Independent Thinking

China’s economic woes mount

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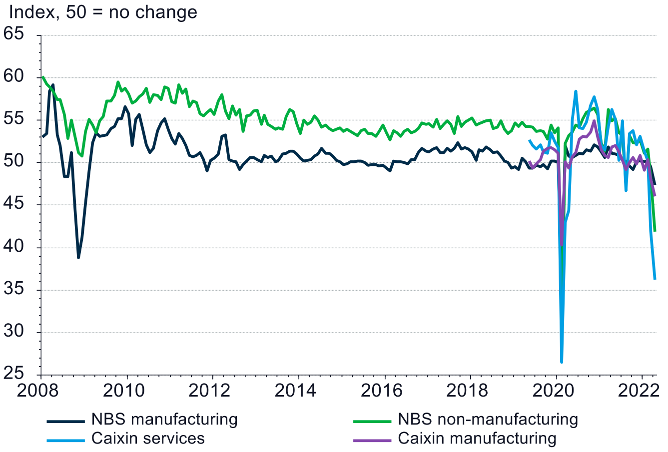
A sharp deceleration in Chinese economic activity has been evident from the data since March. Trouble has been brewing for some time as the economy faces challenges on multiple fronts. A key theme of China’s annual central economic work conference in December was stability, as the government cautioned that the economy faced “demand contraction, supply shocks and weakening expectations”. At the time, the regulatory crackdown against various sectors and the property market downturn were major drags on the economy. Policymakers subsequently enacted stimulus such as a modest cut in interest rates, some easing in property-related policies, and a ramping up of infrastructure spending. GDP growth in the first quarter was broadly respectable.

Since then, however, events in Eastern Europe and the sharp spike in COVID-19 cases have provided strong additional headwinds. The purchasing managers’ surveys fell into contractionary territory in March, with further sharp moves south in April (first chart below). The official non-manufacturing survey has only ever been lower in February 2020, while its manufacturing counterpart was only weaker in February 2020 and at the height of the Great Financial Crisis. The slowing of supplier delivery times in manufacturing attests to the negative impact of virus-related restrictions on supply chains. Meanwhile, retail sales contracted by 3.5% on a twelve-month basis in March (second chart below) and the surveyed urban unemployment rate hit its highest since May 2020.

China manufacturing and non-manufacturing PMIs



Source: Refinitiv Datastream / Fathom Consulting

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China retail sales

Twelve-month percentage change

Source: Refinitiv Datastream / Fathom Consulting

Policymakers are expected to step up the pace of policy easing. At last week's meeting of the central committee for financial and economic affairs, President Xi called for increased investment in areas such as transportation, energy, water conservancy, supercomputing, cloud computing, artificial intelligence platforms and broadband infrastructure.[1] Local governments have ramped up the issuance of special purpose bonds this year to fund increased infrastructure spending, which is likely to be further boosted by a relaxation of off-balance sheet financing for local government financing vehicles, and increased investment by state-owned enterprises. Meanwhile, the Politburo suggested it would make all-out efforts to stimulate domestic demand, and its statement hinted that regulatory efforts to rein in the technology sector may be drawing to a close. More supportive policies for the housing market also seem likely, although the reiteration of the phrase "houses are for living in, not for speculation" suggests that policymakers may continue with a measured approach to easing on this front.[2]

Monetary policy easing by the People's Bank of China (PBoC) has been quite restrained over recent quarters, with policy rate cuts eschewed in March and April.[3] A current major concern is the marked divergence in policy cycles from the US. With nominal yields on Chinese and US government bonds now broadly similar (chart below), the authorities fear further cuts in rates could exacerbate the increase in capital outflows seen in recent months. The PBoC's main focus is likely to continue to be the targeted easing of monetary policy to sectors impacted by the virus and those favoured by the government. The authorities may also accommodate a weakening of the currency to help exporters, but will not want to see rapid moves which stoke fears of capital outflows.

1. President Xi calls for advancing infrastructure development- China.org.cn
2. Endeavors required to promote economic work and talent development_英语频道_央视网(cctv.com)
3. A modest cut in banks' required reserves was implemented in April.

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Ten-year government bond yields

Source: Refinitiv Datastream / Fathom Consulting

It is not clear that large increases in infrastructure spending and targeted monetary easing will significantly boost consumer spending, although they might mitigate the negative pressures on the consumer that are already in place. China's housing market was weak and its labour market was deteriorating even before the spike in virus cases. A number of observers have been calling on the government to target their stimulus more directly at households, although the authorities seem reluctant to go down this road - it is a route they have avoided since the Great Financial Crisis.

Growth in China is likely to remain hostage to the course of the pandemic for most of the year. With less effective domestic vaccines than their western counterparts and lower vaccination rates among the very old, an imminent move away from the government's strict zero-COVID policy could present significant health risks. It would also be tantamount to an admission by President Xi that his much-touted policy is no longer working. He will be loath to do that in such an important political year when he is seeking an unprecedented third term as leader. All indications suggest his 'coronation' is highly likely, but he will want to be in the strongest position possible in coming months as the decisions are made regarding positions in the new Politburo and its Standing Committee.

All in all, the recent spike in virus cases suggests that the government's ambitious 5.5% growth target for 2022 looks increasingly out of reach, despite a likely stepping up of stimulus efforts. One less-demanding growth target that President Xi is reportedly determined to hit, however, is that the Chinese economy outperforms the US this year.[4] There is a growing risk that even that could be a close call.

Further reading

China is not about to drive up global inflation

China housing set for further easing

4. China's Xi Pushing to Beat the U.S. in GDP Growth Despite Covid Lockdowns - WSJ

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