Allison Nathan: Hopes that China's reopening would power the global economy have been quickly dashed. But is that disappointment warranted?

Hui Shan: This is not something we have seen in previous cycles that this entrenched and pervasive lack of confidence playing out in the Chinese economy. So, this a very difficult environment. Unfortunately, doesn't seem to be an easy fix here.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.

[MUSIC INTRO]
Allison Nathan: China's emergence from COVID lockdowns was expected to boost a global economy. But a string of disappointing data is giving investors, policymakers, and market watchers a new reason to worry. To explain the drivers of the outlook for the world's second largest economy, I'm speaking with my colleague in Goldman Sachs Research, Hui Shan, our chief China economist. Hui, welcome back to the program.

Hui Shan: Thanks. Nice to be on.

Allison Nathan: Hui, a lot has happened. Let's just start with some context. How did we get here?

Hui Shan: So, we know that all countries went through COVID. And after reopening, most economies will show a strong and sustained recovery. In the case of China, it's a bit disappointing that the sense that the recovery and reopening impulse only lasted for one quarter. The first quarter was good. But in the second quarter, the recovery seemed to have fizzled out.

And also, what's surprising was the sort of spillover effect that also didn't play out as investors were hoping for,
whether it's the stronger oil demand translating into higher commodity prices or outbound travel being very strong. We saw some of it, but not to the extent the market's expecting.

In retrospect, what was the key driver of China's less than anticipated post reopening recovery? I think there might be two reasons. One is ahead of the COVID pandemic, I think there were just too many imbalances in the economy to begin with. Recall that 2018/2019, China was already under gross pressure stemming from a trade war and also the 2017/18 regulatory tightening, especially on the credit tightening and private companies and so on.

The second reason is that the COVID pandemic, how the government dealt with it, was also significantly different from other economies. In other economies, you saw government protected households and sent cash to households. And that helped to maintain demand. Versus in China the government also did a lot of support, but mainly on the supply side and making sure China can still produce and export.

On the household side, people did not receive cash
handouts. At the same time, we had regulatory tightening on the internet. We had a housing deleveraging campaign. That set of policies led us to today's environment which is reopened, but lackluster recovery.

**Allison Nathan:** And what's your view on China growth at this point? And how has it changed given this disappointing data?

**Hui Shan:** Yeah. Think about the Chinese economy right now. I think there are a few things at play. We have to take them together in projecting the future. One is just that the strength of consumption recovery, how much more and how far we are still below trend. And how do we think about the organic growth power? The second is thinking about a policy response. Is the government going to stimulate? Is the government just going to sit on the sidelines and not do much? And third is the external environment. Will we see a shallow recession in other economies, therefore translating to less external demand for Chinese goods?

When you put everything together, our central projection is that on the external side, we're more optimistic that
Chinese exports can stay flat this year. In the second half, the third quarter may still be some headwind because last year's base was relatively high. The fourth quarter [UNINTEL] should be better because we had a low base, the COVID [UNINTEL] and supply chain disruption, we should see a strong number.

On the organic recovery side, I think we're still seeing consumption recovering, especially in the services sector, contact intensive sector. We see that there's still room for recovery.

Now, the key question is what the government will do. And our base case is that they will do some easing, but not too much.

So, when you add everything up together, our sequential projection will be the third quarter should be better than the second quarter. That's primarily because we're already seeing easing signs that will help the sequential growth. And also, the destocking/restocking, that inventory cycle should be moving from a very strong headwind in the second quarter to less of a headwind in the third quarter. So, for those reasons we're projecting sequential growth to
pick up from second quarter to third quarter. For the full year, our projection is at 5.4 percent GDP growth.

**Allison Nathan:** And where was that coming into the year, just for some perspective.

**Hui Shan:** So, coming into the year, we were waiting for the recovery signal. As we tracked the data, as we got the first quarter data, which was quite strong, we lifted our GDP forecast in March to 6 percent. But now after seeing what's happened in April/May and where the June data was tracking, we revised down our forecast. And the most significant downward revision was for the second quarter growth.

**Allison Nathan:** And so, let's just drill down further into some of the segments of the economy. Are we expecting to see some sectors weaker than others?

**Hui Shan:** If you look at the Chinese economy, it's a big country. Different sectors are faring differently. And even within the same sector, sometimes you might see divergences. For example, if you look at investment, if you look at state owned enterprises, SOE, their investment
growth has been double digit this year versus the private companies, their investment has been flat or negative year on year.

I talk about services, restaurants, these sectors. They were very much depressed by COVID controls. And now, they still have room to increase. They're outperforming.

On the flip side, if you look at the property sector, despite the large decline last year, we continue to see decline in net sales, in housing [UNINTEL]. So, the economy is in a very divergent and differentiated place. And it's hard using just one measure or one parameter to describe is it good? Is it bad?

**Allison Nathan:** And if we think about the segment of the population that's bearing the brunt of this down term, it's young people. The work that you've done has shown 16- to 24-year-olds are in the crosshairs of this. Why is that the case?

**Hui Shan:** The youth unemployment rate in China is very high. According to official stats, 16- to 24-year-old unemployment rate is currently at 20 percent. That's
doubling from in 2019 of 10 percent.

We did some analysis, and it seems that there are both cyclical and structural factors behind the rising youth unemployment rate. On the cyclical front, you can imagine that young workers, the unemployment rate is more sensitive to service sector economic growth. When we look at historic data, that's precisely what the data shows. And currently, as we discussed, demand is weak and young workers have been disproportionately impacted.

Think about the education sector crackdown. A lot of young folks work in the tutoring industry. And they were the forefront in bearing that burden.

But there are also structural reasons. For the current young generation in China, more than half of them go to college. That's much higher than, say, in the US. Only a third of young folks go to college. So, because over time when kids are the only child in the family. The family wants them to go to college. Get a better education. You've got this rapidly increasing number of college graduates. It's harder for the labor market to digest. These folks want white collar jobs.
At the same time, the economic structure has been shifting very rapidly. You think about people who went into college. Majoring in finance. Majoring in real estate. Or majoring in the internet. And when they come out of college, all of the sudden the government wants more people doing semiconductor engineering or technicians. There are mismatches between where people are studying and the graduates colleges are producing versus the labor market demand. So, that's another reason that this is a really hard problem for the government to solve.

**Allison Nathan:** There has been so much focus on the property sector just because it is the largest sector of the economy. So, is it even possible to see growth holding up if that property sector continues to slump as you expect? How much impact is it having on the broader economy?

**Hui Shan:** Yeah. You're right that there's no other sector in the Chinese economy as big as the property sector. It's a very long supply chain. It has upstream all the way to steel, cement, mining. And a downstream when people are moving. They buy a TV. They might buy furniture. They buy home appliances. And so, again, imagine that the
property sector, if it continues to decline at a very rapid pace, it's going to have a tremendous amount of downward pressure on the economy.

I think that's one of the biggest risks or downside risks to the Chinese economy right now. But at the same time, what we saw in the first quarter sales were beating expectations. Part of that was just pent-up demand going into year end and the beginning of this year. Everyone was getting COVID and getting sick. So, a lot of the transactions would have happened. They were concentrated in February/March. And then come April/May we saw a big decline in transactions.

So, if we don't get to the sort of expectation, start to turn more bearish and people are reluctant to buy their properties, which make prices fall further, which dampens sentiment even more, if we don't get into that negative feedback loop, our expectation is that sort of sales are going to stabilize at this low level. And that would help translate that into the economic impact in terms of upstream/downstream, in terms of contribution to GDP. It will be another year of a drag to GDP growth. But perhaps not as dramatic, as negative as last year. So, that's baked
into our forecast. And as you can see, there are certainly downside risks.

**Allison Nathan:** And when you speak to clients, are you seeing any important differences in sentiment between domestic investors versus foreign investors?

**Hui Shan:** Yeah, that’s really interesting question. Sitting where we are, we do talk to both onshore investors and offshore investors. From time-to-time views could diverge. At the beginning of the year, I would characterize onshore investors much more pessimistic than offshore investors. You can understand why that’s the case, right. Other countries reopen, economy rebound, demand [UNINTEL] strong. So that’s the lens offshore investors are looking at China in January/February/March. Whereas for onshore investors they didn’t experience that and they were more cautious. At this point, in Beijing when we talk to investors, what’s interesting is that we noticed a stabilization or even some improvement in sentiment among investors. The logic being look the policymaker already started the easing and things are so bad they can only go north. Whereas offshore clients are disappointed by market performance and growth trajectory turning more
and more bearish. Oftentimes we see the isolation and divergence in investor views when we talk to onshore versus offshore investors.

**Allison Nathan:** And as you've said, the policy response here is going to be tremendously important. China's Central Bank recently cut short-term borrowing costs to help boost economic growth. So, you mentioned you expect more easing. What might that look like?

**Hui Shan:** Yeah. Chinese government is more top down and has a lot of instruments to manage the macro economy. So, when we talk about the policy, it's helpful to think about the monetary policy, fiscal policy. But also housing policy and other industrial-level policies.

How do we think about it? How do we put it in a framework? I think of it in the following way. Monetary policy might be the one facing the least hurdle in terms of easing. Why do I say that? Because you don't really need, for example, National People's Congress Standing Committee to approve anything. Let's say if you want to increase your local government's special bond [UNINTEL], by law that has to be approved by NPC Standing
Committee. So, the hurdle will be higher. Versus cutting the interest rate by 10 basis points, you don't need that type of approval.

So, I think that makes monetary policy to be the forefront of an easing choice. And that's why we saw ten basis points of rate [UNINTEL]. We're expecting another triple [UNINTEL] this quarter. We're expecting another ten basis point rate cut in the fourth quarter. So, we are on the easing path. That's the monetary policy.

On the fiscal policy, it's harder to imagine we'll get dramatically more fiscal resources. Just by doing the math, going through all the channels, land sales are down. The budget's already been approved. Barring some extraordinary event, it's very unlikely for us to see, for example, central government special bond issuance or something major happen.

And then on the property sector, we think the name of the game is risk management. Right? We talk about long-term demographics, fundamental demand, housing for living for speculation. You can see the forward of housing demand is on a downward trajectory. So, the government wants to
prevent it from becoming too much of a negative spillover to the rest of the economy. But they're not interested in engineering a U-turn, engineering a sharp increase in the property sector.

And then for the other industrial level policies, what we saw for example pass a couple years, internet sector, regulatory actions. That might have stabilized or even eased a little bit. Most recently, we saw some headlines coming from Zhejiang province where Alibaba was headquartered. It was suggesting that there is some improvement or encouraging news coming from those sector level regulatory policies.

And then in the new economy, for example, electric vehicles, the support for those new manufacturing sectors, that's going to continue. So, taken together, it's a pretty complex set of rules. But in terms of magnitude, we think it's a moderate amount of easing. But don't expect too much just given that this year's growth target seems to be within reach and the government is really focusing on transforming, restructuring the economy than engineering a short-term sharp increase in growth.
Allison Nathan: So, you're generally painting a picture of somewhat policy restraint in addressing some of this weakness. I think the big question on investors' minds is whether that's enough to bring back confidence, both confidence domestically and investor confidence in the country that it is going to be able to pull itself out of this slump, perform better in the second half of the year and going forward. So, what's your take on that? Is the giving doing enough to restore confidence in the growth picture?

Hui Shan: I think if under our base case expectation, no dramatic increase or no policy measures that will be, quote/unquote "shock and awe," then it's very hard for confidence to turn around. If we don't see a major structural announcement really indicating the government's attitude and actions towards private enterprises will be fundamentally different to inject that dose of confidence, then I don't think just by saying we support private companies, by saying Chinese growth, will be robust going forward, and will be convincing enough to consumers, investors, and so on. So, that is a place for the policymakers that's also very hard to deal with. This is not something we have seen in previous cycles, this entrenched and pervasive lack of confidence playing out in the Chinese
Because previously, you know, you ease the housing policy, and the economy just accelerates very quickly versus this time around. What exactly do you do? For example, if you have a youth unemployment rate that's very high, what do you do? Another infrastructure project is probably not going to solve your problems. If private companies are worried about regulatory uncertainties, what are you going to do? Cutting ten basis points interest rates also doesn't cut it.

So, this is a very difficult environment. We're also trying to think through, what are the options? Unfortunately, it doesn't seem to be an easy fix here.

Allison Nathan: So, what are the implications in that for growth in the medium to longer term?

Hui Shan: In terms of the medium-term outlook, we're on the cautious side. If you think to 2025, by which time the COVID impact will be all behind us and what's the growth forecast? We're anchoring at 4 percent. Before COVID in 2019, you asked us to make a forecast for 2025
for GDP growth, I probably would have said 5 percent. But
given what's gone on over the past few years: some
structural changes, whether it's the housing sector,
whether it's a geopolitical front, whether it's domestic
reorientation, the focus on security, I think the cost of all of
these will be slower economic growth.

Allison Nathan: So, the broader context is that China has
these longer-term policy goals and there are going to be
trade-offs between growth and achieving those goals. Is
that the right way to think about that?

Hui Shan: Yeah, I think so. I think that if you think
about how the Chinese government's priorities have
shifted, both because of the domestic developments and
the debt issue with the property sector with local
government, and they need to find a way to derisk
internally and the external environment. And they need to
find a way to reduce their reliance on external side. Then
you have an economy. Let's say you succeed in both
stabilizing and deleveraging your economy and increasing
your self reliance, then there has got to be some cost.
Right? The cost is slower economic growth. So, that's the
trade-off that's embedded in our GDP forecast.
Allison Nathan: But we often hear that policymakers are very focused on growth for the reason that they understand growth has to be at a certain level to support the population to ultimately achieve their longer-term policy goals. What are you watching that might indicate a change in the trajectory of policy or China's economy more broadly at this point?

Hui Shan: I think it's important to recognize two things. One is that sometimes the policymakers talk about these things as if they can have A, B, C, and D all at the same time, and we know fundamentally that's not possible. Let's say they made out by 2035 they want a double income again. They want to have a certain level of economic growth. But at the same time, they have said again and again for food security, energy security, supply chain security, data security, everything, that security is put at the forefront of their priority list. So, when you think about all the things we talked about, something will have to give.

I think as the forecasters, we just have to make a decision that among all the things that they would like to have, when faced with a hard choice, what ultimately will be their
decision? And in our view, we think the secretary part is more important.

And yes, for instance we didn't have to make that choice, great, we have stronger economic growth and party legitimacy, and people's happiness is all great. But if they have to choose, do you want security or do you want strong growth, we think they probably want to prioritize security. And that's how I think about it.

When investors are thinking about China, we really have to rethink the policy framework. The old cycle. Slow down. Major stimulus. Growth takes priority. That's all the KPIs, economic growth is the top priority. I think we have to rethink that reaction function and policy objective.

I would mention, for example, more recently you hear President Xi Jinping talk about he wants to have more RMB internationalization and other countries using RMB. But at the same time, China's not going to let go of capital control. And fundamentally, those two things are not consistent with each other. When you have a [UNINTEL] hard for other countries to choose or use your currency. But then when faced with that choice, we think that the
government probably is going to put more emphasis on control. So, that's why we think the pace of RMB internationalization may have to slow. That's the underlying forecasting exercise we're doing.

And also, I want to emphasize to investors we do need to shift how we think about China.

**Allison Nathan:** Really interesting, Hui. Thanks so much for joining us again.

**Hui Shan:** Thanks for having me.

**QUESTION:**
And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called The Markets. Each week in just ten minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Search for The Markets. And follow wherever you get your podcasts.

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