China has a property-shaped problem

Zero-COVID is taking the lion's share of the blame for China's worse-than-expected data for July, but the reason the economy was unable to sustain more of a rebound even as lockdown restrictions were lifted is principally down to real estate.

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Key takeaways

- Officials' efforts to revive the property sector are not working. Worse: The steady drop in sales is hammering developers' funding, meaning many firms can no longer afford to complete projects.
- Local governments are stepping in to try and defuse the social tensions stemming from these delayed completions. That may help reduce protests, but what the economy needs is for developers to start work on new projects – generating a recovery in construction activity and heavy industry goods. Without this, the weak real estate sector will continue to stymie the stimulatory impact of Beijing's infrastructure growth machine.
- The continued weakness in the real estate sector and ongoing COVID disruptions are conspiring to restrain household confidence and consumer spending. China's post-lockdown retail sales recovery has already fizzled out.
- In short, China has very little to show for its stimulus efforts to date. This, in itself, is generating a further headwind to growth as companies have been positioning for a far more impactful stimulus, leaving many firms with high inventories that they are now struggling to dispose of.
- The concern here is that the need to cut prices and shift stock is further undermining business confidence. This risks reversing one of China's few positive economic trends: The continued strength in manufacturing investment.

Real estate is at the heart of China's economic problems, with July's data showing that the property bloodbath continues. Home sales dropped 28.1% y/y by value, worse than June's 20.7% y/y fall. With income down so sharply and developers restricted in how much debt they can hold, funding has plummeted. Developers' financing fell 26.0% y/y last month.

Developers now don't have the funds to finish existing projects – including buildings that have already been sold off-plan. Floor space completed in the real estate sector fell 35.7% y/y last month.

This situation has led to a wave of discontent and protests from homeowners who have threatened to stop mortgage payments over unfinished homes. Local authorities are scrambling to pull together the funds to finish these projects. However, while this should boost completions in the short-term, the outlook for new construction starts is still grim given the current dire sales environment.

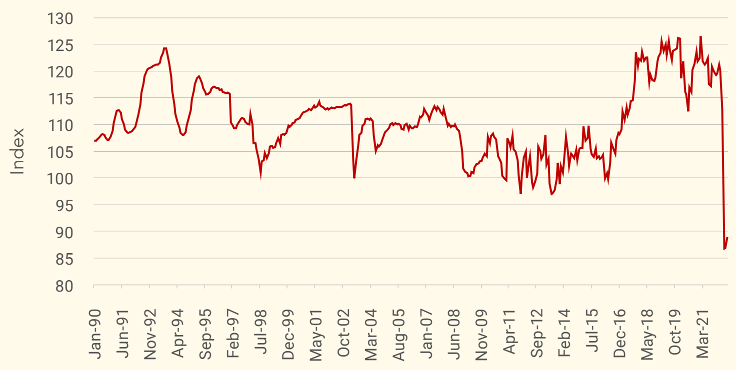
This has worrying ramifications for the broader economy. New construction starts in the real estate sector plunged 45.8% y/y last month – the biggest drop since at least January 2004. This fall effectively torpedoed the stimulus uplift from the recent increase in infrastructure spending – which accelerated 11.5% y/y last month. Weak real estate construction meant that, despite the infrastructure stimulus, industrial value-added output growth came in below expectations in July: 3.8% y/y vs. the forecasted 4.6% y/y increase.

Even this weaker-than-expected reading belies how bad things are. Mining and utilities significantly boosted the headline industrial value-added output growth number, increasing 8.1% and 9.5% y/y, respectively, versus the much weaker 2.7% y/y increase in the manufacturing sector. Alternative data series also point to a much more serious slowdown in industrial activity last month: Freight activity fell 0.8% y/y in July, for example.

Consumer drag

With over 70% of household wealth tied up in real estate, China's housing slowdown also has negative implications for consumption. An eleventh consecutive month of falling home prices and ongoing COVID-19 restrictions have combined to push consumer sentiment to a record low. The NBS's consumer sentiment survey showed that confidence in June remained extremely weak, even though the most severe lockdown restrictions had been lifted [FIG 1].

Fig. 1 – NBS Consumer Confidence Index



Any hopes for a further acceleration in consumer spending in July, after June's post-lockdown bounce back, were dashed. Sales of consumer goods increased just 2.7% y/y last month, decelerating from 3.1% y/y growth in June. Service sector activity was also dire, with the NBS's Service Production Index increasing just 0.6% y/y in July.

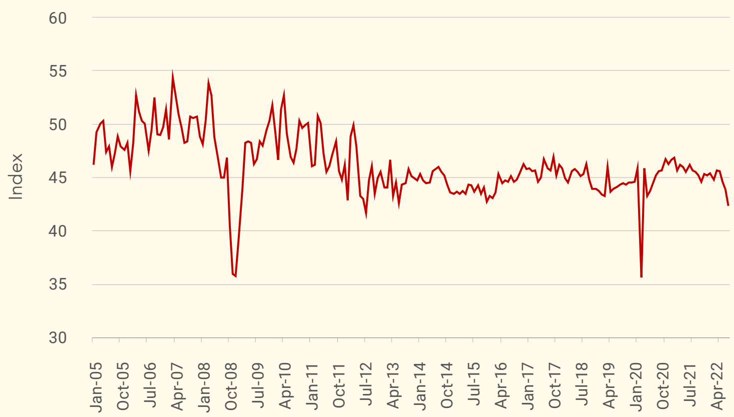
The other drag on consumer spending has been the rise in unemployment. While the headline urban unemployment rate improved last month – falling from 5.5% in June and a peak of 6.1% in April to 5.4% - youth joblessness is still rising. Unemployment among those aged 16-24 hit a new high of 19.9% last month. This not only depresses incomes and consumption in the short-term, but threatens the long-term productivity of China's younger workforce, lest they remain unemployed for an extended period, leading to an erosion of skills, experience, and motivation. Anecdotally, the popularity amongst China's netizens of the term *tang ping* – literally meaning to "lie flat" and encouraging a lifestyle of lower professional and economic ambitions – suggests the long-term impact persistent unemployment can cause.

Little to show

The ongoing drag from real estate on industrial activity and its negative impact on consumer spending – as well as the hit from COVID restrictions – means that Beijing has very little to show for its stimulus efforts to date.

Falling shy of expectations is generating an additional headwind to growth as companies – particularly those upstream to the construction sector – position for a far more impactful stimulus. The NBS Manufacturing PMI data shows that production growth moderated in July. However, factories were still churning out goods faster than demand, with industrial activity consistently outpacing retail sales. The subindex for production was at 49.8 in July, but the new orders index came in at 48.5. Another worrying sign from this survey was that the subindex for order backlogs fell to the lowest since February 2020 [FIG 2].

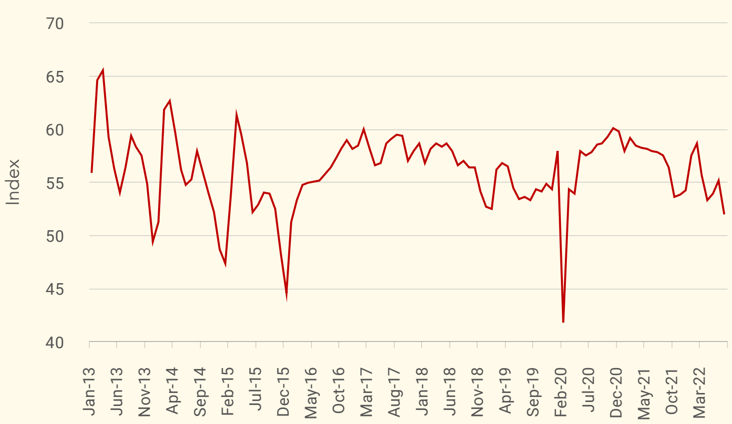
Fig. 2 – NBS Manufacturing PMI: order backlog



Industry data shows that firms' stockpiles remain high – even as prices are cut to try and stimulate demand. Steel mills, for example, currently have finished goods inventories 17% higher than at the same time last year – even though steel prices have fallen 16% since the start of May.

For a manufacturing industry struggling with COVID restrictions, power outages, and a worrying outlook for overseas demand, the problem of high inventories is yet another thing weighing on sentiment. Respondents to the NBS Manufacturing PMI were the most negative about the outlook since February 2020 [FIG 3].

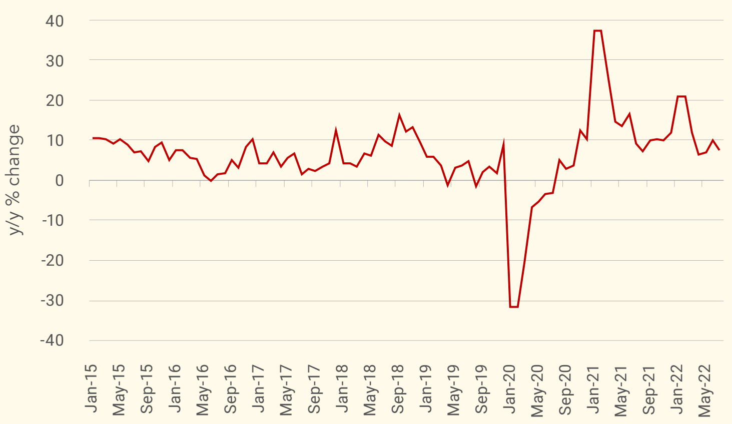
Fig. 3 – NBS Manufacturing PMI: business expectations



This business gloom is also reflected in July's dire corporate lending data. Excluding bill financing, net new corporate loans contracted by RMB 9 billion last month - the first drop in the outstanding value of these loans since August 2016. Net new medium- and long-term corporate loans – which underwrite capex – fell 30% y/y last month.

The concern here is that this turn for the worse in business confidence undermines one of the few remaining areas of strength in the economy: Manufacturing capex. This increased 7.5% y/y last month [FIG 4].

Fig. 4 – Manufacturing FAI



In this environment of deteriorating household and business confidence, rate cuts are a logical response. But the 10bp reduction in the PBoC's lending rates announced Monday is simply not going to cut the mustard.

The PBoC is reluctant to cut rates too far while other central banks are tightening monetary policy, which will enhance China's capital outflows and pressure on the RMB.

Additionally, China's economic woes are not a credit-supply issue, and cutting rates is unlikely to help. China's M2 money supply – the broadest measure that includes deposits –increased 12% y/y in July, the fastest pace of increase in six years. Meanwhile, in the same month, loans to households slumped to RMB 121.7 billion, less than a quarter of June's value. Corporate loans have also plunged. Banks are flush with cash, but there's no one to lend it to. Monetary policy may therefore be losing its bite.

Despite this, the decision to cut rates may be an acknowledgment of the depth of the macro problems facing China, but in the absence of a more effective and better targeted fiscal policy, a monetary policy response from the PBoC isn't going to fix things.