NATIXIS CORPORATE AND INVESTMENT BANKING

RESEARCH

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CHINA HOT TOPICS

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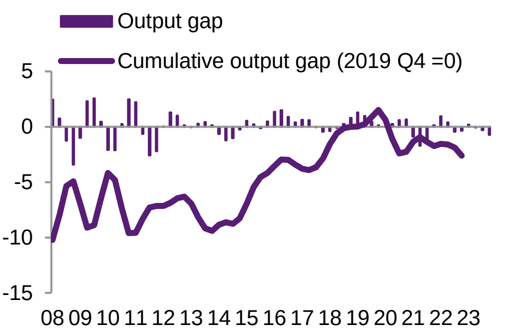
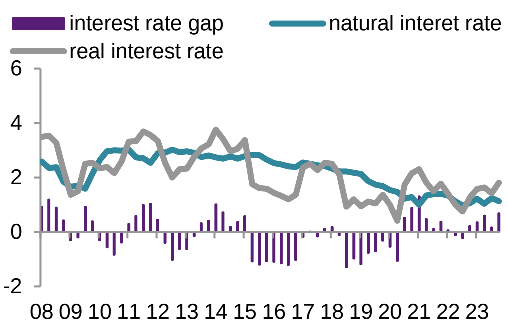
China's output gap



Source: Natixis, Author's calculation

China's natural interest rate versus real interest rate



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When will China recover from the cyclical downturn?

China's economy has been experiencing a structural slowdown, but what is causing concern now is that it is also slipping below its potential and undergoing a cyclical downturn. The faster deceleration in investment compared to consumption, along with weak CPI data, provides already evidence of China's negative output gap.

To assess empirically where China stands with its cycle, we use a model developed by Holston-Laubach-Williams (2023) to simultaneously estimate China's output gap and natural interest rate. Our results show that China has been in a negative output gap since the second quarter of 2022, which briefly turned positive in the first quarter of 2023 when the economy opened following the zero-Covid policy, but has since declined further. Moreover, our estimation of the cumulative output gap suggests that China has not yet fully recovered from the pandemic-related fall in activity.

Related to China's negative output gap is the rapid fall in the natural interest rate (or equilibrium interest rate), which is now significantly below the current real interest rate. This is mainly due to the stubbornly stagnant nominal interest rates, coupled with negative inflation. The fact that the real interest rate is higher than the natural rate points to a tight monetary environment in China these days leading to many market participants to call for substantial interest rate cuts.

Against the backdrop, there are two possible scenarios down the road.

If the PBoC moves quickly to substantially cut real interest rates in the current first quarter of 2024, it could bolster a swift cyclical recovery through the remainder of the year. To achieve this, the real interest rate needs to significantly decrease, either through a reduction in the nominal interest rate or a rise in inflation rate. However, increasing the inflation rate without support from a reduction in the nominal interest rate may not be easy.

If the PBoC does not act as swiftly, given the low probability of a rapid inflation boost in the near term, the deflationary situation could prolong more than in previous episodes, adding challenges to the Chinese economy in 2024.

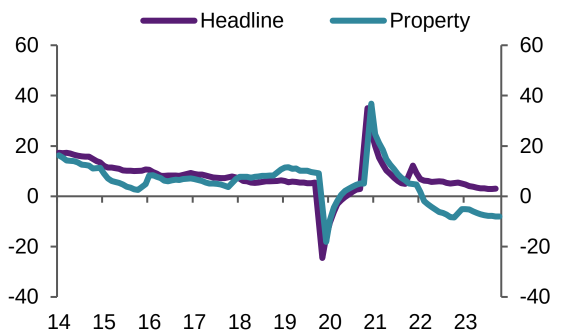
The Chinese economy experienced another slowdown in 2023, continuing a trend that began in 2010. This economic deceleration has been driven by structural factors such as growth convergence, an aging and shrinking working-age population, geopolitical tensions, and global supply chain fragmentation. However, the current rapid deceleration, coupled with stagnant PMI data, provides evidence of China's negative output gap in the business cycle.

Consumption remains resilient but investment sentiment continued to decline

The first evidence to justify the cyclical downturn is the more rapid decline in investment compared to consumption.

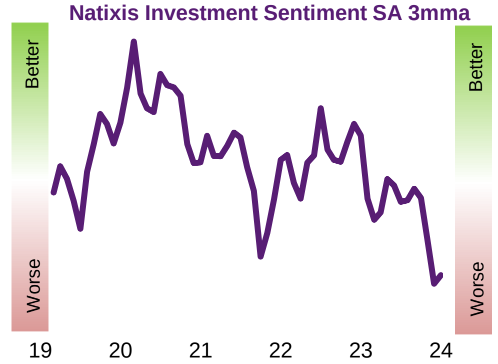
China's fixed asset investment has decelerated since the pandemic, with a year-on-year (YoY) growth of 3% in 2023, compared to 5.4% YoY before the pandemic (**Chart 1**). This decline is largely due to the real estate investment slump, which has persisted since the Evergrande crisis, but many other sectors also followed suits. Manufacturing investment remained relatively strong, but the global competition amid the geopolitical tension poses challenges down the road. Our Natixis investment sentiment indicator indicates that investor confidence hit a new low at the beginning of 2024 (**Chart 2**).

Chart 1
Fixed asset investment (%YoY, YTD)



Source: Natixis, Bloomberg

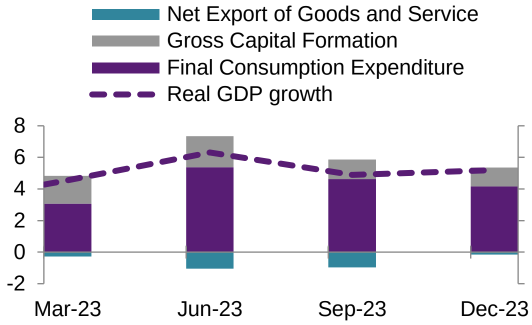
Chart 2
Natixis Investment Sentiment SA 3mma



Source: Natixis, Sina

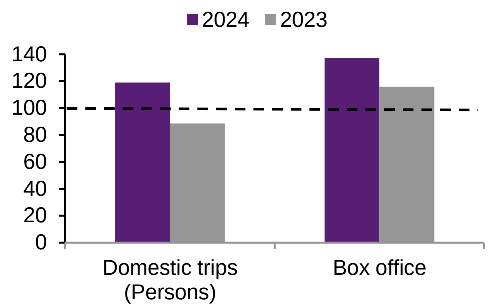
However, the investment collapse does not fully align with the consumption trend. China's consumption contributed 4.3 percentage points to the GDP in 2023, a significant increase from 2019 (3.48 percentage points) and the same as 2018 (4.3 percentage points) (**Chart 3**). During the Chinese New Year in 2024, domestic travel saw a 34.3% increase from 2023 and a 19% increase from 2019, with total domestic travel spending reaching 632.7 billion RMB, up 47.3% from last year and 7.7% from 2019. Overseas travel also showed signs of recovery, with inbound and outbound trips during the holiday reaching nearly 90% of the 2019 level. In addition, box office revenue reached a record high of 8.02 billion RMB, marking increases of 18.5% and 26.4% from last year, respectively (**Chart 4**).

Chart 3
Contribution to GDP Growth (% YoY)



N.B. 2022 Q2 data to be updated upon release of official data.
Source: Natixis, NBS, CEIC

Chart 4
CNY Holiday Consumption Data (2019 = 100)

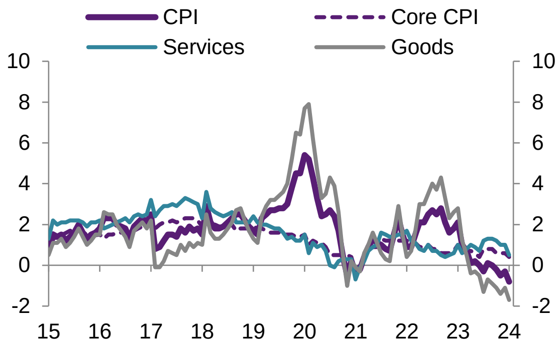


Source: Natixis, News

The deflationary pressures

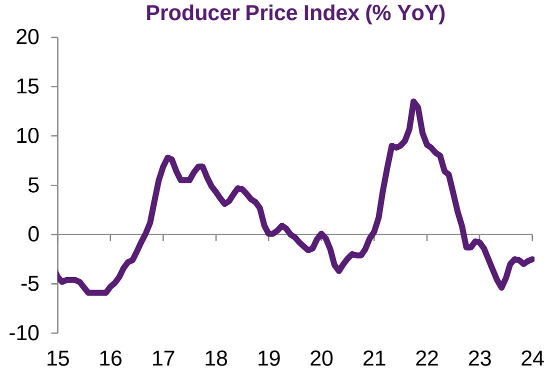
Another indicator of the cyclical downturn is the deflationary pressure, showing weaker demand compared to supply. China's year-on-year (YoY) Consumer Price Index (CPI) has been in negative territory for four consecutive months since October 2023 (**Chart 5**). In the meantime, the negative Producer Price Index (PPI) has been even more persistent, remaining negative since October 2022 (**Chart 6**).

Chart 5
Consumer price index (% YoY)



Source: Natixis, NBS, Bloomberg

Chart 6
Producer Price Index (% YoY)



Source: Natixis, Bloomberg

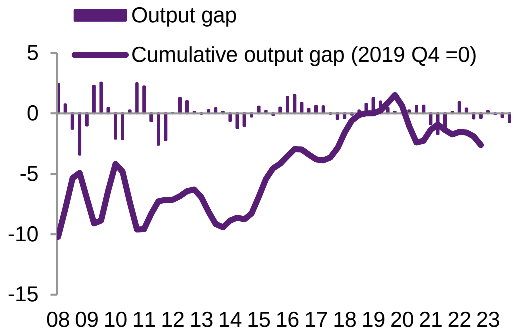
Quantifying China's output gap and natural interest rate

We use a model developed by Holston-Laubach-Williams (2023) to simultaneously estimate China's output gap and natural interest rate. The findings (depicted in **Chart 7**) first indicate that China's output gap shifted to negative territory from Q2 2022, briefly turning positive in Q1 2023 when the economy initially opened following the zero-Covid policy. However, it reverted to negative for the subsequent three quarters, suggesting that China has been experiencing a cyclical downturn for almost two years. If we look at the cumulative output gap since the start of the pandemic, China has not yet fully recovered from the cyclical recession.

When compared to previous episodes since 2014, this current period of negative output gap is one of the longest over the past ten years. Between 2014 and 2019, two episodes of negative output gap lasted consecutively for four quarters before returning to around 10 quarters of positive output gap. If past experience is a reliable indicator, the first half of 2024 will be critical for the Chinese economy to emerge from the negative output gap. This is why there has been growing demand in the market for more accommodative monetary policies, such as interest rate cuts, for some time.

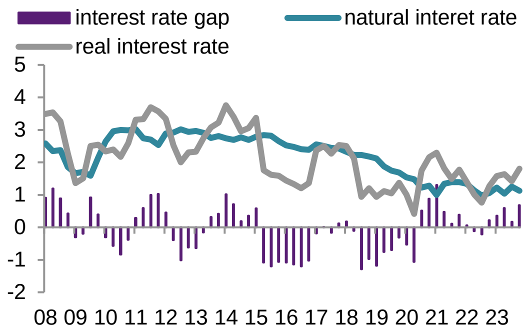
Using the Holston-Laubach-Williams (2023) model, we also calculate China's natural interest rate. We define the real interest rate as 3-month SHIBOR minus inflation expectation. Ideally, the best benchmark interest rate is the loan prime rate (LPR), but the LPR index is only available since 2019. Thus, we use the interbank SHIBOR as a proxy. **Chart 8** illustrates that since Q4 2021, China has maintained a higher real exchange rate than its natural interest rate, with the gap widening further in Q4 2023. This suggests that a tight liquidity environment for the Chinese economy has been affecting the economy, with a potential 70 basis points for the real interbank interest rate to decrease to reach the current natural interest rate level. In fact, for the previous episodes of negative output gap from 2014 to 2019, China was able to lower the real interbank interest rate below the natural interest rate by about 10 bps to stimulate the economy, indicating that a reduction of possibly 80 basis points may be necessary.

Chart 7
China's output gap



Source: Natixis, Author's calculation

Chart 8
China's natural interest rate versus real interest rate



Source: Natixis, Author's calculation

Conclusion: two possible scenarios down the road

Against the backdrop, there are two possible scenarios down the road.

If the PBoC moves quickly to substantially cut real interest rates in the current first quarter of 2024, it could bolster a swift cyclical recovery through the remainder of the year. To achieve this, the real interest rate needs to significantly decrease, either through a reduction in the nominal interest rate or a rise in inflation rate. However, increasing the inflation rate without support from a reduction in the nominal interest rate may not be easy.

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