# Real estate holds the key for 2023

The better-than-expected econ data for December has raised the prospect of a far shorter period of economic disruption from China's messy exit from zero-COVID than most expected. Consequently, the focus is shifting from how long it will take the economy to reach this point of recovery to how long this economic bounceback will be sustained.

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# Key takeaways

- Hopes for a prolonged economic revival are pinned on the Chinese consumer. Households, however, are hardly emerging from the pandemic in rude health. A large part of the unprecedented increase in household deposits last year was likely precautionary savings, given that they suffered a near-halving in real income growth compared to before the pandemic.
- This means that household deposits have the potential to power a strong rebound in economic activity, but only once that broad recovery is already underway and families feel confident enough to draw down their savings. That means that other parts of the economy will need to step up. An exports-driven recovery is highly unlikely, as is one powered by government spending, given the pressure that local finances are under.
- That puts the onus on domestic investment to kickstart growth this year. With manufacturing and infrastructure investment growth already elevated, a pickup in real estate capex is the most obvious route to a recovery in domestic spending.
- The improvement in bank funding for developers raises the prospect of precisely such a recovery in real estate investment this year. That, however, will be capped by still weak housing demand that will restrain spending on new developments, unless officials can find a way of getting developers to invest in new projects before home sales have recovered. Dropping the presales model may be precisely such a mechanism, as this would shift developers' time horizon for capex, from meeting immediate demand for housing to being in a position to make sales in the coming years.
- Putting it all together, and there is a path for economic growth to come in at the higher range of estimates this year. But this will require officials to find a way of driving a real estate recovery without undoing their hard work to reduce risks in this sector.

Of late, tracking China's macro outlook has been a rollercoaster ride. The hope that October's party congress would see a shift to more growth-friendly policies – especially a change to the country's crippling COVID-19 containment measures – was dashed.

By the start of December, however, zero-COVID was on the way out. Investor euphoria at the change in Beijing's COVID-19 strategy soon gave way to concern over China's near-term economic outlook as a wave of mass infections ripped through urban centers.

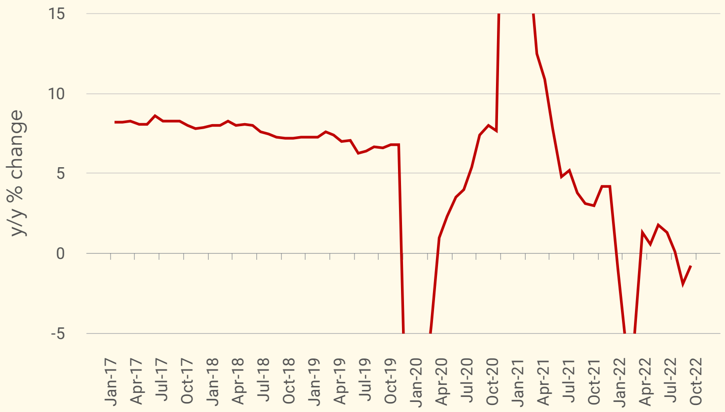
However, sentiment is already shifting again, amid signs of a far faster spread of and recovery from the virus than expected. Policymakers themselves have expressed surprise. Vice Premier Liu He told a Davos forum this week that "The speed of reaching the peak and speed of returning to normality were relatively fast, in a way exceeding our expectations."

The December econ data reflected this condensed infection cycle. The assumption was that retail spending would have collapsed last month: The consensus forecast was for a 9% y/y drop, compared with the 5.9% y/y decrease in November. As it was, however, retail spending contracted by less in December than the previous month, falling 1.8% y/y.

This can partly be explained by the rush to stockpile goods like medicines: The latter saw a 43% y/y jump in retail sales last month. Car sales were also strong in December, increasing 4.6% y/y, partly because of the curtailing of auto purchase subsidies at the end of 2022.

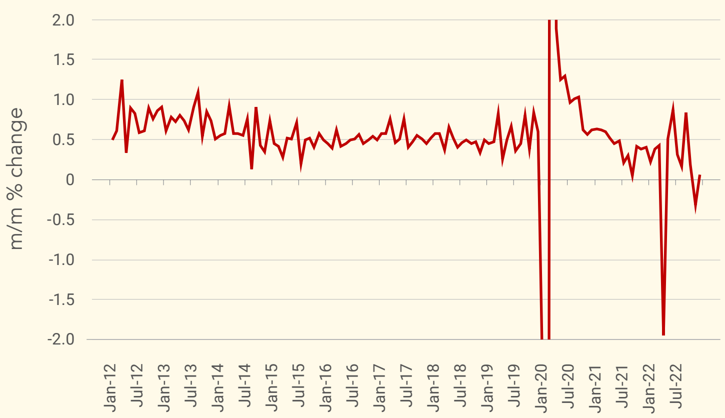
There was also evidence, however, that the better-than-expected retail sales print reflected a far earlier than anticipated resumption of leisure activity as households recovered from COVID-19. For example, while catering sales were extremely weak last month (falling 14.1% y/y compared with an 8.4% y/y drop in November), the stats bureau's broader measure of service sector activity showed a smaller contraction versus the month before **[FIG 1]**.

**Fig. 1 – NBS Service Production Index**



The industrial sector also showed surprising strength last month, with activity increasing in m/m terms on a seasonally adjusted basis **[FIG 2]**. The December unemployment data also indicates that economic activity was relatively resilient last month. In fact, the urban unemployment rate declined in December to 5.5%, from 5.7% in November.

**Fig. 2 – Seasonally adjusted industrial value-added output**




## Post-Lunar New Year bounceback

This evidence of a quick resumption in economic activity once people had recovered from COVID, along with the boon to leisure activity from the dismantling of the previous restrictions on people's movements, coupled with officials' claim that COVID-19 infections peaked at the start of 2023, suggests that China's post-COVID bounce back in economic activity could start gathering steam after the Lunar New Year holiday. This is a lot earlier than the Q2 recovery that most analysts had penciled in.

The question has now become how long China's post-COVID economic bounce back will last, rather than how long it will take the country to reach this point.

Hopes for a prolonged economic revival are being pinned on the Chinese consumer. As has been the case with other countries that have had COVID restrictions removed, household consumption should be boosted, in the short term, by "revenge spending" and the drawing down of pandemic savings.

However, one big difference between China and other countries has been the absence of household stimulus cheques from the government. This and the lengthier period of COVID restrictions in China means that consumers are hardly emerging from the pandemic in great health.

While it is the case that Chinese households increased bank savings by a record amount in 2022, they also suffered a near-halving in real income growth compared with before the pandemic **[FIG 3]**. An element of this increase in bank deposits is, therefore, precautionary.

The absence of COVID restrictions alone will not, therefore, be enough to persuade consumers to part with this cash. Households will also have to feel more confident about their future earnings prospects – something that, at present, they have never been more negative about **[FIG 4]**.

**Fig. 3 – Household deposits vs household income**

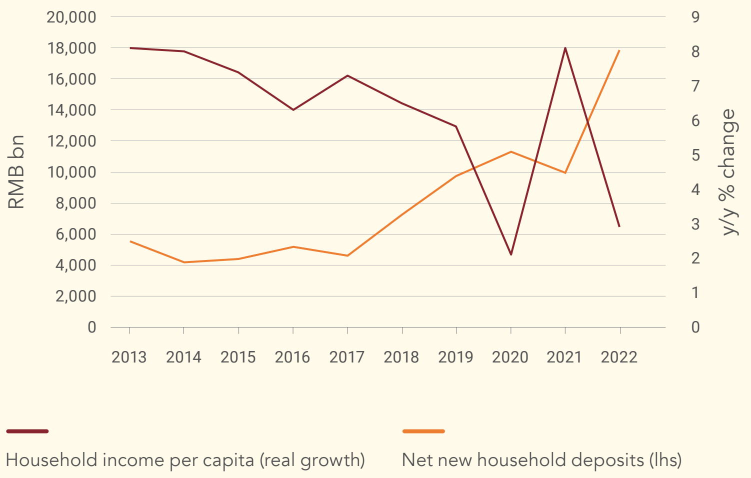
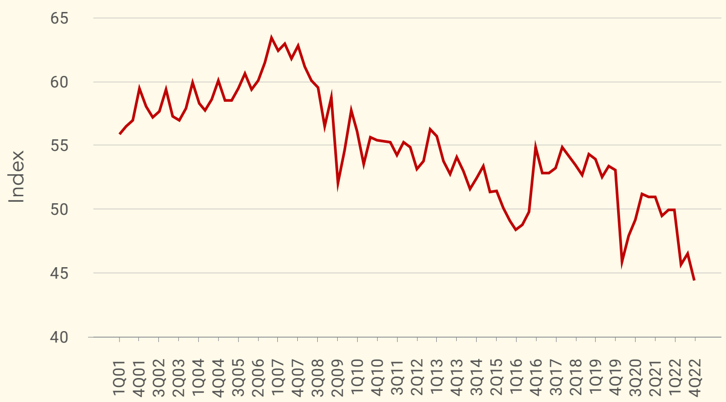



**Fig. 4 – Household future income confidence**




## Broader recovery needs to come first

This means that household savings have the potential to power a strong rebound in economic activity, but only once that broad recovery is already underway. Otherwise, families will likely continue to sit on the precautionary savings they have built up.

Simplistically speaking, a recovery external to household consumption could come from four possible sources. It could be driven by external demand, but that looks unlikely, with overseas consumer spending facing increased headwinds from the higher cost of living. Indeed, net exports turned to a drag on economic expansion in Q4, contributing a negative 41% to real GDP growth.

Alternatively, the recovery could be driven by the other element of domestic consumption: Government spending. But that also seems unlikely. Government expenditure was already running at relatively high levels last year, partially reflecting the fiscal burden from zero-COVID. Combined expenditure across the general public and government-managed funds budget rose 6% y/y in the first eleven months of 2022, compared with a 1% y/y drop in full-year 2021. Moreover, local governments' balance sheets are emerging from the pandemic in terrible shape. The outstanding value of local government debt was 118% of income by the end of 3Q22, just below the 120% risk threshold that requires spending cuts to bring finances back into shape.

This puts the onus on domestic investment to kickstart growth this year. Non-household expenditure in China mainly falls into one of three buckets: Real estate, infrastructure, and manufacturing investment.

The problem, however, is that spending in both the manufacturing and infrastructure sectors was already fairly elevated last year. Infrastructure fixed-asset investment (FAI) increased by 11.5% y/y in 2022, the fastest annual expansion since 2017. However, that level of infrastructure spending required record issuance of government debt: Local governments were allowed to issue RMB 4.15 trillion of special-purpose bonds (SPBs) in 2022. Central authorities, however, have little appetite to increase this debt quota even further this year, amid these mounting worries about local governments' ability to service their debts. According to Bloomberg, this year's SPB issuance quota will be set at RMB 3.8 trillion.

Manufacturing capex in 2022 was also strong, expanding 9.1% y/y, versus 5.1% y/y for total FAI. While officials have indicated an ongoing commitment to financing this capex, with banks coming under pressure to scale up lending to the manufacturing sector, firms themselves may be less willing participants given the deteriorating business environment. Industrial profit growth peaked at 14.0% y/y in March before falling to an 8.9% y/y contraction in November.

## A real estate solution

Real estate investment, which dropped 10% y/y in 2022 – the first annual decline since at least 1999 – is the most obvious route to a recovery in domestic spending. Not only will expenditure be increasing from a low base, but officials are also now throwing significant sums of money at the sector.

According to Caixin, between November 23 and December 1, banks granted developers RMB 2.2 trillion in new credit lines. In addition, in November, the central bank (PBoC) created a new RMB 200 billion relending facility to provide funding for the completion of stalled housing projects, and officials last week confirmed an additional RMB 80 billion lending facility for asset management companies that will enable these entities to help developers. A further facility to finance rental housing projects has also been announced.

This funding is partly aimed at completing homes that have already been sold but remain unfinished. The question is whether this financing will also drive the construction of new projects.

The biggest obstacle to this is the still weak state of housing demand. Home sales fell 28.3% y/y by value in December, compared with a 28.4% y/y drop in November. This has meant that the end-of-year moves to bolster bank financing for developers were undermined by still weak sales revenue. Developers' funding from domestic loans improved from a 30.9% y/y contraction in November to a 5.9% y/y fall in the final month of 2022. This was the smallest y/y decline since the January-February period in 2021. Total developer funding, however, was still down 28.0% y/y in December (a minor improvement on the 35.6% y/y fall the prior month), with financing from deposits and mortgages dropping a combined 30.1% y/y.

On the surface of it, a recovery in real estate investment, therefore, risks being capped unless officials do more to revive housing demand. That will probably require them to junk their focus on keeping home prices stable to bring potential homebuyers back into the market by generating a fear of missing out as the sector starts to reflate again.

Officials so far, however, have been loath to abandon their quest for price stability. Instead, we think another strategy could be emerging: Shifting developers' time horizon for real estate investment by ending the practice of presales (see our report, "Do new bank credit lines for developers signal the end of housing presales?"). This would move the real estate cycle from demand- to construction-led: Developers would need to start building properties to meet a potential recovery in sales years ahead. This, and the mammoth expansion in banks' credit lines for developers, means that we don't necessarily need to see a recovery in home sales for there to be a real estate-led uptick in economic activity. As discussed above, as this real-estate-led recovery increases households' confidence in the macro situation, consumer spending will start to play a greater role in this pickup in growth as excess savings are drawn down.

Putting it all together, and there is a path for economic growth to come in at the higher range of estimates this year, with GDP growth potentially hitting 6% y/y. But this will require officials to find a way of driving a real estate recovery without undoing their hard work to reduce risks in this sector.