Ten Macroeconomic Trends in 2023

Economic Insights

KPMG China

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kpmg.com/cn

Executive Summary

In 2022, China's economy faced strong headwinds and growth slowed. Four challenges had a particularly significant impacts on the economy:

- First, the Covid-19 pandemic continued to spread. The highly transmissible Omicron variant triggered multiple resurgences over the past year, which had a significant impact on the economy. With the removal of almost all quarantine measures, the number of new infections surged in December.
- Second, the real estate market continued to face pressures. In the first 10 months, real estate investment fell by 8.8% year-on-year and is expected to see the first annual decline in history, dragging down overall GDP growth by 1.7 percentage points. In addition, sharp decline in land sales also weighed on local governments' revenue.
- Third, the US Federal Reserve ("the Fed") has raised policy rates rapidly to curb elevated inflation, while China has adopted easing monetary policies to stimulate growth. The differences in policy stance between China and the United States affected RMB exchange rate and cross-border capital flows.
- Fourth, rising geopolitical uncertainty and the conflict between Russia and Ukraine have intensified supply chain pressure and pushed up global inflation. Meanwhile, the United States has continuously exerted its pressure on China's high-tech sector development.

Looking forward, we expect China's economic policies to remain supportive in 2023, as recovery is still fragile. At the Politburo meeting of the Communist Party of China on 6 December 2022, policymakers pointed out that proactive fiscal policy must be strengthened to improve its effectiveness; prudent monetary policy must be targeted and robust; industrial policies must drive the balance between development and security; technology policies should focus on self-reliance and self-improvement; and social policies must always firmly protect people's livelihood. Benefiting from a low base and improved macro environment, China's GDP is expected to grow 5.2% in 2023, picking up from an estimated growth rate of 3.2% in 2022.

In particular, the following 10 macro trends are worth watching in 2023:

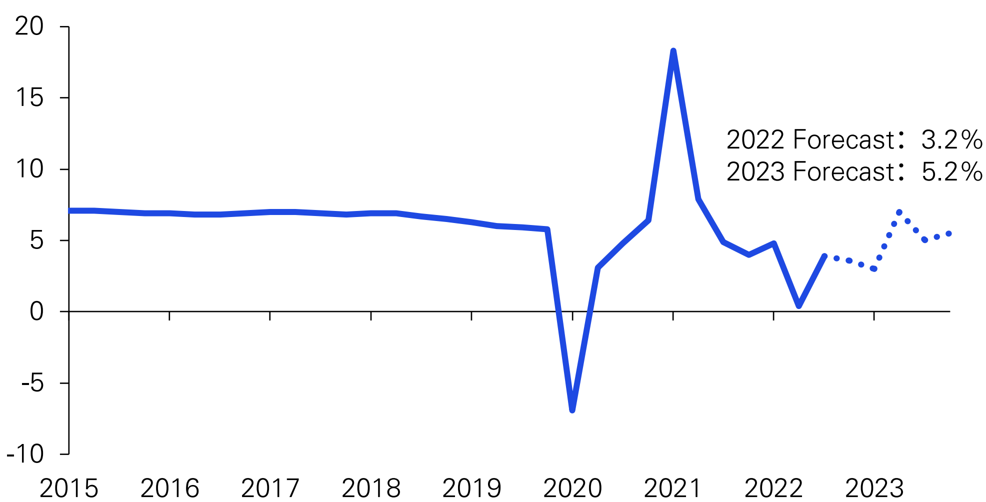
1. China's economic growth rate is expected to accelerate next year, but recovery is still weak.
2. China will exit from its zero-Covid policy. As this occurs, the vaccination rate for the elderly, medical resource preparation, and media guidance are of particular importance.
3. Consumption should improve with relaxed quarantine measures and household savings should help economic recovery.
4. High-tech manufacturing and renewable energy will lead investment growth.
5. Fiscal and monetary policy remain supportive and policy banks are expected to play an important role in funding.
6. The property market will likely remain weak, but the drag on overall growth should lessen.
7. Global economic growth is expected to slow, weighing on China's exports.
8. The Fed is expected to slow its rate hikes, reducing pressures on RMB exchange rate and capital outflows.
9. Geopolitics remains complex and volatile and companies may need to conduct scenario planning to mitigate risk.
10. Basic research investment is accelerating and national security is continuing to be a key theme for China's future development.

1 China's economic growth rate is expected to accelerate next year, but the recovery is still weak

10 Trends

Looking forward, we believe that China's economic growth rate is expected to accelerate in 2023. On the domestic front, as the country continues to optimise its pandemic prevention and control policies and strike a balance between economic and social development, production activities and daily life will normalise, driving the gradual recovery of consumption. Macroeconomic policies will also continue to encourage steady growth. Technological innovation and green transformation will promote manufacturing investments; infrastructure investments will ramp up gradually; and the real estate market will have a less negative impact on the economy. On the international front, falling inflation will make the Fed less eager to set higher interest rates, which will ease pressure on China's exchange rate and capital markets and allow its financial markets to stabilise. In addition, 2022's low base will help contribute to higher year-on-year growth next year. We expect China's GDP to grow by 5.2% in 2023 compared with 3.2% this year (Figure 1).

Fig 1 China's real GDP growth, quarterly, year-on-year, %



Source: Wind, KPMG analysis

Note: The dotted line represents KPMG China's forecast.

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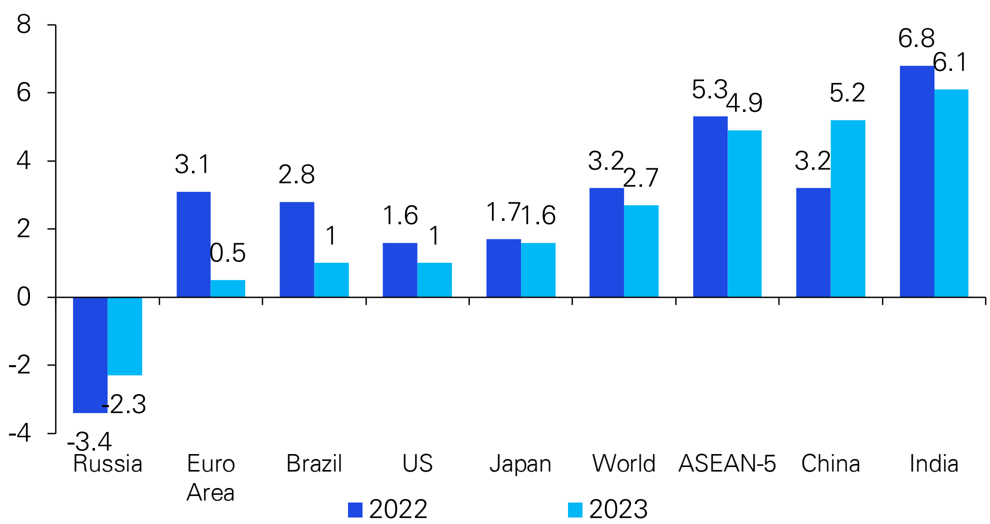
China’s economic growth will accelerate in 2023, but recovery will still be relatively weak. Expected growth of 5.2% will still likely be lower than the pre-COVID level of more than 6%. In addition, the country is forecasted to register an average compound economic growth rate of only 4.7% during the four years following the outbreak of COVID-19, which is lower than expected and not brisk enough to deliver a solid recovery. In 2023, China's economy may face the following challenges: First, shrinking foreign demand due to the global economic slowdown will weigh significantly on the country’s exports; second, as households and enterprises are still cautious with spending, raising their confidence, maintaining growth prospects, and boosting demand remain urgent tasks; and third, less stringent prevention and control policies may result in a short-term surge of the pandemic.

However, we should also note that this expected growth rate of 5.2% will far exceed the global average. In its latest World Economic Outlook report released in October, the International Monetary Fund (IMF) lowered its forecast for global economic growth in 2023 to 2.7%, and pointed out that countries accounting for approximately one-third of the global economy will experience a recession for at least two consecutive quarters within 2023-2024 (Figure 2). Currently, China's economy in aggregate exceeds RMB 114 trillion, representing 18% of the global total and making it the second largest economy in the world. An economy of this size achieving a growth rate of 5.2% is no small feat. The report of the 20th National Congress of the Communist Party of China (2022) puts forward the country's goal of basically realising socialist modernisation by 2035, with its per capita GDP reaching the level of moderately developed countries. According to our estimates, in order for per capita GDP to double from 2020 to 2035, China will need to achieve an average annual economic growth rate of about 4.5% for the next decade or so. Against this backdrop, the country will continue to deepen reform and opening up and give full play to the decisive role of the market in resource allocation, so as to strive for modernisation with Chinese characteristics.

Fig 2 **Real GDP growth forecast for the world's major economies, %**



Source: IMF, KPMG Analysis

Note: China's GDP growth rate is an estimate by KPMG China. ASEAN-5 includes Indonesia, Malaysia, Philippines, Thailand, Vietnam.

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2

China will exit from its zero-Covid policy. As this occurs, the vaccination rate for the elderly, medical resource preparation, and media guidance are of particular importance

On 11 November and 7 December 2022, the State Council's Joint Prevention and Control Mechanism Comprehensive Team issued the "Twenty Measures" and "Ten New Measures" respectively to further optimise the country's pandemic prevention and control efforts. On 26 December 2022, the government announced that China will reopen borders on 8 January 2023. Sun Chunlan, Vice Premier of China's State Council, noted at the symposium of the National Health Commission on 30 November that the Omicron variant's pathogenicity has grown weaker; vaccination has covered a wider portion of China's population; and the country has become more experienced in pandemic prevention and control. As a result, China is now facing "a new situation and new tasks" with respect to its COVID-related efforts[1]. Given how the pandemic has panned out around the world, China may experience waves of infections within a short period of time after its prevention and control measures are relaxed or withdrawn. The winter season has also led to a recent surge in the number of infections here, significantly impacting social and economic activities. We believe that expanding vaccination coverage, improving the accessibility of medical resources, and changing related publicity will be key priorities to ensure a smooth reopening.

1 http://www.news.cn/politics/2022-11/30/c_1129174827.htm

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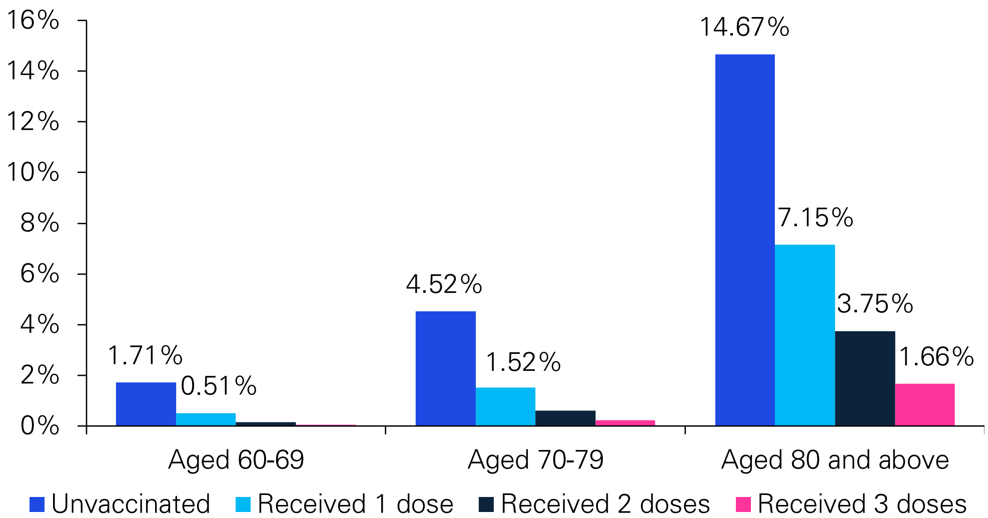
The Omicron variant has now been spreading since November 2021. Many medical studies have shown that compared with the original virus and the other mutated variants that emerged later, the Omicron variant has a smaller pathogenic potential. Notably, the Omicron variant can still bring harm to the elderly and highly vulnerable groups with chronic underlying diseases, but to a significantly lower degree after vaccination. According to the latest statistics from Hong Kong SAR, China, even the first dose of the vaccine can deliver a certain level of protection (Figure 3). Among people over 80 years old who had received one dose of the vaccine, 7.15% who contracted COVID-19 died, much fewer than their peers who had not been vaccinated at all (14.67%). For those who received the third, booster dose, the mortality rate dropped further to 1.66%[2]. In Singapore, more than 90% of the elderly over 80 years old have been vaccinated, and their mortality rate has been reduced to 0.51% after receiving at least 3 doses of the vaccine.

Fig 3 **Mortality rate of elderly COVID-19 patients in Hong Kong SAR, China, %**



Source: Centre for Health Protection Department of Health of Hong Kong SAR, KPMG analysis

As of 28 November, among those aged over 80 in China, 76.6% had been vaccinated and 65.8% had been fully vaccinated, representing a relatively low vaccination rate compared with other economies including Japan, Singapore, France, and Italy (Figure 4). The State Council's Joint Prevention and Control Mechanism Comprehensive Team recently issued relevant notices on promoting COVID-19 vaccination among the elderly[3]. The team highlighted the need to continue to drive full vaccination and enhance immunisation for people aged 60-79, and for those over 80 years old in particular. Caixin.com recently reported that the Chinese government has set a target that by the end of January 2023, 90% of Chinese residents aged over 80 should have received the first dose of the vaccine, and 90% of eligible groups should been fully vaccinated and have received the booster shot[4].

2 https://www.covidvaccine.gov.hk/pdf/death_analysis.pdf
3 Notice on Promulgation of the Work Plan for Strengthening COVID-19 Vaccination among the Elderly, National Health Commission of the People's Republic of China, November 2022, http://www.nhc.gov.cn/xcs/gzzcwj/202211/9bb71c9c7d664fb0bbcd2b3eaaefcf84.shtml
4 https://www.caixin.com/2022-12-01/101972992.html

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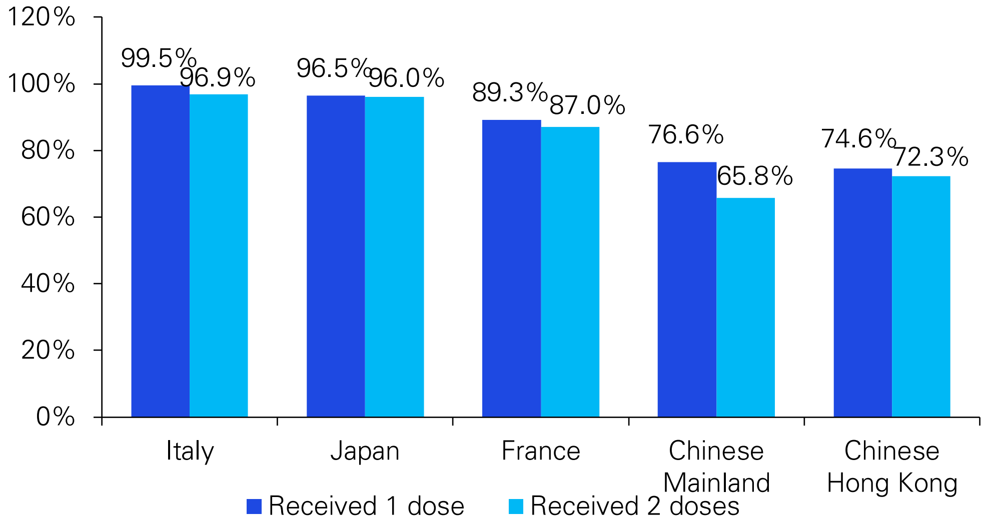
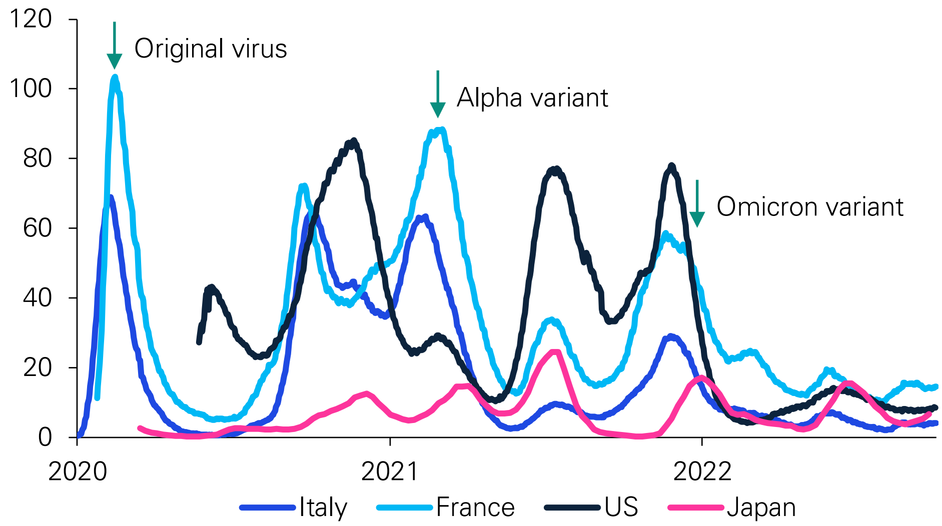
Fig 4 Vaccination rate of people aged 80 and above, %



Source: Our World in Data, local disease control and prevention centres, KPMG analysis
Note: as of 28 November.

In terms of medical resources, China currently has a total of 64,000 intensive care unit (ICU) beds, second only to the United States, but only 44 beds per million people, far behind advanced economies. It is worth noting that as the Omicron variant is less pathogenic, the number of COVID-19 patients who require ICU treatment in the major economies around the world has generally fallen from its peak. In addition, this number has been further reduced following the expansion of vaccination coverage (Figure 5). For example, Italy had a severe medical run following the global outbreak of COVID-19 in early 2020, and ICU usage peaked at 69 beds per million people. However, after new mainstream strains emerged and vaccination increased, ICU usage decreased steadily. By the end of 2021, 97.5% of Italian residents aged over 80 had received their first dose of the vaccine. In 2022, its average ICU usage has dropped to 8.5 beds per million people following a high of 29 at the beginning of the year, indicating that pressure on medical resources has eased significantly compared to 2020.

Fig 5 ICU beds used per million people



Source: Our World in Data, KPMG analysis

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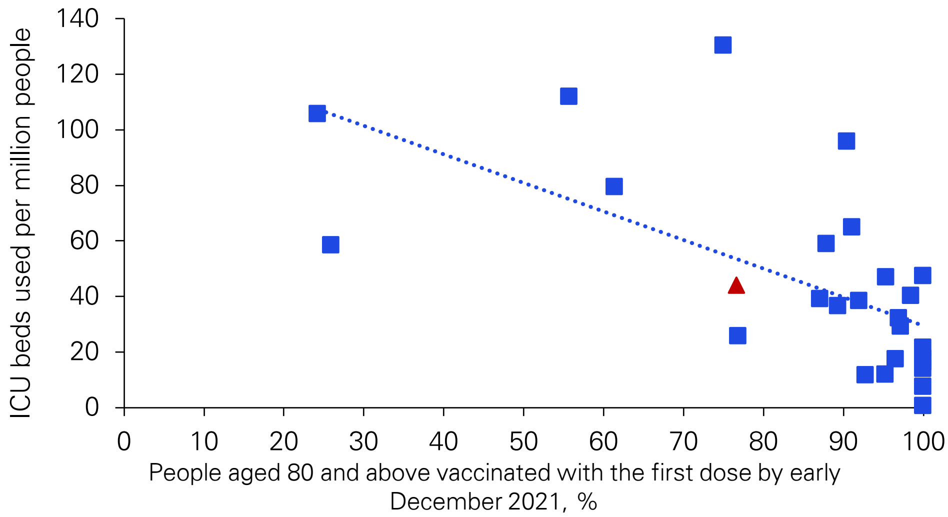
Fig 3 **Relationship between the vaccination rate and peak ICU usage around the world in 2022, %**



Source: Our World in Data, KPMG analysis

Note: The red triangle shows China's current first-dose vaccination rate for people aged over 80 and its number of ICU beds per million people.

Figure 6 further demonstrates the relationship between an increasing vaccination rate of the elderly and peak ICU usage. Over the past year when Omicron was the major spreading strain, peak ICU bed usage averaged 35 in the economies where more than 90% of the elderly aged over 80 had received the first dose of the vaccine. Moreover, the economies with a higher vaccination rate had a lower ICU bed usage peak. Obviously, vaccination can effectively prevent severe symptoms and a run on medical resources, which is the key to fighting the pandemic. At present, the vaccination rate of the elderly in China remains relatively low, and there is a significant gap between Chinese regions in terms of medical resources. The country also falls short in terms of its number of medical personnel, especially those for ICUs. For this reason, the "Twenty Measures" set out the requirement to further establish medical resources. Apart from further increasing the vaccination rate of the elderly, the requirements also call on relevant units to prepare hospital beds and ICU beds and ramp up treatment resources to handle possible waves of COVID-19 infections.

In addition, proper publicity will also play a critical role in promoting the relaxation of pandemic prevention and control measures and the resumption of economic activities in 2023. For some time in the past, waves of the pandemic have had a certain negative impact on public sentiment, especially in cases where certain local authorities enforced countermeasures beyond the central government's guidelines or enacted countermeasures in an indiscriminate manner. When pandemic prevention and control enters a new stage, the media can play a constructive role by providing proper publicity and guidance. In particular, this can include promoting a scientific public understanding of COVID-19, as well as ensuring that people understand the high transmissibility of the Omicron strain and its impact on human body, so that the public will neither underestimate the threat posed by the pandemic nor be overly panicked. In addition, the media can play a role to educate society on graded treatment and self-treatment and relay scientific medical advice and drug lists to help people take proper and timely actions according to their own circumstances, while also advocating social inclusion of people who test positive.

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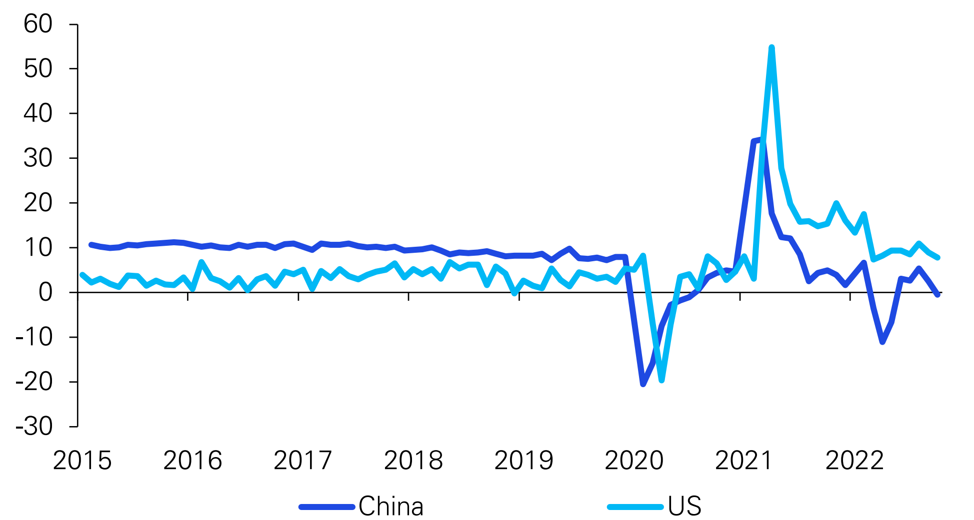
3 Consumption should improve with relaxed quarantine measures and household savings should help economic recovery

10 Trends

During the pandemic, the recovery of household consumption in China has been weaker than that of production and exports. From January to October 2022, the country's total retail sales increased by 0.6% year-on-year, significantly lower than the pre-pandemic level, largely because of the heavy blow to the demand for offline and services consumption. In the short term, the consumption recovery will still be disrupted by the pandemic as well as prevention and control policies. The broader trend of global consumption recovery suggests that consumption will rebound to some degree after pandemic prevention and control measures are released, with a higher growth rate than the rate before the pandemic (Figure 7). As the threat of the pandemic wanes and prevention and control measures are optimised, China's consumption, especially consumption of services, are expected to greatly pick up in 2023.

Fig 7 **Growth of retail sales in China and the United States, year-on-year, %**



Source: Wind, KPMG analysis

Residents' confidence is crucial to the recovery of consumption. Job security and confidence in future income growth are the two main drivers to consumer spending. As such, stabilising employment is China's major macro policy goal. Despite the impact of certain unexpected developments in the second quarter of 2022, the number of newly employed individuals in urban areas reached 10 million in the first three quarters of this year, accounting for 91% of the annual target. Meanwhile, China's surveyed urban unemployment rate stood at 5.5% in October, representing a basically stable employment level. At the same time, Chinese residents' income and income expectations are increasing steadily. In the first three quarters of 2022, per capita disposable income increased by 3.2%, which was basically aligned with the GDP growth rate. In the third quarter of 2022, the income perception index of residents increased by 2.5 percentage points from the previous quarter to 47%, households are expecting better employment opportunities and rising incomes, supporting the recovery of consumption in 2023.

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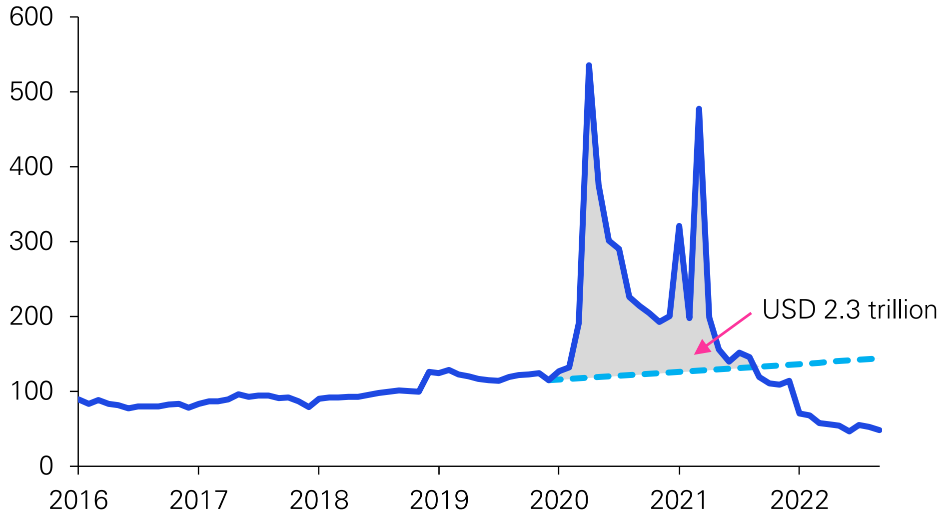
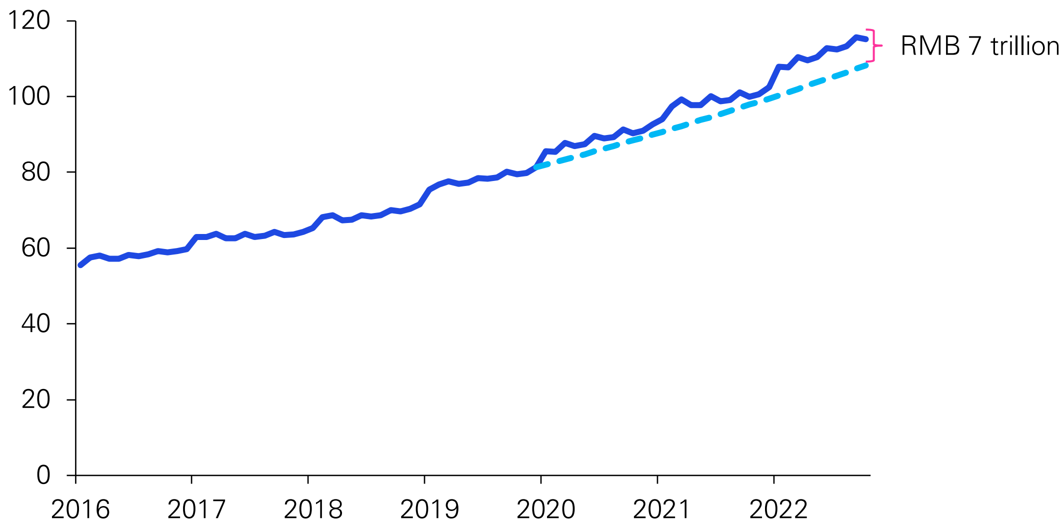
Household savings are also expected to contribute to the post-pandemic recovery of consumption. For example, the US government launched a large-scale fiscal stimulus when COVID-19 was spreading across the country by issuing large subsidies to households. As a result, its household savings soared to about USD 2.3 trillion, leading to a strong rebound in consumption (Figure 8). In China, although the government did not directly provide large subsidies to households over the past three years, as the pandemic has provided Chinese residents with limited opportunities to spend, China's household savings deposits have been buoyed as well. According to our calculation, China's total savings deposits are currently RMB 7 trillion higher than the trendline would suggest. As the pandemic subsides and Chinese residents become more confident about the future, some of these deposits may be spent, which would help boost consumption in the country and serve as a pivotal economic driver next year. However, these increased savings may not be evenly spread among all households, and therefore financial relief for low-income groups and severely affected groups is still very necessary.

Fig 8 **Household savings the US and China**

➢ Monthly savings for US households, seasonal adjusted, USD billions



➢ Outstanding savings for China's households, RMB trillion



Source: Wind; KPMG analysis

Note: The light blue dotted line is the trendline.

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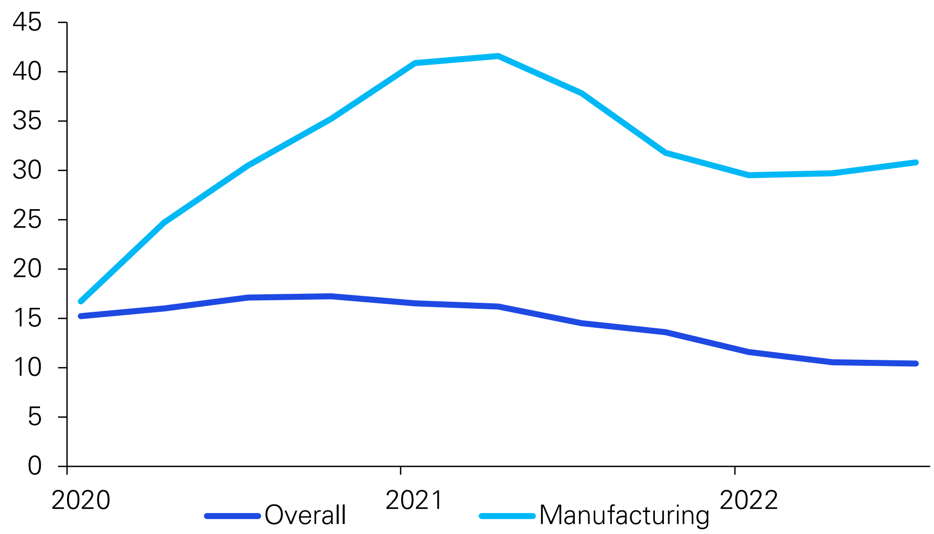
4 High-tech manufacturing and renewable energy will lead investment growth

10 Trends

The manufacturing sector is key to China's continued economic transformation. The country’s 14th Five-Year Plan calls for ensuring that the manufacturing industry accounts for a certain proportion of China’s economy. The share of manufacturing value added in its GDP has started to rise again from its low of 26.3% in 2020, reaching 28% at the end of September 2022. Driven by supportive policies, China’s manufacturing investment recorded impressive year-on-year growth of 9.7% from January to October 2022, 3.9 percentage points higher than the overall investment growth rate. The industry is transforming more quickly toward high-end, green and intelligent manufacturing; and the growth of investments in high-tech manufacturing has been particularly strong, increasing by 23.6% year-on-year during the first 10 months of 2022, which was 17.8 percentage points higher than the overall investment growth rate.

Financial institutions have been fine-tuning their total loan amounts and loan structures by granting a greater proportion of medium- and long-term loans to the manufacturing sector and making more loans to strategic emerging sectors, so as to step up support for the real economy. They have continued to optimise the structure of their loans to manufacturing enterprises, and have reduced overall financing costs. By the end of September 2022, outstanding medium- and long-term loans to the manufacturing sector increased 30.8% year-on-year, 20 percentage points higher than the overall growth rate of medium- and long-term loans (Figure 9). Also at the end of September, China's central bank established a

Fig 9 **Growth rate of outstanding medium- and long-term loans in China’s financial institutions, %**



Source: Wind; KPMG analysis

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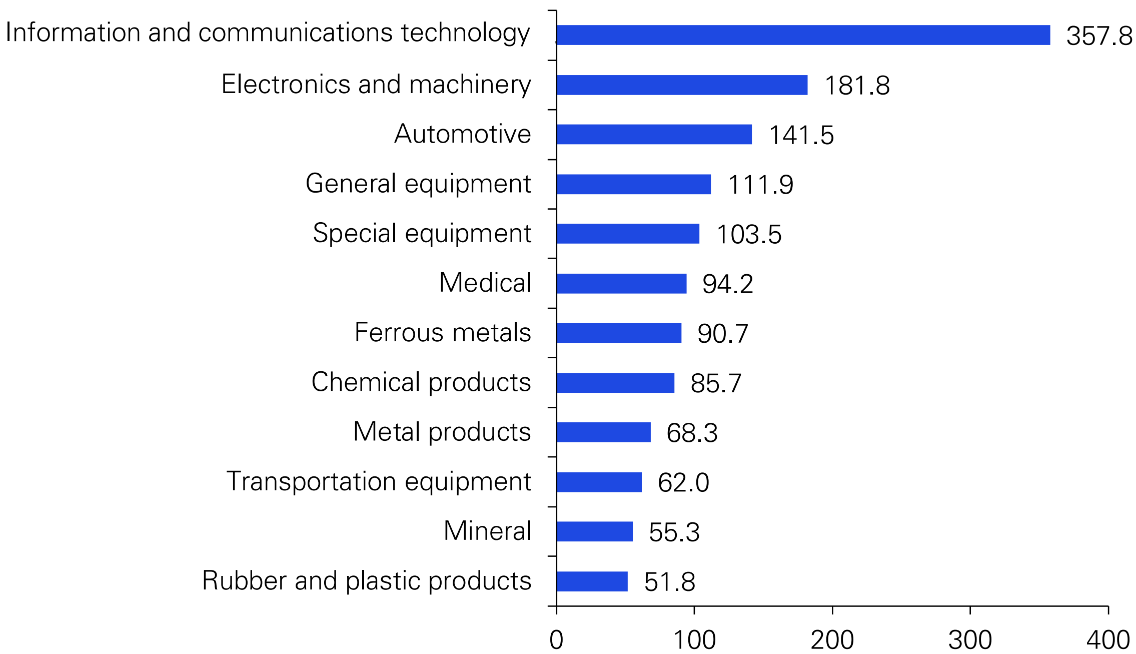
new special relending fund of RMB 200 billion for equipment renovation and transformation, aiming to further boost manufacturing investments. In addition, the narrowing PPI-CPI gap will help reduce costs for middle and downstream enterprises in the manufacturing sector and encourage investments from enterprises to expand their production capacity.

In terms of research and development (R&D) investment, computer and communication equipment manufacturing enterprises invested as much as RMB 357.8 billion in R&D in 2021, accounting for 21% of the total R&D investment of manufacturing enterprises (Figure 10). In addition, the R&D investment made by high-tech manufacturing enterprises such as medical equipment manufacturers and instrument and apparatus manufacturers exceeded 3% of their revenue, much higher than the manufacturing sector's average of 1.46%, indicating that enterprises in such areas have attached greater importance to technological innovation. Continuous efforts and investments have contributed to emerging scientific and technological achievements in China, and high-tech manufacturing has become a critical driving force for the country's industrial transformation and high-quality development. For the foreseeable future, China will continue to drive industrial optimisation and upgrades, and increase support for "Specialised, Refinement, Differential, Innovation (SRDI)” enterprises pursuing high-tech manufacturing. Financial institutions will concentrate their support on high-tech manufacturing and strategic emerging sectors, helping promote the development of advanced manufacturing clusters and improve manufacturers’ strength in independent innovation. We believe that China’s industrial policies will continue to accelerate the conversion of its economic drivers, and will create a synergy effect with favourable financial policies to boost high-tech manufacturing investments.

Fig 10 **R&D investments of manufacturing enterprises in 2021, RMB billions**



Source: National Bureau of Statistics, KPMG analysis

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Meanwhile, driven by the country’s "dual carbon" goals, China CEOs are accelerating the integration of environmental, social and governance (ESG) practices into the company's development strategy, and green transformation is moving into the spotlight. For example, China’s National Development and Reform Commission and the National Energy Administration jointly issued the Medium- and Long-term Plan for the Development of the Hydrogen Energy Industry (2021-2035) in March 2022, which clearly defines hydrogen as an important part of China’s future national energy system, an important driver for the transition toward green and low-carbon energy, and an important beacon for strategic emerging industries and future-oriented industries. In the first half of 2022, private equity financing in the hydrogen energy sector continued its steep upward trajectory, with a total of 21 financing deals amounting to RMB 1.59 billion concluded. The quantity and amount of the deals in this space increased by 50% and 137% respectively compared with the same period last year[5]. As an efficient and low-carbon energy as well as a green and clean raw material, hydrogen can be used across a wide variety of business scenarios in transportation, industry, construction, power and other areas. We have noticed that in general more and more enterprises are shifting their focus toward enhancing sustainability, which may help maintain the rapid growth of investments in new energy sources.

5 The fast-growing hydrogen energy industry, KPMG China, September 2022
https://home.kpmg/cn/zh/home/insights/2022/09/understand-the-hydrogen-energy-industry-in-one-article.html

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Fiscal and monetary policy remain supportive and policy banks are expected to play an important role in funding

10 Trends

During China's Political Bureau meeting on 6 December, officials pointed out that proactive fiscal policy must be strengthened to improve its effectiveness, and prudent monetary policy must be targeted and robust. Therefore, we expect that China will continue to maintain accommodative stance on its macroeconomic policies next year to drive the economic recovery. On the other hand, we do not expect to see any dramatic changes in monetary policy in 2023 out of consideration for stability and consistency, and ensuring growth will remain the primary goal during the year. The country will maintain reasonably adequate liquidity, and ensure a proper increase in the size of the money supply and social financing. On 25 November 2022, China's central bank further reduced its required reserve ratio by 0.25 percentage point to release long-term funds of about RMB 500 billion. These funds will help ensure a proper level of liquidity near the end of the year to facilitate economic activity and support financing. In addition, the central bank will continue to encourage financial institutions to lower their actual loan interest rates, so as to reduce enterprises' overall financing costs and consumers' credit costs. These measures will hopefully increase their willingness to invest and spend, and ultimately drive endogenous growth. From a structural perspective, the central bank has vowed to make good use of existing structural monetary policies and make proper adjustments; and it has also underlined financial support for key areas, and for enterprises severely affected by the pandemic.

Proactive fiscal policy was critical to stabilise the economy in 2022. Although the preferential VAT refund and dwindling land sales have led to a decline in fiscal revenue this year, China's fiscal expenditure has maintained rapid growth. In addition, local governments have accelerated the issuance of new special bonds this year, which has helped maintain brisk growth in infrastructure investment, a crucial lever for stable economic growth. We should also note that China is expected to face greater difficulties in accessing fiscal funds next year. According to data from the National Balance Sheet Research Centre on government debts, by the third quarter of 2022, the Chinese government leverage ratio was 49.7%, about 3 percentage points up from the end of 2021, of which the leverage ratio of local governments increased 2.5 percentage points , indicating that local governments are under greater pressure to repay debts and interest (Figure 11). However, compared with other economies, China has maintained a relatively low government leverage ratio, so there is room for additional debt to be issued in the future. We expect local governments will continue to issue a certain amount of special bonds in 2023 in order to sustain economic growth.

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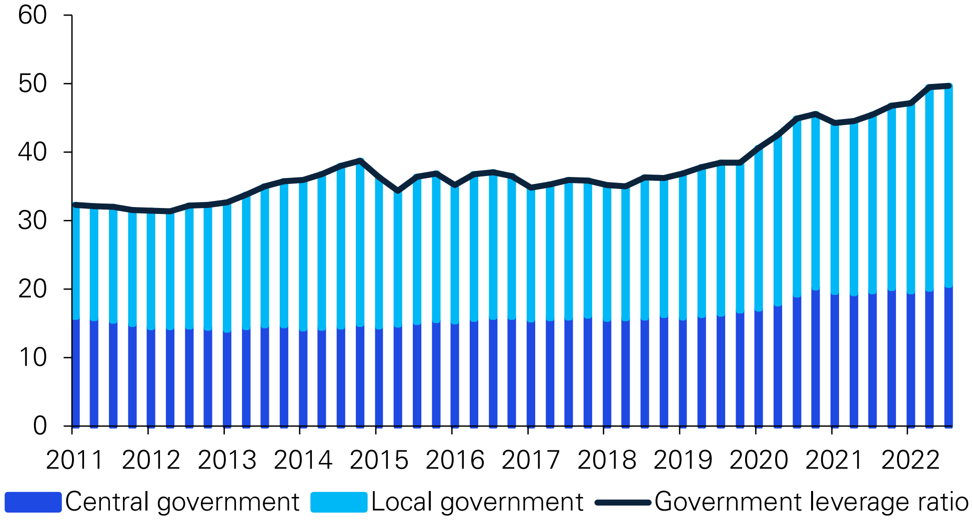
Fig 11 **China's government leverage ratio, %**



Source: Wind; KPMG analysis

In addition to fiscal funds, more policy-based and developmental financial instruments are expected to be used to boost the country's fiscal expenditure in 2023. In the second half of 2022, China's central bank issued such financial instruments through policy banks to support major projects, facilitate the issuance of special bonds, and fuel infrastructure construction. The central bank's China Monetary Policy Report released in the third quarter mentions that policy and development banks need to be instructed on how to fully utilise policy-based and developmental financial instruments, as well as the additional RMB 800 billion credit, to provide effective financial support for infrastructure construction. By mid-November 2022, around RMB 740 billion in funds had been provided through the financial instruments. These financial instruments will facilitate targeted and effective investments and encourage private capital to engage in investments, so as to stabilise the macro economy, achieve more returns, improve employment, and drive consumption. We expect that these financial instruments will continue to play a major role in ramping up effective investments next year.

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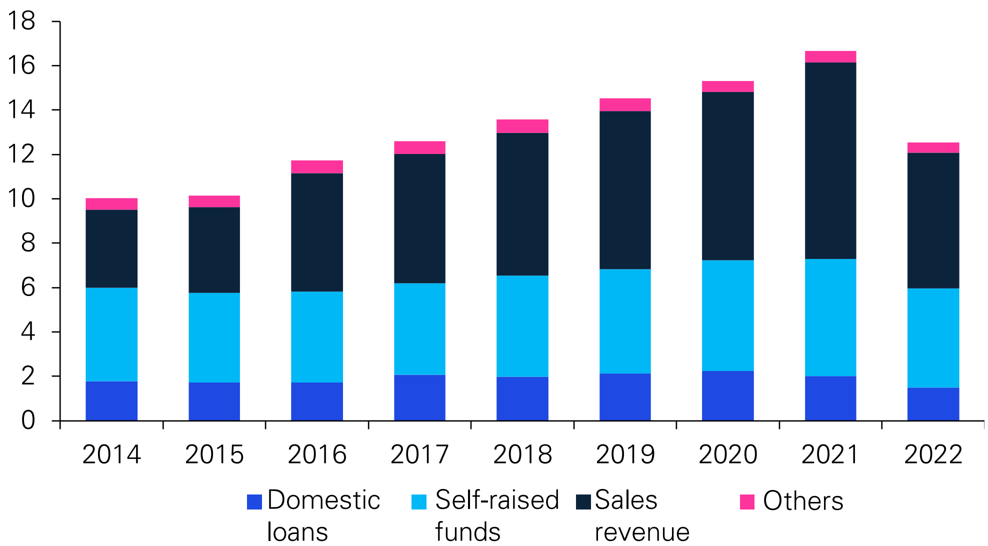
6 The property market will likely remain weak, but the drag on overall growth should lessen

In 2022, the real estate market was under ongoing pressure, and liquidity was a key challenge for real estate developers (Figure 12). On one hand, consumer confidence was weak and house sales slumped, subjecting real estate developers to lower sales income. On the other hand, in the face of stringent regulations, financial institutions slowed down funding for real estate developers, and banks significantly reduced loans to these enterprises. Statistics show that from 2011 to 2019, the average growth rate of outstanding loans to the real estate sector reached around 20%. However, with banks reining in real estate loans in recent years, the growth rate dropped to 3.2% by the end of September 2022. Moreover, many real estate enterprises have been defaulting on their bonds, making such investments less appealing. Therefore, the self-raised funds of real estate enterprises (including through bond financing) continued to decline from January to October of 2022, dropping by 14% year-on-year. Obviously, these enterprises are still seriously short of liquidity and are also not as willing to invest, causing related indicators such as project kick-offs, construction, and land purchases to plummet. As a result, total new start construction area has declined to the lowest level since 2009, and commercial housing sales area has reached its lowest level since 2015. In addition, real estate investment in China dropped by 8.8% year-on-year from January to October 2022. We expect the annual growth rate of real estate investment to decline in 2022 for the first time in history, dragging down overall GDP growth by 1.7 percentage points (Figure 13).

Fig 12 **Funding sources of real estate developers from January to October in recent years, RMB trillion**



Source: Wind, KPMG analysis

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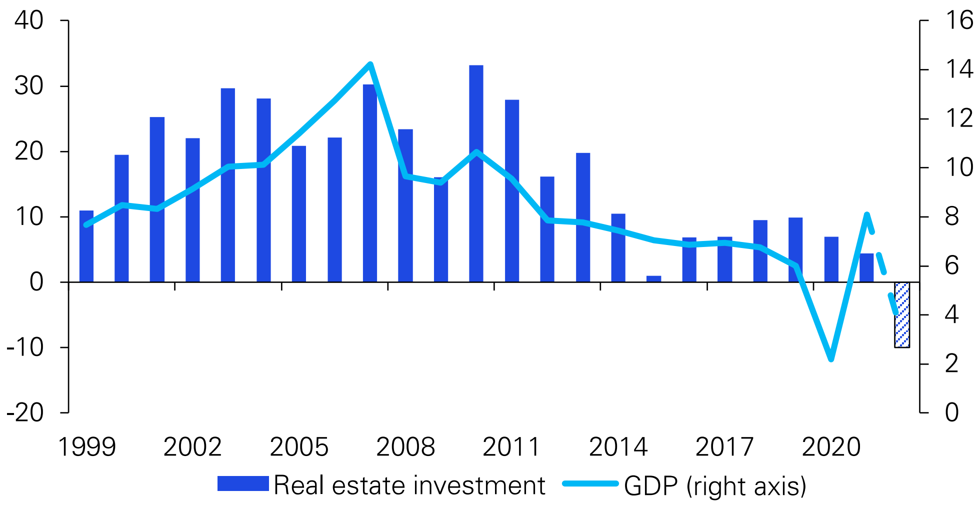
Fig 13 **Real estate investment growth and real GDP growth, %**



Source: Wind; KPMG analysis. Data for 2022 is KPMG forecast.

The real estate market is important to the Chinese economy, and in order to stabilise the market, China has promulgated many favourable policies for the sector this year. In terms of demand, many local governments have lifted bans on purchasing houses and lowered mortgage rates, taxes and other charges to meet people's needs for basic housing and improving demand for quality homes. In terms of supply, the government has put forward a range of policies since November 2022, including the "first arrow" of "Sixteen Measures" to facilitate bank loans to developers, the "second arrow" of supportive measures to facilitate bond financing by developers, and the "third arrow" of supportive measures to facilitate equity financing by developers. These "three arrows" will to some extent improve the balance sheets of real estate enterprises, mitigate their credit risks, and help well-managed private real estate enterprises pursue financing. At the same time, the measures will contribute to the development of a multi-layer real estate financing system that should drive the recovery of the real estate market.

Generally, we expect the real estate market to remain weak in 2023 as it tries to regain momentum. Residents' confidence in the housing market will need to improve; and before that happens, real estate sales will remain sluggish. Besides, the CSRC's policies concerning the real estate sector highlight that funds from the capital market cannot be used to purchase land or develop new projects[6]. Therefore, we estimate that real estate enterprises will still be unwilling to launch new projects or acquire land, but they may continue to complete their existing projects to respond to the requirement for "ensuring the completion of houses under construction and guaranteeing people's livelihoods." Looking forward, a more modest decline in the real estate investment growth rate is expected in 2023, which is predicted to have a smaller impact on the country's economy compared with 2022.

China aims to establish an effective long-term mechanism to ensure the stable and sustainable development of the real estate market. The report of the 20th CPC National Congress (2022) stresses that China will maintain its overall real estate policy that 'housing is for living, not for speculation'. Although the real estate market is facing downside risk in the short term, China's urbanisation still presents significant long-term potential for the market, and demand for better housing conditions will continue to increase, helping to stabilise the market.

6 CSRC spokesperson's answers to journalists' questions regarding support from the capital market for the stable and sustainable development of the real estate market, CSRC, November 2022, http://www.nhc.gov.cn/xcs/gzzcwj/202211/9bb71c9c7d664fb0bbcd2b3eaaefcf84.shtml

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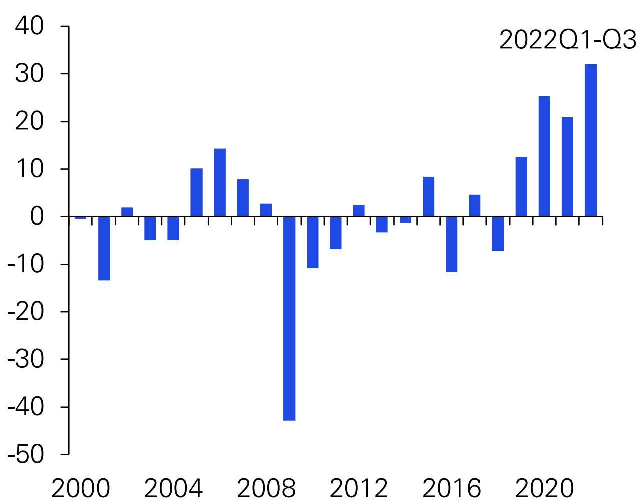
7 Global economic growth is expected to slow, weighing on China's exports

10 Trends

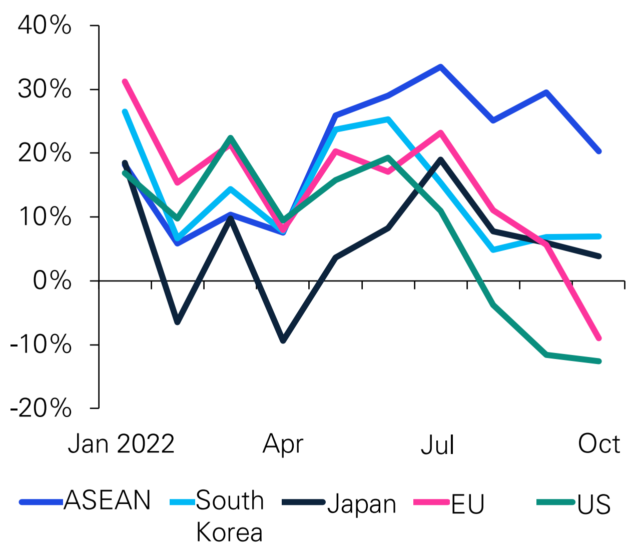
Over the past three years, China has adopted a pandemic prevention and control policy that emphasised priorities different from those of many other countries. During that period, it gave full play to its well-established supply chains and manufacturing industry to seize opportunities arising from surging foreign demand. By the end of 2021, China's exports accounted for 16% of the world's total, 3 percentage points higher than pre-Covid levels. As the recovery of domestic demand has been relatively slow, exports have become China's major economic engine in 2022. Net exports in the first three quarters of the year accounted for over 30% of its GDP growth, a record high over the past 20 years (Figure 14). However, foreign demand seems to have cooled down since August 2022, and the prosperity of the major economies such as the United States and Europe has declined. The Purchasing Managers' Index (PMI) for the manufacturing industry in the US, UK, and Europe had fallen into the contractionary range by October. Currently, China's exports to the US and Europe still exceed 30% of its total exports, so the weaker demand in these countries has weighed significantly on China's exports. As a result, China's exports have started to show a downward trend, with negative growth (denominated in US dollars) recorded in October. Exports to the US and the EU dropped 12.6% and 9.0% year-on-year respectively, the biggest declines for both since April 2020 (Figure 15).

Fig 14 **Contribution of net exports to real GDP growth of China, %**



Source: Wind, KPMG analysis

Fig 15 **China's monthly export growth to major economies, yoy, %**



Source: Wind, KPMG analysis

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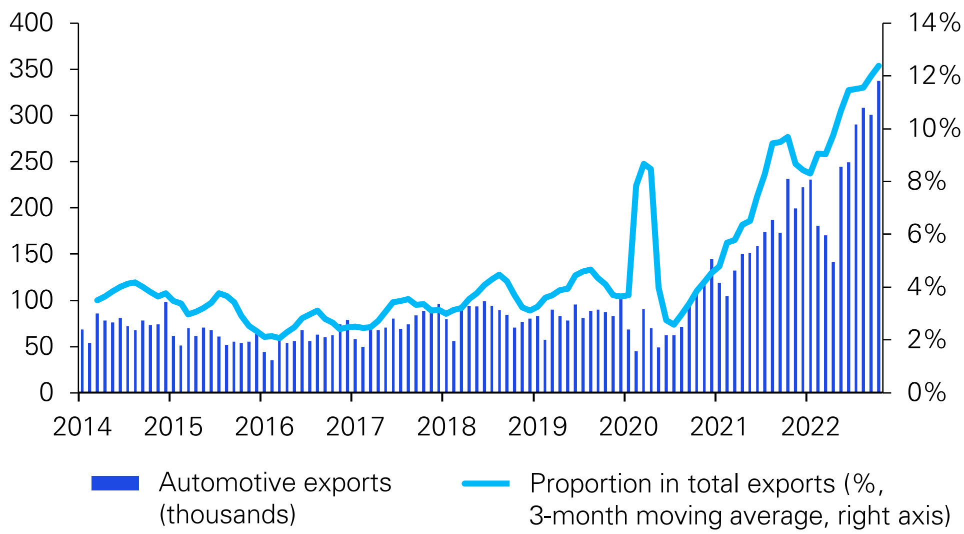
We expect global economic growth to continue slowing in 2023, which will weaken foreign demand and add pressure to China's exports. The IMF has lowered its forecast for global economic growth four times in a row this year. According to its latest forecast in October 2022, it expects global economic growth to drop from 3.2% in 2022 to 2.7% in 2023. Meanwhile, the latest WTO forecast also shows that global trade will lose momentum in the second half of 2022, and growth in the global goods trade is expected to fall from 3.5% in 2022 to 1.0% in 2023. In the 2022 China CEO Outlook recently released by KPMG China, China CEOs shared their views on the prospects for global economic growth, with 90% of respondents saying they believe that it is very likely that the global economy will experience a recession within the coming year[7]. Against the backdrop of a weak global economy, China's exports are expected to grow at a considerably slower or even negative pace in 2023.

While export growth is slowing down, it should also be noted that China's exports are changing structurally and showing new trends. On the one hand, as the Regional Comprehensive Economic Partnership (RCEP) deepens cooperation, China's exports to the Association of Southeast Asian Nations (ASEAN) have maintained a high growth rate of over 20% since May 2022; and at the same time, exports to South Korea and Japan have seen an increase, showing that the trend of Asian Pacific economic integration will continue to strengthen in the future. On the other hand, as China's manufacturing strength keeps improving, its export structure is transforming to include more products from the high-end manufacturing and equipment manufacturing sectors, particularly the automotive sector. Driven by robust foreign demand for new energy vehicles, China's automotive exports have been reaching new highs since 2021, turning the country into the world's second largest automotive exporter after Germany. In recent years, exports as a share of China's total automotive output have soared from less than 4% to over 12% (Figure 16), and new energy vehicles have played an important role in this breakthrough. Recently, many European automotive makers have increased their investments in China, and therefore China's exports of automotive products, especially new energy vehicles, will remain strong in 2023.

Fig 16 **China's automotive exports**



Source: Wind, KPMG analysis

7 KPMG 2022 China CEO Outlook, KPMG analysis, November 2022, https://home.kpmg/cn/en/home/insights/2022/11/2022-china-ceo-outlook.html

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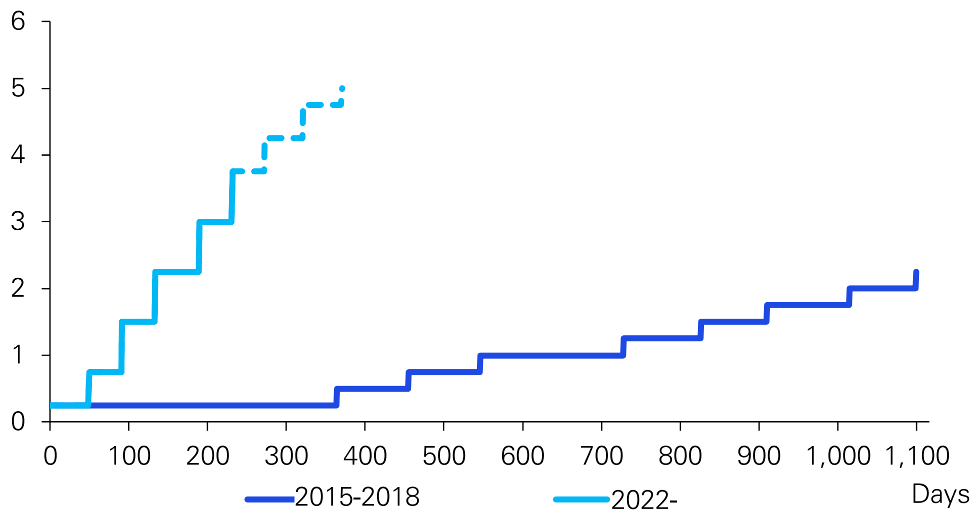
8 The Fed slows its rate hikes, reducing pressures on RMB exchange rate and capital outflows

In order to rein in high inflation, the Fed had raised its interest rate six times in a row as of November 2022, resulting in a total increase of 375 basis points. Compared with the previous rate-rise cycle from 2015 to 2018, in the current cycle, the US central bank has delivered greater hikes within a shorter timeframe. In terms of inflation data, the year-on-year CPI increase in the US has dropped for four consecutive months to 7.7% in October. Although the Fed will continue to raise the interest rate in the short term to control inflation, the soaring rate is weighing down the US economy and has heightened the risk of a recession. Going forward, we expect that these increases will slow down, and the Fed is quite likely to limit its increase in December to 50 basis points, and then pause after notching additional rate rises of 50 basis points and 25 basis points in early 2023. At that point, the market target rate will range from around 5%-5.25% for a certain period of time (Figure 17). We should note that KPMG US's chief economist team expects the Fed to start cutting the interest rate from the second half of 2023 to lower it back to 2.75%-3% by the end of the year [8].

Fig 17 **The Fed's interest rate hikes, %**



Source: Wind, KPMG analysis
Note: The zero on the abscissa axis indicates when the Fed started to increase the interest rate, and the ordinate shows the range of the hikes. The dotted line represents the expected rate hikes as of 3 November 2022.

8 U.S. Economic Outlook 2023, KPMG US, December 2022, https://advisory.kpmg.us/events/webcast-homepage/2022/us-economic-outlook-2023.html

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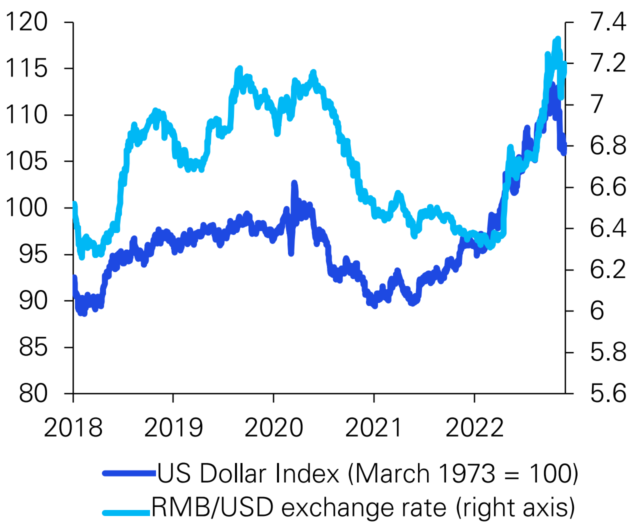
As the Fed slows its interest rate increases, the US Dollar Index is expected to decrease, and the RMB yuan may appreciate against the US dollar. Since March 2022, the Fed's aggressive moves to push up interest rates have resulted in a strong US Dollar Index, and the RMB exchange rate has consequentially slumped. It fell below 7.3 in October, before going up slightly in November (Figure 18). After the Fed slows its interest rate hikes, external pressure on the Chinese economy will ease. At the same time, the Chinese government's economic policy package and subsequent measures will start to take effect, and the country's economic fundamentals should recover steadily. A balance of payments surplus will also enable the RMB exchange rate to regain ground gradually.

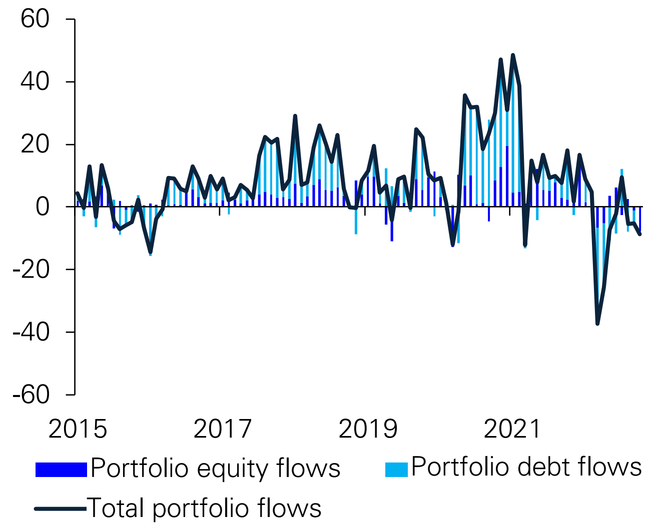
Meanwhile, the Fed's slowdown in interest rate hikes will undermine the yields offered by US treasury bonds, narrowing the interest rate gap between China and the United States and reducing capital outflows from China. The current cycle of interest rate hikes by the Fed has caused the yields on US treasury bonds to skyrocket. In early November, the yield spread on one-year treasury bonds between China and the US hit a record high of over 3 percentage points. According to data from the Institute of International Finance (IIF), from March to October 2022, China's equity and debt markets recorded a total of USD 82.18 billion in net capital outflows, which included around USD 71.4 billion from its debt market and around USD 10.8 billion from its equity market (Figure 19). In October, capital outflows from the equity market continued, while capital outflows from the debt market slowed significantly. On 18 November 2022, the People's Bank of China and the State Administration of Foreign Exchange jointly released the Provisions on Administration of Funds Invested in China's Bond Markets by Foreign Institutional Investors to further enable foreign investors to invest in China's bond markets and enhance the appeal of RMB-denominated assets, with the aim of attracting capital inflows.

Fig 18 **US Dollar Index and RMB/USD exchange rate**



Source: Wind, KPMG analysis

Fig 19 **China's cross-border capital flows, USD million**



Source: Wind, KPMG analysis

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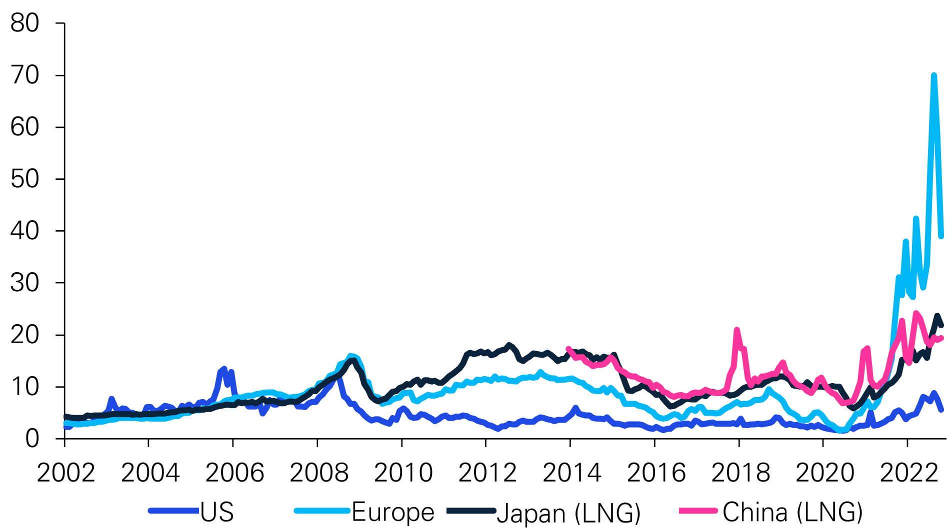
9 Geopolitics remains complex and volatile and companies may need to conduct scenario planning to mitigate risk

The Russia-Ukraine conflict in 2022 has caused a chain reaction in various areas of the global economy, worsening global energy and food shortages in the short term and pushing up inflation around the world. For example, Russia is the world's second largest natural gas producer, so the conflict has had a significant impact on natural gas prices, particularly in the European market. Russia is also Europe's top energy supplier, with 45% of Europe's natural gas coming from Russia in 2021. After the Russia-Ukraine conflict began, Europe sharply cut its energy imports from Russia, leading to surging energy prices there. In August 2022, the price of natural gas soared to a peak of USD 70 per million British Thermal Units (MMBtu), nearly five times the price in August 2021, and 24 times that of August 2020 (Figure 20). In contrast, the United States has been less affected owing to its high level of energy self-sufficiency. Moreover, it has also significantly increased exports of liquefied natural gas (LNG) to Europe. According to data from the U.S. Energy Information Administration, the US's LNG exports in the first half of 2022 increased by 12% from the second half of last year, making it the world's largest LNG exporter, with the EU and the UK importing 47% of Europe's total, the largest share[9]. Natural gas prices were buoyed to a certain extent in China and Japan as well, but not as much as in Europe.

Fig 20 **Natural gas price by region, USD/MMBtu**



Source: World Bank, Wind, KPMG analysis

9 US becomes world's largest LNG exporter in the first half of 2022, EIA, July 2022
https://www.lngindustry.com/liquid-natural-gas/29072022/eia-us-becomes-worlds-largest-lng-exporter-in-the-first-half-of-2022/

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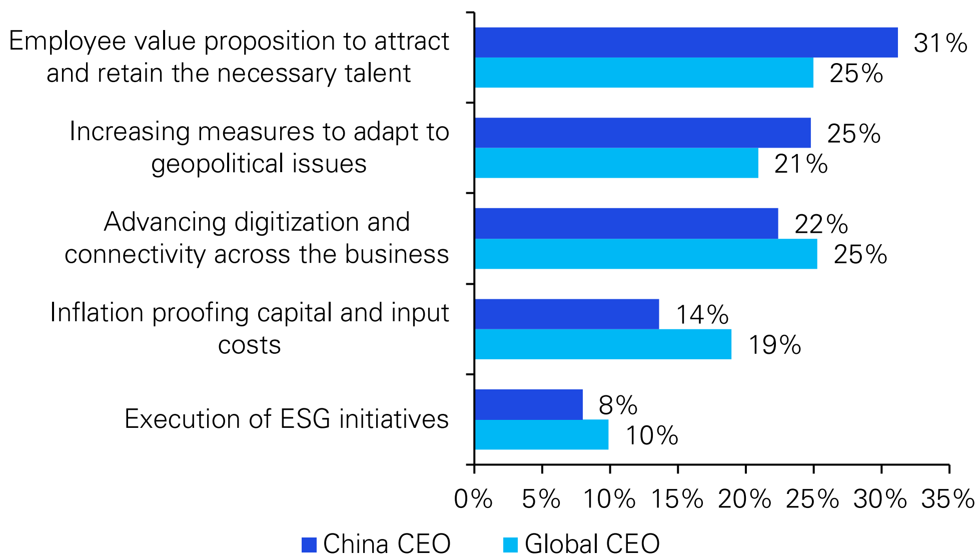
It is worth noting that the conflict between Russia and Ukraine will not only bring about a short-term increase in energy prices but may also cause more in-depth and profound changes in the global geopolitical landscape. China, the United States and Europe account for 55% of the total global economy, and the relationship between them has a dramatic impact on global economic development. Geopolitical conditions will remain complex and volatile next year. On the one hand, the energy crisis has affected industrial production, exports, and investments in Europe, increasing pressure on the recovery of the European economy. Some chemical, steel and other energy-intensive enterprises are reconsidering their global industrial footprint. On the other hand, economic and trade friction will be a long-term feature of the relationship between China and the US. The United States continues to exert pressure on China's high-tech sector through export controls and other means, but this also brings more development opportunities for Chinese players offering substitute products, such as IT innovations.

Competition between major powers as well as regional conflicts not only raise uncertainty around the operation of the global economy, but also impact the investment and operating strategies of enterprises in various ways. Enterprises should make contingency plans to mitigate such geopolitical risks to the largest extent possible. According to the KPMG 2022 China CEO Outlook report, corporate executives are actively taking measures to achieve business growth in this rapidly changing market environment. A quarter of China CEOs surveyed said that continuously strengthening measures to deal with geopolitical challenges is the most important strategy for them to meet their corporate growth targets over the next 3 years, higher than the global average of 21% (Figure 21).

Fig 21 **Top operational priority to achieve growth objectives over the next 3 years , %**



Source: KPMG 2022 China CEO Outlook, KPMG analysis

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10

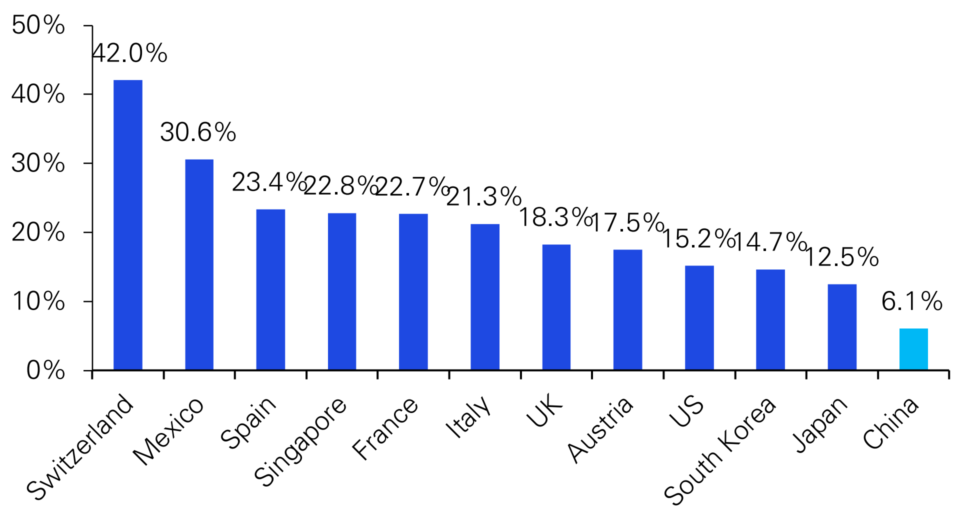
Basic research investment is accelerating and national security is continuing to be a key theme for China's future development

10 Trends

In August 2022, US President Joe Biden signed the Creating Helpful Incentives to Produce Semiconductors and Science Act of 2022 (CHIPS Act), which mainly aims to make the United States more competitive in the global semiconductor industry by stepping up support for the development of its chip industry and preventing specified countries such as China from obtaining advanced chip manufacturing technologies. The Act stipulates that chip companies receiving federal subsidies are prohibited from building or expanding factories to implement such advanced technologies in countries such as China, and companies that violate this rule must refund their subsidies in full. Recently, technological competition between China and the United States has further intensified. In October 2022, the US Department of Commerce introduced new export control measures as well, further impacting China's semiconductor industry.

In order to alleviate these bottlenecks and realise technological independence, China has increased its investment in basic research and underlying technologies in recent years. In 2021, basic research investment increased to about 6.1% of its total R&D investment, but there is still a large gap between this figure and those of developed countries (Figure 22). In its 14th Five-Year Plan, China puts forward the new indicator of "proportion of basic research expenditures in R&D expenditures" and aims to raise that proportion to over 8% by 2025. We expect that China will continue to vigorously drive investment in and policy support for basic research in key areas.

Fig 22 **Major economies' proportion of basic research investment in total research investment, %**



Source: OECD, National Bureau of Statistics, KPMG analysis
Note: The data for China is for 2021, the data for the other economies are for 2020.

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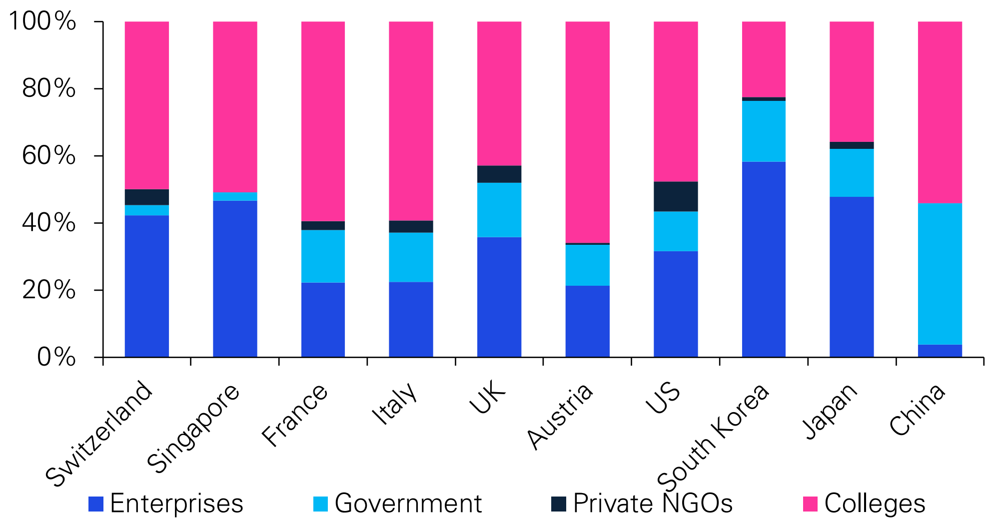
We should note that more than 90% of China's basic research investments have been made by its government and universities; only 3.8% was made by enterprises and almost no investments were made by other social sectors such as private non-profit organisations. This is quite different from the situation in developed countries, where enterprises generally account for more than 20% of basic research investments; at the high end, this figure reached almost 60% in South Korea (Figure 23). In the future, China needs to ensure that enterprises can play a more dominant role in innovation. It may consider tax incentives and other policies to encourage enterprises and other social sectors to invest more in basic research to substantially boost innovation.

Fig 23 **Basic research investment in 2020 by country and sector, %**



Source: OECD, KPMG analysis

The report of the 20th CPC National Congress (2022) attaches as much importance to security as it does to innovation, these two areas being the report’s two core themes. China will need to strike a reasonable balance between achieving economic and social development and ensuring national safety. Over the past few years, global economic uncertainty has heightened as natural disasters became more frequent, food and energy prices surged, and financial markets fluctuated more significantly. Meanwhile, geopolitical tensions made it even more difficult for governments, enterprises, and residents to deal with these challenges. At the same time, geopolitical conflicts have led to a series of restrictive measures in the economy, finance, technology, and other fields, increasingly turning safety into a critical concern. In the future, China will need to improve its national safety system, so as to facilitate its new development pattern, ensure the supply of food and energy, and protect important industrial chains and supply chains.

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