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Asia Economics | Asia Pacific

The Viewpoint: The China Upswing

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With the policy stance clearly shifting from over-tightening to easing, we think the cycle is also turning from a mini-downturn to an upswing in China. We are more bullish than consensus and see GDP growth accelerating to 5.5% in 2022.

- Over the years, China has experienced a number of mini-cycles. This year brought another iteration – the economy started the year on a strong footing but has entered a policy-induced downturn.

- Tightening starts out as countercyclical, typically when external demand is strong, but it eventually becomes pro-cyclical, sometimes because external demand conditions deteriorate. Once growth decelerates beyond the policymakers' comfort zone, their priorities shift to stabilising growth and preventing an adverse spillover on the labour market.

- In the current cycle, with the sharp pickup in external demand, policymakers stuck to their playbook and tightened macro policies to slow infrastructure and property spending. But the Delta wave-led restrictions further weighed on consumption growth. Continued policy tightening pushed growth lower than policymakers' comfort zone. Policy tightening was also aggressive, with a 10ppt drop in debt to GDP ratio in 2021, a magnitude not seen since 2003-07. Moreover, the rapid succession of regulatory actions has taken markets by surprise, adding uncertainty. Now, with GDP growth decelerating to just 3.3%Y in 4Q21 (4.9% on a two-year CAGR basis), policymakers have hit pause on deleveraging and began to ease both monetary and fiscal policy a few weeks ago.

- The Central Economic Working Conference (CEWC) confirms policymakers' resolve and increases our confidence in an upswing. Their statement acknowledged that "China's economic development is facing three pressures: demand contraction, supply shock, and weakening expectations," suggesting to us that they recognise the need to revive private business and market sentiment toward China's growth outlook and that policymakers will continue to take action to stem the downturn.

- The key risk to our call in the near term is the Omicron variant. Omicron's greater transmissibility suggests to us that China's Covid-zero policy will be in place for longer and could force China to impose more selective, surgical shutdowns than during the Delta wave.

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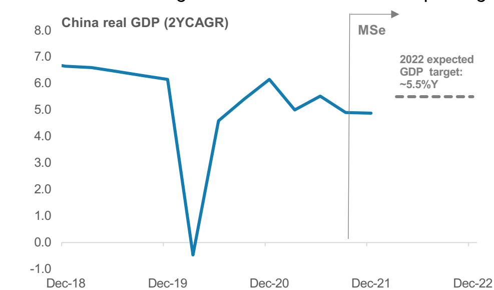
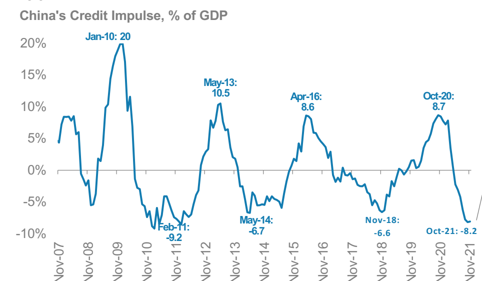
Exhibit 1: China's growth – from downturn to upswing



Source: CEIC, Morgan Stanley Research forecasts

Exhibit 2: Policy easing now underway, credit impulse to rise



Source: CEIC, Morgan Stanley Research forecasts

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The upswing is coming

From downturn to upswing: Over the years, we have seen various mini-cycles in China. Each of them may be different, but they do bear some similarities.

First, the mini-cycles in growth tend to follow the policy cycles, with most downturns starting with some form of macro or regulatory tightening: Policymakers initiate policy tightening in a countercyclical manner at first, but as the tightening continues, it will morph into a pro-cyclical form either because of a turn for the worse in external demand conditions (like the onset of trade tensions in 2H18) or owing to exogenous factors (like the Delta wave of Covid).

Hence, once growth decelerates beyond the policymakers' comfort zone, stabilizing growth and preventing adverse spillover impact on the labour market take over as the top policy priorities. Policymakers will shift their stance – first, pausing on tightening and then moving into easing mode.

In this cycle, policy makers took up aggressive deleveraging, bringing down the ratio of debt to GDP by 10 percentage points in 2021. Though this tightening was initially in a countercyclical fashion, the pace of tightening proved to be too aggressive, considering that the recovery in consumption growth was curtailed because of the Delta wave and China's continued Covid-zero approach, which kept consumption below trend.

With growth decelerating to just 3.3%Y in 4Q21 (and 4.9% on a two-year CAGR basis), policymakers have already hit pause on their deleveraging efforts and have started to ease both monetary and fiscal policies a few weeks back. This easing stance was reaffirmed by the recent CEWC statement (for the key takeaways, please see China Economics: CEWC: An Unequivocal Pro-Growth Stance, December 10 by our chief economist for China, Robin Xing), in which policymakers acknowledge that "China's economic development is facing three pressures: demand contraction, supply shock and weakening expectations."

Second, investors' concerns tend to intensify as the growth headwinds build: As growth slows, they believe that other structural issues like elevated debt will come to the fore again, raising their assessment of the macro risk premium. In fact, this was precisely what happened before in 2015, especially during the RMB regime shift.

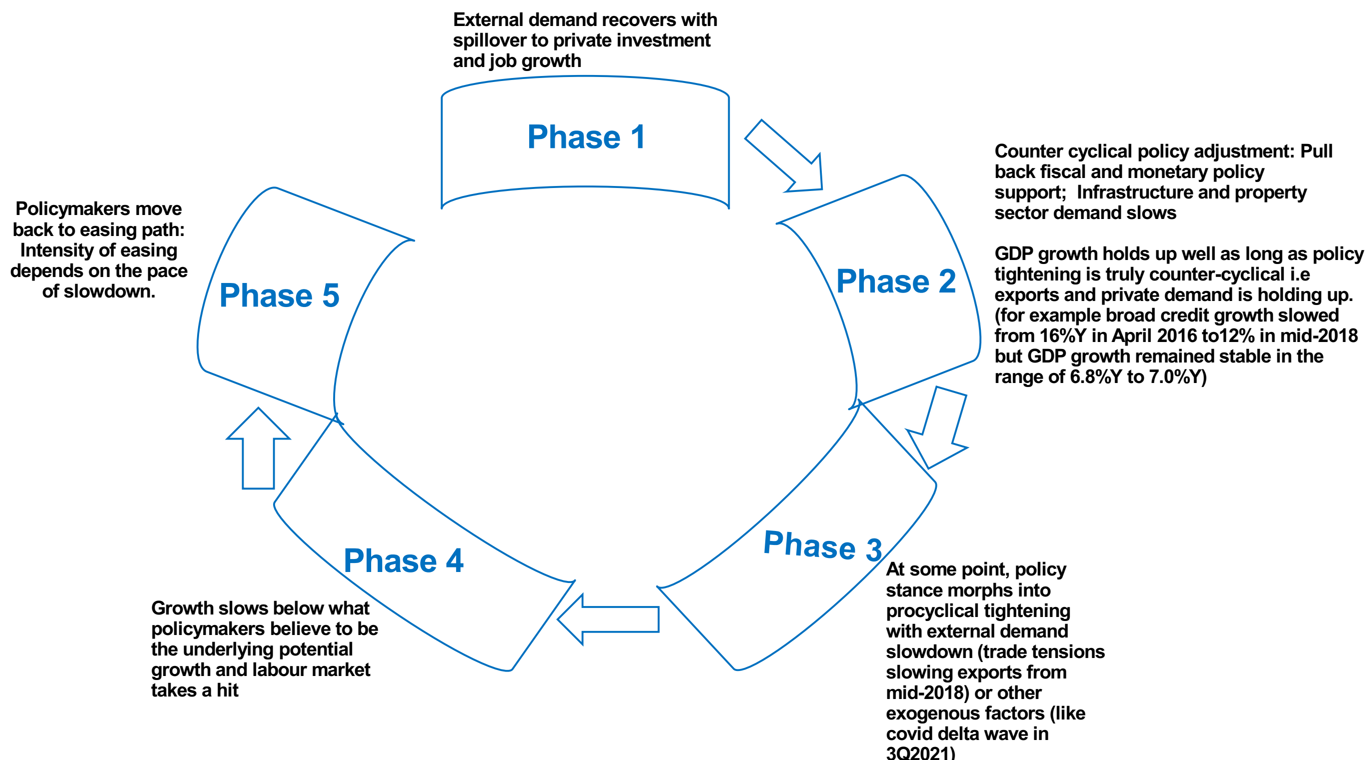
This time around, to pile on the existing concerns about elevated levels of debt and the overhang of a property slowdown, policymakers also implemented intensive, non-leverage-related policy measures with their wide range of regulatory tightening measures. There is an added element of uncertainty because regulatory actions have been taken up in quick succession, surprising the market. In truth, this regulatory tightening cycle lasted for a bit longer than was expected, which in turn has kept market concerns on the boil for longer.

However, this too is changing at the margin. Policymakers are taking a more structured and institutionalized approach and the changes from here on are likely to be more incremental. More broadly, policymakers in their CEWC statement also made clear that

while they want to share the pie more equally, there is still a need to increase the size of the pie. In our view, this should alleviate concerns over potential further actions that would weigh on private corporate sentiment.

Taking these two factors together, we have greater confidence in our call that we will see a growth upswing in China from early 2022. Robin Xing is projecting growth to accelerate to 5.5% in 2022.

Exhibit 3: China's typical policy cycle



Source: Morgan Stanley Research

Four reasons to expect an upswing in China in 2022

Just as a confluence of factors caused growth to slow in 2H21, we think four factors will drive the upswing in China's growth from early 2022.

1) Credit impulse to rise

From overtightening… Since late 2020, we have seen yet another iteration of China's countercyclical growth model at work. Exports growth have been strong and China has in fact gained market share in global exports since the pandemic hit.

Against this backdrop, policymakers have embarked on countercyclical tightening, like they always have. The debt to GDP ratio has been brought down by 10ppt in 2021, the most since 2005. These deleveraging efforts have meant that property investment was slowing, as was infrastructure investment, while manufacturing capex did not pick up meaningfully until recently. Moreover, Covid challenges meant that restrictions have been tightened from time to time, constraining private consumption, which remains below its pre-Covid path.

We think this tightening was somewhat overdone, considering that policymakers were also implementing a lot of non-leverage-related tightening, which also weighed on growth.

More importantly, this tightening turned more aggressive in 2H21 and in some ways morphed into a pro-cyclical tightening.

…to easing: However, over the last few weeks, we have seen first a pause in tightening efforts and then easing in monetary and fiscal policy.

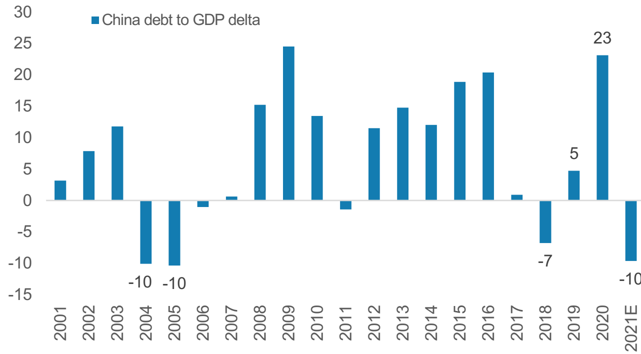
- On monetary policy, we have already had two rounds of RRR cuts (each 50bps), coupled with window guidance to banks to allocate credit to SMEs, renewables, mortgages, and developer loans.
- On fiscal policy, there has already been an acceleration in local government bond issuances, which have averaged RMB491bn per month (1.7% of GDP) from July to November 2021 vs. RMB169bn per month (0.6% of GDP) in 1H21.

CEWC reaffirms the easing path: In our view, the recent statement from the CEWC reaffirms that China is now clearly on an easing path. Our chief economist for China, Robin Xing, notes that policymakers have set stabilizing growth as the top priority for next year.

Specifically, we highlight that policymakers acknowledged that "China's economic development is facing three pressures: demand contraction, supply shock and weakening expectations." The acknowledgement of weakening expectations is key, in our

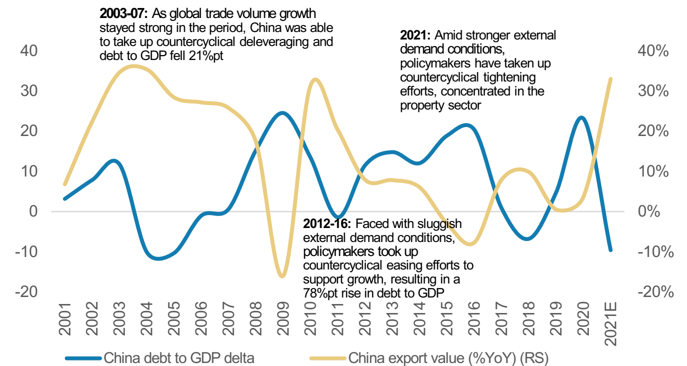
view – it indicates that policymakers recognise the need to revive private business and market sentiment toward China's growth outlook. Among other measures, policy makers are prioritizing investment in areas like pollution alleviation, carbon emission reduction, new energies, new technologies, and new industrial clusters. Credit growth had already bottomed and we expect broad credit growth to rise to 11.5%Y by mid-2022.

Exhibit 4: China has undergone aggressive deleveraging this year...



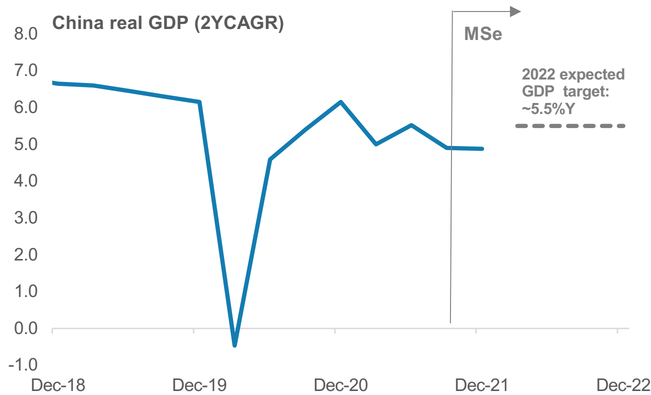
Source: CEIC, Morgan Stanley Research forecasts

Exhibit 5: ...amid strong external demand as part of its countercyclical growth model...



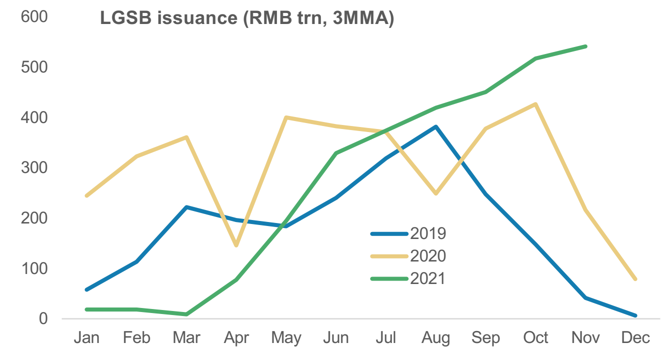
Source: CEIC, Morgan Stanley Research estimates; 2021 export data as Nov-21 YTD data.

Exhibit 6: ...resulting in growth slipping below target...



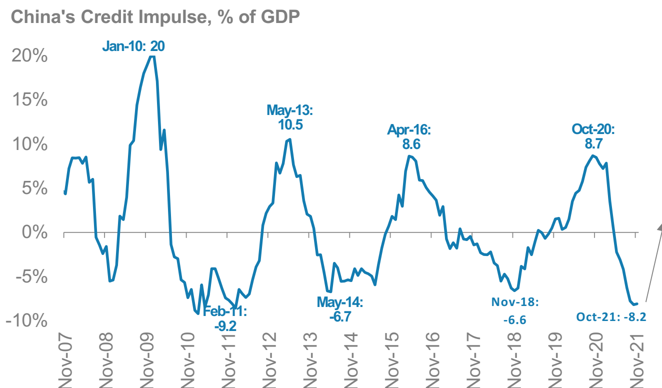
Source: WIND, Morgan Stanley Research

Exhibit 7: ...but fiscal easing...



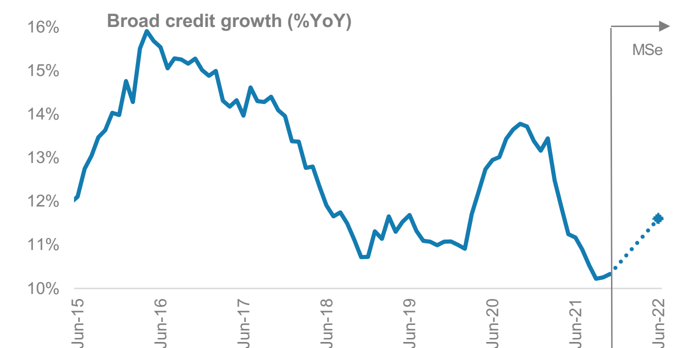
Source: WIND, Morgan Stanley Research

Exhibit 8: ...as well as monetary easing...



Source: CEIC, Morgan Stanley Research forecasts

Exhibit 9: ...is already underway



Source: CEIC, Morgan Stanley Research forecasts

2) Property sector – from disruptive to gradual adjustment

The property sector has faced a multitude of challenges: The property sector has faced multiple headwinds in 2H21, including sharp slowdown in property sales growth amid depleted 2021 mortgage loan quotas, leverage curbs on developers via the "three red lines" regulations and tighter funding conditions from policy measures, and also risk-aversion as high default risks in the sector were priced in.

Pace of adjustment has been disruptive so far: The economy had to adjust in the medium term to slower activity in real estate to reduce financial stability risks as well as reduce the reliance on real estate-driven growth. Yet the current pace of slowdown has been aggressive and disruptive, even in the context of financial stability. At the same time, property purchases from households have been curtailed and the property sector is facing funding pressures from all sides.

We agree that an adjustment is required to reduce the reliance on real estate as a growth driver and to reduce financial stability risks arising from excessive leverage. However, we see scope for this adjustment to take place at a more managed pace rather than the disruptive pace in recent months.

But a recalibration of the policy stance is now well underway: In response to these challenges, policymakers have taken up incrementally more property sector easing actions in the past two months.

On the mortgage front: Banks have been guided to increase mortgage loans and lower lending rates, while select cities have also taken up measures to stabilize the housing market, such as relaxing property purchase restrictions. Reflecting this, November new medium- to long-term household loans (the bulk of which consists of mortgage loans) picked up to RMB582bn from RMB422bn, and much higher than the 2015-19 November average of RMB445bn. New residential mortgage loans also picked up to RMB401bn, vs. RMB247bn in September 2021. The release of new mortgage quotas from January 2022 can provide some support. Indeed, the seasonal pattern suggests that mortgage loan tends to pick up strongly in the first quarter on QoQ basis.

On containing spillovers from property developers' default: Policymakers' quick reaction in the last few weeks with regard to Evergrande's default confirms our view that the default processes will be carried out in an orderly fashion. Indeed, the PBoC, CBIRC, CSRC, and Guangdong provincial government were swift to announce plans to initiate a managed debt restructuring process by organizing a government task force to step in and pledging to protect property buyers' interest.

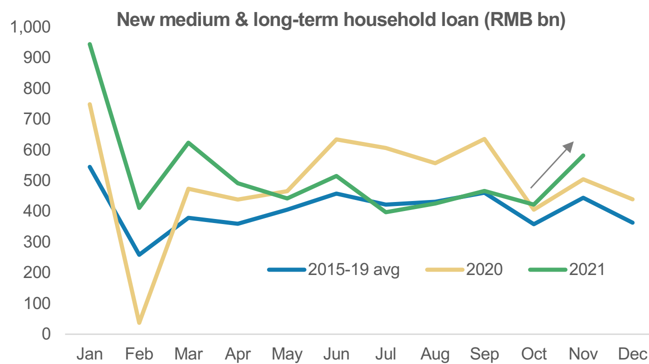
In recent weeks, policymakers have also taken steps to ensure that developers funding needs are being met to ease the liquidity crunch. This includes urging banks to ramp up development loans and lifting onshore bonds and ABS issuance restrictions. Meanwhile, select cities such as Chengdu have eased restrictions on developers access to pre-sales proceeds, an important funding source.

In terms of dealing with potential delinquencies, the banking system starts with limited exposure to the property sector, and because non-performing loans and credit costs sit at low levels overall, it should be able to handle any rise in delinquencies in the property and construction sectors.

Politburo meeting and CEWC confirm more easing is to come: Importantly, the Politburo meeting on December 6 affirmed – and the CEWC statement subsequently reaffirmed – that the policy stance has decisively shifted to one of growth stability and housing sector easing, by pledging to accelerate affordable housing construction, as well as better meeting reasonable demand of home buyers. The CBIRC had also previously stated its intention to support both first-home demand and housing upgrade demand.

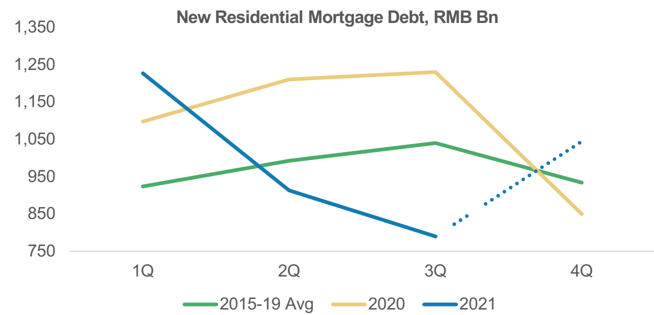
In this context, the worst of property sector overhang is likely behind, as a transition takes place from a phase of disruptive to gradual adjustment. Our property sector analyst, Elly Chen, expects sales to stabilize and resume a positive YoY growth trend in 2H22.

Exhibit 10: Medium- to long-term household loans have picked up more than seasonal pattern



Source: PBoC, Morgan Stanley Research

Exhibit 11: Mortgage lending to inflect amid policy easing



Source: CEIC, Morgan Stanley Research

3) Energy intensity and consumption targets – less onerous in 2022

Difficulties in meeting energy intensity and consumption targets in 2021: From late September 2021, a shortage of coal has affected electricity production and production in energyintensive sectors. Despite the slowdown in 2H21, GDP is still set to grow at 7.8% in 2021 vs. 5.5-6% at trend pre-Covid. What's more, with the GDP growth mix in 2021 being heavily skewed towards the industrial sector, sticking to the energy intensity and consumption reduction targets turned out to be too aggressive too against this backdrop.

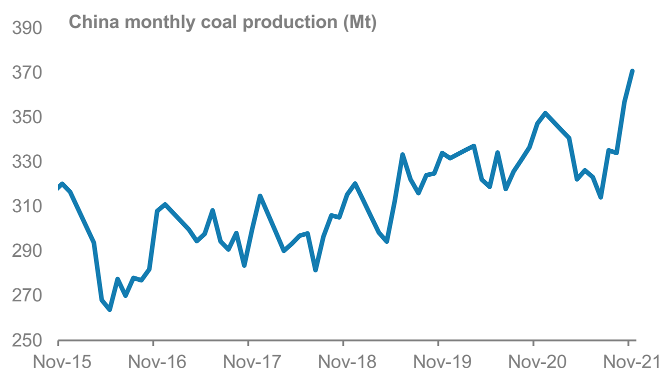
Coal shortages have eased: However, once the issue of coal shortages surfaced, policymakers have intervened quickly and effectively. We have already seen a quick turnaround in coal production and availability, with mines being restarted and electricity producers being allowed to raise prices to cover the rising input costs. Coal production has already bounced back at an average of 5.4%M in October-November. Coal inventory levels at independent power plants have already risen 10% from trough levels.

Nonetheless, despite this swift resolution, the production cuts did result in a growth impact of 20-30bps for 4Q21, as our economics team for China estimates.

A reset of energy intensity targets and shifting growth mix will help: As we move into 2022, we see a number of factors which will help reduce the headwinds.

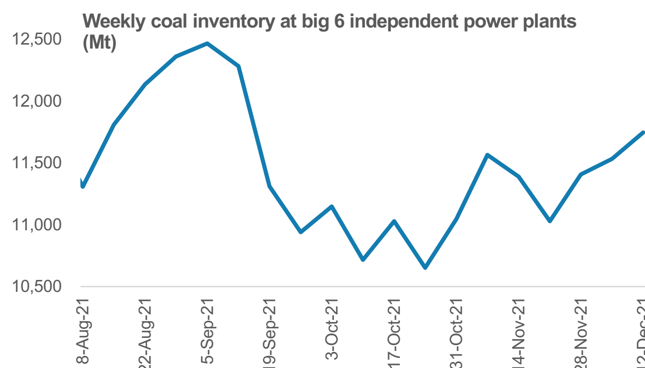
1. There will be a reset in the energy intensity and consumption targets as we head into a new year.
2. The growth mix in 2022 is expected to shift more into services, which are less energy-intensive, providing a natural mitigating factor.
3. Finally, in the CEWC last week, China has announced a shift in its decarbonization campaign, opting for an "investment before de-investment" framework. This means that investment and capacity in alternative energy sources will be ramped up first, before transitioning away from traditional sources, implying that the spectre of energy shortages will diminish.

Exhibit 12: Domestic coal production has now picked up strongly since October



Source: CEIC, Morgan Stanley Research

Exhibit 13: Coal nventory levels at independent power plants have improved



Source: CCTD, Morgan Stanley Research

4) Exports and private capex strength sustained into 2022

Exports and private capex have been strong: External demand has been a key driver in China's post-Covid recovery so far. Exports are recovering at the fastest pace as compared to the last three cycles. Indeed, China's Covid-zero strategy has prevented production disruptions and led to a rise in its global export market share since the pandemic. The sustained strength in exports has now translated into stronger manufacturing capex, with November manufacturing FAI two-year CAGR accelerating to the strongest pace since December 2017. We believe that the manufacturing capex was slow to pick up initially because capacity utilization ratios were still relatively low and companies were not confident that exports strength could be sustained. While investors remain skeptical regarding the sustainability of this strength in external demand and private sector capex, we think that both drivers will continue to provide growth support into 2022.

Similar to the 2003-07 cycle, a favourable global growth backdrop should drive strong trade growth: In this cycle, our global economics team expects global growth to average an above-trend 4.3%Y in 2022-23. Above-trend growth should in turn sustain global trade growth at a pace closer to the 5.9% CAGR it posted during 2001-07, vs. just 1.2% it posted on a CAGR basis over 2008-2019.

Red-hot global capex cycle and inventory restocking to offset DM consumer spending shift to services, global market share normalization: Investors are concerned about two things:

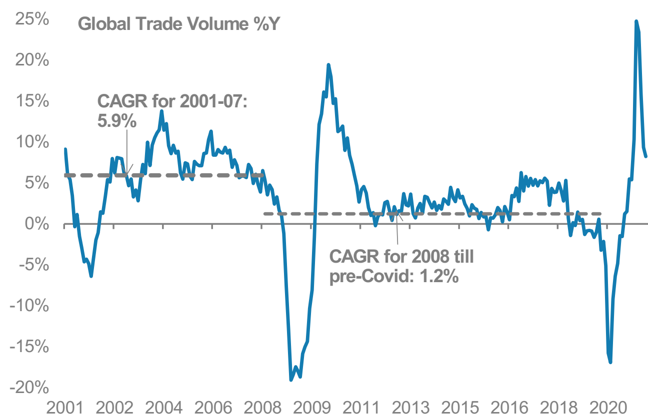
1. Moderating consumer good exports amid a shift in DM consumer spending from goods to services, and
2. China giving back global export share as supply chain and production bottlenecks in the rest of the world normalize.

However, we think that the red-hot global capex cycle, which has already lifted China's capital goods exports to a 26% two-year CAGR in Nove,ber 2021 (vs. 2015-19 CAGR of 1%), will provide key support to China's export momentum.

Moreover, with capital good exports accounting for 35% of China's overall exports vs. 40% for consumer good exports, continued strength in the former would help offset any slowing in consumer goods exports.

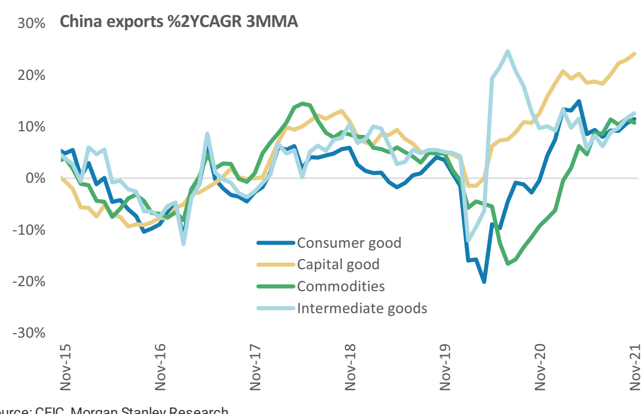
Besides, with US retail inventory to sales ratio still at a record low level, the need to replenish inventories over the next 6-9 months would likely put a floor under China's consumer goods exports, even as underlying consumer spending on goods slows.

Exhibit 14: Favourable global growth and trade backdrop...



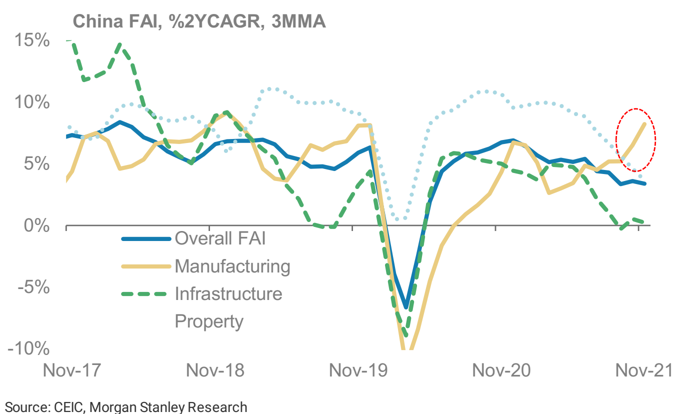
Source: CEIC, Morgan Stanley Research

Exhibit 15: ...has lifted China's exports, especially in capital goods...



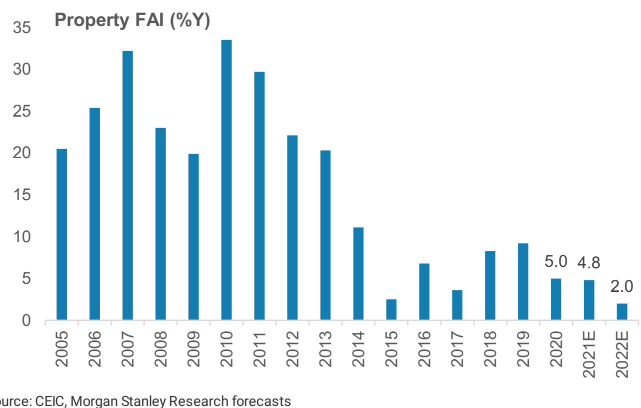
Source: CEIC, Morgan Stanley Research

Exhibit 16: ...with spillover into manufacturing capex



Source: CEIC, Morgan Stanley Research

Exhibit 17: Property capex growth to stay on gradual adjustment path



Source: CEIC, Morgan Stanley Research forecasts

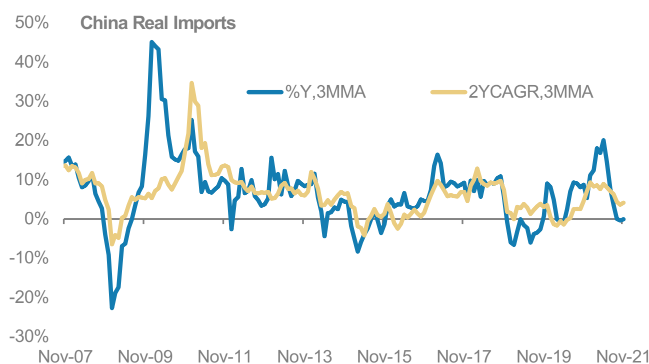
Potential downside risks from Omicron

Consumption on a gradual recovery path: We are expecting consumption to improve only at a gradual pace and more so from 2H22. The sustained strength in exports and manufacturing capex as well as policy support driving infrastructure capex should together support industrial sector employment and wage growth, which should spill over to consumption.

Higher transmissibility of Omicron variant raises the risks of selective shutdowns in the near term: In the near term there could be downside risks arising from the Omicron variant. The Covid-zero approach has kept infections low. Policymakers have also improved the effectiveness of the containment and tracing capabilities over time in a way that each successive wave of outbreaks has had a smaller impact on mobility and hence growth.

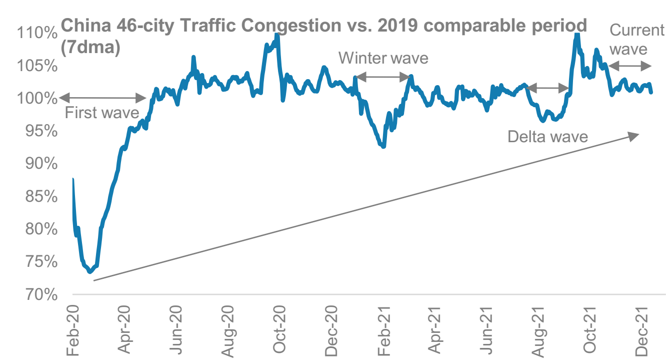
However, the much more transmissible nature of Omicron does suggest to us that this will keep China's Covid-zero strategy in place for longer. It will also bring the risks that China has to take more selective, surgical shutdowns than during the Delta wave.

Exhibit 18: China's real import growth has been soft, reflecting softer domestic demand amid constrained consumption recovery



Source: CEIC, Morgan Stanley Research. Note: Nov-21 growth rates are MS estimates

Exhibit 19: Impact on mobility has been smaller with each successive Covid wave



Source: WIND, Morgan Stanley Research

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