International Commentary — October 14, 2022

China's Economy and the 20th National Party Congress

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.Mckenna@wellsfargo.com | 212-214-5637

Summary

China is set to report Q3 GDP data in the coming days, and while we forecast a return to positive quarterly growth, September data suggest the economy stumbled towards the end of the quarter. Renewed COVID-related restrictions weighed on the services sector, and the slow demise of the local real estate sector hurt demand for loans and other forms of financing over the course of last month. Heading into Q4, we believe China's economy will decelerate as COVID lockdowns sporadically reappear. With activity to slow to close the year, we expect the People's Bank of China (PBoC) to further ease monetary policy and for the Chinese renminbi to weaken as a result.

Against a backdrop of uninspiring economic growth, China will host its 20th National Party Congress starting on October 16 to determine the Chinese Communist Party (CCP) leadership structure for the next five years. Historically, National Party Congress meetings have been a forum to determine CCP leadership, not enact policy change. In that sense, we do not believe “Zero COVID” policies will be lifted and COVID-related restrictions will continue to act as a drag on China's economy going forward. Perhaps more significant, Xi Jinping is likely to secure a precedent-defying third term as General Secretary of the CCP. With Xi's third term likely to be made official, we believe his policy priorities will ultimately shift in a more strategic and legacy defining direction over the course of the next five years and possibly beyond.

Renewed Growth, but Stumbling Momentum

China's economy made only modest progress towards stabilization in Q3. Early in the quarter, we saw tentative evidence of economic conditions improving; however, September data suggest conditions in China may have deteriorated towards the end of Q3 as indicators softened over the course of the last month (Figure 1). Activity proxy indices weakened in September, while a negative economic surprise index reveals most of China's activity and sentiment indicators underwhelmed relative to consensus expectations. As far as industry level data, sentiment in China's manufacturing sector was mixed in September. The official manufacturing PMI climbed back into expansion territory to 50.1; however, the Caixin manufacturing PMI dropped to 49.3 and fell further below the key 50 level. On the services side, COVID-related restrictions sporadically occurred over the course of last month, which weighed on sentiment. The official non-manufacturing PMI dipped to 50.6 from 52.6, and while still in expansion territory, the index fell to its lowest level since May. Sentiment measured via the Caixin services PMI indicates a more severe consumer slowdown as the index dropped to 49.3 from 55.0 in August.

With the manufacturing and services sectors still under pressure, Chinese authorities have continued to set accommodative policy settings. Fiscal policy, at the local and federal level, is likely to turn more expansionary in an effort to support activity, while the PBoC is likely to maintain economically supportive monetary policy settings for an extended period of time. As far as monetary policy, M2 money supply grew 12.1% year-over-year, and while money supply growth dipped slightly from August, Chinese authorities continue to make liquidity available at a relatively rapid pace. With that said, demand for loans and other forms of financing improved from last month; however, aggregate social financing remains subdued at 11.1% year-over-year growth, especially when compared early 2021. We can trace slower demand for loans and financing back to the challenges in China's real estate sector, issues that continue to linger and are unlikely to dissipate anytime soon. These challenges have been percolating for some time, and are having a more profound impact on consumer decisions towards purchasing a home. Through August, Chinese home prices have declined 12 months in a row, while the local real estate developer index is cumulatively down 61% since the middle of 2020. Declining home prices and an overall lack of confidence in China's property sector is weighing on loan demand, and in turn, the broader Chinese economy.

Figure 1

	Jan-21	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan-22	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Economic Activity Proxy																					
Li Keqiang Index	16.4	17.6	15.6	13.9	10.2	8.1	7.5	5.9	6.8	6.5	7.1	5.7	6.3	6.3	7.4	5.1	5.3	7.4	9.3	9.8	
China Activity Proxy	4.6	3.9	7.8	7.0	7.6	5.3	3.4	-0.7	5.2	5.5	6.4	6.8	6.9	5.7	-1.1	-11.4	3.3	11.8	9.1	6.8	4.7
Economic Surprise Index	22.6	2.5	-6.2	24.7	-48.6	-81.1	-40.6	-43.1	-65.3	-64.7	10.8	20.7	46.0	27.4	75.0	90.5	-52.1	-24.7	-14.8	0.7	-29.0
Manufacturing																					
Industrial Production (a)			14.1%	9.8%	8.8%	8.3%	6.4%	5.3%	3.1%	3.5%	3.8%	4.3%			5.0%	-2.9%	0.7%	3.9%	3.8%	4.2%	
Manufacturing PMI	51.3	50.6	51.9	51.1	51.0	50.9	50.4	50.1	49.6	49.2	50.1	50.3	50.1	50.2	49.5	47.4	49.6	50.2	49.0	49.4	50.1
Caixin Manufacturing PMI	51.5	50.9	50.6	51.9	52.0	51.3	50.3	49.2	50.0	50.6	49.9	50.9	49.1	50.4	48.1	46.0	48.1	51.7	50.4	49.5	48.1
Services																					
Retail Sales (a)			34.2%	17.7%	12.4%	12.1%	8.5%	2.5%	4.4%	4.9%	3.9%	1.7%			-3.5%	-11.1%	-6.7%	3.1%	2.7%	5.4%	
Non-Manufacturing PMI	52.4	51.4	56.3	54.9	55.2	53.5	53.3	47.5	53.2	52.4	52.3	52.7	51.1	51.6	48.4	41.9	47.8	54.7	53.8	52.6	50.6
Caixin Services PMI	52.0	51.5	54.3	56.3	55.1	50.3	54.9	46.7	53.4	53.8	52.1	53.1	51.4	50.2	42.0	36.2	41.4	54.5	55.5	55.0	49.3
External Sector																					
Exports (a)	24.6%	154.6%	30.4%	32.1%	27.7%	32.1%	19.2%	25.4%	28.0%	26.9%	21.7%	20.9%	24.1%	6.2%	14.5%	3.7%	16.7%	17.9%	18.0%	7.1%	
FX Reserve Adequacy (b)	15.9x	17.3x	15.8x	15.5x	15.4x	15.1x	15.1x	14.9x	14.6x	14.7x	14.5x	14.5x	13.2x	14.8x	14.4x	14.1x	14.0x	13.7x	13.8x	13.5x	13.3x
Investment & Financing Conditions																					
Fixed Asset Investment (a)		35.0%	25.6%	19.9%	15.4%	12.6%	10.3%	8.9%	7.3%	6.1%	5.2%	4.9%		12.2%	9.3%	6.8%	6.2%	6.1%	5.7%	5.8%	
Total Aggregate Social Financing (a)	13.8%	14.0%	13.1%	12.4%	11.8%	11.8%	11.5%	11.1%	10.8%	10.8%	10.9%	11.1%	11.2%	11.0%	11.3%	10.9%	11.1%	11.5%	11.3%	11.0%	11.1%
M2 Money Supply (a)	9.4%	10.1%	9.4%	8.1%	8.3%	8.6%	8.3%	8.2%	8.3%	8.7%	8.5%	9.0%	9.8%	9.2%	9.7%	10.5%	11.1%	11.4%	12.0%	12.2%	12.1%
Real Estate Sector																					
Real Estate Climate Index	101.1	101.4	101.3	101.3	101.2	101.1	101.0	100.8	100.7	100.6	100.5	100.3	96.8	96.9	96.6	95.9	95.6	95.4	95.3	95.1	
New Home Prices (e)	0.3%	0.4%	0.4%	0.5%	0.5%	0.4%	0.3%	0.2%	-0.1%	-0.3%	-0.3%	-0.3%	0.0%	-0.1%	-0.1%	-0.3%	-0.2%	-0.1%	-0.1%	-0.3%	
Real Estate Developer Equity Index (f)	-11.4%	-1.9%	-2.7%	-6.2%	-6.2%	-12.6%	-28.1%	-24.2%	-27.3%	-33.0%	-36.7%	-38.3%	-36.3%	-40.7%	-41.2%	-42.4%	-46.6%	-45.5%	-52.6%	-55.2%	-61.0%
GDP Growth & Policy Rates																					
Reserve Requirement Ratio (c)	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	12.00%	12.00%	12.00%	12.00%	12.00%	11.50%	11.50%	11.50%	11.50%	11.25%	11.25%	11.25%	11.25%	11.25%	11.25%
Actual GDP Growth (a)	18.3%	18.3%	18.3%	7.9%	7.9%	7.9%	4.9%	4.9%	4.9%	4.0%	4.0%	4.0%	4.8%	4.8%	4.8%	0.4%	0.4%	0.4%			
Actual GDP Growth (d)	0.6%	0.6%	0.6%	1.5%	1.5%	1.5%	0.4%	0.4%	0.4%	1.4%	1.4%	1.4%	1.4%	1.4%	1.4%	-2.6%	-2.6%	-2.6%			

Notes: (a) Year-over-Year Percent Change, (b) Import Cover, (c) Reserve Requirement Ratio For Major Banks, (d) Quarter-over-Quarter Percent Change, (e) Month-over-Month Percent Change, (f) Percent Change Since January 2020

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Speaking of the broader Chinese economy, performance early in the third quarter is likely enough for the economy to report a modest recovery in Q3. To that point, we forecast China's economy grew a little over 3% quarter-over-quarter in Q3, which coincidentally translates to year-over-year growth of slightly over 3% as well. Assuming our growth forecast is accurate, China's economy will have expanded on a sequential basis in Q3 following a Q2 contraction. Despite positive growth in Q3, we believe China's economy is still on pace for less-than-stellar calendar year GDP growth in 2022. To that point, we forecast the Chinese economy to grow 3% in 2022, which is a below consensus view, with risks still tilted towards even slower growth. Just recently, Chinese authorities have reported COVID cases in Shanghai as well as Beijing, and have responded by closing schools and implementing new restrictions. While the new restrictions are likely not stringent enough to have a material impact on activity, should case numbers climb further we would expect authorities to demonstrate their commitment to “Zero COVID” policies and implement lockdowns on a greater scale. Should restrictions broaden, especially across Shanghai and Beijing, activity could slow sharply and China's Q4 growth prospects could dwindle once again. Going forward, we will monitor how COVID cases are evolving nationwide, but will be paying particular attention to infection data in these two cities, and what kind of restrictions go in place.

Regardless of whether broader COVID-related restrictions go back into place, but more so if they do, we believe policymakers are still likely to ease monetary policy further to support local activity. As mentioned, economic activity stumbled in September and early evidence suggests October may not be much better. As China stumbles its way into the end of the year, we believe PBoC policymakers will continue to boost liquidity, and also lower bank Reserve Requirement Ratios (RRR) again before the end of the year. We believe the RRR for major Chinese banks will be lowered another 0.50 percentage points to 10.75% by the end of Q4, which would be cumulative 0.75 percentage points of total RRR reductions in 2022. A further easing of monetary policy would continue to keep the direction of PBoC monetary policy at odds with the Federal Reserve. With the Fed likely to lift interest rates another 125 bps in Q4, interest rate differentials should move further in favor of the U.S. and against China. In that sense, we believe divergences in PBoC-Fed monetary policy can be the primary source of further renminbi weakness. As of now, we believe the USD/CNY and USD/CNH exchange rates can move towards 7.30 by the end of this year, which would mark a level the renminbi has not traded at since late 2007.

Xi Jinping and 20th National Party Congress

Against this backdrop of slowing economic growth, China will host its 20th National Party Congress (NPC) starting October 16. As background, the National Party Congress is held once every five years, and is a platform for the Chinese Communist Party (CCP) to provide an assessment of China's evolution over the last five years and highlight objectives for the next five years. Perhaps more significant, the NPC is an opportunity for the CCP to determine its new leadership structure and identify Party members who will be in specific roles for the next five years. Starting this weekend, Party leadership will elect about 350 members to China's Central Committee. Once the Central Committee is identified, 25 members will be named to sit on the Politburo, the main decision-making body of the CCP. From there, the 25 members of the Politburo will name a smaller and more select group of members to the Politburo Standing Committee—essentially China's top leadership. While CCP leadership and decision-making structures are of significance, arguably most important is who will be named General Secretary of the CCP (i.e. “Party leader” or “President”). By most accounts, Xi Jinping, current General Secretary of the Chinese Communist Party, will be named to a precedent-defying third term as head of the CCP. A few years ago, Xi made changes to the CCP constitution to eliminate term limits, which is why he is legally able to secure a third term. Those constitutional changes, in theory, could also allow Xi to lead the CCP as General Secretary for an extended period of time.

Determining the leadership structure of the Party is important as these members will set the direction of policy for the next five years; however, at the NPC itself, we do not believe any changes to current policy will be undertaken. Historically, the NPC has been a platform to select CCP members and establish Party leadership, not so much a forum to enact policy changes, especially policy related to China's economy. In that sense, we do not believe the “Zero COVID” policy towards virus containment will be lifted this weekend nor do we believe the policy will be abandoned in the immediate aftermath of the NPC. We never fully subscribed to the theory that “Zero COVID” was a form of political posturing ahead of the NPC to elevate the likelihood that Xi secures a third term—Xi likely secured his third term in office years ago. And, with confirmed cases rising in major cities, we have our doubts that current COVID management policy would be lifted as the NPC concludes. Lifting the policy at this juncture could risk social discontent at a time when social demonstrations have already materialized in response to China's housing crisis. Just this week, multiple Chinese authority figures reiterated their commitment to Zero COVID, with the underlying tone of those comments suggesting the policy will be in place for the foreseeable future. We have assumed Zero COVID will persist for an extended period of time, even through the annual National People's Congress in March 2023, when setting our China-related forecasts. This assumption is one of the key reasons for our below-consensus China GDP forecast for 2022 as well as 2023, and also contributes to our view for further PBoC monetary easing and a weaker Chinese renminbi into the early quarters of next year.

Xi being named General Secretary for a third term is significant, and in our view, likely means Xi's policy priorities will shift in a more strategic and legacy determining manner over the course of his time as CCP leader. We could get a sense of how legacy determining Xi wants to be when the National Party Congress "Report" is published and when Xi speaks to its contents. As far as the Report, the title or "banner term" that Xi uses could be telling, and could be further evidence that Xi holds himself in the same regard as Mao Zedong, founder of the People's Republic of China and one of the most significant figures in Chinese history. Mao's ideology was referred to as "Mao Zedong Thought" within the Chinese Communist Party. Historically, General Secretary's have refrained from using the word "thought" in their banner term as a similar title could imply a similar pedigree and cultural influence as Mao. However, in 2017, Xi used the word "thought" in his banner term, which generated concern that Xi would look to consolidate power within the CCP. Indeed, those concerns were validated as Xi moved forward with constitutional amendments and consolidated his status within the CCP over the last five years. Should Xi again use a banner term that includes the word "thought" this could be a signal that Xi is committed to primarily focusing on his long-term legacy. And as far as Xi's speech, should he mention long-term goals such as further progress on the Belt and Road Initiative rather than mentioning contributions of previous CCP leaders, we would take that a sign Xi is likely to stay in power for an extended period of time and his policies may turn more long-term and strategic in nature.

And as far as what those strategic and legacy determining policies may be, Xi may place a particular focus on foreign policy. Relations with the United States have been tense for years now, and with Xi firmly in control of CCP policy and a third term officially secured, policy toward the U.S.-China relationship could evolve. In addition, the China-Taiwan relationship has been contentious to say the least, especially over the course of this year. If Xi does indeed focus on his long-term legacy, the China-Taiwan relationship could evolve in a meaningful way over the next few years. Between now and the 21st National Party Congress in 2027, event risks in the China-Taiwan relationship are abundant. These event risks include a 2024 Taiwan Presidential election, a 2024 U.S. Presidential election, the "Made in China 2025" plan to reduce China's dependence on foreign semi-conductors and technology, as well as U.S. midterm elections in 2026. All of these will be accompanied by China National Day, a public holiday to celebrate the formal establishment of the People's Republic of China in 1949. We will refrain from making forecasts on any potential foreign policy decisions, but note that with Xi most likely to be focused on his long-term legacy post the 20th NPC, opportunity to determine his significance in Chinese history is potentially plentiful.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Jessica Guo	Economic Analyst	212-214-1063	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. (“WFBNA”). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., and Wells Fargo Securities Canada, Ltd. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation offer or solicitation with respect to the purchase or sale of any security or other financial product nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report. The views and opinions expressed in this report are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company.

Important Information for Non-U.S. Recipients

For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority (“FCA”). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 (“the Act”), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU (“MiFID2”). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. (“WFSE”). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in the Directive 2014/65/EU (“MiFID2”). This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE