

Postcard from China

10 key takeaways from China trip

I just returned from a week-long trip to Beijing and Shanghai talking to a wide range of China experts, companies and institutions. It was really good to be back after a four years break due to the pandemic and a reminder of how important it is to put the feet on the ground once in a while to stay connected to what is going on – and also get access to the best experts when it comes to Chinese developments, not least Chinese economists who often see things from a different perspective on top of typically knowing the economic system in more depth. Any experience is of course subjective and depends on the eyes that see and the questions you ask. Bearing this in mind below are my personal 10 key takeaways from the trip. As will be clear, China is facing a lot of challenges currently and caught in a state of low confidence that will require more stimulus in the coming years until the wounds have healed. But there was also still a cautious optimism among most that the Chinese economy would eventually come back and that the country's leaders are still pragmatic and flexible, the hallmark of Chinese leadership during the reform- and opening-up phase starting 40 years ago, despite recent years' rising focus on security and control.

Key takeaways

1. **Confidence is weak.** This was not a major surprise but still interesting to hear everyone talk about it. Households seems to suffer from a bit of 'post-traumatic stress' from the tough lockdowns in 2022. Chinese households generally save a lot for a rainy day and 2022 felt more like a thunder storm than a rainy day so savings are prioritised even higher now. In addition, some households lost part of their savings during the pandemic because they either lost their job or their small business had to close. And social security is very limited. These households now focus on rebuilding their buffers. Once buffers are rebuilt, the savings rate will likely come down and spending picks up. But it will take time and patience will likely be needed and continued stimulus. Many, not least in Shanghai, lost confidence in the central government due to the harsh lockdowns and the long time it took to leave the zero-covid policy. The last six months of economic pain in hindsight felt like a waste to many as the economy could have been opened up long before with the same health impact. The depressed housing market is also affecting sentiment negatively (see below) as well as the uncertain geopolitical picture, sanctions by the US and more focus on a falling population.

Business confidence is also weak. A challenging growth environment has hurt profits and confidence and the recent years of new regulations and crackdowns on selected areas of the private sector created a broader uncertainty about the policy direction. However, an asset manager I spoke to pointed out that while China's entrepreneurs have taken some hits, their entrepreneurial spirit is still very much intact. But currently their investments are dampened by the weak economy.

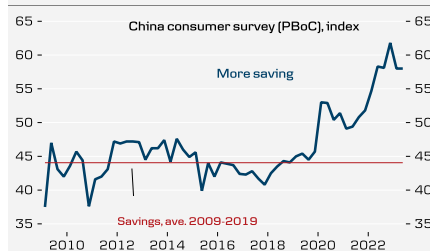
2. **Government taking measures to restore confidence but patience will be needed.** Authorities are very much aware of the weak confidence and the need to rebuild trust with the private sector. The past year has seen a clear charm offensive towards

Key takeaways

1. Confidence is weak
2. Government takes measures to restore confidence but patience is needed
3. Housing and financial risks persist. Goal is stabilisation of housing – not recovery
4. Risk of deeper financial crisis remains
5. Government to scale up stimulus, may aim for 5% growth again in 2024.
6. Demographics and innovation two most urgent structural issues
7. Investors sidelined but will eventually come back
8. Little signs of deglobalisation but diversification in focus.
9. Geopolitical tensions to continue – Taiwan the elephant in the room
10. ESG and carbon measurement a business focus

Source: Danske Bank

Chinese households still focus on saving as uncertainty persists and buffers need rebuilding



Sources: Macrobond Financial, PBOC

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the private sector highlighted by recent *guidelines* by the Supreme Court saying that “strict efforts should be made to crack down on violations of the rights of private enterprises and entrepreneurs, including their vilification or defamation through the internet or publications”. Earlier this year the government presented a 17-point plan to revive private investments and in September China’s top planner created a new department to help private businesses. However, it takes time to regain trust and the most important thing for businesses now will be to see stronger demand.

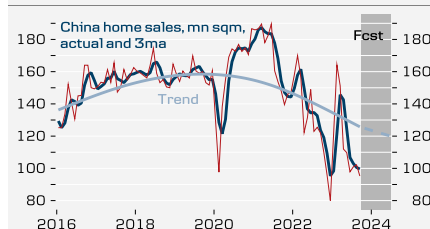
3. **Housing risks persist – government’s goal is stability, not recovery.** The weak housing market is contributing to the low confidence and although the government is taking steps to increase home sales, it has so far had limited impact. The general view was that the government was now aiming for stabilisation more than recovery but there were varying views. Some believed the worse is behind us while others saw further downside risks – especially for housing prices. Home buyers are out there but they are sitting on the fence and want lower prices. However, price controls on new homes underpin home prices leaving the market stuck in the mud with no visible signs of an improvement in home sales. And with sales 40% below pre-pandemic levels, developers will continue to struggle. One economist suggested the government bought the homes instead and rented it out at low levels to young people who struggle to afford them. Another believed we would see a consolidation of the developer sector leading to much fewer private developers and that the government would like to see state developers control a higher share of the market as they are easier to control.
4. **Risk of deeper financial crisis remains.** One financial expert had become more pessimistic over time due to continued negative surprises and she now expected a collapse would unfold sooner or later. Country Garden was the last hope but with its default it was clear the sector would not be rescued by the government. A key concern is the erosion of capital buffers in small banks due to more losses (China has 4,000 small banks) and there is no fire power in local governments to support them as they themselves are under severe pressure and a source of financial risk. Other analysts were less pessimistic and expected the government to be able to continue to muddle through without a collapse. However, overall the talks did leave me a bit more concerned that when I came.
5. **Government to scale up stimulus, may aim for 5% growth again in 2024.** Last week’s *increase in central government bond sale* by 1 trillion yuan was seen as quite significant by most analysts. A chief economist in a big Chinese investment bank pointed out that this had only happened three times before (in 1998 during the Asian crisis, in 2007 under the global financial crisis and in 2020 during the pandemic). He saw it as a strong signal of a change with regard to stimulus and did not believe the past years growth rates were representative for Chinese potential growth. He still saw it around 5%, about 1 percentage points higher than what the IMF predicts. But he pointed out that they often use the forecasts to put pressure on countries for reforms. Some government officials have also hinted at a growth target of 5% next year, which will be an indication of where the government sees potential growth. A 5% growth target would be a strong signal as it will be much harder to deliver in 2024 than in 2023 as the base effects are much less favourable. It would also imply, China would still be pulling around 30% of global growth.

Business confidence weak



Source: Macrobond Financial, Cheung Kung Graduate School of Business, Danske Bank

Home sales 40% below pre-pandemic levels – home buyers still on the fence



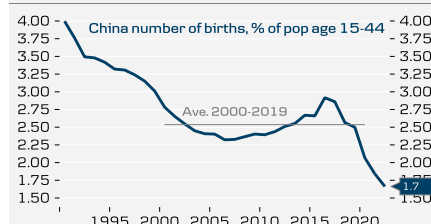
Source: Macrobond Financial, NBS, Danske Bank

6. **Demographics and innovation most urgent structural issues.** One Chinese economist highlighted that China is facing two urgent structural issues: demographics and innovation. Demographics had become a much more urgent issue in recent years as the birth rate had suddenly fallen a lot during the covid years (see chart). With new births falling below the number of deaths the population had started to decline much sooner than expected. He highlighted that previously the population peak was seen around 2027 and it had been a shock that it was already declining. China's leaders knew it was an issue that needed attention but they earlier felt there was more time to solve it. Now it is urgent and a wide range of measures are being tried through *pilot projects* in the usual Chinese way of experimenting in different localities to see what works. Local governments will also compete to see who can be most successful in turning the birth rate and it will be a KPI for local leaders. Housing subsidies for housing for families with two or three kids and subsidies for education and childcare have also been rolled out. But so far they are at a quite low level unlikely to have a big impact. The economist did not see the common comparison with the low birth rates in South Korea and Japan as fully correct as China was an outlier because the birth rate had fallen sharply at a much lower level of development. That made it more serious but also with better scope for improvement with the right measures. He believed the root cause was anxiety during the pandemic, high housing costs (more children requires more space) on top of the high education and child care costs. However, the subsidies for these areas will likely have to be quite significant to have an impact. China often goes its own ways when finding solutions so it will be interesting to see how drastic measures they are willing to take to address this issue and if they indeed will be able to turn birth rates. It will probably also require more certainty over the economic outlook so many of the current challenges are interconnected.

Innovation has been rating high on China's priority list for many years but the urgency now relates to US and European tech sanctions within the microchip space where China is vulnerable. China's need to become more self-sufficient in this area has a very high priority but it is also a daunting task. A chip expert I talked to believed the US sanctions were mainly to hold back China's development and had less to do with security (in line with the Chinese government's view). She said China would not need a great amount of advanced chips for use within a narrow area such as for military use or for super computers, but it would block China from using advanced chips on a big scale. China is able to develop advanced chips used in small amounts - or get enough through back channels - but it would not reach a level where it could be used for commercial scale. She also mentioned there may be new ways of getting more efficiency out of microchips through software in the future (*software-defined technology*), which could be an area for potential breakthroughs as well.

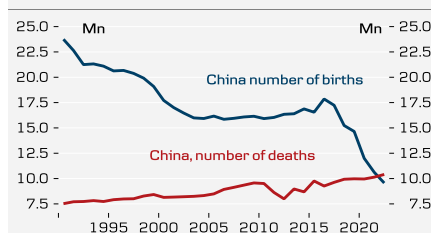
When it comes to other technologies China is moving fast on many fronts such as a) digitalization, b) automation and upgrade of manufacturing (robots etc.), c) green-tech and d) new materials, all areas that have had a central part in China's industrial policy over the past decade and bearing fruit now. In 2023 China ranked number 12 on the *Global Innovation Index* made by the World Intellectual Property Organisation (WIPO) out of 132 countries and in 2022 China bought more than five times more robots than the next on the list, Japan (see chart). According to the *Global Technology Tracker* made by the Australian think tank ASPI, China now leads in 37 out of 44 new technologies with the US being second in most. The tech focus is key for China to lift productivity growth in the future and compensate for the strong demographic headwind. But also challenges the West to a whole new degree. It is also a further reason why any decoupling from China would come at a major cost.

Sudden drop in birth rate has made demographics a more urgent issue



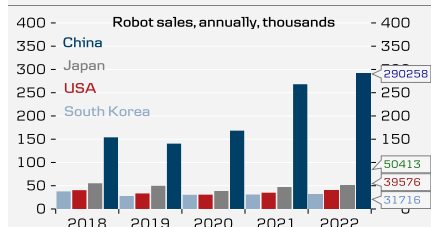
Source: Macrobond Financial, UN, Danske Bank

If China can lift births above deaths population could rise again in the short term



Source: Macrobond Financial, NBS, Danske Bank

China invests heavily in robots



Source: Macrobond Financial, ECB, Danske Bank

China moving fast on technology

"China's global lead extends to 37 out of 44 technologies that ASPI is now tracking, covering a range of crucial technology fields spanning defence, space, robotics, energy, the environment, biotechnology, artificial intelligence (AI), advanced materials and key quantum technology areas."

"for some technologies, all of the world's top 10 leading research institutions are based in China and are collectively generating nine times more high-impact research papers than the second-ranked country (most often the US)"

Source: Australian Strategic Policy Institute

7. **Investors are sidelined but will eventually come back.** Investors (not least foreign) have scaled down investments due to very poor performance in recent years and the current economic crisis. But the feeling is investors are ready to put money to work again at what looks like cheap valuations when the economy works its way through the crisis and the worst is perceived to be behind us. Some believed it would happen soon because the government will beef up stimulus more significantly. Others were less certain on the timing. There was still a predominant belief that China would eventually recover rather than be stuck in a Japanese-like scenario of low growth (3% or lower). China's leaders have historically been pragmatic and adapting and using crises to push through new reforms. There was some hope this could happen again. The recent support to the private sector and foreign businesses could be seen as a sign of this but implementation will be key.

8. **Little sign of de-globalisation but diversification in focus. Global businesses still believe in China's long term potential.** So far the limited signs of de-globalisation we can find in the data is also resembled in the message from the businesses I talked to. There is clearly focus on diversification and building resilience in supply chains but "China+1" seems to be the mantra with moving maybe 20-30% of production to other places, not least APAC countries, but not pulling out of China completely. An obstacle for moving supply chains is that it a) tends to be very expensive (there is a reason production is in China in the first place) and b) for some more advanced products it is hard to find the same quality of manufacturing skills elsewhere. It is often mentioned that India is far from China's manufacturing level and in many cases not a viable alternative. One company said it had tried and given up. Vietnam is maybe the strongest alternative to China and often mentioned but being 100 million people, there is a limit to how much production can be moved there from a country of 1.4 billion people. In many cases, companies will also need to import components from China if they move to other countries so the reliance may not really be reduced. Instead the supply chain would actually be longer and not shorter.

So far multinational companies (MNC's) keep investing but "China for China" is the buzz word here. With scope for a continued rise in China's middle class by 2-300 million over the next decade opportunities are still there. However, focus is also on growing in other markets to diversify and not increase China's share of their total market exposure. While uncertainty is higher, sentiment is generally more positive than in Europe. It puts requirements on local operations to have a close dialogue with their headquarters in Europe or the US. Generally there is also a bit of wait-and-see mode currently to see which way things are going when it comes to geopolitics, the domestic policy path and short term growth challenges.

9. **Geopolitical tensions to persist.** China's fast tech development also implies it is becoming a much greater competitor to Western companies and a producer of many of the green-tech products that will be in high demand in the coming years. It is already clearly visible in the trade data where EU imports from China have surged over the past couple of years, not least due to a sharp rise in imports of EV's from China (70% of them being Western brands produced in China). The development points to continued trade tensions and a push from politicians for protectionist measures, as indicated by the EU investigation into China's EV subsidies. It will to some extent be balanced, though, by the need for EU companies to access the Chinese market and fears of retaliation should work to dampen protectionism.

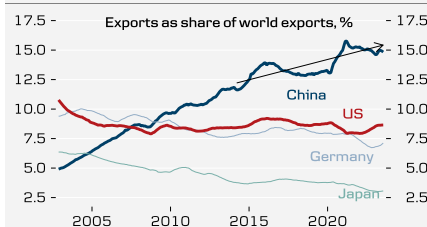
The trade tensions come on top of China's push for a changing world order less dominated by the West and the general feeling is that China will push to be the voice of the Global South and increasingly challenge Western countries in global issues – and with some support from Global South countries as witnessed lately in the Israeli-

Offshore stocks very weak as foreign investors have pulled out for now



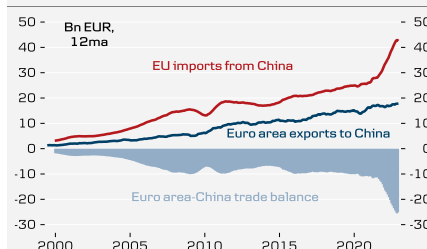
Source: Bloomberg, Danske Bank. Note: Past performance is no guarantee of future performance

China's global export market share is still trending higher – little sign of production is moving to large extent



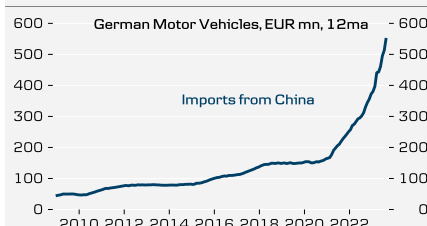
Source: Macrobond Financial, IMF

De-risking? What de-risking?



Source: Macrobond Financial, ECB, Danske Bank

German imports of cars from China have surged in the past years



Source: Macrobond Financial, German Federal Statistics Office

Palestinian war and the war in Ukraine. I talked to an official of the Communist Party who was very critical of the US and what he said was a containment and encirclement strategy of China and that it was US threatening security while China had to respond to its' provocations and its' attempts to hold China back. You sense that China has given up a bit on the US relationship and no longer sees US attempts to ease tensions as sincere or something that can be trusted. It explains why it seems to be so difficult to get a meeting between Xi and Biden (although it looks to be coming in November). The US-China tensions may have eased lately but it seems a small window of improvement before the US goes into Presidential election year next year with a lot of China bashing likely to follow. Few have any expectations of a lasting improvement in US-China relations but focus will be on how to avoid a Taiwan war. Taiwan was the elephant in the room in many conversations. Not discussed a lot and most see a small risk of a war but also seeing a big impact if it was to happen. But for now it seems to have a moderate impact on actual business decisions.

- 10. ESG and carbon measurement a business focus.** On a slightly different note, I also discussed ESG issues with some businesses and an ESG consultant. Businesses in China are in the process of implementing EU's *Carbon Border Adjustment Mechanism*, which requires a measurement of carbon use in the production in China (and other countries), both own and that of suppliers. It is phased in gradually with initial focus on production most at risk of "carbon leakage", such as cement, iron and steel. Once the permanent system enters into force on 1 January 2026, importers will need to declare each year the quantity of goods imported into the EU in the preceding year and their embedded green house gasses, which will serve the base for how much compensation they might have to pay. The mechanism will serve as a push for finding suppliers with better carbon efficiency but also increase costs of having production in China. Paradoxically it could also work to drive back some of the more polluting industries back to Europe (steel, cement etc.) making it harder to reach EU goals on Co2 emissions.

Other ESG issues that requires attention relates to navigating more scrutiny by Western consumers and governments when it comes to general human rights such as forced labour issues in Xinjiang and the risk of China taking steps deemed unacceptable, for example if China was to deliver lethal weapons to Russia. It is not currently the case but are some of the geopolitical risks now facing companies that spill into the ESG area.

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