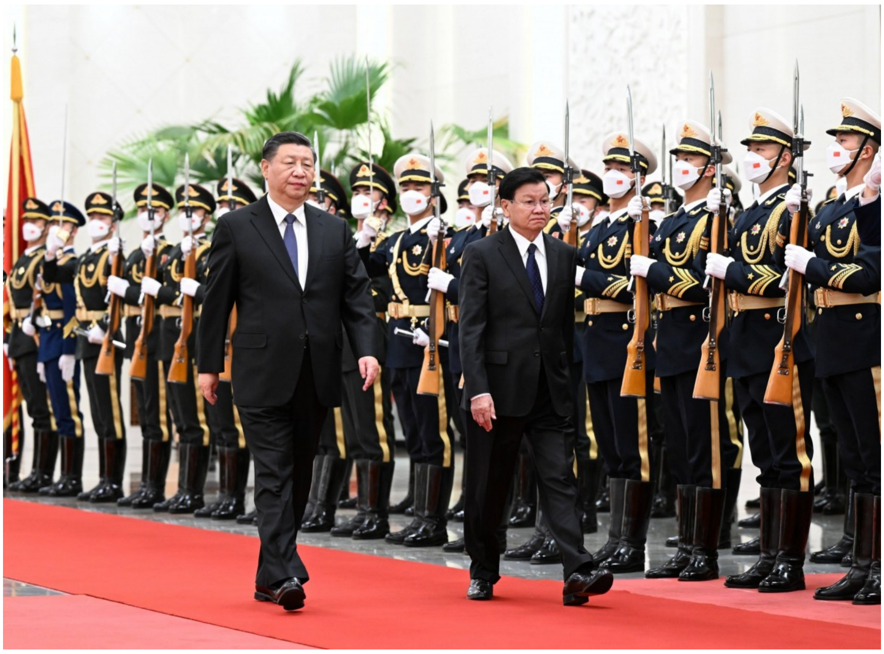
Our 3 calls for China

The outlook for China's economy next year will depend on when Covid measures are eased and international borders are reopened. Recession in the US and Europe are additional hurdles, while fiscal spending could provide some support



Xi Jinping, general secretary of the Communist Party of China - 30 November 2022

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1 Covid measures will ease only gradually in the first half of 2023

There are likely downside risks associated with the higher number of Covid cases, which have become more widespread across the country in the fourth quarter. We expect this pattern to continue at least until the first quarter of next year. Even with the relaxation of Covid measures, the high number of cases will affect both retail and production adversely as residents will likely be cautious about going to crowded places early on.

The timing of a further relaxation of Covid measures is important to the forecasts. We expect the government to gradually shift the focus away from the number of cases in order to avoid a further economic slump. A significant easing of Covid measures could happen in the second half of the year after gradual, piecemeal measures in the first quarter. A full reopening may only happen when the government is confident that Covid cases will no longer put pressure on the hospital system. This is more likely to be an event for 2024 than 2023. The economy should see faster growth in 2024 and 2025 when China reopens, construction of unfinished homes has been completed, and external demand recovers slightly.

2 External demand will be weaker in 2023 due to recession in the US and Europe

The US and Europe have been the number two and three export destinations for China. Though not a new stress to the economy, external demand should deteriorate as the US and Europe are likely to be in recession in the first half of next year. According to our forecasts, the timing of the recession will not overlap with the peak export season of the fourth quarter. But whether export demand can recover after the recession is still in question.

China's trade with ASEAN - which is the number one export destination for China - and the rest of Asia also depends on the consumer market in the US and Europe. As such, both exports and imports should see an annual contraction in the first half of 2023. As China recovers, and the US and Europe emerge from recession around the second half of the year, China's trade should show some momentum. Import growth should be stronger than exports as the economy rebounds from easier Covid measures in the second half.

3 Challenge of technology advancement means record high fiscal deficit

The US CHIPS Act has imposed bans on semiconductors and other items being shipped to China. This has pushed the Chinese government to invest in its own technological advancement. Together with the private sector, China is going to increase spending on R&D to develop high tech, especially in the area of semiconductor chip design and manufacturing. It will then move further into producing its own semiconductor machinery. This should be a long journey and it could be difficult to beat the ever-moving advancement of technology.

The level of difficulty here implies that the Chinese government will need to support this R&D process. Up to October 2022, the fiscal deficit to GDP had been around 7%, which was higher than the historic high (data goes back to Dec 1995) of 6.2% in 4Q20. The fiscal deficit to GDP should increase to 8% in 2023 even if there is less spending on Covid tests and quarantines, with about one-third of this money going to support high-tech development. Overall government debt, including local government financial vehicles, should increase to 137% of GDP in 2023 from 129% in 2022.

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