MERICS Economic Indicators – Stimulus measures drive China’s economic rebound

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Curb your enthusiasm: China’s economy rebounds but is not yet in the clear

China’s economy made a comeback in the second quarter, raising hopes for a swift recovery. GDP growth bounced back to 3.2 percent in the second quarter following a contraction of 6.8 percent in the previous quarter. Despite the improvement, the economic impact of the pandemic continues to leave its mark.

After the government’s initially slow response, China’s economic recovery benefited from proactive government policies, which sought to control the outbreak of coronavirus, while limiting the economic fallout. The government was swift to enact policies that sought to alleviate the immediate economic impact of the severe slowdown on companies and employees. A rescue package worth over 4 trillion RMB, that included tax cuts, lower interest rates, reduced utility prices and employment support, provided China’s economy with a necessary lifeline as the shock unfolded.

The recovery also benefited from surprisingly resilient global demand for “Made in China” goods. Although falling demand has left its mark on growth, the versatility of China’s industrial complex proved to be a boon.

The V-shaped recovery is not taking place across the board and is at risk of losing its initial momentum. Most notably, consumption and employment remain suppressed. The possibility of renewed or extended shutdowns, both in China and elsewhere around the globe remains a risk to the economy.

The government was right to abolish its GDP growth target for 2020. It still remains to be seen if the CCP can hold back on becoming overly eager to show China’s strength to the world by fueling a fast recovery. Doing so would come at the expense of efforts to establish a more sustainable economic growth model.

Governments in many countries have stepped up their role in the economy to prevent total mayhem. Likewise in China. But the recent approval by the Central Comprehensively Deepening Reforms Commission of a three-year action plan to strengthen the role of state-owned enterprises (SOEs) in the economy suggests that the already strong role of the state in China will be further enhanced yet further.

China’s economy appears (so far) to be the first in and first out of the Covid-19 crisis. Renewed optimism has resulted in a stock market frenzy and a strengthening USD/CNY exchange rate. China’s economy is seeing some light at the end of the tunnel. Yet, despite the improvement in the second quarter, the economy remains on life support in the form of continued monetary and fiscal stimulus.
The MERICS China Confidence Index (MCCI)

The MERICS China Confidence Index measures household and business confidence in future income and revenues. The index is weighted between household and business indicators. It includes the following indicators: stock market turnover, future income confidence, international air travel, new manufacturing orders, new business in the service sector, urban households’ house purchase plans, venture capital investments, private fixed asset investments and disposable income as a share of household consumption. All components have been tested for trends and seasonality.

The MCCI was first developed in Q1 2017.
MACROECONOMICS

Government-engineered investment surge catapults growth into positive territory

- Strong GDP growth indicates that China’s economy is coming out of the deep slump triggered by the Covid-19 lockdown as fast as it entered it. Real GDP beat most analysts’ expectations, expanding by 3.2 percent year-on-year in Q2, meaning that China has escaped recession. For the first half of the year, economic growth was down 1.6 percent, but this marks a significant improvement on Q1.

- Government stimulus measures were the major factor in the rebound as they brought in looser fiscal and monetary policies. Surging investment, measured in gross capital formation, contributed 5 points, or 156 percent, to GDP growth. This is higher than the 85 percent in response to the Global Financial Crisis in 2009. As a result, construction activity has already exceeded 2019 levels, expanding by 7.8 percent in Q2.

- The end of lockdowns in other countries combined with falling commodity prices resulted in net exports contributing half a percentage point to second quarter GDP growth. Resilient global demand has also contributed to a recovery in manufacturing, which bounced back to 4.4 percent in the last quarter.

- Despite some improvement on Q1, consumption has failed to recover. It continued to contract, pulling down GDP growth by 2.9 percentage points. Similarly, the service sector is failing to recover as insecurity holds back consumption. The hard-hit hotel and restaurant sector contracted by 18 percent while the recovery in other services sectors remained weak.

- The stimulus measures have driven credit growth, which far exceeded nominal GDP growth: up 12.8 percent versus a rise of 2 percent. This level will not be sustainable.

What to watch: Over-reliance on investment can kick start the economy, but consumption needs to pick up for the recovery is to become stabilized.
Business

V-shaped recovery completed: manufacturing is up and running

- China's industrial sector made a roaring comeback as the economy re-opened after the government-ordered shut down to combat Covid-19. Value-added production improved continuously, and expanded by 4.8 percent in June. Industry's swift recovery has nearly eradicated the negative impact seen at the height of the crisis. In the first half of 2020, manufacturing only contracted 1.4 percent.

- As a result, capacity utilization rates have improved and are nearing pre-crisis levels. Capacity for manufacturing improved to 74.8 percent in the second quarter, just below 77.1 percent recorded in the same period of 2019.

- 15 out of the 17 largest industrial sectors tracked by the National Bureau of Statistics returned to growth in June. This included the hard-hit automotive industry, which made the strongest comeback of all. Output increased by 13.2 percent in June. However, output of e-vehicles slipped: June output contracted by 18.6 percent.

- Boosted by strong domestic and global demand, output for electronics led the pack, expanding by 12.6 percent in June and 5.7 percent year to date. The recovery benefited from increased production of smartphones: output increased by 26.1 percent in June.

- The government’s infrastructure stimulus is doing its part in driving increased supply of building-related materials. Output for cement increased by 8.4 percent, while steel production rose by 7.5 percent in June.

What to watch: External and global demand will need to pick up for manufacturing to keep its momentum.
China’s foreign trade remained remarkably resilient as the Covid-19 pandemic swept first through China then the rest of the world. Exports and imports have bounced back from the massive contraction in the first quarter when China was shut down. Measured in USD terms, exports contracted by 6.1 percent while imports contracted by 7.1 percent in the first half of the year.

Demand for major industrial input commodities including energy, metals and plastics accelerated in terms of imported quantity in the first six months. Measured in USD, weak prices suppressed overall import growth.

Exports rebounded most strongly in April (3.5 percent) as delayed orders were shipped, only to slow again in May (-3.3 percent). The latest uptick in June (0.5 percent) comes amid the re-opening of key markets. This is also reflected by exports to Germany and France returning to positive growth.

Exports have benefited from the ability of Chinese companies to quickly scale up needed commodities, most notable medical equipment and instruments, which increased by 100 percent in June. Similarly, consumer electronics, a key Chinese export, have fared well: exports of mobile phone expanded almost 30 percent in June. However, shipments of intermediate goods, including car parts (-18.1 percent) and steel parts (-26.6 percent) have been slow to recover amid struggling global demand.

Global trade is set to become more politicized as tensions between major trading partners look to be heating up. This will add an additional layer of uncertainty to foreign trade over the coming quarters.

What to watch: China’s export recovery faces a volatile and uncertain situation as countries return to (partial) lockdown and the global impact of the recession unfolds.
To support China’s crisis-hit economy, the central bank has rolled out an accommodative monetary policy. The interest rate on the People’s Bank of China (PBOC) 14-day reverse repo has been lowered slightly, and a large amount of cash injected into the market through a series of interventions.

The monetary easing combined with continued low economic growth is increasing leverage levels. Aggregate total credit was up 12.8 percent year-on-year at the end of Q2. With nominal GDP only expanding at 3.1 percent this means credit-to-income is expanding and that each incremental unit of credit issued generates lower growth.

Faced with lower profits and revenue, small and medium sized enterprises (SME) will struggle to stay afloat and to secure liquidity. The financial damage will become increasingly visible as credit borrowed during the peak of the pandemic mature.

The PBOC’s targeted stimulus efforts included instructions to banks to increase their lending to private-sector SMEs. The latest data suggests the policy is failing, as banks are not willing to take on the higher risk associated with SMEs. As a result, corporates are finding alternative financing sources outside of banks: shadow banking aggregates are recovering, and corporate bond issuance is growing at record levels.

China’s stock markets in Shanghai and Shenzhen skyrocketed, reaching the highest levels since 2018. Rising stock prices are due to monetary easing, combined with growing confidence among investors that China has overcome the first phase of Covid-19 more successfully than other countries. Rising inflows from foreign investors could be seen in the higher usage of the Hong Kong Stock Connect channel.

What to watch: The bull run seems to be based on weak fundamentals, raising the risk of a stock market correction.

Related MERICS Analysis: Stimulus package reveals China’s financial constraints
Supporting China’s SMEs affected by Covid-19 is crucial to avoid a socioeconomic disaster
Investment

SOEs lead the investment recovery

- Fixed asset investment is showing a V-shaped recovery after contracting by 16.1 percent in the first quarter. Although investments remained down by 3.1 percent year to date at the end of the second quarter, a serious recovery is underway.

- China’s state-owned enterprises (SOEs) have been particularly responsive to the government’s stimulus efforts. With better access to creditors and less constrained by market risks, SOE investments returned to growth, expanding 2.1 percent in the first six months.

- The government’s infrastructure stimulus is beginning to show results, though overall investment in infrastructure was down by 2.7 percent year to date. The focus on railway and digital infrastructure is having an impact: investment into railroads rose 2.6 percent while IT related investment was up a whopping 21 percent. China State Railway Group has said in a statement that national railway projects are valued at 325.8 billion CNY in the first half of the year. As for 5G, the Ministry of Industry and Information Technology has said that 600,000 5G stations are expected to be built by the end of the year.

- The more risk averse private sector’s appetite for investment remains dampened. Investment contracted by 7.3 percent in the first half of 2020. Private companies’ appetite for new investments is likely to be subdued. Many are still struggling to stay alive, as revenue and profits have deteriorated.

- Another bright spot is the real estate: investment was up 1.9 percent. Growth was driven by stronger investment in residential buildings (2.6 percent) land transactions (5.8 percent).

What to watch: Private sector investment will need to pick up for the economic recovery to be on more solid footing.

Related MERICS Analysis: China bets on ‘new infrastructure’ to pull the economy out of post-Covid doldrums
Prices

Prices tumble as demand struggles to recover

- Government stimulus policies have not pushed up prices, leaving room for more expansive fiscal and monetary measures. However, the weak price trend also indicates that demand is a weak spot as China’s economy tries to get running again.

- Consumer price inflation continued to ease downward over the second quarter, reaching 3.8 percent for the first six months. Prices continue to be impacted by elevated pork prices and lower oil prices. However, both outliers have peaked following the supply and demand shocks of the previous months. Nonetheless, deflationary pressures are mounting as non-food and fuel related prices are falling.

- Core inflation is at its lowest level since May 2010 and is close to deflationary levels as it had fallen to 0.9 percent in June. Prices for major retail categories as well as rents continue to fall. Services, including education and health care, are recording price increases but have also shown slower growth over the second quarter.

- The purchasing price index (PPI) remains negative despite a slight recovery in June. The PPI improved from -3.7 percent in May, its lowest value in 4 years, to -3 percent in at the end of the quarter. Falling fuel prices continue to be a major drag on the index. Prices for inputs as well as sales prices (factory gate prices) mostly continue to fall, indicating potential oversupply.

- Real estate prices have avoided a major shock during the crisis. Prices eased downward over the quarter, slowing to 4.9 percent on average for 70 major cities in May compared to the same period last year. Crisis-hit Wuhan exemplified the resilience of the real estate market, with prices rising by 7.4 percent, well above average.

What to watch: If demand fails to pick up considerably over the next quarter, the risk of deflation will become more pronounced.
Labor market

Employment fails to recover amid uptick in GDP growth

- The weak employment situation remains a key concern for the government. Surveyed urban unemployment continues to stick at historically elevated levels of around 6 percent. Although reliable official data is lacking, layoffs are estimated to be anywhere between 20 and 100 million. In response, the government has reduced its annual target for new urban jobs to 9 million, down from 11 million.

- Refunds of corporate social security contributions, plus regional government cash incentives to keep employees on the payroll, aim to prevent layoffs. Plans to increase the retirement age from 60 for men and from between 50 and 55 for women appear to have been put on hold for now.

- Following decades of rapid economic growth and stalled social welfare reforms, China’s social safety net seems unprepared to deal with the employment shock. The impact puts the government’s ambitious target for poverty alleviation (i.e. lifting the entire population above the official poverty line) by the end of 2020 at risk. In response, access to minimum subsistence allowances and unemployment insurance has been expanded.

- The labor market impact of 2020’s record number of 8.74 million fresh university graduates may be exacerbated by overseas students returning to China looking for jobs. The government has initiated programs to encourage company hiring by providing a hiring bonus.

- Falling income expectations and pay cuts are adding to the difficulties workers face. Disposable income nosedived in the first quarter, and has since recovered from contracting by 3.9 percent in Q1 to only 1.3 percent in the first six months. Even as employment data improves, wage growth is expected to recover at a slower pace.

What to watch: Inequality risks are set to widen further as the country’s most vulnerable are the worst-affected by the crisis.
Retail
Consumer spending remains trouble spot for recovery

- The willingness of households to consume remains constrained by persistent economic insecurity. Retail spending continued to improve over the second quarter, but momentum remained weak. June retail sales were down 1.8 percent compared to the same period last year.

- Overall retail sales are still far from returning to positive growth. In the first six months of 2020, growth contracted by 11.4 percent. For retail spending to pick up, consumer sentiment needs to improve substantially. The government will need to do more to stimulate consumer spending, including tax breaks and improved access to social security. Most importantly, employment and wage security needs to improve.

- Consumers’ preference for increased savings was close to an all-time high in the first quarter, according to the People’s Bank of China’s Urban Depositor Survey. However, the preference for higher savings barely budged once lockdowns were eased in the second quarter, dropping to 52.9 percent from 53 percent in the first three months.

- Although consumers held back from buying costly items, purchases of lower priced daily necessities (16.9 percent) or food (10.5 percent) continued to bounce back in June. However, car sales, which account for around 10 percent of retail sales, contracted by 8.2 percent in June, after showing some improvements in April and May.

- The service sector remains in a dire state. Expenditure for restaurant dining has improved after the massive hit in the first quarter. But it still contracted by 15.2 percent in June and was down 32.8 percent for the first six months. As people shun travel and stay close to home, passenger traffic numbers continue to look bleak.

What to watch: A rebound in services and consumption for durable consumer goods would indicate a more solid recovery.