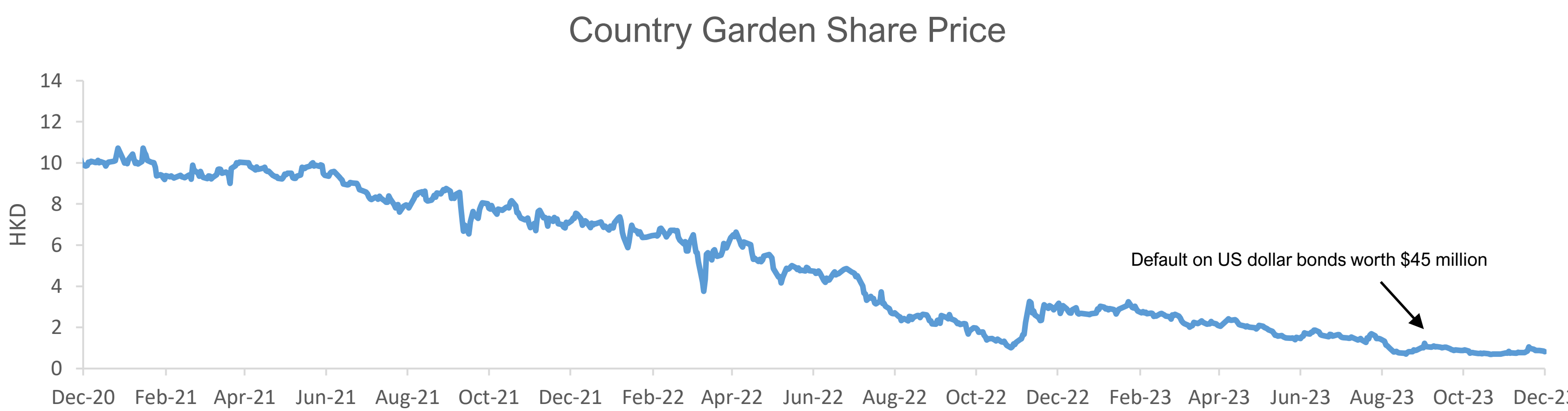
Source: *Refinitiv Eikon; Share Price as on 5-December-2023*

China property market crisis – (4/4)

Country Garden – Another Property Developer Facing Major Debt Troubles

Country Garden was founded in 1992 and is one of the biggest property developers in China. It has, like its peers, been functioning with a similar business model of borrowing more from offshore bonds to fund its land acquisition and begin newer projects. Unlike Evergrande, Country Garden's focus has been to develop properties in tier 2 and tier 3 cities of China and has more than 3,000 projects spread throughout all China's provinces, compared to Evergrande's approximately 800.

During 2020–23, it has been facing a liquidity crisis and has been struggling to pay its offshore debtors, leading to a sharp decline of around 70% in its share price. In August 2023, the company reported defaulting on two US dollar offshore bonds with a cumulative amount of $45 million. During the same period, it announced a 48.9-billion-yuan ($6.68 billion) loss for the first half of the year. Due to the pressure in the housing market, Country Garden is expected to delay upcoming coupon payments and use the grace period to formulate a debt restructuring plan similar to the Evergrande situation.



Source: *Refinitiv Eikon; Share Price as on 5-December-2023*

Impact on various markets and asset classes – (1/8)

Trends In Various Domestic/Global Markets And Asset Classes

- The Chinese economy was expected to drive a third of the global economic growth this year; however, the dramatic slowdown in recent months raised alarms worldwide.
- Global investors have withdrawn close to $10 billion from the Chinese stock market, most of it being blue chips.
- A prolonged slowdown and deflation of the second-largest economy of the world is expected to hurt the global economy as opposed to helping it.
- The sluggish Chinese economy could have a rippling effect across the financial markets.

Equity Markets – The Worst Hit Market With Blurry Signs Of Recovery

Source: *Refinitiv Eikon*

Impact on various markets and asset classes – (2/8)

Equity Market Background And Current Scenario

2020–21

- The Chinese stock market has been in a free fall since the outbreak of COVID-19.
- China's economy recovered in 2021, posting its strongest growth in ten years, majorly due to strong exports. The slow-moving real estate market started to exhibit indications of a much-expected collapse during this time, which ultimately led to the central bank lowering its medium-term lending rates for the first time since 2020.

2021–22

- As the global markets geared up for the re-opening of markets in 2022, the ongoing Zero-COVID policy in China proved to be the dominating factor for its tepid growth.
- With 70% of household wealth tied up in real estate investments, it became difficult for Chinese citizens to invest in stocks. Rising unemployment, bleak consumer spending and declining exports contributed to the decline in the Chinese markets.

2023–till date

- The Shanghai Composite has been trading about 20% below its 2021 highs as the post-pandemic period failed to bring about a sustained recovery in consumer spending or to thaw the nearly frozen real estate market. Conversely, the Hong Kong stock market posted a 45% decline from its peak in 2021.
- Escalating tensions between the US and China add to the selling pressure. FDI in China depreciated to $8 billion USD last year, a level last seen in 2004. The US increased its pressure on venture capital firms and global asset managers regarding their investments in China. President Joe Biden issued an executive order in August that restricted the US investments in China's high-tech industries, resulting in the withdrawal of $42 billion from China's capital and current accounts. The largest net outflow since 2016, when the PBOC abruptly devalued the Yuan and sent the stock market plunging, occurred in September, when about $75 billion left the nation.

Source: *Refinitiv Eikon*

Impact on various markets and asset classes – (3/8)

China Based ETFs Reflecting A Decline In Performance

- Less than 4% of the stocks traded on mainland stock markets are owned by foreign investors. However, in the last ten years, they have been more active, providing funding for Chinese businesses through listings in the US and Hong Kong.
- Many Chinese companies are likely to be oblivious to the loss of foreign capital. Overall, international investors view the US and other emerging markets as high-yielding places to park their money, while China struggles with several issues causing the slowdown.

A Snapshot Of Performance Of The Top 10 China Based ETFs

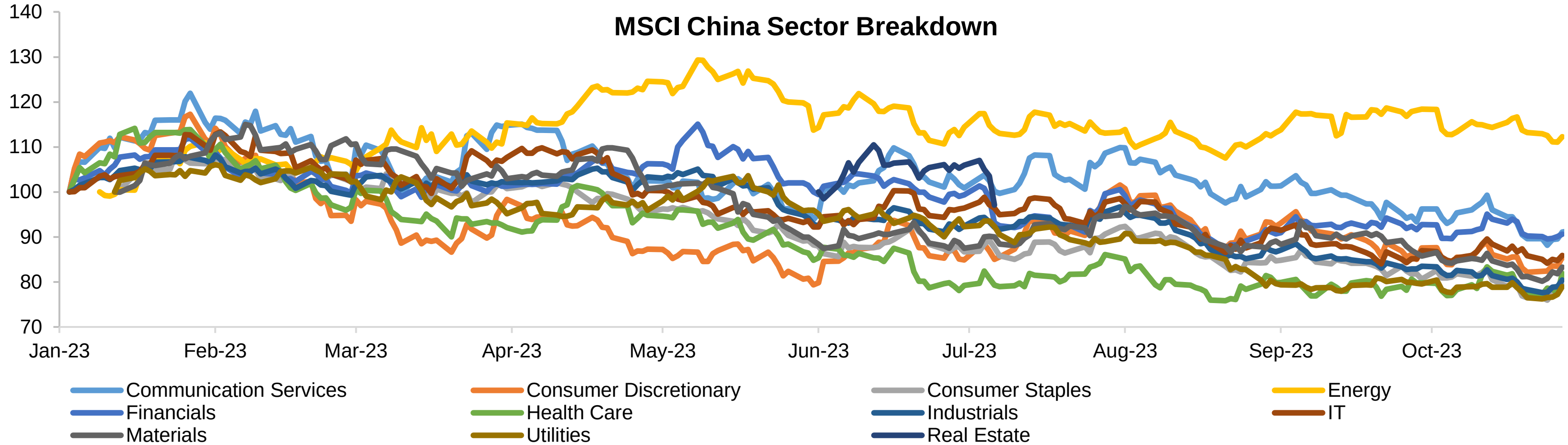
Particulars	AUM (USD mn)	Performance (%)			Number of holdings	NAV (USD)	Currency
		YTD	1Y	3Y			
iShares MSCI China ETF	6,716	-8.35	3.79	-17.75	1000	43.25	USD
KraneShares CSI China Internet ETF	5,837	-7.22	16.80	-26.33	32	28.32	USD
iShares China Large-Cap ETF	4,913	-7.56	5.47	-16.36	51	25.69	USD
Xtrackers Harvest CSI 300 China A-Shares ETF	2,019	-11.03	-5.25	-12.30	289	25.12	USD
SPDR S&P China ETF	822	-8.07	2.64	-16.67	1500	71.69	USD
Invesco China Technology ETF	707	-14.65	1.33	-21.69	152	37.57	USD
Direxion Daily FTSE China Bull 3X Shares	650	-43.22	-20.08	-59.67	2	24.99	USD
WisdomTree China ex-State-Owned Enterprises Fund	561	-15.51	-4.84	-21.62	196	29.30	USD
Direxion Daily CSI China Internet Index Bull 2x Shares	372	-29.29	8.08	-60.59	2	36.26	USD
KraneShares Bosera MSCI China A 50 Connect Index ETF	304	-15.93	20.34	-3.47	51	21.57	USD

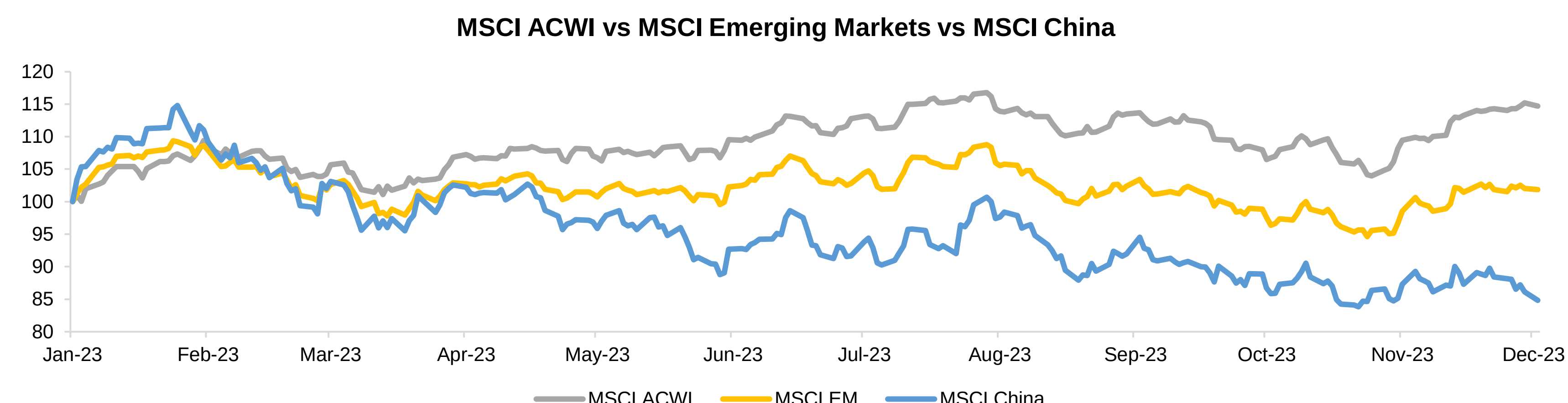
Source: *Refinitiv Eikon, VettaFi website; top 10 ETFs based on the AUM*

Impact on various markets and asset classes – (4/8)

MSCI ACWI And MSCI EM indices performing better than MSCI China Index

- Fund managers with a focus on benchmark index tracking have limited flexibility.
- China makes up nearly 30% of MSCI's Emerging Markets Index, despite its recent underperformance. If index compilers removed a cap that now only accounts for 20% of the free float-adjusted market value of mainland-traded Chinese companies, China's benchmark share would also increase significantly.

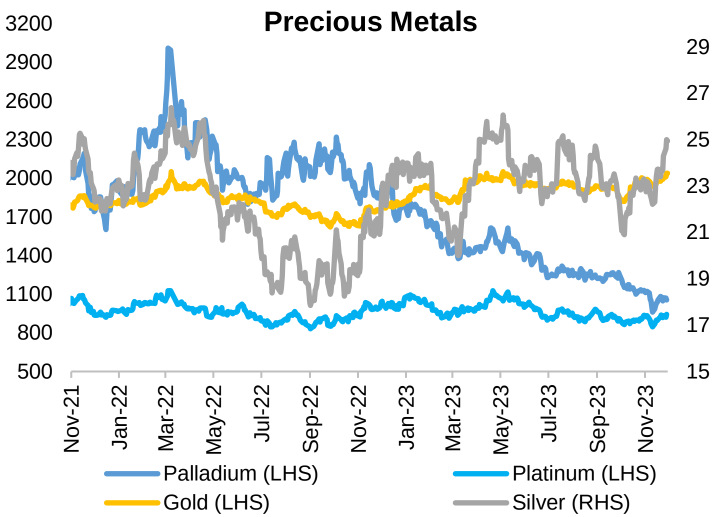


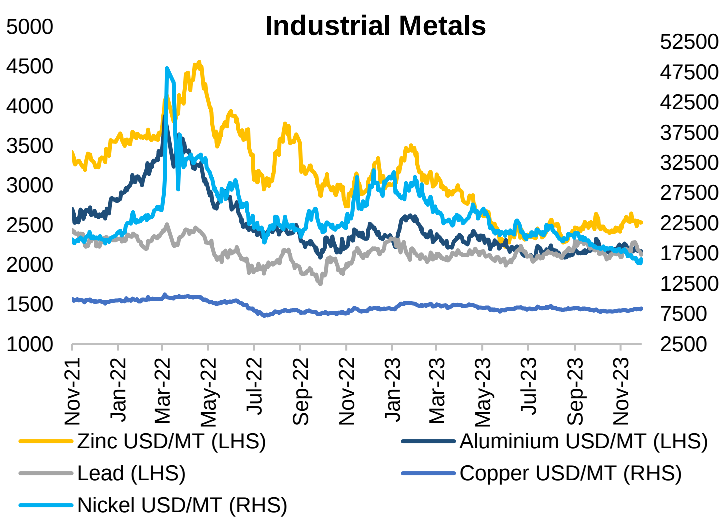


***Source:** Refinitiv Eikon, Values re-based to 100*

Impact on various markets and asset classes – (5/8)

Trends In The Commodity Markets





Commodity	3M (%)	6M (%)	YTD (%)	1Y (%)
Brent Crude	-2.95	7.66	-3.42	-0.07
Natural Gas	9.04	19.77	-37.72	-61.48
Gold	5.25	4.94	11.75	16.52
Silver	0.88	7.56	4.09	19.26
Platinum	-3.88	-8.34	-12.07	-7.59
Palladium	-15.54	-25.20	-41.11	-42.57
Copper	-0.28	3.51	0.27	4.38
Zinc	4.47	10.89	-15.53	-13.99
Lead	-2.16	-2.41	-8.87	0.28
Aluminum	2.11	-3.46	-7.49	-7.31
Nickel	-19.27	-20.74	-44.66	-38.16

- China consumes a similar amount of energy goods to the US and yet a significantly high share of global non-energy commodities (such as metals). This suggested that a shift in the outlook for the Chinese economy could expose firms in commodity-related industries to increasing financing costs, making it difficult for them to secure or roll over debt.

Source: *Refinitiv Eikon, Bloomberg*

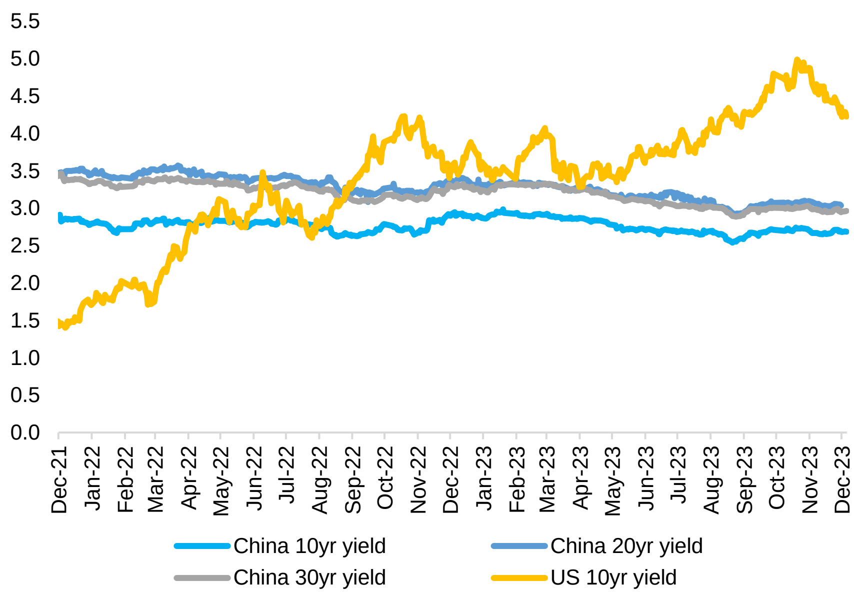
Impact on various markets and asset classes – (6/8)

Trends In The Bond Markets

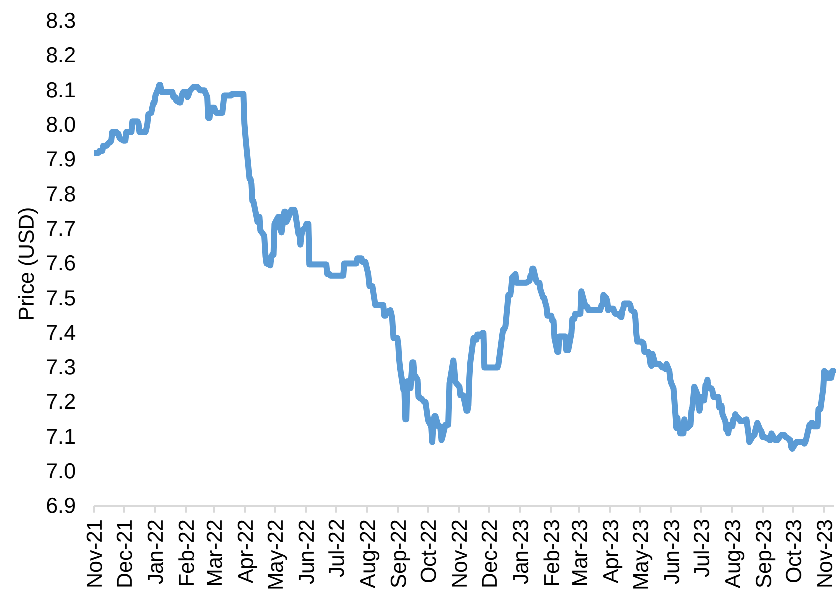
Bond Markets – Other Developed Economy Bond Markets Proving To Be More Lucrative Than China

- Toward the beginning of the year, global investors reduced their holdings of Chinese government bonds, a steady source of secure returns during the pandemic, as they prepared for some monetary tightening in China and focused on stock markets in the reopened economy.
- China's bond market was the outlier in 2022 as global central banks raised rates hurriedly to fight inflation, while policymakers in Beijing faced a sharp COVID-induced slowdown. However, as the economy reopened swiftly, PBOC eventually reined in stimulus.

China Government Bond Yields vs. US Bond Yield (%)



iShares China Government Bond ETF



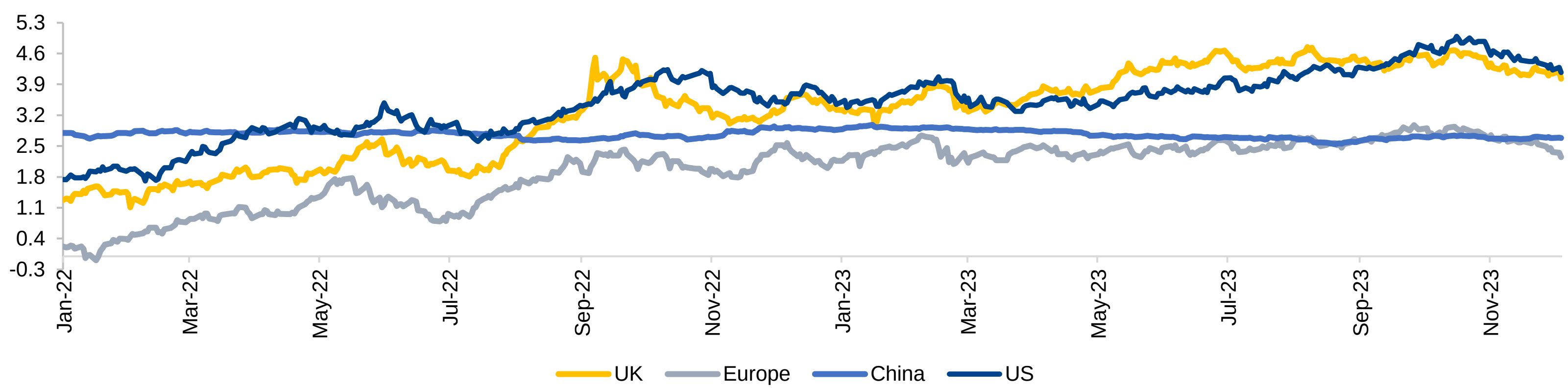
Source: *Refinitiv Eikon*

Impact on various markets and asset classes – (7/8)

Other Developed Economy Bond Markets are Proving to be More Lucrative than Chinese Bonds

- Signs of a peak in developed market rates are another reason why China's bonds, yielding roughly 3% on 10-year investments, are less appealing. In contrast to the global tightening trend, China has been easing monetary policy over the past two years.
- The move away from Chinese onshore bonds by overseas investors was evident in the offshore dollar high-yield bond market, where performance was hit by defaults of property developers during 2022 and a loss of confidence in the sector. As a result, Chinese high-yield dollar credits lost almost 30% in 2022, despite a strong comeback in Q4, helped by the 16-point relief package for the property sector.
- In addition to losing confidence as property bond issuers restructured their debt, the US dollar bond investors feared borrowers would opt to pay back their onshore RMB-denominated debt before their US dollar debt, increasing uncertainty over dollar bond repayments.
- China's top parliament approved a 1 trillion Yuan ($137 billion) in sovereign bond issuance to help rebuild areas hit by this year's floods and improve urban infrastructure to cope with future disasters.
- The proposed increase in bond issuance comes as Beijing prepares to inject a fresh dose of fiscal stimulus to shore up the economic recovery; however, worries that reverting to debt-funded stimulus would undermine the move to a consumer-led economic growth model.

Developed Markets 10yr Yields vs. China 10yr Yield



Source: *Refinitiv Eikon*

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Impact on various markets and asset classes – (8/8)

Diversification of Supply Chains in Other ASEAN Markets

- Due to the various factors that contributed to the slowdown of the Chinese economy, global players could have a diversifying view towards expanding into other ASEAN economies. The promising ASEAN markets could have a positive inflow of funds towards expanding various businesses through drivers such as labor laws, demographics, investment incentives, and infrastructure.
- **Singapore** is considered the best performing on all parameters; however, high costs limit FDI to capital-intensive and high-skilled sectors. Singapore as a region can function well as a place of regional headquarters and innovation centers, instead of capturing a broader fundamental shift of the supply chain from China.
- **Malaysia** has shown great results in all parameters. It is an ideal location for corporates looking for a well-developed market to build manufacturing facilities in a moderately skilled sector and low costs.
- Corporates may also choose **Vietnam**, **Indonesia,** and **Thailand's** large working populations and invest in low- to moderately-skilled manufacturing sectors in the regions. These countries are equipped with strengths that include textiles and electronics for Vietnam, natural resources for Indonesia, and auto manufacturing for Thailand.
- The **Philippines** proves to be a lucrative alternative to China due to its recent liberalization of FDI rules, high English proficiency, and low costs, which could attract investments in the future.
- **India** aspires to rival China as a hub for manufacturing and a major participant in the global supply chain. It has introduced initiatives to support domestic industry, such as the Production Linked Incentive, or PLI. India's "China plus one" policy may benefit if Chinese exports decline.

Conclusion and Current Market Scenario

The Path Forward

- Due to the weakening demand for exports worldwide and the worsening crisis in the property sector, the Chinese economy shrank in the last few months. According to the most recent statistics, the economy expanded 4.9% during the July–September quarter, exceeding estimates of 4.5% growth but falling short of the 6.3% growth in the preceding quarter. The economy grew 5.2% Y/Y for the first nine months of this year, which is in line with its goal of 5% growth for 2023.

- In line with other major economies globally, the Chinese government is taking a new approach and directing the course of action to shift away from depending solely on government-led investment in infrastructure projects and toward a consumer-driven economy. The government is anticipated to increase spending in a traditional manner due to the rising unemployment rate and the poor performance of foreign investments. The International Monetary Fund recently lowered its growth projections for China, putting it at 4.2% in 2024 and about 5% this year. The decline in consumer confidence, the slowdown in global demand, and the real estate crisis were cited as the reasons for the downward trend.

- Rating agencies such as Moody’s recently announced a cut on its outlook on China's government credit ratings to negative from stable, on the back of lower medium-term economic growth and rising debt in the world's second-largest economy. The shift to a negative outlook reflected mounting evidence that China's fiscal, economic, and institutional stability will be seriously jeopardized if authorities are forced to support state companies and local governments that are heavily indebted. It affirmed China's A1 long-term local and foreign-currency issuer ratings, while expecting the country's annual GDP growth to be 4.0% in 2024 and 2025 and slow down to an average of 3.8% from 2026 to 2030.

- At the Central Economic Work Conference, held in Beijing recently, China’s leaders pledged to spur domestic demand, resolve the country’s spiraling real estate crisis, expand high-level foreign investment, diffuse risk related to local government debts, and prioritize the development of strategic sectors. The government also emphasized on strengthening macro policies, while continuing with its proactive fiscal policies and prudent monetary action to support an economic recovery in 2024.

2500+
Global clients

500+
Strong, professional team across multi-disciplinary domains

120+
Sectors and sub-sectors researched by our analysis

80+
Countries where we have delivered projects

ABOUT ARANCA

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Valuation & Financial Advisory
CFOs in Start-ups, PE/VC Firms, Corporate M&A Teams, Mid-market Companies

Technology | IP Research & Advisory
R&D, Tech Scouting, Open Innovation, IP Teams, Product Development

Investment Research & Analytics
Brokerage, Hedge Funds, IRPs, I-Banks, AMCs, Investor Relations

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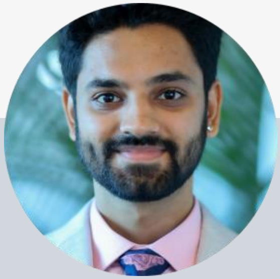

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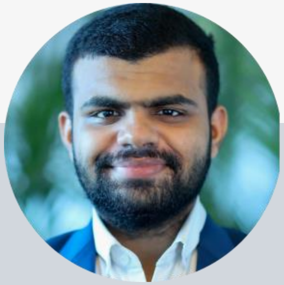

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