Prospects

Aperiodic – n°24/020 – 25 January 2024

CHINA – Will the Wood Dragon overcome deflation?

Last week brought two important statistics from China: 2023 growth, which came in at 5.2%, just above the official 5% target; and, above all, the latest population numbers. China's population declined by 2 million in 2023.

2023: the scars of Covid are not the whole story

After a 2022 marked by lockdowns and public health restrictions, 2023 was expected to be a year of recovery. Following a very strong first quarter, with consumer spending picking up during the Lunar New Year holiday, **the momentum quickly ebbed away**. Household savings habits adopted between 2020 and 2022 persisted, now motivated not by concerns over health but by worries about the real estate sector, which remained in the grip of a mounting crisis throughout the year.

The real estate sector as a whole accounted for as much as 25% of China's economy. However, key indicators for the sector (building permits, housing starts and home sales) have shown no growth since January 2022. While efforts to restructure offshore debt – most of it in US dollars – have moved forward, with investors agreeing to take their losses on the chin, progress on the domestic front has been much slower. The authorities still aim to save those projects that are salvageable. However, with 50% of developers in default, buyers are hard to find and construction is only resuming in dribs and drabs.

Despite efforts by the authorities to limit price falls so as not to create a panic among Chinese households, 70% of whose assets are invested in real estate, prices have come down by 10-15%, and sometimes more in medium-sized and outlying cities.

For the time being, **the crisis of confidence triggered first by the zero-Covid strategy** and subsequently by the real estate turmoil appears difficult to stamp out. On top of this, there are doubts over the health of the labour market, particularly when it comes to young people. The National Bureau of Statistics of China last month released jobless figures for 16-25-year-olds for the first time since June. These numbers indicate that 14.9% of this age group is now unemployed, down from 21% at the last known data point; to give a "more accurate" picture of the state of the labour market, they no longer include young people looking for part-time work.

Against this backdrop, **China's inflation – or rather deflation** – figures are worrying but not surprising. Deflation is being driven by weak demand across the board and falling property prices. Year-on-year inflation has not exceeded 1% at any time since February 2022 and has even fallen to zero or below since June. While the rest of the world continues to wrestle with what is seen as excessive inflation, deflation is not good news either: it delays investment and consumption decisions by prompting economic agents to adopt a wait-and-see attitude, generally leading to recession.

Lastly, **the scars of Covid are also reflected in population numbers**. Last year there were 690,000 more deaths than in 2022, for a total of 11.1 million deaths. This high mortality rate is undoubtedly partly down to the epidemic, which is known to have peaked in early 2023. With 9 million births, 500,000 fewer than in 2022, the population declined for the second year running, even as India's

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population continues to grow. Perhaps the Year of the Dragon, which begins on 10 February, will see a surge in births?

2024: will the Year of the Dragon keep its promises?

Such is the symbolic power of the Year of the Dragon – which comes around every 12 years – **as a portent of success and prosperity in China** that its self-fulfilling nature should not be underestimated. Combined with wood, it is said to bring growth, creativity and revival.

An early indication of growth will come in March when the official target is announced, expected to be between 4.5% (under a conservative view) and 5% (if a more optimistic view is adopted in an effort to rekindle the flame of confidence).

The picture is likely to be more complicated when it comes to creativity. The Chinese authorities appear to be still locked into economic policies which, while they may have proved their worth in the past, are no longer fit for purpose. They still do not believe in a consumer-led recovery and, since the real estate sector cannot support the economy as it has in the past, they are now prioritising industry – in particular the automotive, metals and electrical equipment sectors.

Encouraged to support businesses in these sectors, publicly owned banks have significantly increased their new lending, even at the risk of once again creating excess capacity, as happened in the steel and cement sectors in the 2010s.

The bottom line, then, is that a revival in **the Chinese economy will require a genuine paradigm shift**. At Davos, premier Li Qiang painted a picture of an open China, “firmly committed” to opening up its economy, “removing all restrictions […] in the manufacturing sector” and guaranteeing “national treatment for foreign businesses” in front of an audience of somewhat circumspect economic decision-makers.

Shifting between talk of openness and condemnation of western countries, which China criticises for putting increasingly restrictive controls on investment and exports, particularly in the field of new technologies, Li Qiang apparently failed to completely convince his audience. While markets are still awaiting significant new measures in support of the economy, investors are worried about government’s role in the economy and its regulatory implications.

☑ **Our opinion –** There is no denying that 2023 heralded a significant change in the Chinese economy. With China finally free of the zero-Covid policy and its destructive effects on growth and jobs, the reopening of the economy should have translated into a sharp recovery in consumer spending, previously shackled by public health measures. Instead, the euphoria quickly subsided, overtaken by China’s structural weaknesses. While lacklustre consumer spending can partly be put down to Covid and new habits adopted during the epidemic, the travails of the real estate market reflect a deeper sickness, long identified as a potential “grey rhino” for the Chinese economy. Twenty years of unfettered real estate development and what basically amounted to a Ponzi scheme by developers drawn by the promise of unending price rises ended up bringing this high-growth sector to its knees. After more than a year of announcements of stimulus measures consistently judged too tentative, it is clear that the real estate market is still not showing any sign of recovering and has yet to bottom out. Perhaps prices have not yet fallen far enough to get the wheels turning again; what is certain is that it will take time to clean up the sector.

Against this backdrop, it will take every bit of the dragon’s power to pull China out of its deflationary spiral and every ounce of creativity for the authorities to play the right cards rather than keep on repeating the same old policies, which are no longer suited to China’s economic environment. China had stood out for its ability to plan and implement, ensuring its economic success and growth over the past 20 years; its loss of effectiveness in this regard is worrying, especially given the shift in the government’s focus onto the economy, with all the arbitrary decisions such a shift might entail.

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