MERICS ECONOMIC INDICATORS

Quarterly analysis of economic trends in China

Q1/2020

China's economy in the Corona crisis: A historic fall

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MERICS Q1 analysis

Hold your optimism: a sharp rebound is unlikely

China's economic growth came to a screeching halt in the first quarter of the year, due to the government's measures to contain the Covid-19 virus. Macroeconomic indicators fell off a cliff and, for the first time since the cultural revolution in 1976, China's economy contracted with GDP growth falling by 6.8. Despite signs of economic recovery in March, China's economy is far from normal.

The effect of the shutdown is unprecedented. Previous crises over the past two decades, like SARS in 2002/3, the global financial crisis of 2007/8, and the stock market turbulences in 2015/16, pale in comparison to the current devastation.

Starved of revenue, industrial profits tumbled by 38 percent in the first two months with almost half a million companies reported to have closed. Small and medium sized enterprises (SME) are particularly vulnerable. They were already struggling for financing since the onset of the deleveraging campaign in 2018 and lack the credit lines that large businesses have. This has resulted in layoffs – and wage losses – in what is usually a key hiring season following the Chinese New Year.

Restarting the economy will be an uphill struggle as the full scale of the simultaneous supply and demand shock unfolds. With the prospect of a massive global recession, the outlook is dim. The risk of further bankruptcies and defaults is likely to grow over the coming months.

The government has responded by announcing new stimulus measures on a daily basis. With fiscal policy aiming at shoring up demand and supporting struggling companies, the fiscal deficit ceiling could well rise to over 3 percent of GDP. Meanwhile, the PBOC has used all its monetary policy instruments to lower lending costs and ensure sufficient liquidity.

The aim of the stimulus measures so far has been to alleviate the immediate economic challenges. For now, the government is holding back from unleashing an all-out stimulus package – as it did during the 2007/8 global financial crisis – since this would wipe out the progress made over the past two years in reducing the buildup of risks in the financial system.

Compared to 2007/8, this crisis has hit China when its economy is in a very different state. It is already highly leveraged with GDP growth at much lower levels. Increasing infrastructure spending, as the government did in 2009, is not a solution this time, since the structure of the economy has changed with private companies and the service sector now playing a greater role.

The measures introduced since last year targeting the private sector, like tax breaks, reduction in red tape, and efforts to improve access to capital, all helped cushion last year's slowdown. The expansion of such measures over the first quarter of this year are more likely to ease the immediate pain rather than provide a major boost in economic growth.

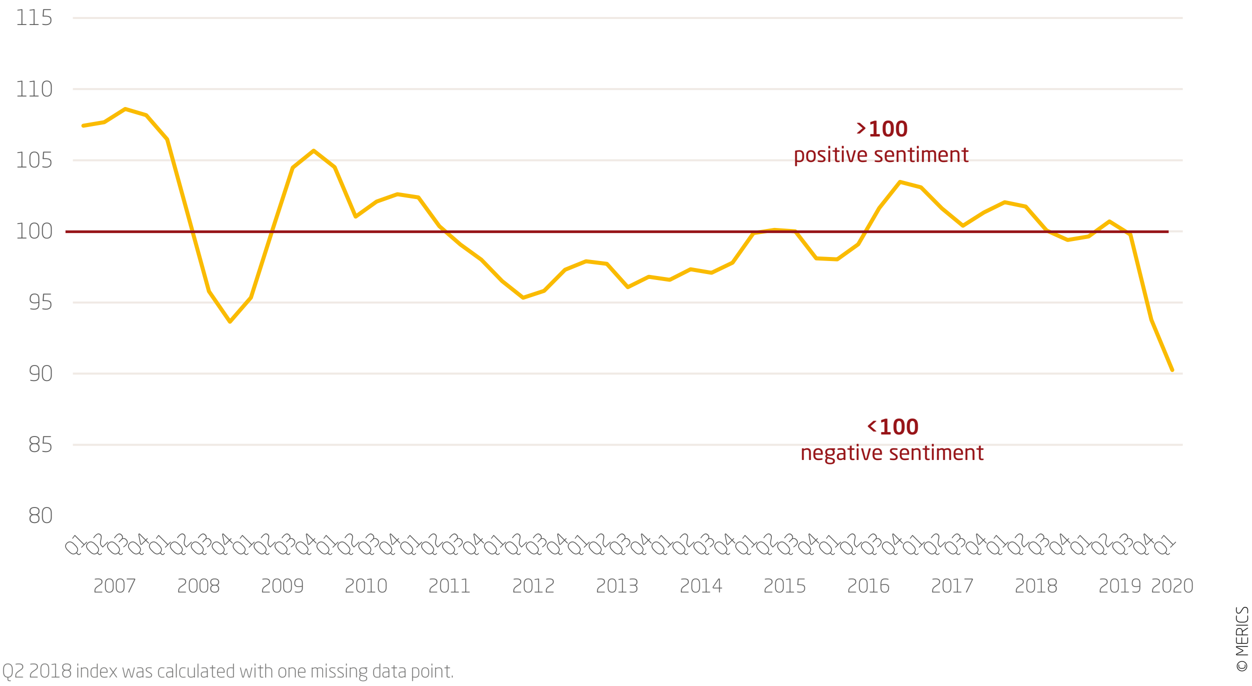
More stimulus measures can be expected over the coming months, but China's government will not be able to defend GDP growth levels in the same way that it did in the past. Nor would it be wise to do so. Reaching the growth target of around 6 percent is now unattainable and the target may even be dropped, as PBOC advisor Ma Jun has suggested. What this all means is that during this global economic crisis, we cannot expect China to be the engine for growth.

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.

MCCI reading is lower than during the Global Financial Crisis
MERICS China Confidex Index

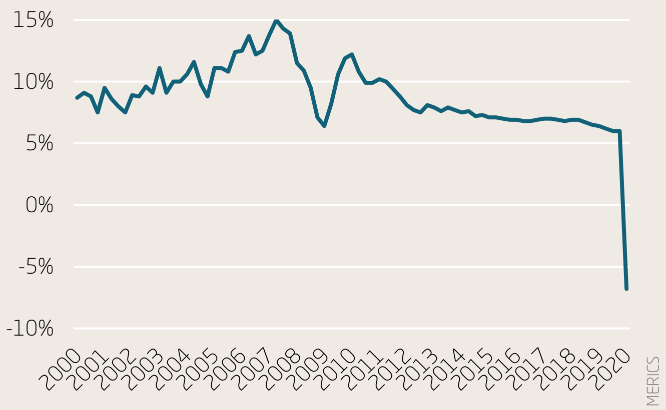


Note: Q2 2018 index was calculated with one missing data point.

Macroeconomics

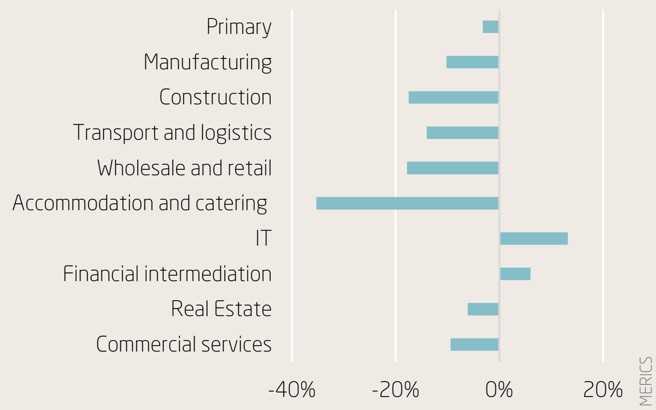
China's economy faces unprecedented slowdown

Lockdown causes worst economic results since 1976
GDP growth, yoy real



Sources: CEIC, NBS

IT and financial services only sectors expanding
Q1 GDP growth by sector, yoy real



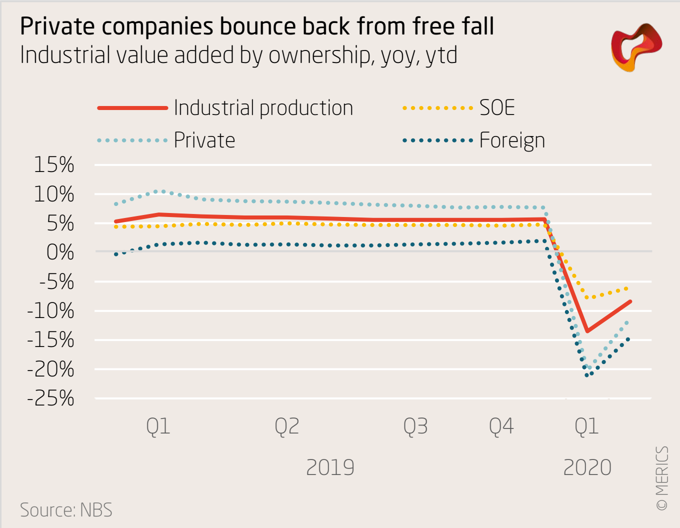
Source: NBS

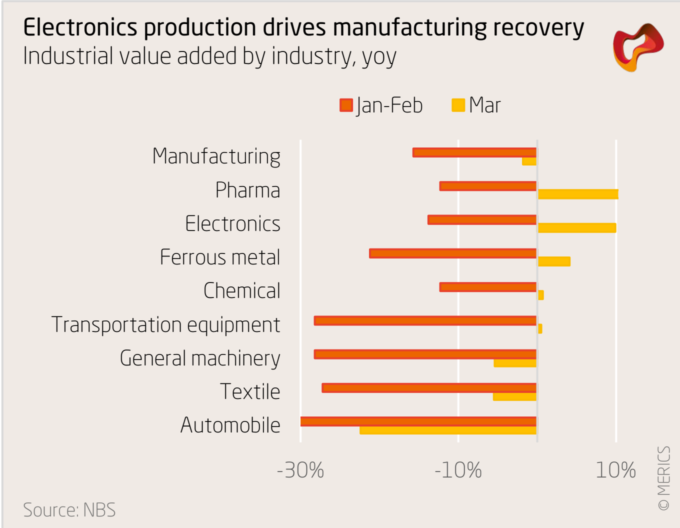
- The Chinese government's unprecedented lockdown of most of society in response to the Covid-19 outbreak caused the economy to contract by 6.8 percent in the first quarter. Compared to the previous quarter growth fell by almost 13 percentage points. Nominal GDP contracted slightly less, by 5.3 percent. This was far below credit growth, meaning that the financial situation has deteriorated significantly.
- This is the first time that real GDP growth has been negative since 1976, the year Mao Zedong died. Prior post-reform crises, including the global financial crisis of 2007/8, pale in comparison to the current economic meltdown.
- Closure of most manufacturing in February and gradual re-opening in March has severely impacted the secondary sector. Manufacturing and construction contracted by 10.2 and 17.5 percent respectively.
- Quarantine measures also severely impacted the service sector, which contracted by 5.2 percent in the quarter. Transportation, accommodation, retail and restaurant services suffered a huge blow. Stimulating demand will be crucial for any recovery.
- The government is pulling every policy lever at its disposal to support the economy. Both fiscal and monetary policy is being deployed. However, China does not have the same financial strength as it did during the global financial crisis, meaning that stimulus measures cannot match those of that era.
- This fact, combined with global demand falling, means a full recovery in Q2 is very unlikely. On average only 45 percent of GDP is generated in the first half of the year. Full year GDP growth could benefit from a stronger recovery later in the year. But given the global and domestic uncertainties, reaching a growth target of around 6 percent seems unlikely.

What to watch: A key question will be whether or not the country's leadership abandons its GDP growth target this year.

Business

Industrial production rebounds in March but not over the hump yet





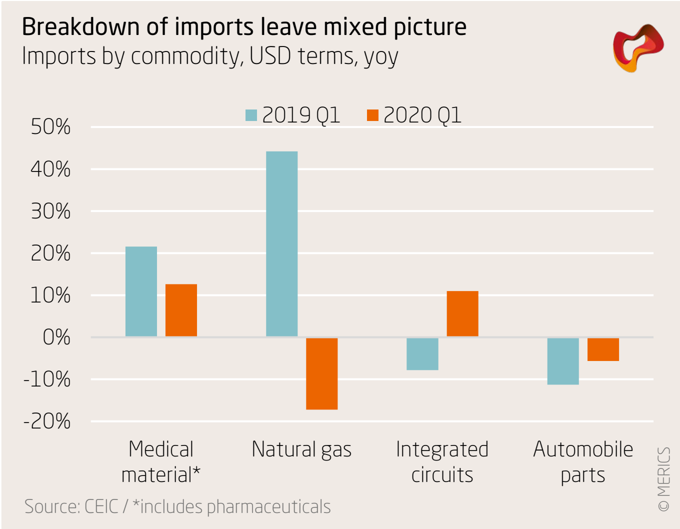
- Following a sharp contraction in the first two months of the year (-13.3 percent), by the end of March the figures for industrial production looked far less gloomy (-1.1 percent). With industrial capacity utilization at67.3, this was 8.6 percent below the rate in Q1 in 2019. Industrial production, meanwhile, was down 8.4 percent for the first three months, China's manufacturing sector is far from operating normally.
- An improvement in business expectations, as measured by the Purchasing Managers' Index (PMI), indicates that the worst may be over. The PMI bounced back from a record low of 35.7 in February (values below 50 reflect falling sentiment). However, domestic and external demand will continue to be subdued. Shortages in the supply of foreign components due to the production shutdown abroad risk causing further disruptions. It looks highly unlikely that there will be a swift recovery.
- The improvement in overall production was largely thanks to the strong recovery of the electronics industry. Output rebounded sharply to 9.9 percent in March following a contraction of 13.8 percent in January and February. However, faltering external demand since the second half of March looks likely to thwart that recovery in the coming months.
- While manufacturing by state-owned enterprises contracted by 7.9 percent in the first two months, private and foreign owned producers were hit more severely, contracting over 20 percent. That said, the March rebound was more pronounced for private manufacturers.

  The government has stepped up support measures to shore up demand and support struggling companies. Special emphasis has been given to SMEs, with reductions in taxes and social security contributions as well as improved access to capital.

  What to watch: Should the private sector fail to respond to the government support measures, the leadership might rely more heavily on SOEs for growth.

International trade and investment

Unfolding global recession will continue to strain foreign trade

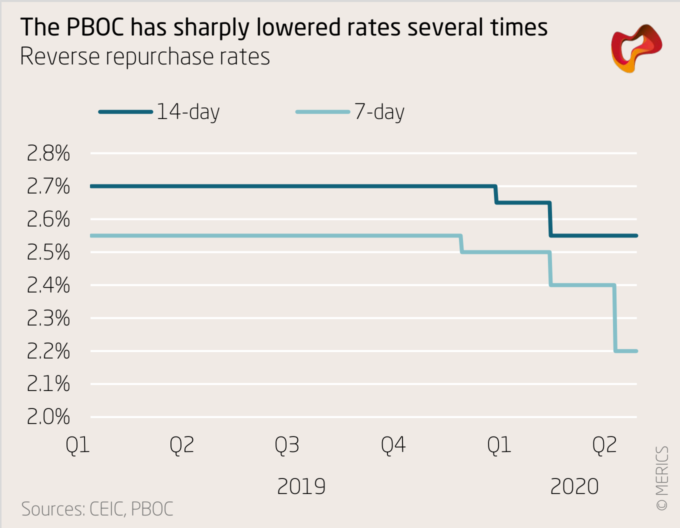


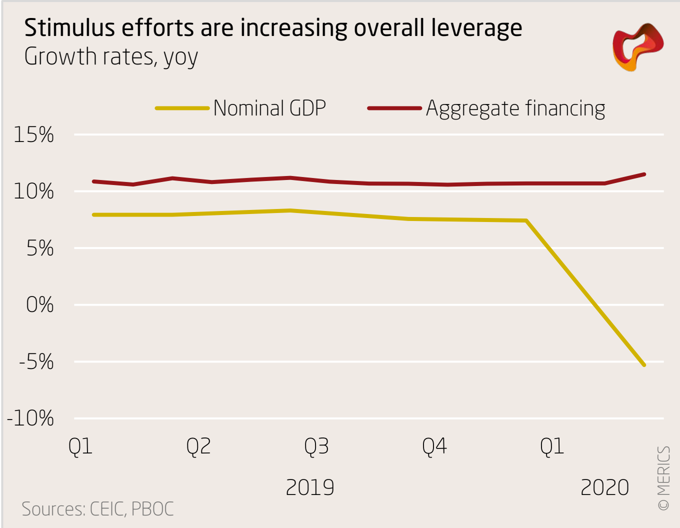
- China's exports tumbled in the first two months (-17.2 percent) as production was shut down across the country in the wake of the Covid-19 crisis. An improvement in exports during March helped ease the freefall but could not prevent a sharp contraction of -13.3 percent for the quarter.
- The slight uptick in March is attributed to outstanding shipments prior to the Covid-19 lockdown imposed in major markets during the second half of the month. As the global recession strikes and foreign buyers are barred from entering the country, new export orders of both industrial as well as consumer goods look to face a bleak start in the second quarter. Struggling export-oriented SMEs are particularly vulnerable and in danger of going out of business.
- Weak imports indicate that most of the economy is in crisis mode, but overall did hold up well, contracting 2.9 percent in March. Reflecting the fall in energy demand during the Covid-19 lockdown, delivery of natural gas plummeted by 16.8 percent in the first three months. One bright spot was the strong import figures for integrated circuits (11 percent) as electronic supply chains came back to life.
- Quarterly total trade with ASEAN surpassed that of the EU for the first time. But the global recession and the risk of an expansion of lockdowns in the region can be expected to impact trade with many of China's neighbors over the coming months.
- Following the December phase 1 deal, the Chinese government halved previously imposed punitive tariffs on 75 billion USD worth of US goods in February. Imports of agricultural products and pork from the US surged, but it will be an uphill battle for China to reach its import commitments. Complicating matters are tighter export restrictions for high tech components, which are currently under consideration by the US Department of Commerce.
- Depreciation of the USD/CNY exchange rate eased by the end of the quarter following a peak of 7.11. But the steepest fall in foreign reserves since November 2016 indicates heavy intervention by the PBOC was necessary.

What to watch: Imports would need to improve dramatically to indicate a recovery in China's domestic demand over the second quarter.

Financial markets

Markets are dominated by the government's response to Covid-19



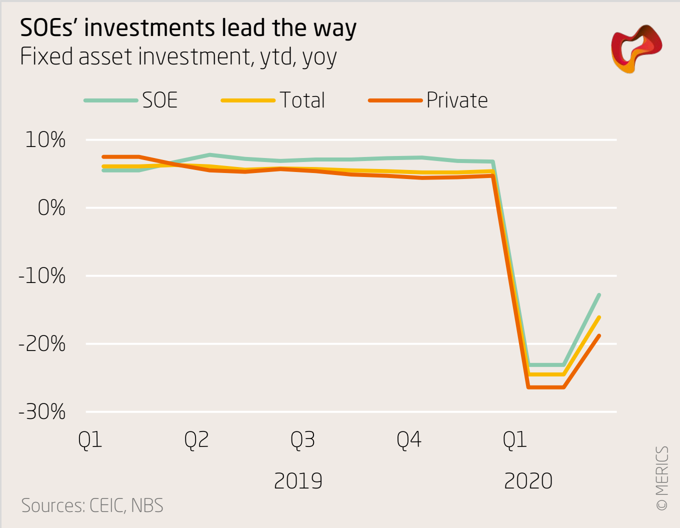


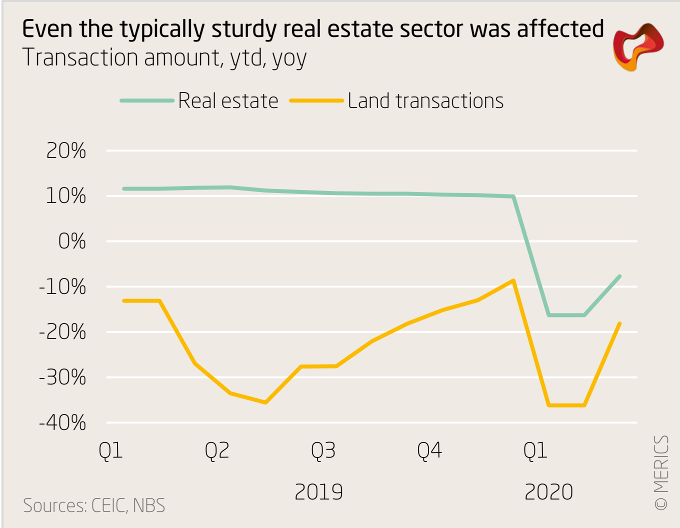
- Following the Covid-19 lockdown, the PBOC has used every policy tool at its disposal to combat the economic slowdown and related liquidity issues. Interest rates have been lowered, massive amounts of cash have been injected, and bankss' reserves have been lowered, releasing large sums into markets. In response to the worsening economic outlook and loose monetary conditions, treasury rates have fallen continuously.
- Growth of total outstanding credit has picked up over the quarter. In March, total credits grew by 11.5 percent, almost a whole percentage point faster than the preceding month. With nominal GDP contracting by 5.3 percent, China's credit-to-GDP ratio has grown significantly. The Chinese government has been trying since 2018 to deleverage the financial system. Current developments risk setting progress back significantly.
- Growth of most credit aggregates picked up towards the second half of the first quarter. Outstanding bank loans were 12.7 percent higher in March than the same time the previous year. Most of these were to the corporate sector while consumer lending slowed. Net bond financing grew even faster at 17.4 percent. Outstanding shadow banking credits are lower than the same time last year, but are recovering.
- In a difficult environment local governments, businesses, and employees are all struggling with lost income. As revenues dwindle, those that can draw on credit lines, while others go out of business. A wave of defaults is very likely. This may in turn cause difficulties in the banking system as well as real estate markets.
- The Shanghai Composite index has fallen by around 9 percent since the beginning of the year – a much better result than the 20-30 percent falls seen in international indices. There are several reasons for this. First, China maintains strict controls on capital outflows, making it difficult for domestic investors to flee to offshore markets. Second, government support has helped boost stock performance. And third, as is evident from usage of the Hong Kong Stock Connect mechanism, international investors have been moving money into China hoping its markets would perform better during the crisis.

  What to watch: Rising levels of non-performing loans.

Investment

Investment badly hurt by economic shutdown



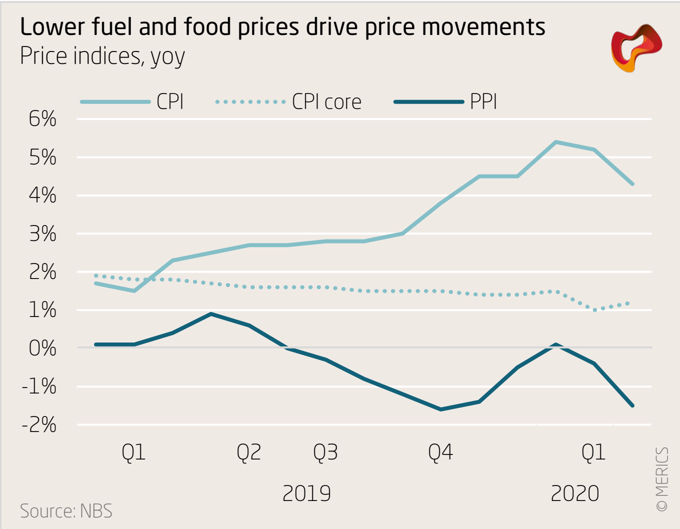


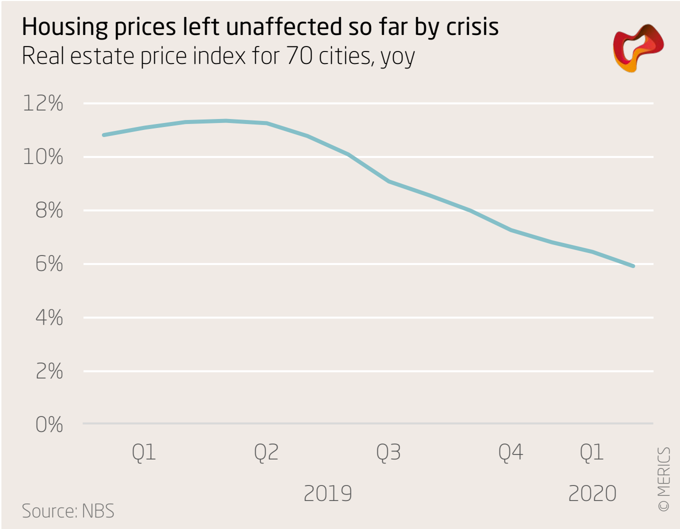
- Fixed asset investment dove sharply in January and February, at 25 percent below the year before. In March there was a recovery, but Q1 investment was still 10 percentage points lower than last year. Private sector investment contracted more than that of SOEs in the first quarter (-18.8 percent compared to -12.8 percent respectively). SOEs benefited from better access to capital and have been encouraged by the State Council to ramp up activity.
- Investments in manufacturing contracted by -25.2 percent in the quarter. As with most indicators, the worst contractions took place in the first two months (-31.5 percent) followed by an upswing. Companies will be hesitant to add or upgrade production capacity in the context of struggling domestic and external demand.
- Infrastructure investments were particularly hard hit. In total they contracted by 19.7 percent. Some of the sub-industries, like air transportation, contracted by almost 60 percent. The dip will likely reverse in Q2 as the government prepares to support the economy through investment.
- Land transactions were 18 percent lower than the previous year. This will negatively affect local governments' budgets as land sales are a revenue source for them. Furthermore, it will likely mean less construction during the rest of the year.
- Real estate investment was 8 percent lower – a potentially worrying sign. If demand for real estate declines it may cause price falls, which in turn would wipe out large amounts of wealth.

What to watch: Sales of excavators and other construction equipment soared in March, suggesting large scale stimulus is coming.

Prices

Easing inflation leaves room for more expansive stimulus measures



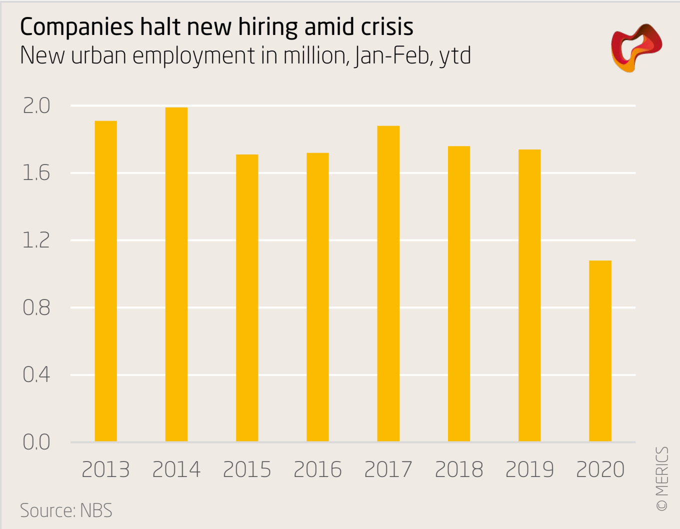


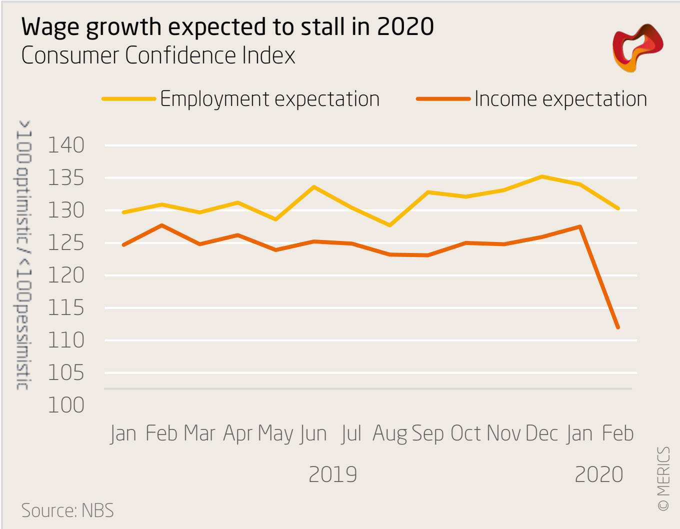
- The government lockdown and unfolding economic crisis triggered a simultaneous supply and demand shock with little impact on overall price levels thus far. The overall low inflationary pressure provides room for more expansive fiscal and monetary policy to support economic growth.
- Consumer prices peaked in January at 5.4 percent but have since eased over the quarter, dropping to 4.3 percent in March. The fall in CPI was primarily caused by two factors unrelated to Covid-19: the slower overall increase in food prices as the rapid rise in pork prices caused by the African Swine Flu peaked, and falling global fuel prices. Core inflation (excluding food and fuel prices) gradually slowed further, down from 1.3 percent in the quarter compared to 1.6 percent in 2019.
- The purchasing price index remained negative, falling further over the quarter. PPI contracted by 1.5 percent in March – its lowest level since October 2019 – and 0.6 percent for the quarter. The contraction was primarily driven by falling prices for fuel (-21.7 percent) as well as chemicals (-12.4 percent). Falling factory gate prices are so far mainly limited to manufacturing of various raw materials.
- If falling producer prices become more widespread due to falling demand, companies' profits will tumble further, increasing the risk of rising defaults.
- The real estate market has so far avoided a major Covid-19 induced crisis. Since July 2019 housing prices have gradually transitioned toward lower increases. Depending on the duration of the economic crisis, this stability will be put to the test. Demand could soften considerably as households hold back on long-term investments due to rising uncertainty, while struggling homeowners may sell assets to service financial obligations.

What to watch: Real estate prices will be a key indicator in monitoring the severity of the economic crisis.

Labor market

Tough year ahead as distressed companies lay off employees



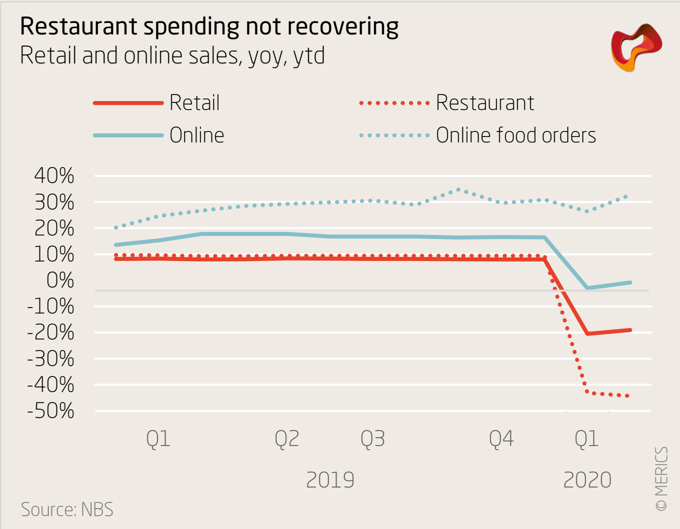


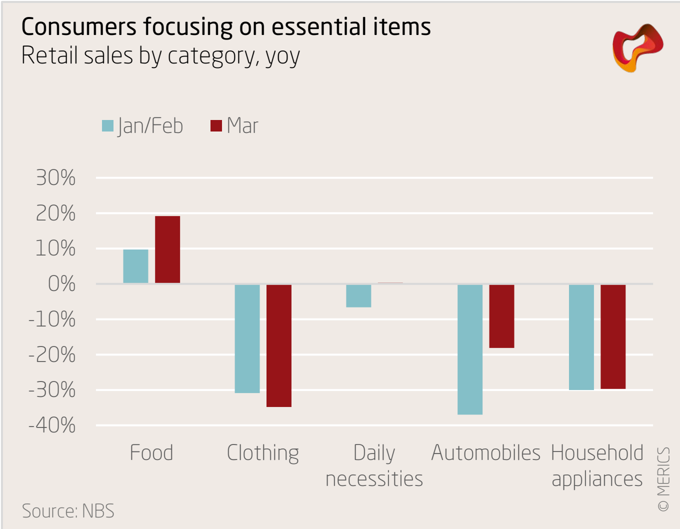
- As a result of the forced closure of large areas of economic activity across the country, China's surveyed urban unemployment figure jumped to an all-time record of 6.2 percent in February, easing slightly to 5.9 percent in March. With cash-stripped companies filing for bankruptcy and a global recession unfolding, employment issues are set to become more pronounced.
- For the first time, China may struggle to fulfill its employment target, which, in 2020, is 11 million new jobs. The total of 1.08 million new urban jobs created by March is 38 percent below last year's figure and is dwarfed by an estimated 8 million layoffs. The country's record number of 8.74 million university graduates are facing a bleak job market.
- Low income migrant workers employed in manufacturing and services sectors are most exposed to layoffs or income losses. However, more highly skilled workers at struggling SMEs will also become more vulnerable should bankruptcies mount.
- Some wage losses incurred over the first quarter are likely to be permanent, impacting the aggregate annual income of a significant share of employees in 2020. Disposable income shrank by 3.9 percent. As wage growth stalls this will affect household finances, including their ability to service debt and to consume.
- The government has responded with a variety of support measures to minimize layoffs. These include a reduction in employers' contribution to social security premiums, totaling over 120 billion CNY, as well as refunds of unemployment insurance totaling over 20 billion CNY. The State Council is encouraging employment by state-owned enterprises and is providing incentives for SMEs to hire graduates.

What to watch: The government's support policies to stabilize employment will have to deal with a second wave of economic shock as the impact of a global recession and increasing SME bankruptcies makes itself felt.

Retail

Consumer spending remains in crisis





- Though the most severe lockdown measures were beginning to be relaxed by the end of the quarter, households' eagerness to make up for forgone consumption is subdued. In March total sales contracted by 15.8 percent, and 19 percent for the quarter.
- The strict quarantine measures accelerated the shift from brick-and-mortar shopping to online. The online share of total retail spending increased from 20.7 percent in December last year to 23.6 percent in Q1. However, falling consumer sentiment also resulted in online sales contracting by 0.8 percent for the quarter.
- Online food sales maintained high-paced growth of over 30 percent in Q1, with only an insignificant dip during February. This contrasts, however, with plummeting restaurant spending. Consumers' hesitation in going to restaurants through March resulted in a contraction of 44.3 percent.
- Retail spending on non-essential and big-ticket items was heavily impacted, reflecting insecurity about employment and income. Despite a slight improvement in March, automobile sales remained deep in the red, contracting by 30.3 percent in Q1.
- The government is highly concerned about struggling retail sales amid fragile consumer sentiment. In response, local governments are attempting to incentivize citizens by issuing e-vouchers. However, it will remain an uphill struggle to return to normal spending patterns over the coming months.

What to watch: An uptick in retail sales is key to boosting demand and necessary for the recovery of the economy.