

China 2023 Outlook

After Winter Comes Spring

- After a very challenging 2022, we expect China GDP growth to accelerate from 3.0% this year to 4.5% next year on the back of China's potential exit from its zero-Covid policy, which we assume will start shortly after the "Two Sessions" in March. China's reopening would imply a strong consumption rebound, firming core inflation, and gradually normalizing cyclical policies in 2023.
- Beneath the full-year growth acceleration, the Chinese economy is likely to display a distinct "two halves" next year. Our growth forecast is notably below consensus in H1 but significantly above in H2. This is due to our belief that the initial stage of China's reopening may be *negative* to growth, with Covid cases surging and population mobility temporarily declining, similar to the reopening experience of several other East Asian economies.
- The delayed reopening boost suggests that policy may need to stay accommodative in the first half of 2023 before normalizing in the second half once consumption and services rebound sharply. It also leads us to project above-consensus GDP growth for 2024 (5.3%) as the reopening tailwind lingers through 2024H1. In the outer years of our forecast horizon (2025-2027), however, we expect growth to return to a trend of around 4%, as we expect structural headwinds to reduce China's potential growth rate meaningfully.
- By expenditure categories, Chinese exports are poised to slow on weakening external demand, while growth drivers rotate from investment to consumption on reopening. Within consumption, sectors that have been most constrained by Covid such as travel and entertainment have the most room to recover. Within investment, we expect infrastructure investment to decelerate significantly, followed by manufacturing investment next year. Property investment should continue to contract, although the drag from the property sector to the broader economy may become smaller next year.
- China's reopening is likely to be a major driver of asset prices in 2023. We expect higher equity prices, modestly higher rates, higher commodity demand (especially energy), and a stronger RMB vs USD next year. However, its reopening is also likely to carry some Chinese characteristics. We do not think inflation will rise as much as in western countries after reopening, with core CPI inflation only increasing from 0.7% this year to 1.2% next year. Outbound international travel may return on a more gradual timeline, peaking in 2024 in our baseline.

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After Winter Comes Spring

2022 has been a disappointing year for China growth and markets. After two years of relative success in keeping Covid at bay, the emergence of the much more transmissible Omicron variant significantly challenged China's zero-Covid policy. The two-month strict lockdown in Shanghai during April-May led to severe disruptions in both industrial and services activity, resulting in -10.4% qoq annualized real GDP growth in Q2. Despite strenuous efforts by the government to frontload and expand fiscal spending, with Covid cases rising again in multiple major cities in Q4, real GDP growth is on track for a meager 3.0% yoy in 2022, significantly lower than the "around 5.5%" growth target set at the beginning of the year. During the first 10 months of 2022, Chinese equity prices fell almost 30% and the RMB depreciated 15% against the USD.

Recent news flow on China's Covid policy has been more encouraging. On November 10, the Politburo Standing Committee held a meeting discussing China's Covid situation, placing less emphasis on "calculating the political cost" and more emphasis on optimizing Covid control measures to reduce the negative impact on the economy. On November 11, the government unveiled "20 measures" to shorten quarantine times, to make inbound international travel easier, and most importantly, to lay out a plan on necessary medical preparations (e.g., scaling up storage of Covid treatment drugs, expanding hospital capacity, and increasing the elderly vaccination rate). In our view, these are strong signals of the top leadership preparing for a final exit from three years of zero-Covid policy, likely soon after the "Two Sessions" next year. We place a 60% subjective probability on Q2 reopening and think there is a 30% chance for an earlier exit.

China's reopening path drives our 2023 economic outlook. For definition, we define "reopening" as ending the "dynamic zero-Covid policy" and fundamentally changing the government's reaction function in the face of Covid outbreaks. In the current pre-reopening regime, the government targets stopping the spread of the virus. In a reopening regime, by contrast, we assume the government would no longer lock down buildings, districts, and cities when cases rise, as long as the healthcare system is not overwhelmed. In many respects, we expect China's reopening experience to bear resemblance to most other countries' reopening experiences, with growth accelerating, especially for household consumption and services industries, inflation picking up, and cyclical policies turning less accommodative ([Exhibit 1](#)). However, a reopening in 2023 would also likely display features that are meaningfully different from many other countries.

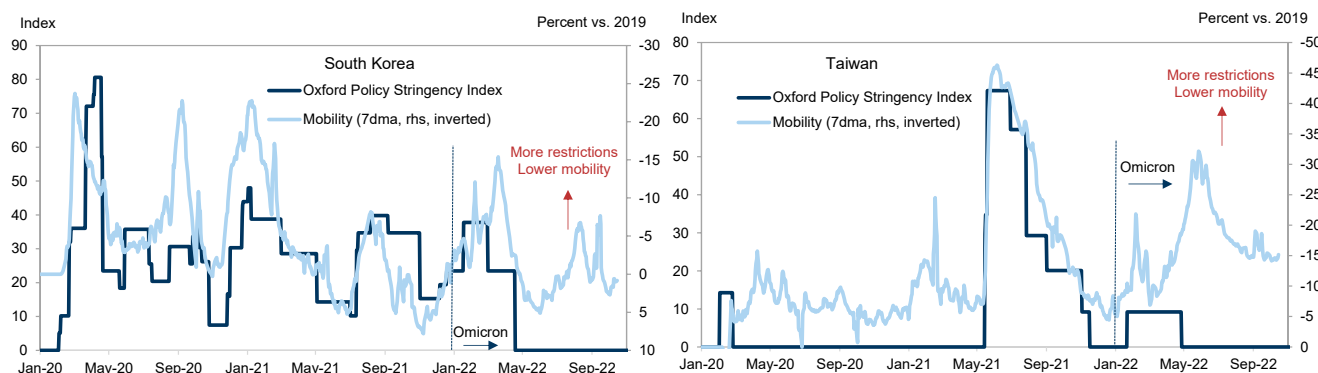
Exhibit 1: Reopening drives our 2023 China economic outlook

		2019	2020	2021	2022F	2023F
GDP	% yoy	6.0	2.2	8.1	3.0	4.5
Domestic Demand	pp	5.2	1.6	6.4	2.1	4.7
Consumption	% yoy	6.2	-0.4	9.7	1.9	6.1
Household Consumption	% yoy	6.4	-1.8	12.3	1.0	7.0
Government Consumption	% yoy	5.9	3.0	3.9	4.0	4.0
Gross Fixed Capital Formation	% yoy	5.2	3.2	2.3	3.5	3.0
Net Exports	pp	0.7	0.6	1.7	1.0	-0.2
Exports of Goods (nominal USD)	% yoy	0.5	3.6	29.8	8.5	-2.0
Imports of Goods (nominal USD)	% yoy	-2.7	-1.0	30.7	2.0	4.0
Inflation						
CPI	% yoy	2.9	2.5	0.8	2.0	2.2
Core CPI	% yoy	1.7	0.7	0.8	0.7	1.2
PPI	% yoy	-0.5	-1.8	8.1	3.8	-1.8
Other						
Current Account	% GDP	0.7	1.7	1.8	2.4	1.7
USDCNY (eop)	level	6.96	6.53	6.35	7.20	6.90
OMO 7-Day Repo Rate (eop)	%	2.50	2.20	2.20	2.00	2.00
TSF Stock Growth (eop)	%	10.7	13.3	10.3	10.5	9.5
Augmented Fiscal Deficit	% GDP	12.0	17.2	11.3	14.3	12.3

Source: Haver Analytics, Goldman Sachs Global Investment Research

In most western countries, economic activity accelerated almost immediately after reopening. In China, however, growth may soften during the initial stage of reopening, similar to the experience of several East Asian economies that previously implemented relatively tight Covid controls. For example, in both South Korea and Taiwan, governments lifted Covid restrictions earlier this year after vaccination rates reached sufficiently high levels and Omicron became too difficult to contain. Case numbers surged since few people had been infected before due to relatively successful Covid controls earlier. Mobility declined as individuals cut down social interactions for fear of contracting Covid, even though there were virtually no government mandated restrictions anymore (Exhibit 2).

Exhibit 2: South Korea and Taiwan’s experience shows mobility declines in the initial stage of reopening



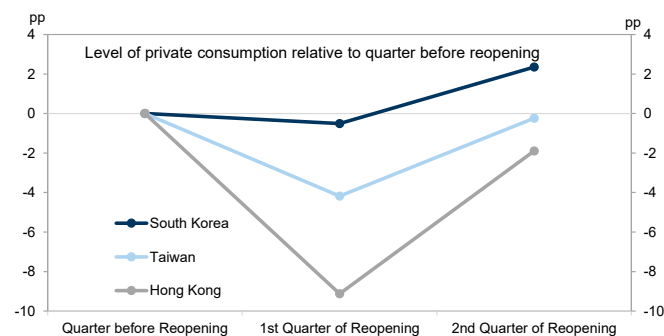
Google Mobility Data is sourced from <https://www.google.com/covid19/mobility/> Accessed: 2022-10-17.

Source: University of Oxford (covidtracker.bsg.ox.ac.uk), Google LLC "Google COVID-19 Community Mobility Reports"

Such behavioral responses led to a growth slowdown, albeit short-lived, rather than a growth acceleration immediately after reopening. Exhibit 3 shows that the level of real private consumption outright fell in South Korea, Taiwan and Hong Kong during the first

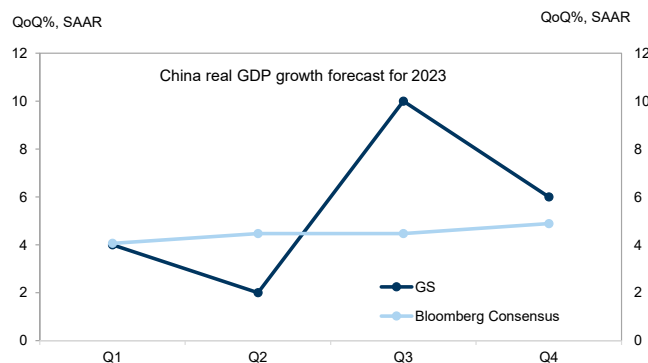
quarter of their respective reopening, followed by a sharp rebound in the second quarter as case numbers dropped and the fear factor faded¹. We think Chinese growth is likely to display a similar pattern next year. Under the baseline assumption of reopening starting in April, our Q2 sequential growth forecast is meaningfully below consensus (2.0% qoq ann vs. Bloomberg consensus of 4.5%) whereas our Q3 sequential growth forecast shows a much stronger rebound (10.0% qoq ann vs. Bloomberg consensus of 4.5%, [Exhibit 4](#)). Overall, we expect full-year GDP growth to accelerate from 3.0% in 2022 to 4.5% in 2023, with a weak H1 but a strong H2.

Exhibit 3: Private consumption outright fell during the first quarter of reopening in South Korea, Taiwan and Hong Kong



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 4: Our 2023 China GDP forecast features a weak H1 but a strong H2 compared to market consensus



Source: Bloomberg, Goldman Sachs Global Investment Research

A more back-loaded positive “reopening impulse” has three implications for our outlook. First, our projection of above-trend sequential growth in 2023H2 and 2024H1 implies year-over-year growth peaks in 2024Q2. As a result, our full-year GDP forecast for 2024 is noticeably above consensus. Second, because of the significant slack currently in the economy and the still sluggish growth expected in the first half of next year, the increase in our core CPI inflation forecasts in China from 2022 (0.7%) to 2023 (1.2%) is much more modest than experienced by other countries post-reopening. Lastly, policymakers are likely to keep cyclical policies accommodative during the first half of 2023 to support overall growth, and to only withdraw support when the robust reopening impulse kicks in H2. Hence, we expect infrastructure investment to stay strong in H1 while growth drivers rotate to consumption and services in H2.

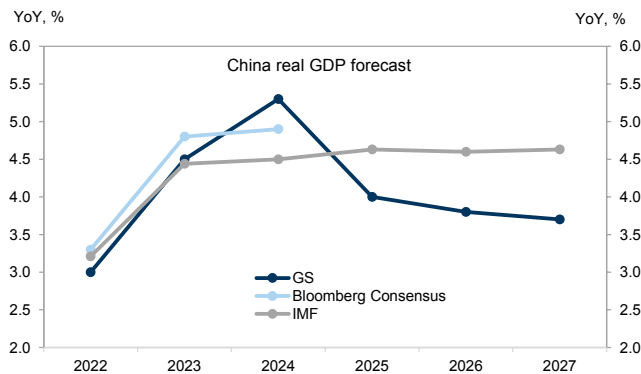
Although our 2024 GDP growth forecast of 5.3% is clearly above consensus on reopening tailwinds, our projections further out (2025-2027) are squarely below ([Exhibit 5](#)). This is because we believe China’s potential growth will be meaningfully lower than previously thought on social, economic, and geopolitical developments over the past few years ([Exhibit 6](#)). While a [2019 PBOC working paper](#) suggested that China’s potential growth rate was 5.1-5.7% during the 14th Five Year Plan (2021-2025), we think it has fallen below 5% now for a few reasons.

First, despite the latest “16 measures” announced by PBOC/CBIRC, the policy-driven housing deleveraging campaign that started in late 2020 and early 2021 has

¹ Hong Kong and South Korea reopened in Q1 2022, Taiwan reopened in Q2 2022.

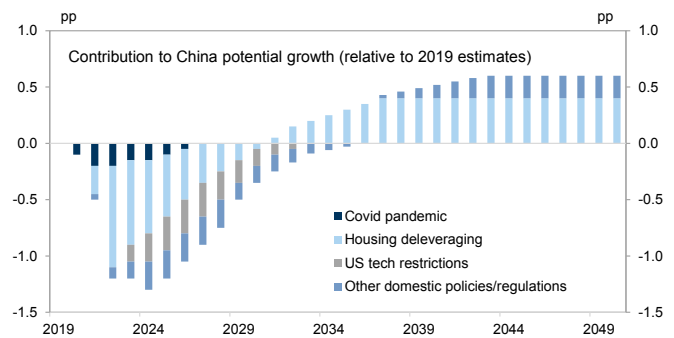
fundamentally transformed the industry and triggered a multi-year trend of falling property investment. This abrupt change may help reduce major financial risks and redirect investment to sectors more positive for China’s long-term sustainable growth down the road, but over the next few years, it may mean lower production capacity. Second, despite the first Biden-Xi in-person meeting in Biden’s presidency lifting sentiment, the strategic competition between the US and China is likely to continue. Strict implementation of the semiconductor controls by the US will lead to output losses in both the semiconductor industry itself and those downstream sectors that use advanced chips in the medium-term. Third, domestic policy priorities, ranging from increasing self-reliance to ensure food, energy and supply chain security, to more equitable income and wealth distribution under “Common Prosperity,” may slow productivity growth in the coming years, although breakthroughs in home-grown technologies and improved income and wealth distributions, if achieved, can enhance potential growth in the decades thereafter. Taken together, we estimate that Chinese potential growth has fallen to around 4%, which underpins our 2025-2027 forecasts once Covid distortions disappear.

Exhibit 5: We expect above-consensus growth in 2024 but below-consensus growth thereafter...



Source: Bloomberg, IMF, Goldman Sachs Global Investment Research

Exhibit 6: ...on lower potential growth in the medium term

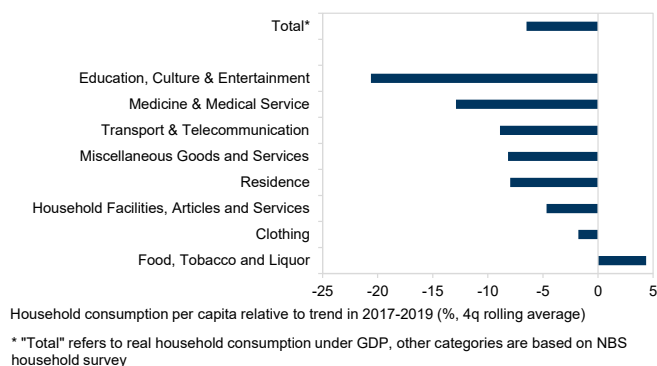


Source: Goldman Sachs Global Investment Research

Consumption the bright spot of the economy in 2023

Consumption will likely be the bright spot of economic growth in 2023 should China reopen as we expect. Household consumption growth could rebound strongly in 2H of next year after the initial stage of reopening and after a large share of the population adjusts to living with Covid.

Year-to-date household consumption only expanded by 3.5% yoy in nominal terms this year (vs. 9% in 2019, pre-Covid), a very sluggish growth rate amid multiple waves of local Covid outbreaks and restrictions. Many categories of spending, in particular entertainment and medical services consumption, have been materially below trend (Exhibit 7). We forecast real household consumption growth to be 1% yoy in 2022, around 6pp below our estimate of trend level.

Exhibit 7: Multiple categories of spending remain below trend in 2022

Source: NBS, Goldman Sachs Global Investment Research

While consumption might be weak in the initial stage of reopening due to potentially a very large number of Covid infections, we expect consumption to rebound strongly in 2H 2023. After people recover from Covid, the first stage of consumption recovery could be somewhat “mechanical” – a majority of the population would no longer be under lockdown, and as the authorities lift Covid control, currently suspended consumption categories—for example certain entertainment businesses—would resume operation.

The extent and sustainability of consumption recovery, however, hinges on the potential improvement of labor market, household income and consumer confidence. Investors are concerned about potential scarring effects from the property market downcycle and the prolonged weakness in the labor market after almost three years of fighting Covid.

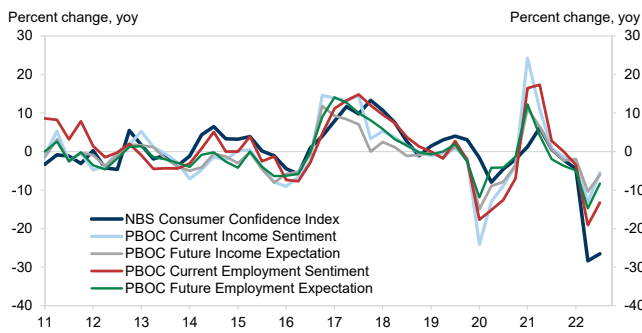
We expect the unemployment rate to fall, labor income to improve, and consumer confidence to be restored somewhat in 2023.

- The **labor market** has been weak this year – the youth unemployment rate climbed to a record-high level of 19.9% in July this year. The slack in the labor market is not only reflected in higher unemployment rates, but also in more vulnerable spots of the labor market – for example, the migrant worker population in Q3 2022 remained below the same period in 2019 (pre-Covid). Despite the recovery of NBS reported wage income growth in Q3, private enterprises’ labor cost index has been low, as shown in the soft CKGSB BCI (Cheung Kong Graduate School of Business, Business Conditions Index) survey labor cost index in Q3. We expect the **unemployment rate** to fall in 2H 2023 – our forecast of the urban surveyed unemployment rate (for 31 major cities) could decline from 6.0% in October 2022, to 5.0% by the end of 2023, on the back of broad growth recovery and potential improvement in employment demand.
- Restoring **confidence** remains crucial for the consumption outlook. Consumer confidence has appeared quite dampened so far this year ([Exhibit 8](#)), and we expect some improvement next year. Our previous analysis suggests households’ confidence is closely linked to property prices, food price inflation, and stock market performance – we expect almost all drivers to argue for stronger consumer

confidence next year.

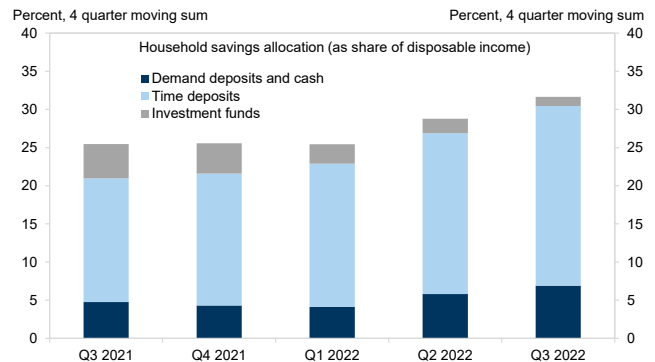
Having said that, we do not expect a strong boost to consumption from **pent-up demand**. As we analyzed before, despite falling interest rates this year, households continue to allocate more of their savings to less liquid financial assets such as time deposits (Exhibit 9), implying potentially limited help to near-term consumption. This is in sharp contrast to other economies such as the US where the savings rate fell significantly below pre-Covid levels as households tapped into previously accumulated excess savings upon reopening. As a result, we expect the savings rate to gradually fall towards trend (which might drift lower on the back of demographic headwinds such as higher dependency ratio; Exhibit 10). Indeed, we did not see evidence of much pent-up demand from Shanghai in Q3 2022 nor Hubei in Q3 2020 as these two regions came out of stringent Covid lockdowns in the prior quarters, although savings rates did fall to pre-lockdown levels after the relaxation of Covid restrictions in tandem with strong recovery in household consumption (Exhibit 11).

Exhibit 8: Consumer confidence has been weak this year



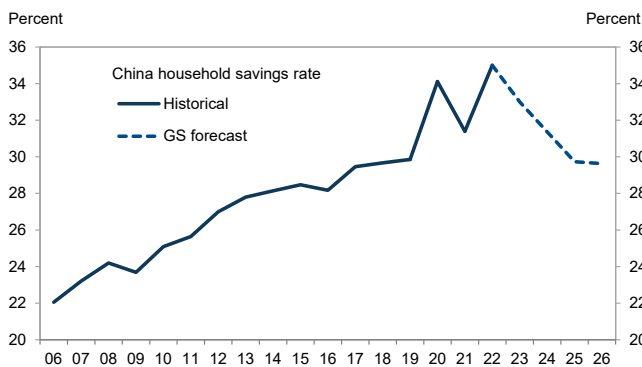
Source: Haver Analytics

Exhibit 9: Households allocated more savings to less liquid time deposits relative to demand deposits/cash



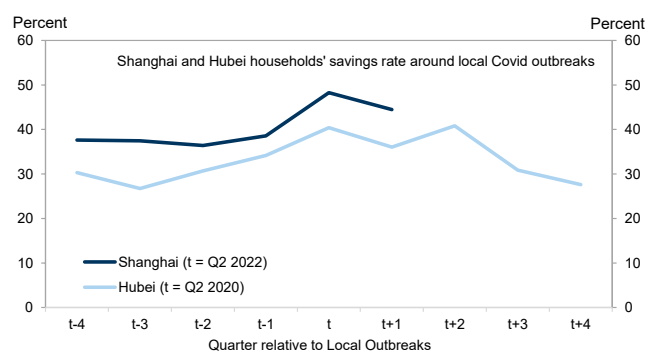
Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 10: We expect savings rate to gradually fall towards trend level in the next few years, from the elevated level in 2022



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 11: The savings rate in Hubei in 2H 2020 and Shanghai in Q3 2022 fell to pre-lockdown levels after protracted Covid restrictions



Source: CEIC, Goldman Sachs Global Investment Research

Looking further ahead, we expect household consumption to continue recovering towards trend. On a full-year basis, due to our expectation of a weak 1H 2023, we expect real household consumption growth to be 7% yoy, implying 2023 full year

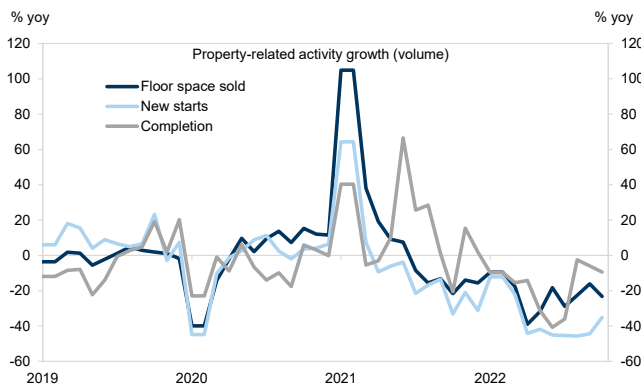
consumption still 5pp below trend, and in 2024, real household consumption to grow 9% yoy, narrowing the gap vs trend to around 1pp, before fully recovering to trend level by 2025².

Property not yet out of the woods, but its drag could be less painful

The property sector is the largest single sector in China’s economy and its ups and downs usually have a meaningful impact on headline GDP growth. Unlike previous easing cycles when the property sector used to be a major driver of growth recovery, the ongoing property downturn that started in the summer of 2021 has been a significant drag, due to the unprecedented regulation tightening and protracted Covid lockdowns.

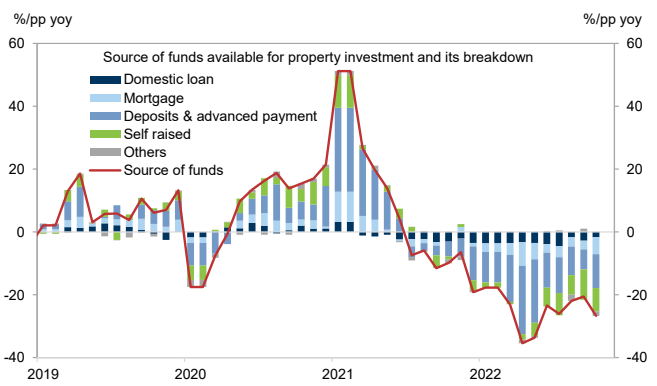
The authorities introduced “Three Red Lines” in August 2020 to curb developer debt levels and “Two Red Lines” in January 2021 to constrain banks’ property-related lending, which, together with other tightening measures, have reshaped China’s property sector. Protracted Covid lockdowns have exacerbated issues by further reducing developers’ revenue from new home presales. A series of high-profile credit defaults by leading property developers since summer 2021, such as Evergrande and Sunac, have escalated risk spillover to the whole sector and related up- and down-stream industries. These factors combined have contributed to a self-fulfilling property downcycle. As a result, most property activities have experienced a double-digit contraction so far this year (Exhibit 12), property sector financing has remained depressed, and USD property HY credit spreads have reached a new high (Exhibit 13).

Exhibit 12: Most property activity has contracted sharply so far this year



Source: CEIC, Data compiled by Goldman Sachs Global Investment Research

Exhibit 13: Funds available for property investment have not bottomed out yet despite more housing easing



Source: Wind, Data compiled by Goldman Sachs Global Investment Research

Policymakers started to ease some property policies since the start of this year, including cutting mortgage rates, requiring banks to increase lending to the property sector, establishing investment funds to support troubled developers on the delivery of their pre-sold homes, and giving local governments more flexibility to ease their local

² Our estimates of the household consumption trend level have taken into account potential scarring effects from the property downcycle and Covid control.

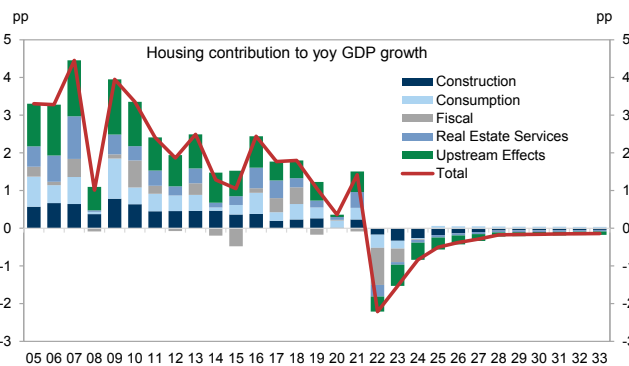
housing policies. As the latest move, the PBOC and CBIRC’s new “16 measures” (see takeaways by our property, financials and credit strategy research teams) suggested policymakers’ increased concern on the property-related risks and stronger intention to improve the funding conditions for developers.

That said, policymakers’ long-term stance that “housing is for living in, not for speculation” remains intact and we expect no significant reversal any time soon. Some structural factors – such as falling population growth and an ageing population – may continue to constrain the property sector over the longer-term.

We expect property-related activity growth to improve in coming quarters on more favorable base effects and incremental housing easing measures. However, the pace could be gradual and bumpy, as protracted Covid restrictions may continue to bite in coming months before the actual reopening, many lower-tier cities are unlikely to see a full recovery in this easing cycle due to structural factors, and a significant improvement in property developer funding conditions is likely to require further and broader easing. We maintain our view that the ongoing property downturn will likely be a multi-year growth drag for China, but it could be less painful in 2023 (-1.5pp to headline GDP growth) vs. 2022 (-2.2pp; [Exhibit 14](#)).

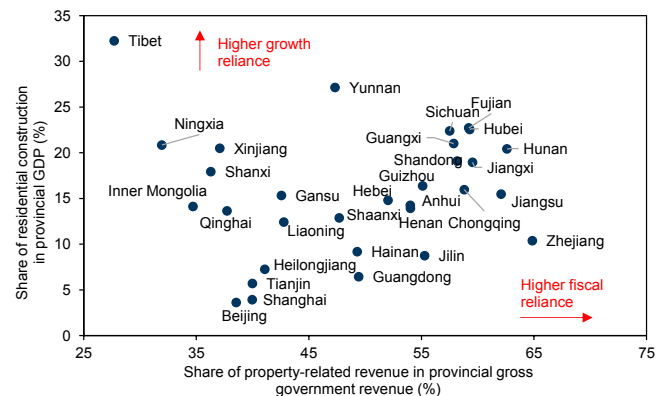
Amid the likely multi-year property downturn, we expect the divergence between large and small cities, inland and coastal regions, and state-owned and private developers to remain significant. After the top Party leadership reshuffle in October, we expect policymakers to stick to their long-term policy goals such as “Common Prosperity” and the “Dual Circulation” strategy in coming years, which in our view suggests a likely end game: reducing the economic and fiscal reliance on the property sector ([Exhibit 15](#)), stepping up public housing and gradually expanding property taxes to more pilot cities over the longer-term.

Exhibit 14: We expect the ongoing property downturn to be a multi-year growth drag



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 15: Navigating regions with high reliance on the property sector



Source: Goldman Sachs Global Investment Research, Wind, local government budget reports, provincial bureaus of statistics

Investment growth to slow, with continued divergence across sectors

Among major GDP components by the expenditure approach, investment served as a

stabilizer this year when final consumption weakened notably. Headline fixed asset investment (FAI) growth increased modestly to +5.8% yoy in year-to-date 2022 (January-October) from +4.9% in 2021, as stronger infrastructure investment (rising to +11.9% yoy in year-to-date 2022 from +2.6% in 2021) slightly more than offset weaker property investment (falling to -8.8% yoy from +4.4%; [Exhibit 16](#)). Manufacturing investment growth remained solid at +9.7% yoy in January-October this year, despite a decline from +13.5% in 2021. This significant divergence reflects an asymmetric impact of Covid restrictions, property downturn and policy stimulus across sectors.

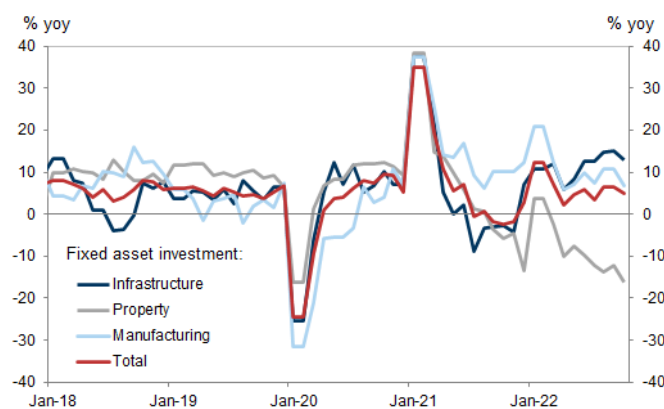
- By major sectors, we expect infrastructure FAI growth to drop sharply to 2% yoy in 2023 from an expected 12% in 2022, as overall fiscal policy should be less expansionary next year (to be elaborated later), especially for spending on traditional infrastructure projects (e.g., roads and railways), due mainly to less demand and room for further infrastructure construction. In early 2022 we flagged that “funds are less of a constraint in 2022, the upside for infrastructure investment could face bottlenecks from project pipelines and government incentives.” For 2023, especially after an actual reopening, we believe bottlenecks from government incentives could be eased, while funds and project pipelines will be the new combination of constraints. That said, “new infrastructure” projects, such as green capex and industrial parks, may remain solid thanks to continued policy support, although their boost to headline infrastructure FAI growth appears limited due to still-small market share.
- Manufacturing FAI growth may moderate further to 5.0% yoy in 2023 from an expected 9.5% in 2022, on slower export growth and a potential shift from goods consumption (especially work-from-home related electronics) to services consumption. That said, we expect continued policy support for high-tech manufacturing sectors as part of China’s “Dual Circulation” strategy, to enhance the “self-reliance” of the economy amid elevated uncertainty around US-China relations.
- Property FAI growth should remain sluggish at -10% yoy in 2023 (vs. -9% in 2022 based on our projection), as the sharp contraction in land sales and new home starts this year will likely translate into weaker construction-related property investment next year, especially given still-tight financing conditions for developers. By comparison, other FAI (total FAI excluding manufacturing, infrastructure and property) growth may increase modestly in 2023 thanks to the reopening boost to consumption and services.

Taking stock of the above analysis, we expect headline FAI growth in nominal terms to decline to 1.5% yoy in 2023 from 5.5% in 2022, mainly on weaker infrastructure and manufacturing investment ([Exhibit 17](#)). Excluding price factors, real FAI growth may moderate to 0.5% yoy from 1.5% by our estimates. Divergence across sectors may remain notable next year.

By ownership, government/SOE-led FAI grew by 10.8% yoy in January-October 2022 and outperformed private FAI (+1.6% over the same period), as the former benefited more from the ongoing fiscal stimulus, while the latter suffered more from protracted Covid lockdowns. However, we believe the divergence between public and private

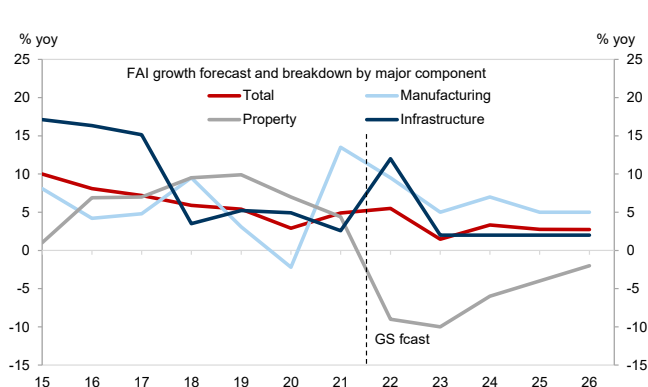
investment could narrow next year when reopening becomes more apparent and policy stimulus gradually normalizes.

Exhibit 16: A clear divide between infrastructure and property FAI this year



Source: CEIC, Data compiled by Goldman Sachs Global Investment Research

Exhibit 17: FAI growth should slow in 2023, mainly on weaker infrastructure and manufacturing investment

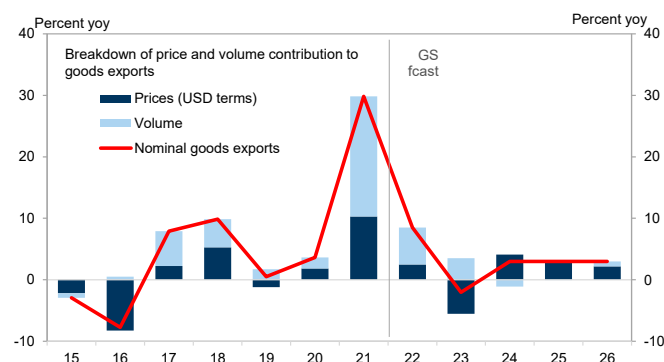


Source: CEIC, Data compiled by Goldman Sachs Global Investment Research

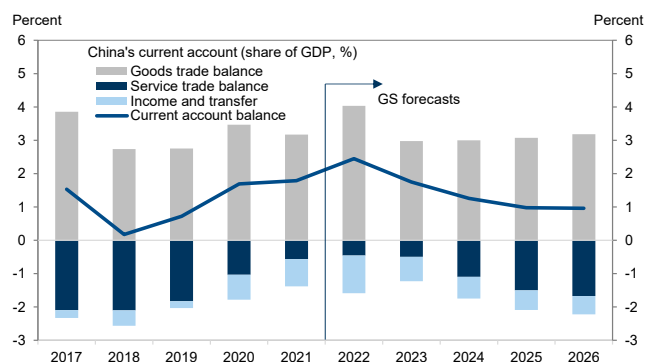
Exports likely to contract in 2023

Exports growth in USD terms fell significantly to -0.4% yoy in October from 29.8% in 2021. The deceleration was driven by both falling export prices and volume. As supply chain stresses eased and China domestic PPI inflation dropped, export price inflation moderated. Moreover, export volume fell as well due to weaker DM demand amid tighter financial conditions and the ongoing European energy crisis. As China's PPI inflation may decline further in 2023, export prices could decline 5.5% in 2023 (vs. +2.5% expected in 2022). In volume terms, we expect export volume growth to moderate to 3.5% in 2023 from 6.0% expected in 2022, due to weaker external demand as we expect slower growth in ex-China economies. Taken together, we expect nominal goods exports to decline 2% yoy in 2023, down from an 8.5% gain expected in 2022 ([Exhibit 18](#)). Goods import growth could accelerate to 4% yoy in 2023 from 2% in 2022, benefiting from likely stronger domestic demand after the expected reopening of China's economy. As import growth may outpace export growth in 2023, China's goods trade balance is likely to fall from 5.1% of GDP this year to 4.0% next year.

The services trade deficit has stayed muted since the initial Covid outbreak in 2020, as cross-border travel has remained under strict restrictions for the past three years. With China expected to gradually reopen next year, we expect a gradual widening of services trade deficit. Policy relaxation around cross-border travel might come later than the relaxation of domestic Covid controls in our view, because policymakers might be more eager to support domestic consumption rather than Chinese residents' overseas spending. We expect the services trade deficit as a share of GDP to be broadly unchanged in 2023, gradually widen to around 1.1% of GDP in 2024, and eventually converge close to the pre-Covid level of around 2% of GDP in 2025-26. Combining the narrower goods trade surplus and widening services trade deficit, we expect the overall **current account balance** to gradually weaken over the next few years, to 1.7%/1.3%/1.0% of GDP in 2023/2024/2025, on the backdrop of a consumption rebound and expansion of domestic demand ([Exhibit 19](#)).

Exhibit 18: Exports may contract in 2023 on falling prices and slowing volume growth

Source: CEIC, SAFE, Goldman Sachs Global Investment Research

Exhibit 19: We expect smaller current account surpluses in coming years

Source: Goldman Sachs Global Investment Research, SAFE

CPI in reflation, PPI in deflation

After bottoming in January/February, China's headline CPI inflation has accelerated by 1.2pp to 2.1% yoy in October. It was mostly driven by higher food price inflation (contributing around 2.2pp), mainly on a sharp rise in pork price inflation. In contrast, nonfood price inflation declined notably on a fall in fuel costs and services inflation, as Covid restrictions have constrained domestic demand. For next year, we expect headline CPI inflation to move higher to 2.2%, from 2.0% expected this year ([Exhibit 20](#)).

Dynamics in pork prices should continue to be the major driver of headline CPI inflation for H1 2023. Sow stock, which predicts future potential pig/pork supply with a lag of around 11 months, recovered modestly after a consistent decline between last Q3 and April 2022. This could keep pork prices elevated for the first half of 2023. The reopening boost to demand would drive CPI inflation higher, especially for core inflation, in H2. We expect core inflation to rise to 1.2% in 2023 from an expected 0.7% in 2022.

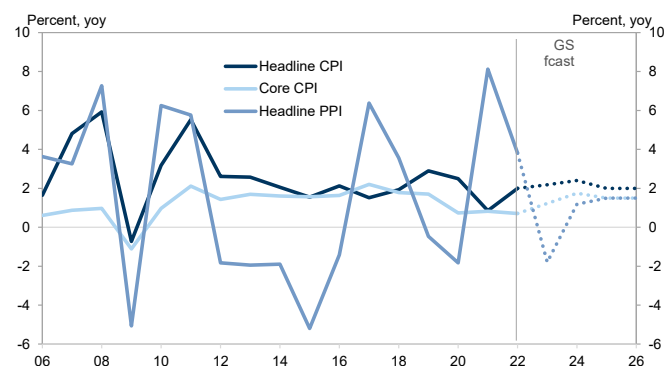
We expect the acceleration of both headline CPI and core CPI inflation to stay mild, in stark contrast with the experience of most western economies, for the following reasons:

- The reopening boost to China's inflation could be delayed to H2 2023 in our baseline. As the initial stage of reopening may result in an immediate surge in Covid infections and reduced household mobility in Q2, the boost to demand could be delayed by a quarter.
- Although other countries' reopening experience suggests most upside risk to labor cost and services inflation, the lack of government cash-backed subsidies to households during the pandemic and a very weak labor market at present imply more muted increases in labor cost and services inflation in China upon reopening. The ongoing property downturn also will likely constrain the upside to rent inflation after China's reopening. In addition, in China's CPI basket, the services component has a lower weight than most DM economies.
- China experienced less supply-side damages to its industrial sector during the global pandemic. Slowing external demand for Chinese goods next year may exert

downward pressure on domestic goods prices. Supply chain recovery globally is likely to deliver a disinflationary impulse to China as well.

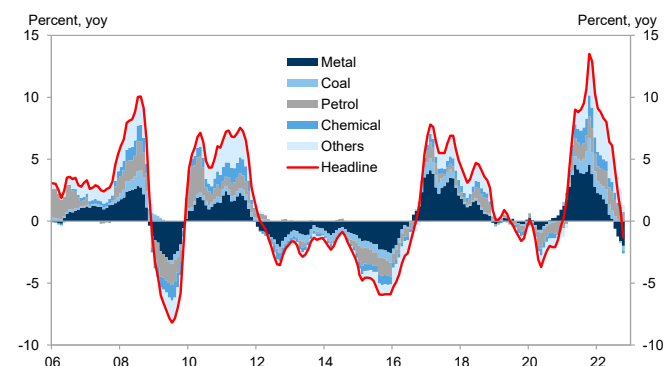
- Energy price regulations could alleviate inflationary pressures from increasing demand for travel, if this becomes a major concern next year.

Exhibit 20: CPI inflation is likely to accelerate modestly, while PPI may deflate further in 2023



Source: Wind, Goldman Sachs Global Investment Research

Exhibit 21: PPI inflation in upstream sectors such as metals and energy has moderated significantly on falling commodity prices



Source: Wind, Goldman Sachs Global Investment Research

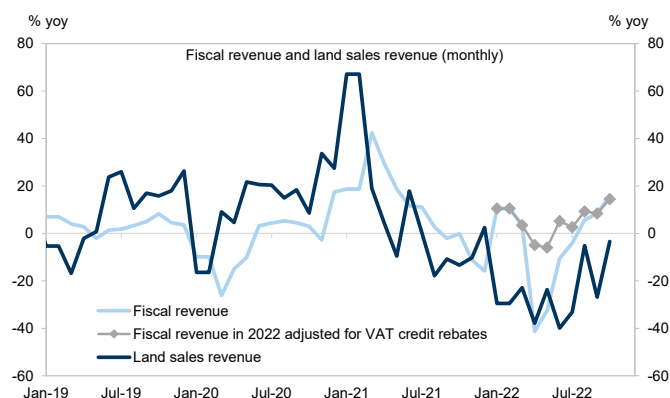
PPI inflation moderated significantly to -1.3% yoy in October from 9.1% in January, primarily driven by lower prices in the metal and energy sectors ([Exhibit 21](#)). This reflects easing supply chain disruptions, falling commodity prices on recession fears, and weak demand related to the property downturn. We expect PPI inflation to decline to -1.8% in 2023 from 3.8% expected in 2022, primarily on falling commodity prices as our basic materials team forecasts.

Fiscal policy: Frontloading in H1, and gradual normalization in H2

China's fiscal conditions have faced significant challenges since spring this year, from the sharp contraction in land sales, large-scale tax rebates/deferrals, and more spending on Covid controls ([Exhibit 22](#)). We also see fiscal stress unevenly distributed across regions, with Covid-hit and property-reliant local governments bearing the brunt. Given the larger-than-expected government funding gap this year, China has consumed some one-off policy buffers accumulated from previous years (e.g., a RMB500bn unspent LGSB quota accumulated from previous years and RMB1.1tn PBOC profit transfer for the government), borrowed some policy space from the future (e.g., RMB400bn funds frontloaded from the 2023 budget for transfer payment this year) and leveraged more off-budget channels. However, we estimate these policy solutions appear insufficient to fill the government funding gap ([Exhibit 23](#)).

VAT credit rebates were an important support for corporates this year and consequently a drag on government finances, but their impact could reverse somewhat in coming years. VAT credit rebates function similarly to interest-free lending from the government to corporates, and corporates that have received more rebates this year may need to pay more taxes next year or even beyond. Note the RMB2.3tn in VAT credit rebates (as of mid-November) is equivalent to 36% of VAT revenue (RMB6.35tn) and 19% of the annual increase in corporate loans, based on 2021 data.

Exhibit 22: VAT credit rebates and land sales revenue have weighed on government funding this year



Source: Wind, Goldman Sachs Global Investment Research

Exhibit 23: New fiscal challenges appear larger than new solutions thus far

Impact of new shocks on China's fiscal conditions					
New challenges	Additional funding gap		New solutions	Additional funding support	
	(RMB bn)	(% of GDP)		(RMB bn)	(% of GDP)
Falling property-related revenue (mainly land sales)	700	0.6	New quota for policy bank lending	800	0.7
Larger-than-scheduled VAT credit rebates	700	0.6	New quota for railway construction bond issuance	300	0.2
Additional tax cuts and deferrals	850	0.7	Frontloading the 2023 budget for transfer payments	400	0.3
Covid-control expenses (e.g. frequently mass testing)	500	0.4	New quota for policy bank bond issuance	600	0.5
Tight curbs on LGFV bond financing	600	0.5	Additional LGSB issuance by using unspent quota	500	0.4
Sum	3350	2.8	Sum	2600	2.2

New challenges and new solutions refer to new shocks relative to the 2022 budget report.

Source: MOF, State Council, Goldman Sachs Global Investment Research

We believe the official deficit target and LGSB quota should be higher in 2023 than this year, due to the unique pattern of fiscal policy this year (i.e., “borrowing from the past and future”), constrained off-budget funding channels (especially via land sales and LGFV financing), and still-strong growth headwinds.

Specifically, we expect the official on-budget fiscal deficit to rise to 3.2% of GDP in 2023 from 2.8% in 2022, returning to the 2021 level. LGSB quota is likely to increase to RMB4tn in 2023 from RMB3.65tn in 2022, but the actual amount of LGSB proceeds spending next year should be smaller than this year, as some of the RMB1.2tn LGSB proceeds raised in Q4 2021 were spent in early 2022, and the government has used the RMB500bn additional quota accumulated from previous years. Among non-government

financing channels, land sales revenue and LGFV financing may remain sluggish, while policy bank support should remain solid.

Accordingly, we expect our proprietary augmented fiscal deficit (AFD) to narrow by 2pp of GDP in 2023 mainly on a potential improvement in fiscal revenue and less LGSB proceeds spending compared to 2022. However, the pace of fiscal policy normalization should be more gradual than in 2021 when AFD narrowed by around 6pp. Moreover, we expect fiscal policy to be frontloaded again in 2023, similar to 2020 and 2022 ([Exhibit 24](#)), due to the lingering impact from the zero-Covid policy and property downturn, as well as our baseline assumption for a gradual reopening from Q2 2023 onwards. According to a 7 November report by *Yicai*, some local governments have recently received part of the 2023 LGSB quota pre-approved by the MOF, for early issuance next January.

Exhibit 24: We expect our proprietary augmented fiscal deficit measure to narrow by 2% of GDP in 2023, after a 3% widening this year

	Percent of GDP	2019	2020	2021	2022F	2023F	Change in 2022	Change in 2023	
1	=3-(2+4)	Official on-budget deficit	2.8	3.6	3.2	2.8	3.2	-0.4	0.4
2		Budget revenue	19.3	18.0	17.7	16.5	17.2	-1.2	0.7
3		Budget expenditure	24.2	24.2	21.5	22.3	22.2	0.8	-0.1
4		Net drawdown of fiscal deposit and transfer from other fiscal accounts	2.1	2.6	0.6	3.0	1.8	2.4	-1.2
5	=3-2	Effective on-budget deficit	4.9	6.2	3.8	5.8	5.0	2.0	-0.8
6		Local government special bond	2.2	3.5	2.8	3.7	3.1	0.9	-0.6
7	=8+9	LGFV bond and railway construction bond net issuance	1.3	2.3	2.2	1.7	1.3	-0.5	-0.5
8		LGFV bond net issuance	1.3	2.3	2.1	1.5	1.1	-0.6	-0.4
9		Railway construction bond net issuance	0.0	0.1	0.1	0.2	0.2	0.1	-0.1
10	=11+12	Policy bank support (including PSL)	1.4	2.0	1.1	1.8	1.8	0.8	0.0
11		Policy bank bond issuance	1.2	2.3	1.4	1.7	1.6	0.2	-0.1
12		PSL	0.2	-0.3	-0.4	0.2	0.2	0.5	0.1
13		Trust loans	-0.2	-0.5	-0.9	-0.3	-0.2	0.6	0.1
14		Land sales revenue	2.4	2.6	2.2	1.5	1.3	-0.7	-0.2
15		Central government special bond	0.0	1.0	0.0	0.0	0.0	0.0	0.0
16	=5+6+7+10+13+14+15	Augmented deficit	12.0	17.2	11.3	14.3	12.3	3.0	-2.0

Source: MOF, Wind, CEIC, Haver Analytics, Goldman Sachs Global Investment Research

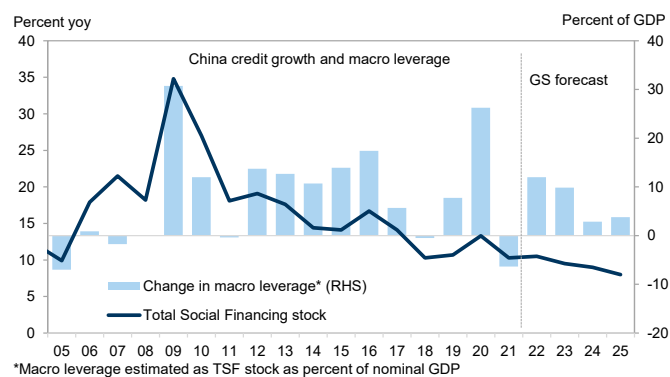
Monetary policy to normalize upon reopening but to stay attentive to financial risks

Fiscal easing has done the heavy lifting of supporting growth this year, as we discussed above. To accommodate the expansionary fiscal policies, broad credit growth has been fast relative to GDP growth, with the macro leverage ratio (proxied as TSF stock to GDP ratio) to increase by around 12pp of GDP in 2022 (based on our forecast), and interest rates staying low to facilitate fast credit extensions amid weak credit demand.

Going into next year, our expectation of reopening and growth rebound in 2H of 2023 allows room for monetary policy normalization. In particular, we expect interest rates to drift higher on the back of our expectation of stronger credit demand and less accommodative credit supply compared with this year. Overall credit growth could slow in 2023 compared with 2022 – growth recovery led by a consumption rebound suggests growth next year could be less “credit intensive,” compared with this year when infrastructure investment has been a key driver for overall economic growth. We forecast TSF stock growth to be 9.5% yoy in 2023, implying another 10pp increase in

the macro leverage ratio, but slower than the pace in 2022 (GS forecast: 10.5% yoy at end-2022), and thus implying a negative credit impulse to growth in 2023.

Exhibit 25: We expect smaller increases in the macro leverage ratio next year as monetary policy stance normalizes from the very accommodative level this year



Source: CEIC, Goldman Sachs Global Investment Research

Beyond cyclical policies, we will likely see policy persistence in **structural reform measures** under President Xi's leadership, in particular, manufacturing upgrading/supply chain security, de-carbonization, and promoting "Common Prosperity" could continue to be policymakers' medium- to long-term goals. These policy goals could facilitate the gradual transition of the Chinese economy away from relying on traditional drivers (such as property investment and traditional infrastructure construction) and imported key products, to depending on more "high-quality" and sustainable drivers such as high-tech manufacturing and renewable energy.

Risks, upcoming events, and markets

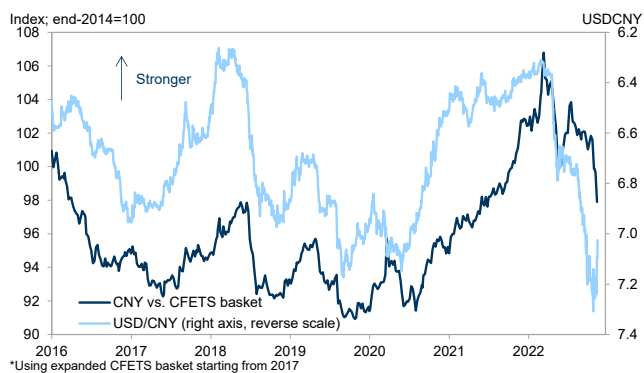
We view risks to our 2022-23 growth forecasts as largely balanced. Upside risks could come from an earlier-than-expected reopening (or stronger-than-expected pent-up demand for consumption and services following reopening), a massive policy stimulus package and more resilient-than-expected exports. By comparison, downside risks include a more prolonged implementation of the zero-Covid policy, a worse-than-expected slowdown in external demand, a re-escalation in US-China tensions and increasing financial risks (especially related to small banks, private property developers and some financially stretched LGFVs). As we believe 2023 will be a pivot point for Covid and macro policies, we also highlight key upcoming high-level policymaker meetings ([Exhibit 26](#)).

Exhibit 26: Upcoming key policy events will lay out the framework of macroeconomic policies for next year

Dates (possible)	Key political and policy events
Early Dec 2022	Politburo meeting on 2023 economic policy outlook, preparation for CEWC
Mid Dec 2022	Central Economic Work Conference (CEWC)
Jan/Feb 2023	Second Plenum of the 20th CPC Central Committee
Mar 2023	Two Sessions - NPC and CPPCC
Apr 2023	Politburo meeting on Q2 economic policy outlook
Jul 2023	Politburo meeting on 2H economic policy outlook
Oct/Nov 2023	Third Plenum of the 20th CPC Central Committee

Source: Goldman Sachs Global Investment Research

Exhibit 27: CNY depreciated against the USD and a basket of currencies so far this year



Source: Wind, Goldman Sachs Global Investment Research

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Reg AC

We, Hui Shan, Maggie Wei, Lisheng Wang, Xinquan Chen, Yuting Yang and Andrew Tilton, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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