

MIMS – Research Area

Macro Research Team

Report – November 2024

The Great Balancing Act of China: Shifting Economic Perspectives Ahead

The economic challenges facing China reflect the underlying complexity of its macroeconomic landscape, shaped by its interconnectedness with other economies. These dynamics have fueled discussions in macroeconomic theory, particularly the concept of *Japanification* (Koo, R.).

In this report, we focus on the key factors for a forward-looking macroeconomic analysis of China, beginning with real estate and the stock market. Subsequently, we examine the core macroeconomic challenges, such as the consumption deficit and the deflationary forces at play, before exploring the broader and more practical impact of China's current macroeconomic scenario on global markets.

China's Real Estate Market

For South Asian Countries, owning a plot of land to pass down through generations is a major life goal for many, and China is a prime example of this peculiar culture. The nation's housing market has always been an important part of the scene, accounting for up to 20% of the economy's growth and 29% of the GDP at its peak. House prices and profits grew quickly and consistently from 2004 to 2017 (Figure 1, Figure 2). In 2020, just before the government cracked down on property market leverage and sent prices on a downward spiral, average housing prices nationwide were about 13 times incomes, and 25 times in Beijing. That's extremely high compared with an average of six times in the United States and eight times in the United Kingdom. This reality sparked concerns of a bubble build-up, which later proved valid.

Recognising the importance of the real estate sector in China, the People's Bank of China and the Ministry introduced the Three Red Lines Policy in August 2020, with the aim to reduce developers' leverage, improving debt coverage, and increasing

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liquidity. Under this framework, selected large real estate developers are assessed against three criteria, after which they will be categorized into the colors green, orange, yellow, and red, deciding the extent they are allowed to grow their debt in the next year.

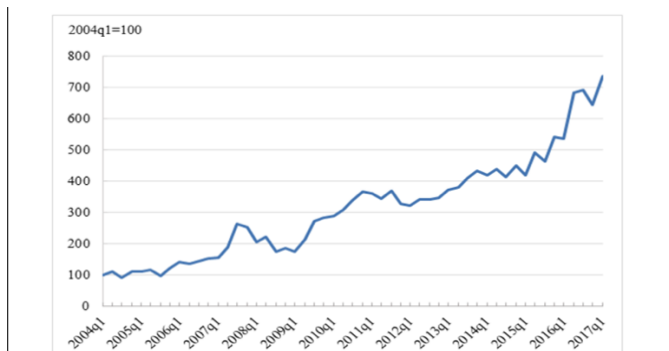
1. Liability to asset ratio of less than 70% (excl. advanced receipts)
2. Net gearing ratio of less than 100%
3. Cash to short-term debt ratio of at least 1

If all three criteria are passed (green), the company can increase its debt up to 15%. A breach of one (orange), two (yellow), and three (red) criteria will decrease the percentage to which debt can grow to 10%, 5%, and 0% in the following year respectively. The policy has objectively prompted housing companies to make up for the lack of cash flow through sales receipts. However, an analysis on the liabilities of mainland property companies listed on Mainland and Hong Kong stock exchanges found out that the majority of them had crossed at least one



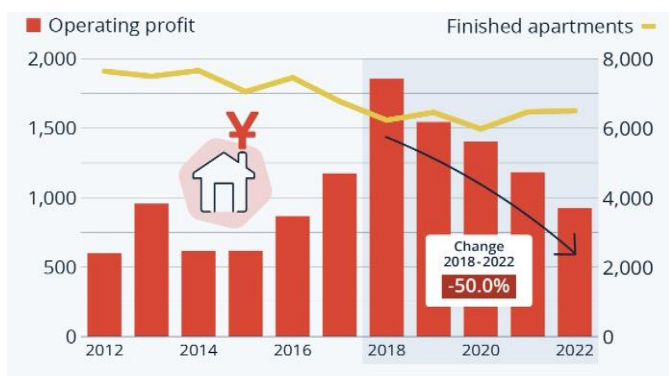
of the lines, with Evergrande and Countrygarden as prime examples. In the midst of a lengthy restructuring process, Evergrande failed to make bond payments, and reported losses of US\$ 66bn in 2021 and US\$ 81bn in 2022.

Figure 1
The importance of China's real estate sector is proven by the increasing house prices



Source: VoxChina (Deng Y., Gyourko J., Wu J.)

Figure 2
Operating profit vis a vis finished apartments has been decreasing



Source: National Bureau of Statistics of China

The collapse of the housing market sent shockwaves across the Chinese economy. The slowdown in economic growth was evident, as real estate and related industries such as construction and material accounts for 25-30% of the GDP and up to 70% of household wealth. This led to the decline of consumption, production, and investment. Since the industry is capital-intensive and heavily debt-funded, the banking sector was at risk of NPLs

through the default of property developers. The local governments were also badly hit, as the majority of their income came from land sales revenue and some have high levels of debt tied to infrastructure projects. In the long run, the crisis might facilitate a shift towards a consumption-driven economy from an investment-driven one.

China's Stock Market

The China Securities Regulatory Commission (CSRC) maintains stringent oversight of market operations, while the People's Bank of China (PBOC) exercises significant influence through monetary policy mechanisms. The dual regulatory framework demonstrated its full capacity in September 2024 through a comprehensive stimulus package. The centerpiece of this intervention was a 50-basis-point reduction in the Reserve Requirement Ratio (RRR), which injected RMB 1 trillion into the banking system. Concurrent measures included a reduction of the seven-day reverse repurchase rate to 1.5%, a Medium-Term Lending Facility (MLF) rate decrease of 30 basis points, and Loan Prime Rate (LPR) adjustments of 20-25 basis points downward. The government further implemented a RMB 500 billion swap facility enabling the use of equity and fixed-income securities as collateral, alongside a RMB 300 billion special funding mechanism facilitating corporate share buybacks and strategic institutional investments. In the real estate sector, existing mortgage rates were reduced by an average of 50 basis points, while second-home down payment requirements decreased from 25% to 15%, affecting approximately 50 million households with projected annual savings of RMB 150 billion.

The market response to these measures was substantial, with the SSE Composite recording a 25% surge in late September 2024. Trading volumes expanded significantly, particularly in sectors strategic to government initiatives. Technology stocks, especially those in semiconductor manufacturing and artificial intelligence, demonstrated notable outperformance, while the renewable energy sector, including electric vehicle manufacturers and their supply chains, exhibited robust appreciation.

Despite this policy-driven rally, structural vulnerabilities persist. Corporate debt-to-GDP ratios remain elevated at approximately 160%, while local government financing vehicles (LGFVs) face



ongoing debt service pressures. The real estate sector continues to grapple with excess inventory and deteriorating developer balance sheets. The sustainability of the current market trajectory depends heavily on the effectiveness of monetary transmission mechanisms, resolution of structural impediments in the property market, and success in managing LGFVs' debt obligations without triggering systemic stress. While robust policy support has established a floor for market valuations, the transformation toward a consumption-driven growth model and the resolution of structural imbalances will ultimately determine the market's long-term trajectory.

The Issue of Low Consumption and Downward Pressure on Inflation

Investment, Consumption, Japanification Risk

China's rapid economic transformation is closely linked to its investment-led growth model. In the 30 years leading up to 2010, the share of investment in China's GDP gradually rose from 35% to 47% in comparison to developed economies (20%). Over the same period, the share of final consumption steadily declined from about 65% to below 50% in 2010. This investment surge was financed by high domestic savings resulting from several government policies which were channeled into the financial system as subsidies for infrastructure, manufacturing, and real estate investment.

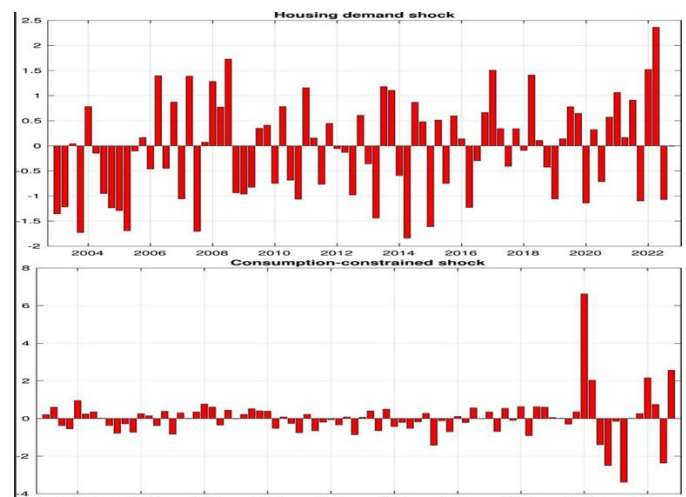
Despite recognizing the need to rebalance the economy toward consumption, progress has been slow. Japan's experience in the 1980s offers a comparative perspective, signaling the end of China's *miracle growth* literature and the potential start of *Japanification* (Koo, R.). Japan's consumption share of GDP didn't bottom out until 1991 at 63.3%, compared to a global average of around 74–75%, given the combination of unconventional monetary policy, structural economic factors, and anchored deflation expectations. Despite the difference in monetary policy strategies and implementation with respect to Japan, China's consumption levels are so low relative to global norms that rebalancing the role of consumption in the overall economy requires years of sustained (structural) effort, during which

consumption must contribute a much higher share to GDP growth than seen so far.

Research on China's macroeconomic fluctuations faces challenges due to the lack of basic quarterly macroeconomic data and inconsistencies in the available information. However, analyses of shocks that the Chinese economy has experienced—such as the COVID-19 pandemic and the real estate market crisis—provide insights into different sources of economic fluctuations (Figure 3).

The real estate market crisis has significantly impacted Chinese consumption and savings trends. High housing prices have prompted households to devote an unusually large share of their incomes to saving for down payments and servicing mortgages, squeezing consumer expenditures—a mechanism known as the "substitution effect." This effect may be stronger in China than in advanced economies due to its rapid urbanization. Also, rising housing prices have prompted a generation of young, non-homeowners to cut back on consumption to accumulate savings.

Figure 3
The analysis of housing demand and consumption-constrained shocks provide clear insights into the sources of economic fluctuations



Source: S&P Global

The housing crisis is one of the *three severely impaired main pillars of investment growth* (ECB, July 2024). Total fixed asset investment in China consisted predominantly of infrastructure, real estate, and manufacturing in roughly equal parts.



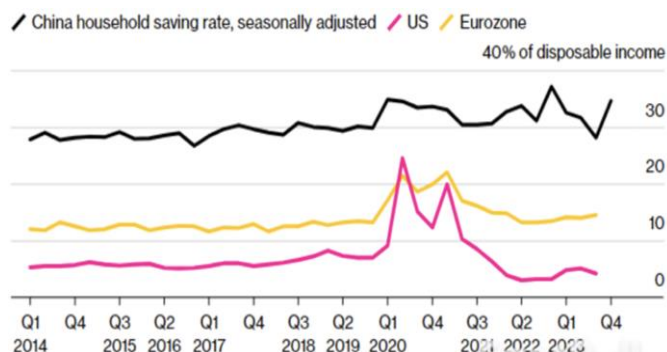
With new restrictions on leverage and policies aimed at derisking the sector, real estate investment growth turned negative in late 2021.

Given the shortage of safe assets in China's underdeveloped financial market, housing has served as a safe asset, and Chinese households choose housing to store wealth—for cultural reasons as well. The bubble burst exposed the economy to this shortage, fundamentally prompting households' demand for housing assets as stores of value and generating a housing boom. However, the collapse intensified the shortage, shifting households' demand for housing outward.

As of late 2024, China's private consumption has been experiencing subdued growth. Consumer confidence indices of the Federal Reserve Bank of St. Louis show that Chinese people remain cautious about the near future. Sentiment remains at an all-time low with high living costs, job security concerns, and income disparities among the top reasons (McKinsey & Company survey, 2024).

If we were to consider as a counterargument the expansion of China's middle class, their consumption patterns have become more conservative. This conservatism is likely due to concerns about future income stability, prompting households to save more as a precautionary measure in a country where a high savings rate is already structural (Figure 4).

Figure 4
China household savings rate has long been the highest compared to the US and Europe

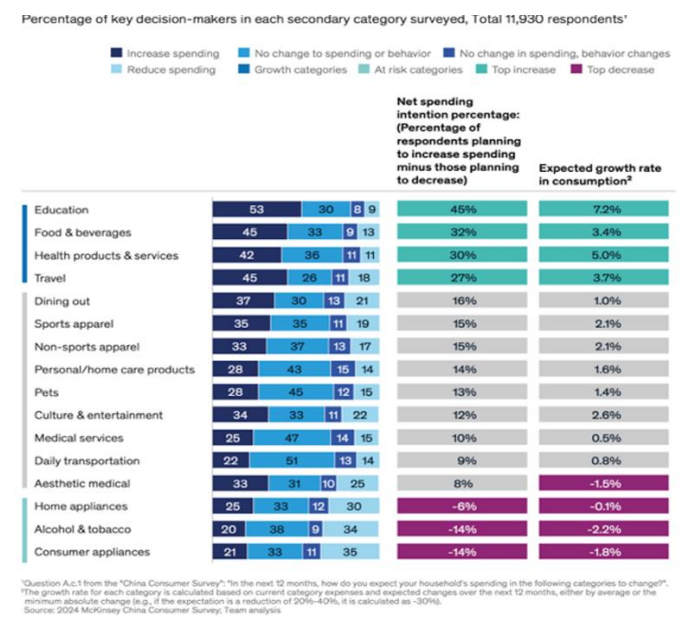


Source: China National Bureau of Statistics, US Bureau of Economic Analysis, Eurostat, Bloomberg

China's consumer spending patterns reveal a selective approach. Consumers are shifting their purchases to services and experiences, reflecting a growing health consciousness and an increasing willingness to invest in sectors that improve personal well-being. Comparing net expenditure intentions (Figure 5) and expected consumption growth rates (Figure 6), there is potential growth for the following categories: education, food and beverages, health products and services, and travel. These categories are linked to people's increasing health consciousness and willingness to spend on services and experiences that improve their lives. In contrast, areas tied to the broader economy and real estate market—such as home appliances and consumer electronics—show slower growth.

Given this current situation, the strategy of the Chinese government aims at promoting a more consumption-driven growth model and at modernizing household consumption patterns, in line with its fiscal and monetary policy.

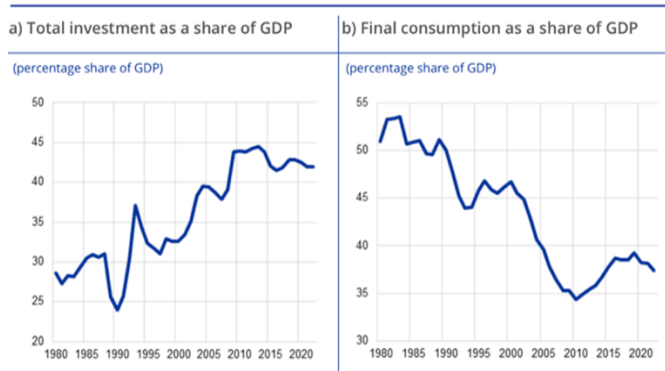
Figure 5
Chinese consumption expectations reveal that consumers are shifting their purchases to services and experiences



Source: McKinsey & Company



Figure 6
Trends in China's output components: More investment, less consumption in GDP



Source: OECD and ECB staff calculations

China offers trade-in programs for consumer products, incentivizing consumers to exchange old vehicles and home appliances for new, more sustainable models.

Looking ahead, analysts (World Economic Forum, July 2024) predict that China's GDP growth will continue at a moderate pace, probably reaching the 5% target. To explain this, we must consider, aside from the strength of the Chinese economy in other GDP components, the weight of private consumption on the overall economy. Household consumption accounts for about 38% of China's GDP, in strong contrast to higher values recorded in other developed economies like the United States (about 60%) and EU countries (50–55%). This means that shifts in consumption patterns have a less pronounced impact on China's overall economic growth.

With appropriate policies and structural reforms, there is room for consumption to play a more significant role in driving China's economic growth in the future.

Inflation Downward Pressure

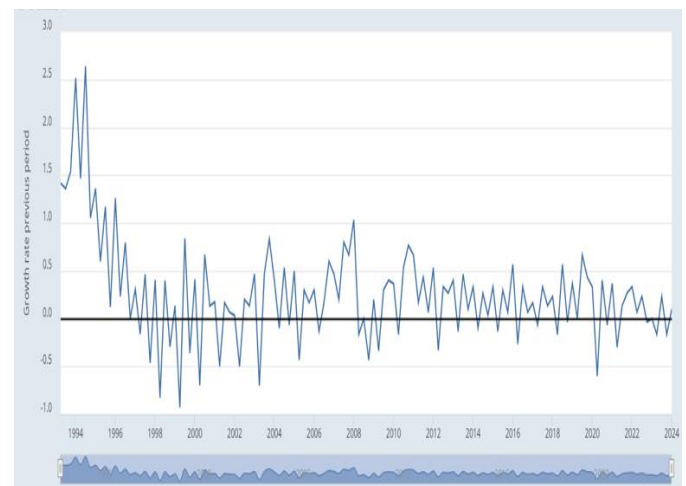
China presents an inflation profile which is complex to understand. While India and Brazil present an annual inflation growth (September 2024) of 5.49% and 4.42% respectively, China presents 0.4%, signaling the deflationary trend started in the first quarter of 2023, and validating the hypothesis of Chinese *Japanification*.

Chinese inflation has experienced a downward evolution along the last decades (Figure 7). During

the 1990s China suffered of a period of high inflation.

The Hong Kong Monetary Authority report (2003) proves through an estimated new Philips Curve and the application of Johansen approach for testing cointegration of multiple time series the significance of long-run relation between the Chinese Consumer Price Index (CPI) and global prices, including exchange rates fluctuations.

Figure 7
The Consumer Price Index (All Items) has experienced a downward evolution along the last decades



Source: Federal Reserve Bank of St. Louis

Since last February, China's Consumer Price Index (CPI) has returned to growth following four months of deflation caused by the country's real estate crisis, which significantly weakened consumer sentiment. The inflation rate appears relatively stable at around 0.5%. However, heightened competition among Chinese companies, exacerbated by weak demand, alongside falling raw material and commodity prices, may exert further downward pressure on the CPI.

With the aim of mitigating deflationary risks, the People's Bank of China has been actively intervening, particularly in the real estate sector, by lowering the one-year loan prime rate, which serves as the benchmark for most corporate and household loans. The rate was cut by 10 bps in July and most recently by 25 bps on October 21. Given the recent developments, it is worth focusing on a particular



aspect of monetary policy that could exacerbate deflationary pressures: the role of monetary easing in China. While financial systems in developed economies are typically structured so that an increase in the money supply drives demand to grow faster than output, leading to inflation, in China this dynamic does not produce the same effect. China's financial system is structured in such a way that monetary expansion predominantly translates into credit growth, which, due to institutional factors, is channeled primarily toward the supply side of the economy. For instance, most of the credit in China flows through businesses, state-owned enterprises, local governments, and central authorities in Beijing, to investments in infrastructure, real estate, manufacturing, and resource extraction industries (Pettis, M., 2024). A much smaller portion goes to households, and even then, until recently, it was largely allocated for home purchases rather than general consumption. The consequence of this cycle is that credit expansion tends to bolster supply more than demand, resulting in downward pressure on prices in China.

Is Japanification a Valid Hypothesis?

Several of China's downward inflationary pressures mirror those seen in Japan during the 1990s. The onset of the *Lost Decades* in the 1990s saw Japan's economy mired in protracted stagnation, with deflation emerging as the primary macroeconomic issue. Here, the period of near-zero inflation (and deflation) has been attributed to three factors: economic, behavioral, and structural. The latter refers to both the demographic component - aging population as a catalyst of shrinking workforce- and the technological component - technology improvement as a catalyst for reduced prices - . The behavioral component refers to the anchoring of deflation expectations among the Japanese citizens, known to be risk-averse. The economic component refers to the situation of the whole economy, which becomes clear from the flattening of the Phillips curve. This implies that price changes became less sensitive to economic conditions (Ikeda et al., 2022). In China, the impact of expansionary monetary policy is shaped by unique institutional frameworks and an aging demographic trajectory similar to Japan's. China's share of residents over 60 will rise from 17.91% in 2020 to 33.09% by 2040 (Statista, July 2024).

Recent literature (Koaster et al., 2021; Auclert et al., 2021) emphasizes the impact of aging on inflation, primarily through its effect on consumption and economic activity. Although empirical evidence remains limited, current data (Lee et al., 2024) indicate a negative correlation between inflation and the speed of population aging. This dynamic is especially relevant for China, where weak consumer sentiment exacerbates downward price pressures. Regarding the issue of the alleged real estate bubble, it is important to highlight that the rate of real estate price growth in China has never reached the levels seen in Japan. Moreover, Japan's bubble was driven primarily by speculation in commercial properties, whereas China's focus is predominantly on residential properties, viewed by many Chinese as long-term investments.

On the other hand, while China remains a developing nation with a per capita income roughly 15% of that of the United States, Japan's per capita income was around 120% of the U.S. level when its deflationary spiral began. This distinction highlights the fact that, unlike Japan during that period, China does not meet the criteria for a developed economy, which underscores the divergent nature of their economic conditions.

While there are certain parallels to be drawn with Japan's economic situation in the 1990s, there are also key differences that suggest China still has significant room to steer clear of the deflationary zone it is currently navigating. The Chinese government could prioritize economic development via the restructuring of struggling property developers and local government financing entities, and enhance social safety nets to bolster long-term household consumption.

Implications on China's Stock Market

The Quasi-persistent Relevance of Commodities and Electric Vehicles

The much-maligned (property market crash, piling local debts, sagging consumption, deflationary pressures) economic trajectory of China, the world's largest importer of crude oil, lithium, iron ore, liquified natural gas and copper, has played a vital role in the demand levels, volatility and overall



investor sentiment across global commodities markets. The World Bank's commodity price index is expected to slide 5% to its lowest level since 2020 in 2025, with meagre oil and metal prices as the catalysts. While individual commodity markets are expected to diverge in price movements, the strengthening of global supply streams will drive prices down in aggregate.

The onset of the COVID-19 pandemic saw bulk commodity prices in China sink to four-year lows. The reopening saw prices rebound to pre-pandemic levels, notably with iron ore prices hitting all-time highs and the exposition of the economy's underlying structural deficiencies. Consumer confidence eroded from a relatively optimistic 120.5 in February 2022 to August 2024's 85.8, a 10-year low, while Chinese producer prices have registered negative year-on-year changes for 24 consecutive months, signalling entrenched deflationary pressures.

China's explosive growth narrative has shaped the twenty-first-century international Brent crude oil market: over 60% of annual demand growth has come from China since 2013. Despite fears over Middle East tensions, crude oil prices have been weak in 2024, with sluggish Chinese demand a key culprit: a 16% rally in crude oil imports in August to 49.1 million barrels (largest since mid-2023) was still well below 2023's figure.

Looking ahead, it is unlikely that Chinese demand will pick up the slack. The stockpile of crude oil acquired by a record 2023 is thought to have satisfied Beijing's desired quota, while Chinese oil refineries have become over-capacitated (18.5 million versus 13.8 million barrels per day refined), forcing a pivot away from increasing capacity beyond 20 million per day. Furthermore, domestic oil production rose 2.1% from January to July 2024. Petrochemicals, responsible for ~90% of recent Chinese oil demand growth, may drive demand recovery, since decarbonization is less of a focus in China than in Western countries. In the absence of a Chinese economic recovery, crude oil prices will be more of a supply-side story. In addition to significant cheating within the cartel (Iraq, Kazakhstan, UAE), non-OPEC+ members have increased production, which will force OPEC+ to increase production to avoid losing market share.

Historically, Chinese manufacturing and construction sectors have consistently grown as

sources of demand for metals, but significant oversupply has accumulated in reaction to their contractions. With steel overcapacity, iron ore port holdings have accumulated throughout 2024, extending downward pressure on prices.

Developed economy easing cycles will bring relief as capital-intensive sectors, such as currently weak global manufacturing, will begin to pick up, but with capacity to continue growing into 2026, subdued iron prices will persist in large part due to China. Copper prices have been bullish (closely tied to the green transition) although relatively volatile since 2020. While projected by Fastmarkets to average \$10.265 per tonne over Q4 2024, a record high, Goldman Sachs recently cut projections by ~33%, due to persistent headwinds from its most important participant, China (China consumes 54% of the world's refined copper and is the third largest producer). Despite these bearish factors, many of which are shared with steel, China's strong commitment towards green industry supports a long- and medium-term bullish view. The versatility of the metal in decarbonization efforts, infrastructure investment and in data centers ensures that demand will continue to grow both outside and inside China, irrespective of its current economic difficulties.

The \$1.4 trillion fiscal spending plan adds another complex variable to this landscape. The first measures announced focus on relieving local government debt crises but ignore direct stimulation of consumption (recapitalizing banks or property market intervention). However, these measures are expected once Beijing assesses the exogenous effects of President Trump's second term. In regards to our analysis, expectations regarding the packages have improved market sentiment, which may mitigate downward price pressures. However, Chinese exports serving as a buffer for stalling domestic demand, will affect price movement in global commodity markets in the near future.

There is a global reliance on Chinese production of lithium and cobalt which holds 70% of lithium and cobalt refining capacity. This positions the country as the centre of global EV production, as 85%- 95% of the global production capacity of the major components of EV batteries (the defining feature of EVs) is in China.

China dominates the EV market and positioned itself as the industry leader thanks to aggressive government policies and substantial subsidies.



Beijing has also encouraged EV adoption and has the most EV charging stations in the world, with over 3 million.

The continuous growth of the Chinese EV sector is challenging the Western EV and automotive industry equity markets because Chinese firms have one obvious advantage: price. Cheap labour and manufacturing and hefty government-sponsored incentives (subsidies, tax breaks) make Chinese vehicles the cheapest to produce. This allows the entire supply chain to be kept in China and favors the integration of Chinese firms into foreign markets. This advantages Chinese EV and car companies, namely BYD (the largest EV company by market share) and others such as Geely (owners of Lotus and Volvo) or CATL (EV battery producer), that have gained traction in equity markets in recent years.

On the other hand, the pressure on Western firms has led to a reaction by the respective governments to protect domestic industries. Tariffs of 100% on imported Chinese EVs in North America and 45% in the EU have been imposed, and further tariffs on imported Chinese EV components have also been announced. These have fueled the fire as trade tensions heat up between China and the West. This is incredibly relieving for American EV-dedicated companies such as Tesla (the largest automotive company in the world) and Rivian. However, it is also a call to action for other traditional internal combustion engine brands that are beginning to develop hybrid and fully electric offerings to keep up with increasing consumer conscience and decarbonization objectives. This is particularly relevant for Asian brands, such as Toyota or Hyundai, since South Korea and Japan also have access, though at a smaller capacity, to lithium and cobalt production.

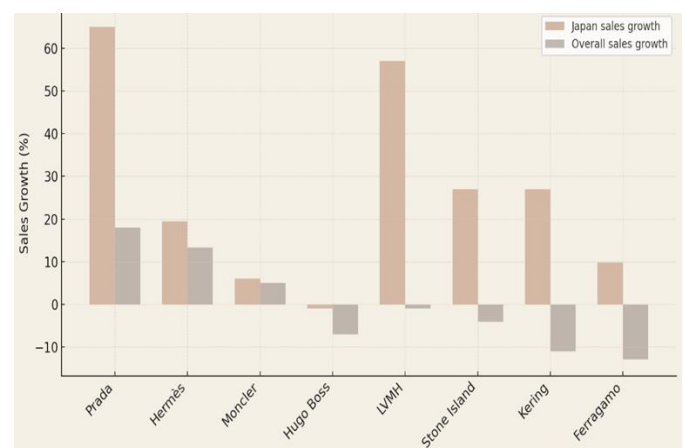
The Role of Macroeconomics in China's Luxury Sector

The H1 2024 financial results for luxury companies in China reveal a complex and polarized market, with the luxury sector advancing at two different speeds. On one side, brands like Prada, Hermès, and Brunello Cucinelli report record-breaking results; on the other, some of the world's top luxury companies, including LVMH, Kering, Salvatore Ferragamo, Burberry, and Lanvin, have seen earnings drop significantly, with double-digit declines across

various metrics, resulting in a huge crash on the stock market. The Asia-Pacific region, particularly China and Japan, plays a pivotal role in this uneven performance, with Luxury companies that are facing a declining in sales citing China's softening consumer spending as a major factor behind the market downturn. But blaming China for luxury brands' performance challenges is an oversimplification. The fact that Chinese consumption is struggling is evident, but the share of consumers that the luxury market deals with is a particular category that cannot be generalized with the total consumers. Chinese luxury consumers are still spending significantly—they are simply doing so abroad, in markets like Japan, Dubai, and France, where price differences are substantial. Chinese luxury spending has shifted internationally rather than declined. Evidence of this shift in luxury spending away from China can be seen in the sales growth luxury brands have experienced in Japan—even among those struggling in other markets (Figure 8).

Brands like LVMH and Kering, which reported sales declines in the APAC region, still saw gains in Japan.

Figure 8
Chinese luxury spending has shifted to Japan, proven by Japan Revenue vs Overall, Q2 2024



Source: Company Data

Japan's luxury boom is largely driven by a weaker yen, which has made high-end goods more affordable compared to neighboring markets like mainland China, in line with our macroeconomic



analysis of Japan. This has spurred a significant increase in tourist spending, particularly by Chinese visitors, who accounted for 16% of tourists and 20% of total tourism spending in Q1 of 2024. This trend has encouraged luxury brands to expand their operations in Japan, either by increasing their retail footprint or accelerating planned expansions. However, those brands should be careful with investments in Japan, due to the high volatility of this market. Recent market events like the Bank of Japan rate increase makes Japan a really complex and volatile country from both a macroeconomic and investor sentiment perspective, making microeconomic price-setting particularly challenging for brands.

This disparity in results is largely driven by the behavioral component, i.e., the current shifting in luxury consumer preferences. Underperforming brands often struggle with inconsistent brand storytelling, while high-performing brands excel at it, reflecting a broader shift from a product-centric to a client-centric model in the industry.. Consumers are becoming increasingly selective, favoring iconic brands like Hermès, Chanel, Moncler, and Prada. This has led to a growing polarization within the luxury sector.

At the current market condition, the luxury sector is struggling but there are some investment exceptions that can turn to be profitable after a careful analysis of consumer preferences and macroeconomic trends.

The analysis proves the degree of *nimbleness* required for specific components of China's economy. The hypothesis of China's *Japanification* could prove valid, if the upcoming macroeconomic data confirm it. Alternatively, the combination of fiscal stimulus and incentives might turn out to be more effective than domestic monetary policy and standard transmission channels.



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