



MACRO
POLO

3Q2022 Outlook: Economic Rebound Will Dissipate Nearly As Soon As It Arrives

Houze Song

3Q2022 Key Takeaways:

- The Chinese economy will likely rebound to ~4% in the third quarter because of the low-base effect, but that “V-shaped” growth will be illusory and will quickly fizzle out.
- Relaxation of Zero Covid restrictions and hints of property and auto sales recovery mask underlying weakness in the economy, particularly consumption.
- A durable recovery is only possible with new stimulus and a significant shift in the Zero Covid strategy, neither of which is forthcoming before the end of the year.
- The increasing likelihood of stagflation in advanced economies will depress Chinese exports, further exerting downward pressure on growth.

With daily Covid cases now significantly lower than the peak in April, more easing of fiscal policy, and rebounds in property and auto sales, signs appear to point to a Chinese economy that is about to roar back to life just like it did in the third quarter of 2020.

But that would be the wrong reference point. Instead, the Chinese economy will more likely resemble the US economy in 3Q2020, when the end of the national lockdown triggered a sharp recovery that quickly yielded to a stalled economy by the fourth quarter. The anticipated V-shaped recovery never took full shape until 2Q2021, when Covid was more under control and the US government deployed more stimulus.

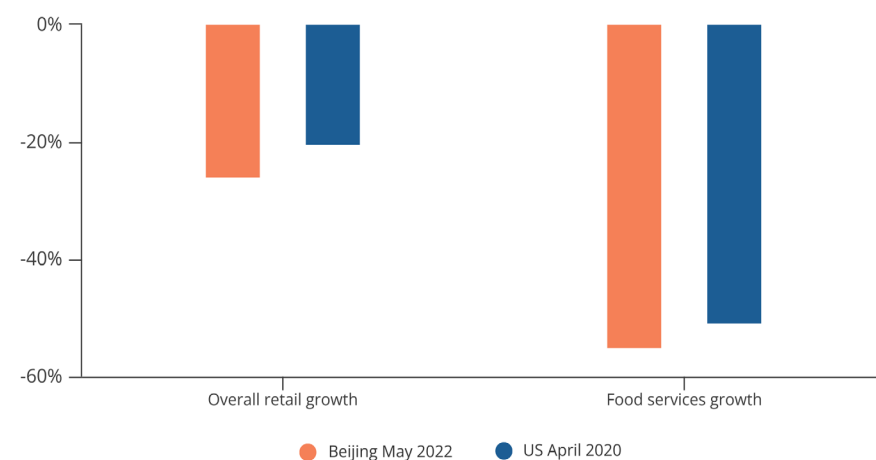
Yet China is unlikely to move away from its Zero Covid strategy before 2023. Even if it moderates the kind of draconian lockdowns seen in Shanghai, sporadic lockdowns of smaller scale will nonetheless incur economic costs. Moreover, the modest stimulus has already run its course, and a second round of stronger stimulus does not seem to be on the table.

Therefore, domestic consumption has little hope of meaningful recovery, which is the only route to a sustainable recovery. Adding to lackluster domestic consumption will be a worsening export picture as advanced markets appear to be on the cusp of recessions. As a result, a third-quarter rebound will be a misleading indicator of the strength of the Chinese economy.

Zero Covid Continues to Drag on Consumption

As the latest Covid wave is being brought under control, the worst of the lockdowns appear to be behind China. But there's little reason to cheer, because even partial lockdowns will exact a considerable economic toll, particularly on consumption. Take Beijing, for example. Although the Chinese capital never went under full lockdown like in Shanghai, its May consumption plummeted, with retail and dining down 25.7% and 56.9% respectively (see Figure 1).

Figure 1. Retail and Dining in Beijing Fell More Than During the US Lockdown in 2020



Source: Wind and MacroPolo.

Even regions that have avoided Covid outbreaks are seeing their retail sales decline. For example, Hubei, which has had fewer than 100 total cases this year, still saw negative retail growth in April and May.

This implies that even as Beijing tries to fine-tune Zero Covid, turning around consumption will be challenging in the near term. In theory, consumption should see the biggest rebound because it has fallen off a cliff. Yet even as investment and exports in May grew by 6% and 15%, respectively, consumption contracted by -7%.

As such, the latest rebound in property and auto sales should be interpreted as a result of pent-up demand and should not obscure residual weakness in the broader economy.

After property sales fell by -47% in April, they have now picked up steam in major cities. But much of the revenue from those sales will simply go to servicing property developers' debt rather than being plowed back into new investments. Given that China's property developers are still going through a major financial crisis, don't count on property investment to buoy growth.

Another factor that will hurt domestic demand is high energy prices. As the world's largest importer of oil and gas, China will pay significantly more for energy imports. Through May, China has already paid \$66 billion more for its oil/gas imports compared to last year. That extra payment for energy imports will further reduce domestic demand.

Meanwhile, households and the private sector have been both [scaling back](#) spending and deleveraging. There's little evidence of a turnaround in the latest data, as both households' income growth expectation and corporate borrowing demand are weaker than in 1Q2020.

Clouds on The Horizon

As if that's not enough pressure on the economy, two additional factors will further weigh on growth: fading fiscal stimulus and weaker exports.

We maintain the view that Beijing is unlikely to dramatically increase fiscal spending. In fact, it will likely do the opposite and gradually wind down the current stimulus in the third quarter. As [noted](#)

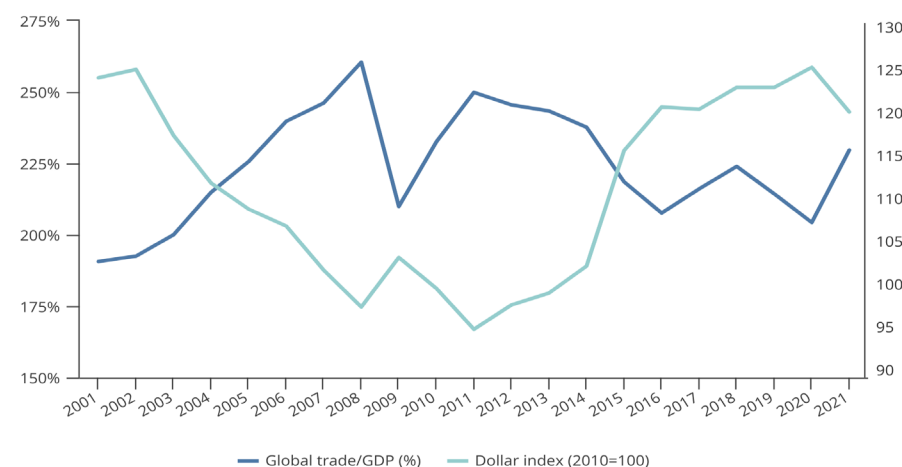
[in the](#) previous outlook, Beijing has front-loaded deficit spending, and that spending will be ~\$75 billion less in 2H2022 than in 2H2021. The latest announcement of \$65 billion in new infrastructure investment is a drop in the bucket and simply not large enough to stimulate growth.

Although a senior People's Bank of China (PBOC) advisor [reportedly suggested](#) raising the fiscal deficit target this year, it is unlikely to become actual policy. These comments from the central bank should be interpreted as shifting the responsibility onto the Ministry of Finance because the PBOC's hands are tied on monetary stimulus.

Moreover, the lone silver lining for growth over the pandemic years—booming exports—will likely have less of an impact going forward. China was able to increase its share in global trade despite the US-China trade war, but exports aren't likely to come to the rescue this time.

Not only is the US economy expected to slow down, the composition of US demand appears to have shifted from goods to services. Both are negative headwinds for Chinese exports. In addition, the US dollar has appreciated by 5% so far this year because of the Federal Reserve's tightening. Historically, US dollar appreciation has tended to coincide with a contraction in global trade/GDP, likely because a more expensive US dollar reduces the trade credit supply (see Figure 2).

Figure 2. Strong Dollar Is Usually Bad for Global Trade



Source: BIS, IMF, and WTO.

Therefore, in the coming months, global trade growth could potentially dip below global economic growth. This implies that China's export growth may slow to the low single digits, a significant decline compared to the double-digit growth over the pandemic years.

It's About Politics Now

The bottom line is that the growth picture still very much depends on Zero Covid. Although markets [reacted positively](#) to the news of less strict quarantine for foreigners, this tweaking around the edges approach won't make a material difference on the domestic economy.

That's because just as Covid has become politicized in the United States, Zero Covid is now very much about political victory before the 20th Party Congress. Despite the initial bungling of the Shanghai lockdown, that effort is [now being portrayed](#) as a major victory. In a stroke of symbolism, Xi Jinping used his recent trip to Wuhan, where it all began more than two years ago, [to lecture the public](#) on the merits of Zero Covid.

Almost every week a major Chinese city has to implement partial lockdowns to contain Covid because cases are popping up in various provinces. These lockdowns are smaller in scope and don't last as long, but they certainly impose a cost on the economy—especially when the Chinese government isn't willing to stimulate much. In an environment of limited stimulus and deteriorating global growth, about the only thing Beijing can do to “maintain stability” is to focus on jobs, particularly that of youth unemployment. For instance, China just graduated millions as the Class of '22, a cohort that's as unlucky as the American Class of '09 during the financial crisis.

Although Beijing has made tackling youth employment its top priority, there are limits to what it can do. The government can provide temporary state jobs to new graduates, but those tend to be of low quality and lower pay. Many recent graduates have dropped out of the job market, instead trying their luck at applying to graduate school or the civil service.

Beijing will certainly do what it must on employment ahead of the Party Congress, but any meaningful decisions on Zero Covid and stimulus will only come after its conclusion. As a result, the Chinese economy will likely continue to be stranded in a state of mild recession until early 2023.