MACRO POLO
Decoding China's Economic Arrival

MACRO OUTLOOK

Full Recovery Remains Elusive

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3Q2020 KEY TAKEAWAYS

- Second-quarter GDP growth suggested a bigger growth rebound than expected, but the actual economic recovery is weaker than what the headline growth implies.

- The recovery has been highly uneven, leading to divergent outcomes across different income groups and sectors.

- The effects of stimulus have been limited in generating a durable recovery, which means additional direct relief to sectors and industries will be needed to ensure a fuller recovery.

- As such, growth momentum will swiftly evaporate in the third quarter as Beijing's response shifts even further toward targeted relief efforts rather than stimulus.

China officially reported 3.2% GDP growth in the second quarter, an impressive rebound from a very rough first quarter. Yet upon closer inspection, the recovery is both uneven and unlikely to endure, which means growth will likely decelerate quickly in the third quarter.

Supply-side revival over the last couple months has driven the rebound. But it belies a much weaker recovery than meets the eye. This is driven in large part by the fact that the latest round of stimulus has mainly benefitted the capital-intensive sectors, with limited spillover effects on the broader economy. The unleashing of pent-up demand, too, has been ephemeral and looks to be dissipating already.

The weakness continues to stem from significant financing pressures on small- and medium-size enterprises (SMEs) and the associated unemployment, challenges detailed in the previous outlook. Since stimulus has not addressed these challenges, Beijing will likely further shift its focus in 3Q2020 to direct relief efforts to the most vulnerable sectors in the economy. Although this should support a more enduring recovery, it will come at the expense of growth, which will likely revert back to a U-shape.

This quarterly outlook first analyzes why actual recovery is weaker than what the headline growth suggests. It then details what response from Beijing should be expected given the still tenuous recovery.

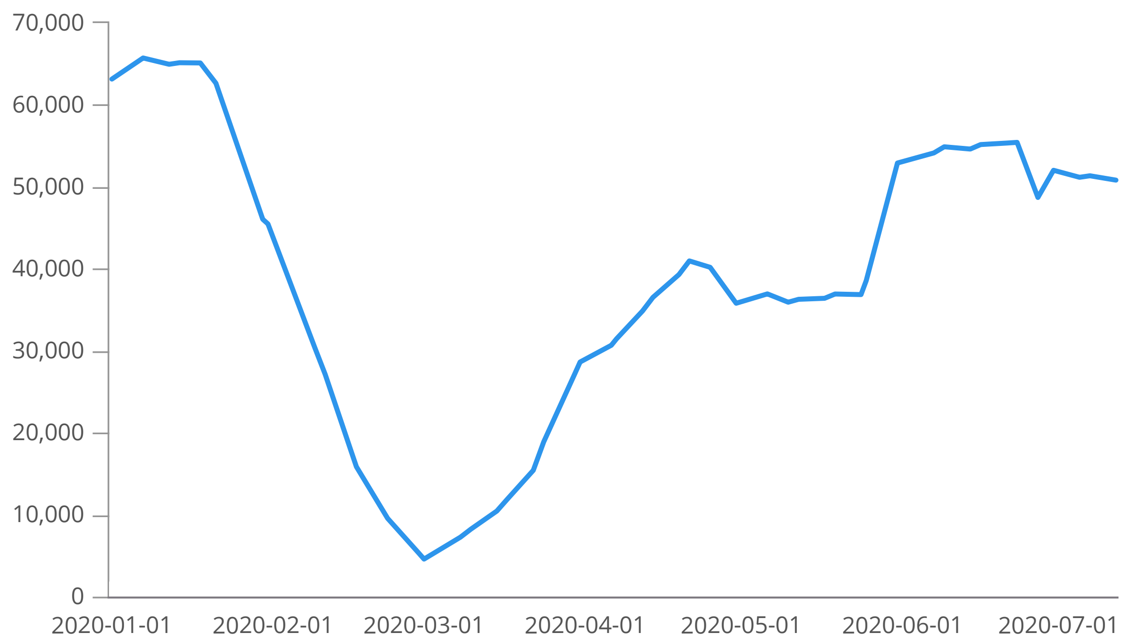
THE ILLUSION OF V-SHAPED RECOVERY

Growth in the previous quarter can be largely attributed to the unleashing of pent-up demand and monetary stimulus, both of which are temporary and are already petering out. Not only have they been limited in their impact, these responses have also led to an uneven recovery across the Chinese economy. Therefore, what may be interpreted as a "V-shape" rebound rests on still shaky economic fundamentals.

Diminishing Pent-Up Demand

The drastic lock-down earlier this year forced Chinese consumers to delay their purchase of durable goods like automobiles, which also constitute the largest category of pent-up demand. But auto sales are now leveling off and have even somewhat declined in recent weeks (see Figure 1). Recent monetary tightening will likely reinforce this trend in coming months because demand for goods such as cars and property are highly sensitive to interest rates and credit availability.

Figure 1. Auto Sales Already Weakening (# units sold)



Note: This is the 30-day moving average of the daily wholesale volume of passenger cars.
Source: China Passenger Car Association via Wind.

Sales of other durable goods have also begun to sputter. For example, furniture sales growth reverted back to negative territory in June after expanding in May. More broadly, the producer price index of consumer durables continues to contract, suggesting weak demand.

Uneven Recovery

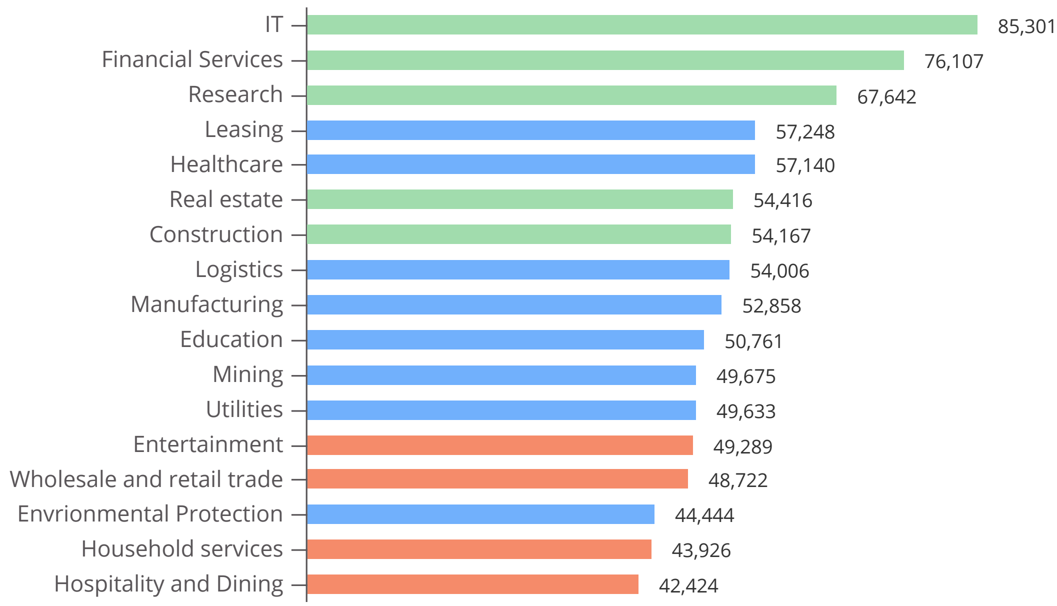
Auto sales also highlight another feature of the current recovery: its unevenness among income groups. For example, sale of compact cars, which tend to be the least expensive category, has recovered less than pricier models (see Figure 2). This divergence is likely due to the fact that lower income groups, the most likely buyers of compact cars, are facing worse economic prospects and have not benefitted much from the stimulus to date.

Figure 2. Pricier Cars Are Seeing Stronger Sales

Note: Sale for all classes of cars has been divided by their respective December 2019 sale level.
Source: China Passenger Car Association via Wind.

Indeed, looking across industries, high-wage sectors like information technology, financial services, and real estate have all fully recovered or are growing even faster than during the pre-pandemic period (see Figure 3). Meanwhile, the majority of low-wage sectors like hospitality and retail are still facing contraction. Not only have high-wage sectors benefitted more from the stimulus, the pandemic has also disproportionally affected labor-intensive, low-wage sectors, thereby widening the gap in recovery.

Figure 3. High-Wage Sectors Have Recovered More Swiftly (yuan/year)



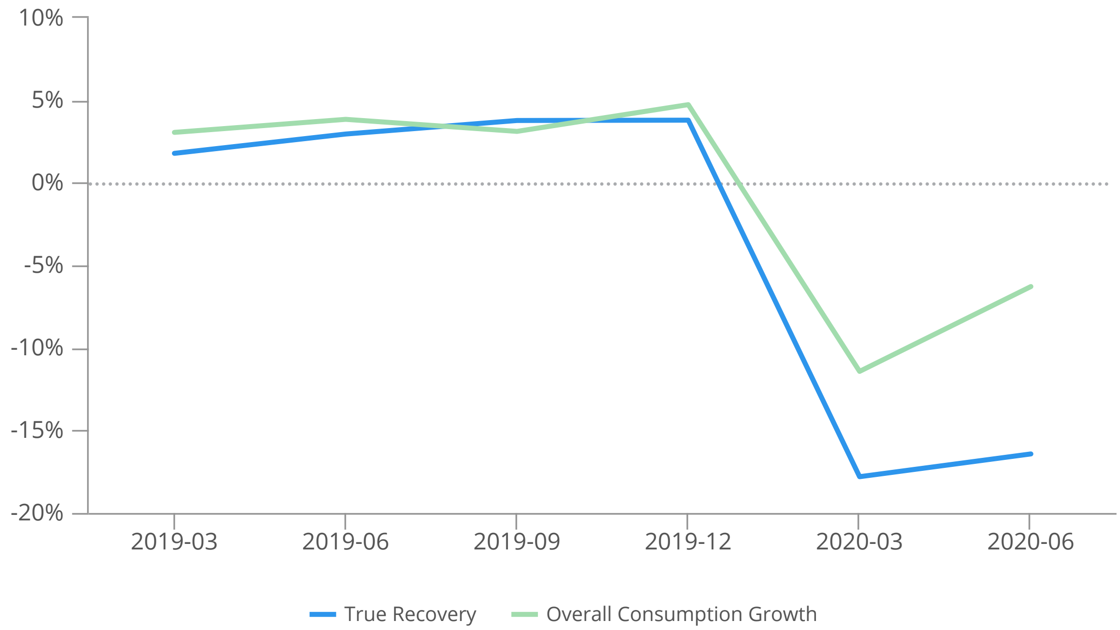
Note: Red means the sector is still in contraction, green means full recovery.

Source: Wind.

Whither Organic Demand?

A true recovery hinges on organic demand, which is different from the type of "revenge consumption" that has driven auto sales. Non-durable discretionary goods can be used as proxies for the extent of organic demand recovery (non-durable goods are less affected by stimulus or pent-up demand).

Figure 4. True Recovery Significantly Weaker than Headline Growth (%)

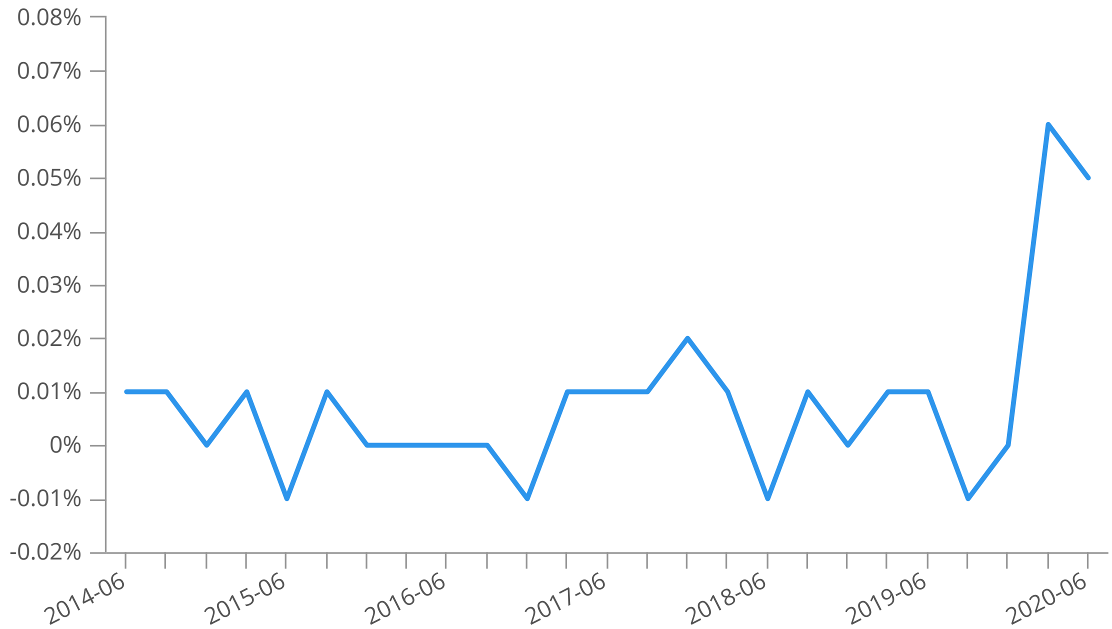


Note: True recovery uses clothing consumption as a proxy.

Source: Wind.

Clothing is one such non-durable good that can illustrate the weakness of underlying demand, which is the result of households' continued unwillingness to spend. For instance, the seasonally adjusted household savings rate rose six percentage points in the first quarter, with negligible improvement in the second quarter (see Figures 4 & 5). The high level of precautionary savings effectively puts a ceiling on demand-side recovery.

Figure 5. Precautionary Savings Remain Elevated (%)



Note: This shows change in the quarterly household savings rate compared to the same quarter last year. A positive reading indicates an increase in the savings rate.

Source: Wind.

The slow pace of demand-side recovery is directly related to the financial struggles of SMEs, which will continue to affect their hiring. Revenue per employee at private industrial firms is still 10% below last year's level, with little improvement since April. Given these conditions in the private sector, it is not a surprise that the Purchasing Managers Index remains in contractionary territory.

The weak labor market makes the recovery difficult to sustain, particularly in light of the ineffectiveness of the stimulus. In the coming months, then, growth will depend crucially on policy support.

POLICY OUTLOOK: TILTING FURTHER TOWARD DIRECT RELIEF

Beijing's policy responses, guided by the principle of "relief first, stimulus second," so far have aligned with the diagnosis above. It has chosen to focus less on headline growth and has instead prioritized tackling poverty, unemployment, and corporate distress. While Beijing recognizes the uneven impact of Covid-19 on SMEs and services sectors, it will likely need to further double down on direct relief efforts to generate a more durable recovery.

Switching Gears on Monetary Policy

The People's Bank of China (PBOC) is already shifting course on monetary policy to place more emphasis on supporting the most vulnerable sectors. In June, the PBOC launched new facilities to encourage lending to SMEs while tightening liquidity overall. This suggests that the broad-based monetary easing since February has been replaced by a more targeted approach.

It is worth noting that the central bank's shift has little to do with concerns over an overheating economy. Although industrial prices were up 0.4% in June compared to May, that is likely temporary. Industry capacity utilization is still at record lows, with the output/asset ratio 10% below the historic average. This suggests that there is considerable slack in supply, which can easily increase by another 10% with no impact on inflation. Moreover, official unemployment is high at around 6%, which means minimal wage growth pressures.

More Tax Cuts, Less Investment

For 2020, Beijing has increased the central fiscal deficit from 2019 by an additional 3.6 trillion yuan ($510 billion), of which only 1.4 trillion yuan ($200 billion) has been used through May. This seems to suggest that fiscal stimulus will continue to boost headline growth in the second half. But in fact, fiscal policy will be used in the same way as monetary policy: support demand rather than chase growth through investment.

More significant tax cuts and relief spending will likely come in the third quarter. Through the end of May, central revenue already declined by more than 1.2 trillion yuan ($170 billion), a sharper drop than the 900 billion yuan ($130 billion) Beijing projected. Yet despite the larger-than-expected revenue shortfall, tax cuts will likely be significantly larger than what Beijing anticipated, which means that it will have to borrow more to finance tax cuts. Compared to investment, tax cuts generally have less of an effect on growth because a portion of the cuts will be saved by consumers and corporates.

When it comes to targeted relief measures, 605 billion yuan ($86 billion) of fiscal borrowing has been earmarked for efforts such as income support for vulnerable populations and assistance to SMEs. An additional 200 billion yuan ($28 billion) will be used to recapitalize struggling local banks. While this is certainly an indication of the vulnerabilities in China's banking system, it also shows that Beijing understands the trade-offs between financial stability and near-term growth.

Both tax cuts and bank recapitalization will have little effect in boosting growth, even if they help to pave the way for a more durable but gradual recovery. In the third quarter, then, there is a high likelihood that growth will revert back to a U shape.

LONG CLIMB BACK TO NORMALCY

Some have described Covid-19's impact on the US economy as "riding the elevator down and climbing the stairs back up." When it comes to China, it may seem like its economy rode the elevator both ways, as quarterly growth snapped back from-6.8% to 3.2%.

But the reality is less encouraging. The second-quarter recovery mainly implies that economic activities have restarted from near nil, as China managed to safely re-open the economy without huge challenges.

A full recovery, however, requires much more than simply reopening the economy. To ensure a recovery based on organic demand will require addressing more entrenched problems like precautionary savings, high unemployment, and lack of liquidity for SMEs.

Given the limited improvement on these fronts after a round of stimulus, it appears China's climb back to full recovery will be slow and may even backslide from time to time.