

MACRO OUTLOOK

No Swift Recovery as Demand Remains Weak

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2Q2020 KEY TAKEAWAYS

- The Chinese economy rebounded in March but the recovery isn't likely to endure in 2Q because of the confluence of headwinds that will exacerbate weak demand.
- At the heart of the challenge is the liquidity shortage in the private sector, which accounts for more than half of China's GDP. As private businesses continue to face cash flow constraints, they will be forced to scale back investment and hiring, which will further weaken consumer confidence and reinforce a vicious cycle of deflation.
- Beijing will be able to deal with the anticipated export drop with fiscal stimulus, but it will have difficulty reigniting domestic demand because its policy responses will be inadequate in addressing private sector problems.
- These factors combined will weigh on second-quarter growth, with the recovery looking much more like a "U" than a "V." Instead of countering with a broad-based stimulus, Beijing is likely to take more time to consider a medium-term strategy aimed at making growth more sustainable, which could be unveiled at the delayed National People's Congress (NPC) in May.

Concerns over a second-wave coronavirus outbreak have accompanied Beijing's decision to reopen the economy in late February. But after almost two months, and with imported cases seemingly under control, these concerns are abating. The pandemic may have passed, but the Chinese economy is still far from being nursed back to health.

This is evident from the historic -6.8% GDP contraction in the first quarter, but that should not be surprising given the shock to the economy. The important question is what the recovery will look like and how long it will take, which will offer leading indicators to other economies as they begin the process of reopening in coming weeks.

The modest rebound in March data, which came in significantly better than the abysmal readings in February, should not warrant much immediate optimism. That's because although production seems to have recovered fairly well, the main risk lies on the demand side.

As I had written previously, [demand](#) holds the key to a swift recovery. Yet signs do not bode well for such a scenario to materialize. Not only is China confronting a sharp contraction in global demand



that will damage its export sector, it has to also deal with the thornier challenge of reviving domestic demand. That hinges on the private sector.

Relatively speaking, policymakers will have a much easier time handling the trade disruption because it has ample experience in offsetting the impact from weak global demand. Mitigating the impact from export decline may be necessary, but it will not be sufficient in orchestrating a sustained recovery. For that to happen requires dealing with the widespread liquidity shortage in the private sector, which will have knock-on effects on consumer confidence and deflation.

Yet when it comes to supporting the private sector, despite [recent signals](#) and pledges from the State Council, Beijing will be unable to support the private sector to the extent needed to bolster growth. For one, the central government has too many policy challenges to juggle. It is also concerned that unbridled stimulus will generate moral hazard and lead to more speculative investments. To the extent that policy support for private firms will be inadequate, that means the vast majority of Chinese firms will continue to suffer from a cash crunch and some will face bankruptcies.

This outlook will first analyze the private sector liquidity shortage problem, because it is central to how China manages its recovery and how it will amplify other existing symptoms. It will then forecast Beijing's policy responses, with the base case being a modest stimulus that will just offset the decline in exports, with this pattern of "just enough" stimulus likely holding for the remainder of the year.

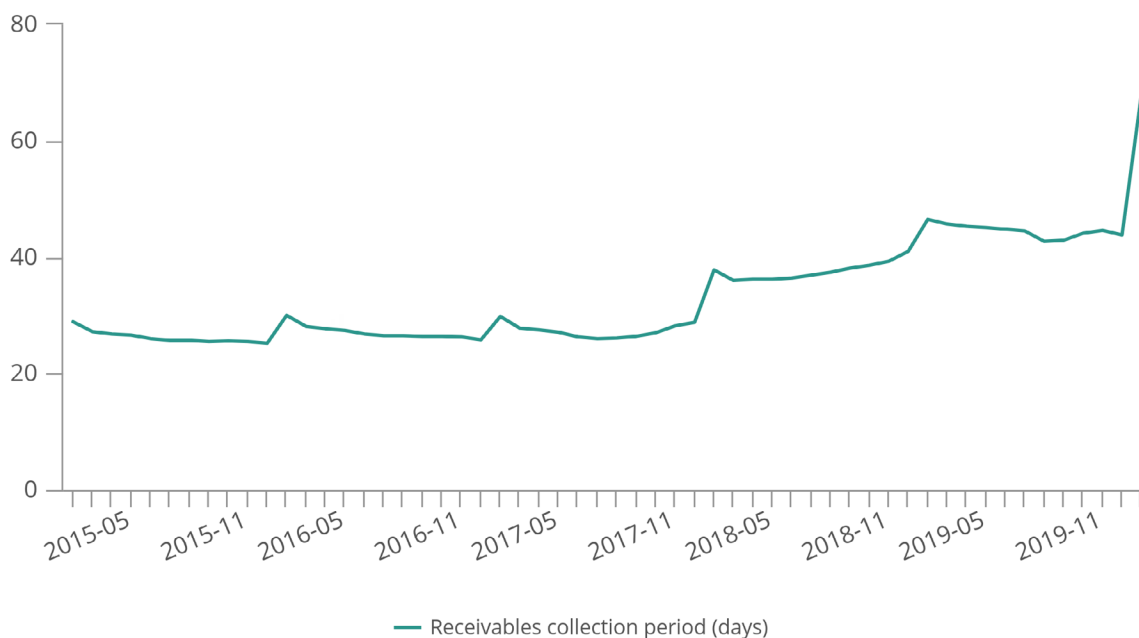
In other words, near-term policies will primarily be aimed at putting a floor on growth but will not be particularly effective in creating upsides to growth. The bottom line is that in the coming months, the decent rebound since February will likely morph into a U-shaped recovery. Instead of launching another massive stimulus, Beijing appears to be taking more time to consider a medium-term strategy to transition the economy and sustain growth. That strategy could well become clearer at the NPC that is likely rescheduled for later in May, which we will cover in a future research note.

PRIVATE SECTOR IN THE DOG HOUSE

A number of initial predictions saw a dramatic but short-lived economic contraction resulting from the pandemic, with the potential of a V-shaped rebound in the second quarter. But recent developments suggest otherwise, which is most clearly illustrated by the lasting impact on corporate balance sheets.

What makes the pandemic's impact particularly damaging is that it is like kicking private firms in the stomach while they're already down. The slowdown in 2018-2019 had already significantly eroded private firms' liquidity positions, as shown in the significant extension of the collection period for their receivables, meaning it is taking much longer for firms to get cash (see Figure 1).

Figure 1. Private Firms Have More Difficulty Collecting Cash

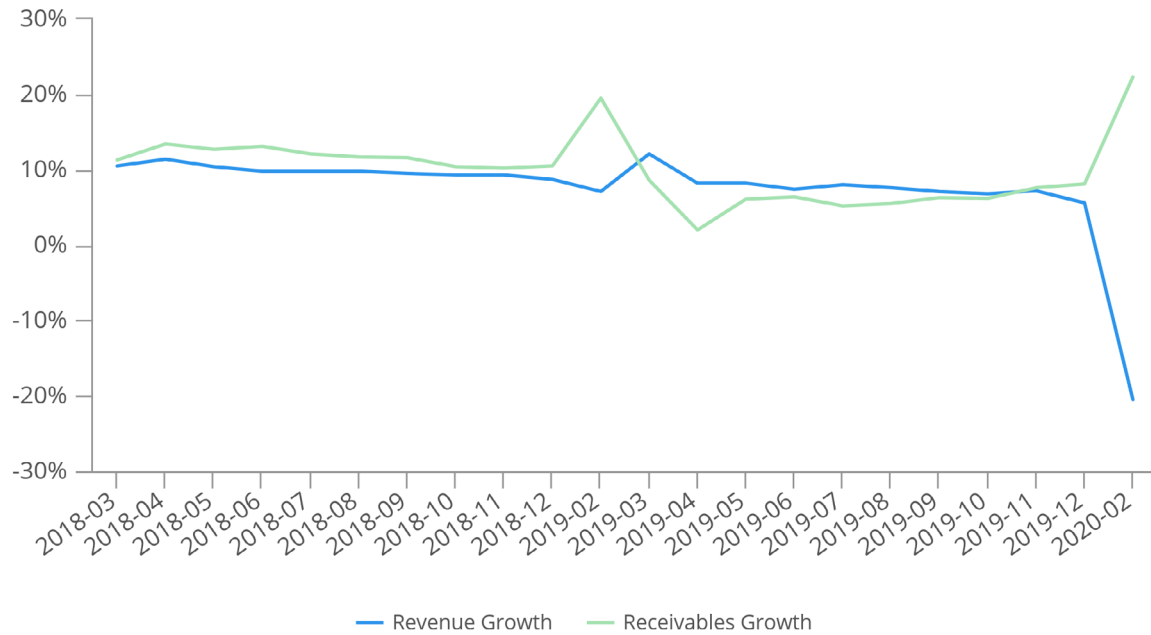


Source: Wind.

Beijing's response at the time was not proportionate to the scale of the challenge, even though it had sent some of the strongest signals in supporting the private sector. That's because amid the trade war of 2018-2019, Beijing felt more compelled to spend political capital to go to bat for a private sector that had suffered as collateral. Yet despite central government assurances to protect private firms at the time, Figure 1 shows that they continued to struggle financially.

Those struggles continued into 1Q2020, when private industrial firms saw a large drop in their revenue and a concomitant increase in their holding of receivables, or private “IOUs.” So private firms now have too little cash on hand while holding onto what amounts to illiquid assets (see Figure 2).

Figure 2. Private Firms’ Revenue Dropped While Amassing More IOUs



Source: Wind.

Private firms are bearing the brunt of the cash crunch because they tend to be smaller firms that lack state support. Although monthly data is only available for private industrial firms, the bad shape they’re in suggests that many private firms are doing even worse. That’s because industrial firms tend to be larger and have more cash and collateral on their hands than the average private firm, meaning they can weather current conditions better. Since the private sector accounts for more than half of China’s GDP and [80%](#) of urban jobs, its prospects do not bode well for a rapid economic recovery.

Beijing To The Rescue?

Although the April 21 State Council meeting pledged to reduce burdens on the private sector, particularly for small and micro enterprises, Beijing won’t be able to prevent private firm finances from deteriorating. The central government faces constraints that would be familiar to any government of a large and complex economy.

For one, the sheer size of the private sector—China has some 80 million private businesses—means that a blunt and indiscriminate stimulus would create massive moral hazard. Only about one-third of these businesses have received modest credit support so far. To provide sufficient credit to the remaining 50 million-plus businesses within a short period of time would be impossible, let alone doing proper due diligence to separate the wheat from the chaff.

For instance, it's difficult to tell whether firms were healthy before the crisis and simply need a helping hand during this period or whether the firms are short of cash due to poor management and performance. Moreover, some private businesses have reportedly already used Beijing's liquidity support to [invest in property](#), directly undermining Beijing's efforts to contain the property bubble.

Given Beijing's inability to directly alleviate private firms' liquidity crunch, it will likely rely more on policies that will cushion the impact from an ailing private sector, particular on the unemployment front. One option is to expand the social safety net to better cover migrant workers, less than [20%](#) of whom are currently covered by unemployment insurance. Unemployment benefits are already paltry at just ~\$200/month, so a modest improvement in benefits coverage should not be very costly and would be politically popular with the Chinese public. And expanding unemployment benefits for migrants was precisely what the latest State Council meeting announced.

DEFLATIONARY CYCLE A REAL RISK

The challenges in the private sector will ripple through the economy in the form of second and third-order effects. Cash-strapped firms tend to cut back on current spending, which usually includes holding less inventory and scaling back on investment and hiring. These are all rational behaviors for individual firms in dire straits, but cumulatively they have significant repercussions for the overall economy.

Those repercussions will reinforce two pernicious headwinds: weak consumer confidence and deflation. Chinese consumers, like all consumers around the world right now, are naturally feeling uncertain about the future and hesitant to make major purchases. Given the fragility of consumer confidence, if firms start to lay off workers massively, that confidence will further erode.

In addition, firms' near-term desire to hold less inventory means lower demand and less revenue for its suppliers. This will eventually percolate through the supply chain, as suppliers along it will



successively cut back on their spending as demand wanes. Weak consumer and corporate demand will then add to deflationary pressures. By forfeiting current purchases, near-term demand will be weakened further, thereby leading to more price drops.

This feedback loop can be self-reinforcing, which is why the confluence of these headwinds can spiral into a vicious cycle that makes the recovery much more challenging. The presence of all these factors in the Chinese economy makes this not simply a speculative scenario, but one that will likely transpire in the coming months.

POLICY RESPONSES

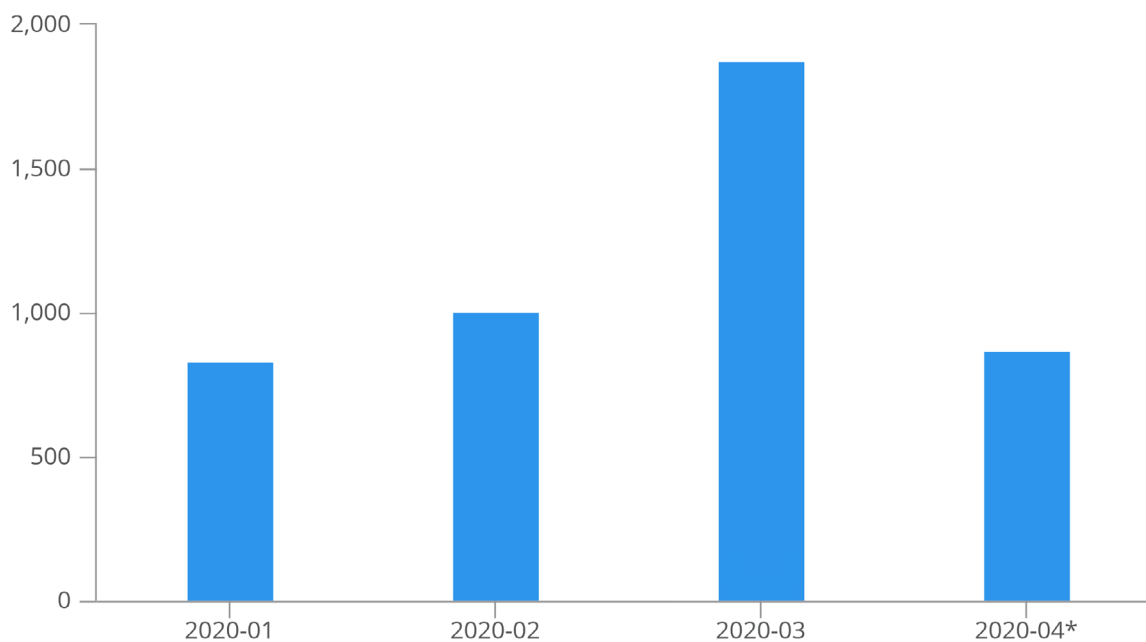
Without a meaningful turnaround in private sector prospects, some version of this deflationary cycle should be expected in the second quarter. But the extent and severity of the impact can be managed by the appropriate policy responses. Even given limits to what Beijing can and cannot do in the current environment, it should be able to prevent the worst outcomes. But any expectations for a V-shaped recovery is unrealistic, as 2Q growth is increasingly looking U-shaped.

Therefore, the general policy direction in 2Q will be mainly aimed at preventing a double dip in growth rather than juicing growth. It is reasonable to expect Beijing to more or less offset the direct impact of the export decline on aggregate demand and to halt deflationary trends.

Stimulus Will Not Boost Growth Much in 2Q

Fiscal stimulus will make only a modest contribution to growth in 2Q. Although Beijing [announced](#) on April 20 another 1 trillion yuan (\$140 billion) of local government borrowing, that has to be put into the context of rapidly declining fiscal revenue. Government revenue was already down -26% in March, and that decline is likely to persist in 2Q. A back-of-the-envelope estimate suggests that currently announced fiscal borrowing is barely able to support a small growth (5% y/y) in fiscal spending in 2Q.¹

Stimulus in the form of credit growth already significantly accelerated in March, increasing from 10.7% in February to 11.5% in March. Yet, March appears to have been the near-term peak in stimulus, as credit growth may have normalized in April, as suggested by net bond issuances (see Figure 3). This implies that 2Q growth will be helped by the March credit stimulus only, which was

Figure 3. Net Bond Issuances Normalized in April

Note: Net bond issuances include those from corporates, banks, and government. April data calculated using daily averages through April 20 multiplied by the total trading days in April. Since there was just one RRR cut in 1Q (0.5% for smaller banks, releasing \$29 billion), bond issuances should be a good proxy for tracking credit growth.

Source: Wind and MacroPolo.

not very significant (because of the lag effect, any credit stimulus that might come in May, for instance, will not have an effect on 2Q growth).

Although the new credit issuance to GDP ratio was 53% in 1Q2020 compared to 38% in 1Q2019, the size of the credit doesn't necessarily correlate with its actual impact. Much of that borrowing by businesses went towards compensating for revenue loss rather than extra spending. In other words, the bulk of the new credit was simply used to maintain business as usual. Therefore, it is more instructive to look at additional business deposits as a result of the stimulus, which translates into cash on hand that can be spent in 2Q. So assuming all extra deposits will be used to create new demand, this will equal to a stimulus of about 2% of 2Q GDP.

Taken together, fiscal and credit stimulus should be able to offset the impact from the expected export decline, which could shave-3% off 2Q GDP.² However, given the modest size of the stimulus, it is unlikely to propel a rapid rebound in 2Q.

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When it comes to deflation, Beijing will likely reach into its trusty old playbook and deploy familiar tools aimed at temporarily stabilizing demand for industrial goods and more direct interventions on the supply side to keep prices stable. This could also lead to another round of consolidation in the industrial sector, with smaller firms getting acquired or going bankrupt. It also means more state presence in the economy, but it should be effective in preventing deflation from seriously threatening the economy.

CONCLUSION

The 2Q outlook is fairly clear. In the absence of a robust, economy-wide stimulus, the recovery will be closer to a U shape. For Beijing, the current uncertainty is leading to more consideration of a medium-term strategy. This likely explains why it has been conservative on stimulus and has yet to announce the exact date of the annual NPC in May. Beijing seems to assess that the impact of the pandemic will percolate for some time and that a powerful stimulus in the short term is a waste of ammunition when preparing for a protracted battle.

How Beijing is preparing for the medium term may become clearer after the NPC, though it probably has not settled on its full year plan nor made a decision on growth targets. The government has offered some hints in the latest Politburo meeting on the economic recovery, with the formulation of “six protections” (*liu bao*). Unlike former Premier Wen Jiabao’s formulation of “protect the eight” (*bao ba*) during the 2008 financial crisis, the latest phrasing is not about hitting a growth target but rather emphasizes protecting livelihoods and ensuring food security first and foremost. That aligns with the intended expansion of unemployment benefits and social safety net for displaced migrants, as well as extending some life lines to small private firms.

But beyond the immediate term, the latest Politburo meeting also yielded some insight into the contours of a medium-term strategy that stresses generating and sustaining domestic demand, which includes ideas on investment in new digital infrastructure and elevating the role of private businesses. Focusing on domestic demand is the right diagnosis for the Chinese economy, and these initiatives, if fully implemented, will be bullish for China’s growth in the long run. But there are numerous factors to balance at the moment, and the uncertainty of the pandemic and the fluidity of the global economy can throw a wrench into the most well-intentioned plans.

Forecasting the future with high confidence amid dramatic shifts and vast uncertainty can sometimes feel like a fool’s errand. But understanding China’s medium-term calculus will be important in how it views the vulnerability in its economy and the prospects for its future growth. We will be examining medium-term prospects, including what can be realistically implemented, in a future analysis.



Endnotes

[1] In 2Q2019, total fiscal expenditure was 8.3 trillion yuan (\$1.2 trillion) while revenue was 7.16 trillion yuan (\$1 trillion). Assuming revenue drops by 5% in 2Q2020 and spending increases by an equal percentage, this means 2Q2020 deficit needs to be 1.9 trillion yuan (\$270 billion), which is already larger than the currently announced government borrowing for 2Q.

[2] This back-of-the-envelope estimate is based on IMF projection of 2020 global trade growth dropping by 11% compared to 0.9% in 2019. Given that exports account for around 20% of China's GDP, the export decline will have a direct cost of less than 3% of GDP. Moreover, since the domestic value-added of Chinese exports is just over 50%, the real damage to the domestic economy is probably closer to 2% of GDP.