ECONOMIC VIEWPOINT

China's Economic Slowdown: Root Causes and Implications

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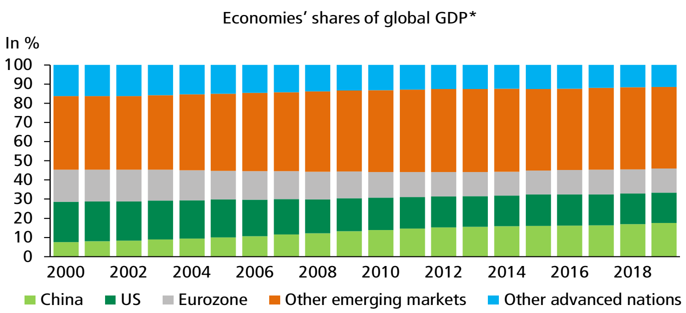
China is a key part of the global economy. Yet there's a sense that obstacles to its rapid development over the past 25 years are becoming increasingly common. Economic activity has not been spared by the pandemic, as shown once again by recent lockdowns. This *Economic Viewpoint* takes a look at the recent challenges facing China's economy, the factors set to affect domestic demand and its longer-term outlook. For now, the country's economic turmoil is hurting its standing as a global supply chain leader more than it's hurting exports to China.

China's significance to the global economy is well established. Since the early 2000s, the Chinese economy's share of global GDP has surged from 7.5% to over 17% (graph 1). And while growth no longer tops 10% like before the 2008–2009 recession, China can count on this larger share to offset slower growth in real GDP. But above all, China manufactures many of the world's goods and plays a central role in today's increasingly complex supply chains—and that's why it's key to the global economy. As a result, the challenges it faces are also faced by the rest of the world, a fact made crystal clear by the pandemic.

GRAPH 1
China commands larger share of global GDP

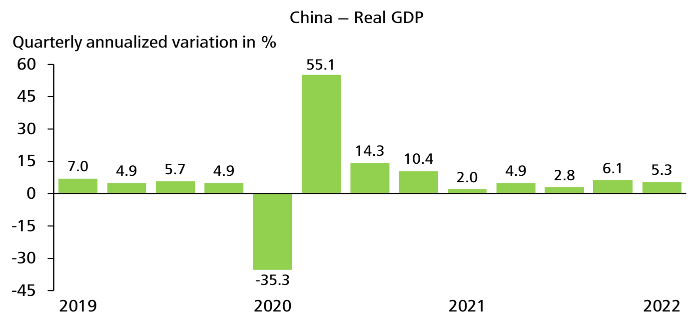


* Based on purchase power parity.
Sources: World Bank and Desjardins, Economic Studies

Limits of the Zero-COVID Policy

The zero-COVID policy was very effective in 2020 during the first wave. Real GDP saw an annualized quarterly variation of -35.3% in the first quarter of 2020, but the spread of the virus was quickly contained by strict lockdowns, which allowed a very swift reopening of the economy. Industrial output was the cornerstone of this recovery, with Chinese factories among the only global facilities still in operation. The second-quarter rebound in real GDP was 55.1% in annualized quarterly variation (graph 2). The country was one of the few major economies to have experienced positive growth in 2020, at 2.2%. This strong recovery carried over into 2021, with real GDP growing 8.1% during the year.

GRAPH 2
Strong rebound in 2020



Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

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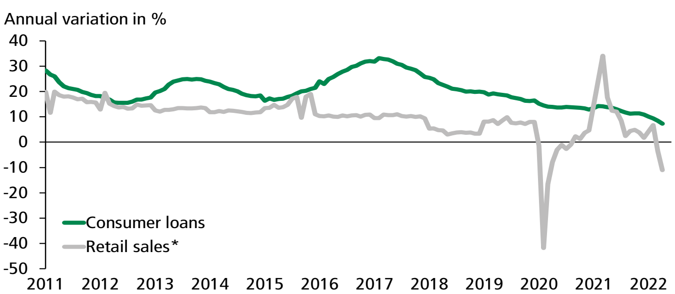
However, the Omicron variant proved more contagious than the first strain of COVID-19. When a new wave began in March 2022 in China, rapidly imposing strict lockdowns did not curb the spread with the same effectiveness as in 2020. This meant health measures had to remain in place longer, ultimately for a total of two months, and economic activity was severely curtailed during the period. The Chinese authorities shut down restaurants, gathering places and public transit in a number of regions. At times, they even blockaded entire neighbourhoods to prevent the population from getting out. Unsurprisingly, retail sales took a tumble in April and May with annualized variations of -11.1% and -6.7% respectively (graph 3). However, the authorities further protected the manufacturing industry from the fallout of prolonged strict lockdowns by opting for partial plant closures. As a result, the annual change in industrial production for the same months was limited to -2.9% and 0.7%, respectively (graph 4). In these circumstances, we anticipate a negative change in real GDP for the second quarter, followed by an economic rebound.

GRAPH 3
Recent slump in Chinese retail sales



* Excluding May 2021 data.
Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

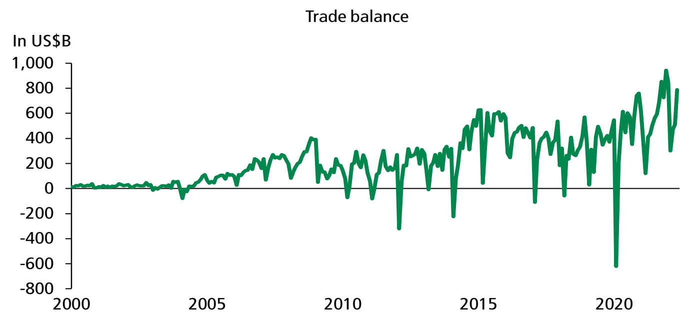
GRAPH 4
Industrial output curbed by fresh COVID-19 outbreaks

Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

Difference Between China's Domestic and Export Economies

In spite of concerted efforts by the Chinese government to diversify its economy, the industrial sector still accounts for the lion's share of GDP, driven more by foreign than domestic demand. For instance, the Chinese manufacturing industry exports the vast majority of its output, while a large portion of its imports are inputs for processing and export. This economic structure is reflected in the country's trade balance, whose surpluses have grown by over 1,000% since the beginning of the 2000s (graph 5), earning China a reputation as the world's factory. However, domestic demand is not negligible, particularly when considering the 1.4 billion people living in the country. Nevertheless, this economy is still clearly divided into two parts: an export economy and a domestic economy. For trading partners, this fragmentation is significant, as the economic implications differ according to which part of the economy slows down.

GRAPH 5
China is still a net exporter

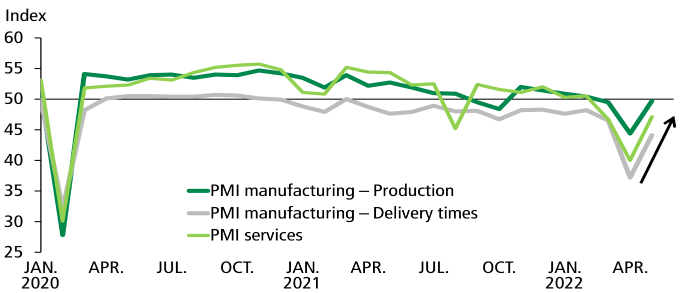


Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

Value Chain Disruptions

As discussed earlier, industrial output has been disrupted by prolonged strict lockdowns. At the same time, the PMI manufacturing index of delivery times dipped below 50 points, pointing to longer delays (graph 6 on page 3). Exports and imports, however, were more resilient despite slight monthly declines in April of 1% and 3%, respectively (graph 7 on page 3). Both indicators flipped back to positive territory in May, especially exports, with a monthly growth of 13%. Although the worst seems to have been avoided in the very short term, the effects of this latest wave may be felt more in the coming months. Businesses usually place orders with Chinese factories six months in advance.

GRAPH 6
Chinese recovery begins as last health measures lifted



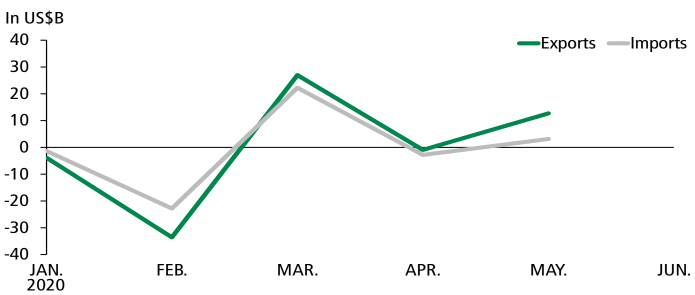
Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

TABLE 1
China: A key player in modern supply chains

MARKET SHARE (%)	NUMBER OF PRODUCTS*						
	China	US	Germany	India	Mexico	Netherlands	Canada
0 to 9.99	2,385	3,831	3,527	4,622	4,415	4,651	4,793
10 to 19.99	917	947	1,009	234	116	368	110
20 to 29.99	545	266	378	78	36	109	29
30 to 39.99	404	122	133	39	14	41	17
40 to 49.99	301	56	34	22	7	20	17
50 to 59.99	185	57	25	13	3	10	6
60 to 69.99	122	23	5	18	3	3	6
70 to 79.99	91	12	3	1	6	5	3
80 to 89.99	44	12	6	5	5	6	6
90 to 100	6	7	1	1	10	0	1
TOTAL	5,000	5,323	5,121	5,033	4,615	5,213	4,988

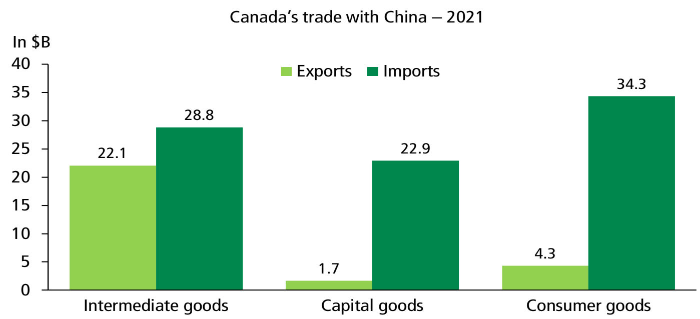
* Based on the HS-6 level comprising 5,428 different products.
Sources: Global Affairs Canada and Desjardins, Economic Studies

GRAPH 7
Exports and imports growing again



Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

GRAPH 8
Consumer goods: Canada's top imports from China



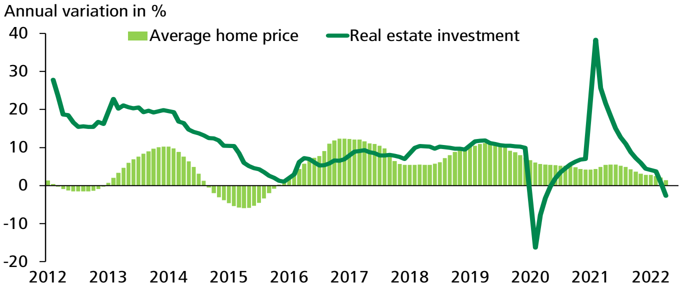
Sources: Statistics Canada and Desjardins, Economic Studies

According to Global Affairs Canada, China is the largest supplier of 1 in 12 internationally traded products, particularly electronics, textiles and inorganic chemicals. Of the 5,000 products it exports, China enjoys market share of over 50% for 448 of them, compared with 101 for the United States (table 1). If Chinese manufacturing fails to clear the backlog built up this spring, global supply chain woes could persist or even worsen. Here in Canada, trade relations with China consist mainly of consumer goods imports, which accounted for 39.9% of all imports from China in 2021 (graph 8). Intermediate goods, which are parts required for Canadian production, ranked second at 33.5%. For Canadian businesses and consumers, the slowdown in industrial production in China means more scarcity for some goods, production or delivery delays, and the potential for extra costs. What's more, this would impact not only imports from China, but also any imports of goods dependent on Chinese inputs. As the old auto industry adage goes, "It takes 2,500 parts to build a car, but only one not to." China's industrial slowdown is also likely to impact Canadian exports of intermediate goods, particularly commodities, with the potential to drive price normalization.

More Deep-Seated Issues

Although supply chain snags are having a significant impact on growth, the situation is expected to normalize sooner or later. The Chinese government has repeatedly shown its willingness to adopt draconian measures to control the pandemic and revive its economy. However, the Asian giant is facing more deeply rooted domestic economic and financial issues. First, the housing market, a key pillar of the Chinese economy, has recently cooled off. Between 2016 and 2019, average home prices soared 8.2% a year (graph 9 on page 4). During the pandemic, average growth was just 3.2%. The previous outperformance in this market was driven by continued expansion in home supply, easy access to credit for both developers and households, and the market's role as a household investment vehicle. The Chinese opted to invest in housing over the stock market, which is seen as offering more unstable and lacklustre returns. As a result, the market has been weakened by several years of rising debt loads, particularly for real estate developers, and unsustainable long-term business strategies.

GRAPH 9
Chinese housing market under pressure

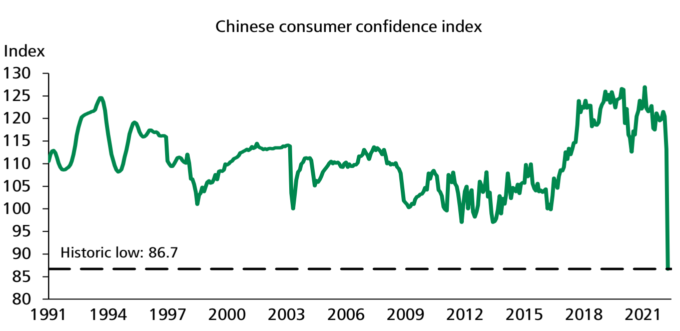


Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

Authorities, who were well aware of the situation, rolled out a plan in August 2020 tightening access to refinancing for real estate developers to prompt them to deleverage. Among the businesses affected was Evergrande, the country's second-largest developer at the time. Faced with a very high debt load and a lack of refinancing options under the new rules, the company defaulted on international bonds worth US$1.2 billion in December 2021. This fuelled concerns about the company's ability to repay the remainder of its debt, meet its obligations for pre-sales of unbuilt houses and repay buyers if homes were not completed. In the months that followed, other businesses defaulted on specific debt segments, taking housing market concerns up a notch. This saw the variation in average home prices slip into negative territory. With the situation still uncertain, the future of the market will hinge on the effectiveness of government measures.

The lockdowns severely dampened Chinese consumption, pushing down retail sales as discussed earlier. This sent consumer confidence to an all-time low of 86.7 in April (graph 10). In addition, many businesses have been closed for a long time, making it difficult to restart consumption. However, these problems remain short-term and are expected to be resolved in the coming months. The issue is more closely related to the housing market, a key savings mechanism for households. Without this popular savings vehicle, and in view of the global growth slowdown, Chinese households may tighten their purse strings to put money aside.

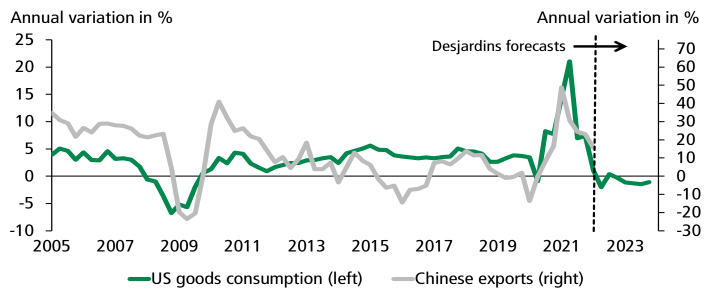
GRAPH 10
Post-lockdown household confidence sharply lower



Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

In addition, global goods consumption is set to slow in favour of services as the impact of the pandemic fades and interest rates rise. After two years of robust growth, US goods consumption is expected to decline by 0.3% in 2022 and 1.3% next year (graph 11). The US is the largest market for Chinese industrial output. For China, this means limited earnings potential for the manufacturing sector. The economy will be unable to count on its top historical growth drivers—housing markets, domestic consumption and exports. The Chinese government is still trying to rectify the situation with its gigantic US$5.3 trillion economic stimulus package, coming in at one-third of GDP. The program strives to fuel consumption and investment and ensure financial stability. This plan will be critical to easing tensions across production chains and could drive demand for raw materials for infrastructure investments. Furthermore, the Chinese central bank is maintaining an accommodative monetary policy as inflation remained low at 2.1% in May 2022 (graph 12).

GRAPH 11
Anticipated weakness in US goods consumption likely to dampen Chinese export growth



Sources: Bureau of Economic Analysis, China Customs and Desjardins, Economic Studies

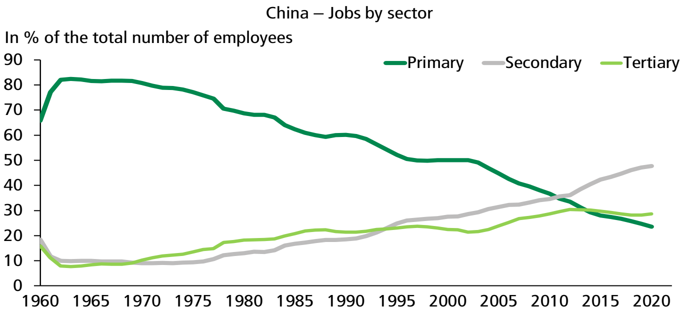
GRAPH 12
Inflation still under control

Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

Structural Slowdown

It has long been clear that China's economy wouldn't be able to sustain the stellar growth rates of the 2000s and 2010s. Joining the World Trade Organization and becoming "the world's factory" sparked very solid growth in the 2000s and helped it weather the 2008–2009 recession with relative ease. This strong economic growth has resulted in a more urbanized Chinese population with workers enjoying improved income growth. These developments reflect, first, a labour shift from the primary sector (natural resources and agriculture) to the secondary sector (manufacturing and construction) and, to a lesser extent, to the tertiary sector (services) (graph 13).

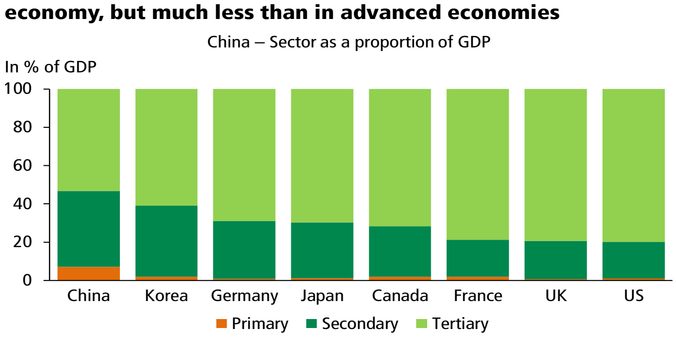
GRAPH 13
Manufacturing dominates the Chinese job market



Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

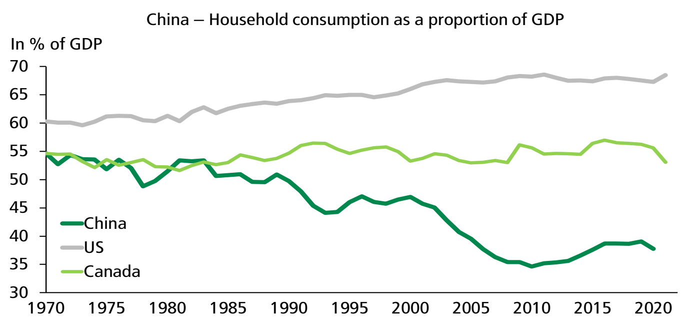
Further transformation and modernization would bring the Chinese economy more in line with advanced countries, which typically also have lower rates of real GDP growth. The structure of the economy and its distribution across the primary, secondary and tertiary sectors remain very different from conditions in advanced economies, where the tertiary sector accounts for a much larger share of output (graph 14). Consumption is also thought to play a larger role as a destination for total production. But this is not yet the case in China. Consumption as a proportion of Chinese GDP improved in the first half of the 2010s but rapidly stalled (graph 15). Exports continue to drive the Chinese economy more than domestic demand. Its "modernization" is therefore incomplete. Will it get there or pursue an alternative, unfamiliar model? This may suggest the potential to keep outgrowing advanced countries. However, it faces a number of challenges. An external demand-based model leaves the Chinese economy vulnerable to export bans in the event of geopolitical tensions. Moreover, other economies could sooner or later seek to diversify their goods supply or even repatriate more of their production, which would threaten China's essential role in global value chains. And while its economy is not yet at the same level, Chinese society has begun emulating the bad habits of European and North American economies. Despite recent steps to relax its birth policy, births are declining (graph 16) and the Chinese population is aging. There has also been a slowdown in productivity, despite the Chinese government's desire for its manufacturing industry to focus on higher value-added products. Lower productivity is due in large part to the less effective allocation

GRAPH 14
The service sector accounts for a large share of the Chinese economy, but much less than in advanced economies



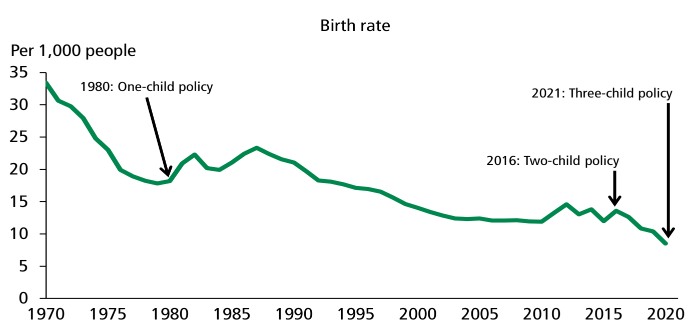
Sources: World Bank and Desjardins, Economic Studies

GRAPH 15
Consumption much less predominant in China than in North America



Sources: World Bank and Desjardins, Economic Studies

GRAPH 16
China's low birth rate: Government relaxes policy in response



Sources: World Bank, European Parliament and Desjardins, Economic Studies of production resources. This is the result of the growing role of the government and excessive spending on infrastructure offering less and less return on investment. Sluggish population growth coupled with slowing productivity suggests more modest economic growth potential in the medium and long terms.

A Healthy Chinese Economy Remains Crucial to the Global Economy

China is particularly important to the global economy. The pandemic and its aftermath have clearly shown the crucial importance of Chinese industry in global supply chains and its major influence on commodity prices. Despite its outsized population and large economy, China still plays a more critical role in terms of global supply than demand. The promise of opening its market and the potential to sell to 1.4 billion increasingly wealthy Chinese consumers has entrepreneurs chomping at the bit around the world. But such desires remain largely unfulfilled as China's domestic demand is still relatively modest, and fuelling short- and long-term growth is fraught with difficulties. So, despite government efforts, China will continue focusing on exports with a view to meeting global demand rather than on imports to its own market. China can, however, become an even greater powerhouse for global economic growth, particularly if it can further liberalize its economy, avoid attracting protectionist threats from other nations and fully engage in the fight against climate change.