MACRO POLO
Decoding China's Economic Arrival

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MACRO OUTLOOK

Economy Stabilized, but Recovery Will Be Weak

KEY TAKEAWAYS FOR 1Q2020

- China's growth has likely bottomed out, but the upside to economic recovery is very limited given the combination of weak fundamentals and tepid policy support.

- The overall macroeconomic policy stance will still be hawkish rather than expansionary, so the policy outlook will simply be slightly less negative than the status quo ante.

- Therefore, the economy is likely to remain weak and significantly below its growth potential for all of 2020, yet there are few signs that Beijing plans to stimulate.

- Postponing the deleveraging agenda may appear to be positive for near-term growth, but in reality it won't move the needle much.

The new decade brought early positive signs for the Chinese economy. Indicators show that the economy has stabilized and more importantly, the expected US-China phase-one trade deal has, at least for now, removed a lingering risk over the global economy.

But this revival in sentiment may quickly turn into disappointment because while the Chinese economy has bottomed out, the upturn will be quite limited. Any rebound in the Chinese economy isn't likely to endure; instead, what will endure is Beijing's restraint on stimulus. As a result, the Chinese economy will continue to operate significantly below potential and with low inflation. While the risk of growth falling below 6% in 2020 is minimal, nominal GDP growth will likely remain below 8%.

This Macro Outlook will first assess the current conditions of the Chinese economy. It will then turn to Beijing's policy signals, in particular whether it intends to implement a large stimulus (unlikely). Finally, we will offer our forecast of policy actions and the 2020 growth outlook.

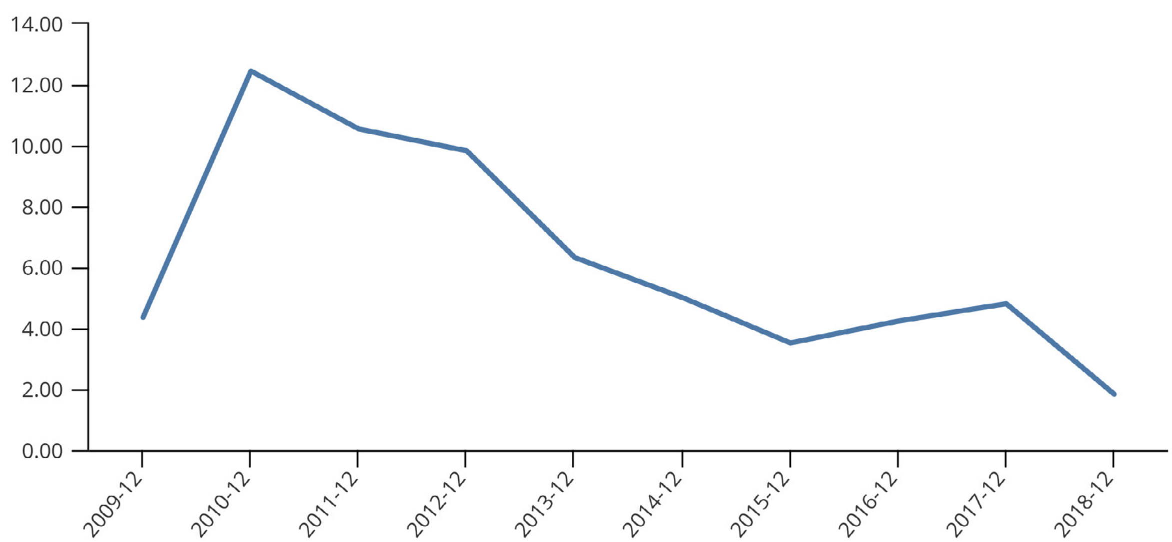
STABLE BUT WEAK

There are broad-based signs that the Chinese economy stabilized in 4Q2019. The Purchasing Manager Index has returned to expansionary territory since November, while consumption, industrial production, and energy demand have all pointed toward stabilization. Even so, the economy remains very weak and excess capacity is widespread, which can be seen in rising unemployment and weak inflation.

At 5.1%, the current official urban unemployment is 0.3 percentage points higher than in 2019, which translates into 1.3 million additional unemployed workers. But these headline figures don't paint the whole picture, as other factors may be contributing to a higher unemployment rate than reported.

One factor is that rural migrant workers seem to be having a hard time finding non-agricultural jobs. For example, as recently as 2017, total migrant workers increased by 4.8 million, roughly in line with historical trends. But in 2018 and 2019, that figure dropped to below 2 million per year, implying that more than 4 million migrant workers have been unable to find a non-agricultural job (see Figure 1).

Figure 1. Migrant Worker Growth Has Declined Sharply Since 2018 (millions)



Source: Wind.

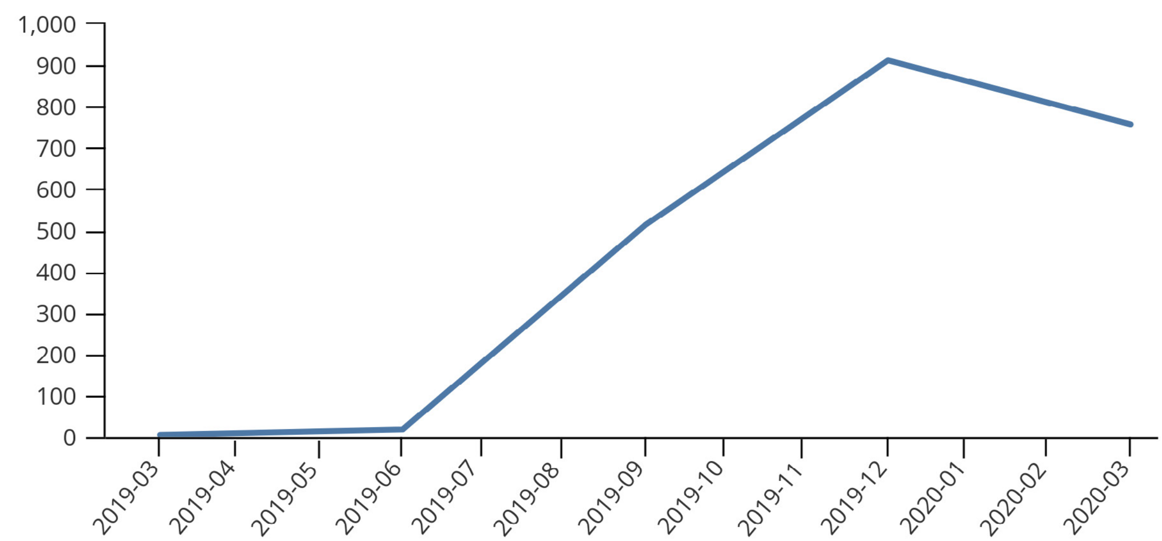
Moreover, survey evidence suggests that layoffs have been artificially low because of government subsidies. This is particularly so in the export sector because the state wants exporters to keep as many workers on payroll as possible. But without a quick rebound in exports, the effort to sustain jobs cannot last long, so another wave of layoffs should be expected.

The persistent slack in the labor market will make achieving full employment very challenging through 2020, which will put a drag on growth. Currently, there are at least 5 million Chinese who want to work if opportunities become available. But based on the pace of job creation, it will likely take more than a year to absorb the current number of unemployed workers.[1]

Weakness of the economy can also be seen in the inflation data. The Producer Price Index has been negative year-on-year since July and shows no signs of abating. Meanwhile, excluding food and energy, Consumer Price Index growth has been weakening since the start of 2019. As a measurement of the overall price level, the GDP deflator was 0.4% at the end of September 2019, suggesting that low inflation is indeed broad based.

This low inflation environment has been obscured by the spotlight on skyrocketing pork prices, as a result of the African swine flu. Although pork prices doubled during 2019, there are signs that the increase will start to abate in coming months. Based on quarterly pork consumption patterns, first and fourth quarter consumption tend to be higher than in the other two quarters. As pork supplies have shown signs of rebounding, in the coming months, the supply and demand gap is unlikely to be much larger than in 4Q2019 (see Figure 2). This suggests that the pork supply shortage has already peaked and that prices will likely stabilize soon.

Figure 2. Pork Shortage Has Already Peaked (10,000 tons)



Note: To calculate the supply shortage, the 2017 quarterly pork demand is used as a proxy for 2019 pork demand. The 2017 figures are used because they better reflect true demand before significant inflation lowered demand and therefore can provide a more accurate picture of the actual supply shortage.

Source: Wind.

Taken together, elevated unemployment and falling inflation suggest that the Chinese economy is currently operating significantly below potential. Put differently, the main problem for the economy is that it faces constraints on demand. A stimulus could certainly give domestic demand a shot in the arm, but the question remains whether Beijing will choose to do so.

JEERS, NOT CHEERS, FOR POLICY SUPPORT

We believe Beijing will continue to show restraint on stimulus, largely as a precautionary measure. Despite the latest thaw in US-China trade tensions, it appears that Beijing continues to believe that negative shocks are in store, which requires policymakers to conserve ammunition for when the other shoe drops.

What exact form that shoe-drop will take isn't clear. But Beijing nonetheless wants to remain vigilant toward potential exogenous shocks to the economy. The readout from the December 27, 2019 Politburo meeting, which took place after the announcement of the phase-one trade deal, continued to see "significant increases in risks and challenges" in the external environment, an assessment unchanged from before the phase-one deal.

Moreover, the December 2019 Central Economic Work Conference (CEWC) offered few hints of a large stimulus in the works. For example, in contrast to the 2018 CEWC's emphasis on "strengthening" stimulus, the 2019 meeting simply offered "fine-tuning" the stimulus. In addition, the call for ramping up local government bond issuance, a clear sign of stimulus, was dropped from the CEWC readout. It's also notable that the 2019 CEWC took place before the phase-one deal was reached. Since Beijing avoided stimulus before the trade resolution, there is even less reason to loosen policy after the fact.

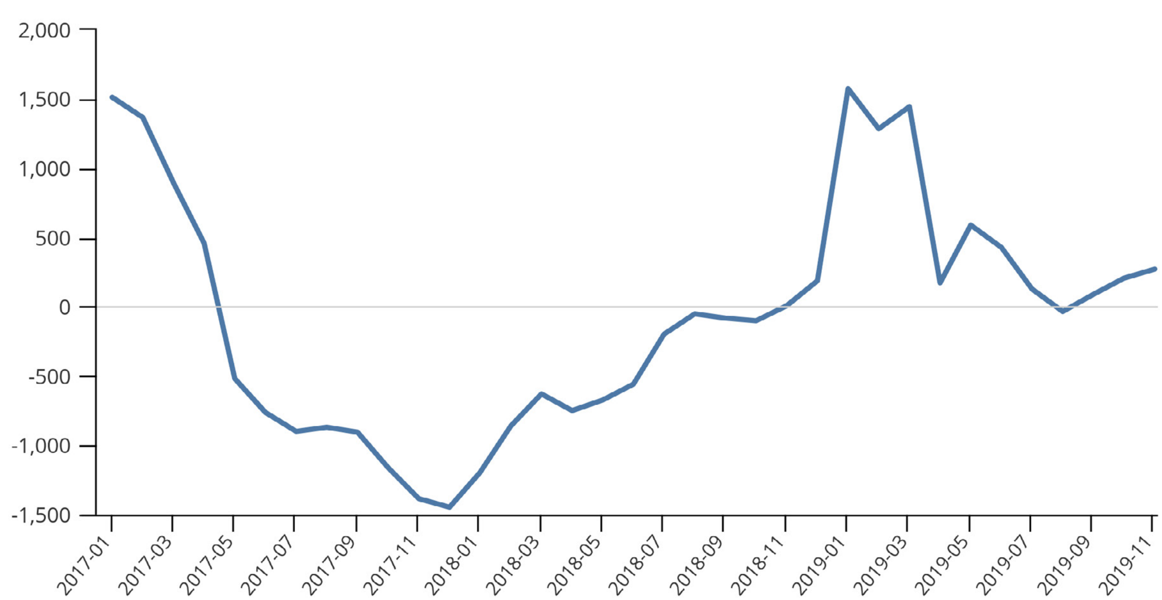
Withholding stimulus and anticipating external shocks, Beijing's approach for now is to address the pain points of existing policy, particularly deleveraging. Indeed, policymakers are signaling that the pace and scope of unwinding shadow banking will be tapered. It is worth noting, however, that tapering does not mean abandoning the agenda. Beijing simply does not want a repeat of what occurred in 2018, when tackling shadow banking proceeded rapidly and aggressively, dragging down growth with it. Instead, policymakers are moderating the pace to avoid large disruptions that could further hurt growth.

In the meantime, the government is unlikely to relax its effort on containing local government debt. Beijing appears to have learned its lesson from letting local government off-budget borrowing run wild. Although it is now easier for local governments to roll over their existing off-budget debt, a rebound in new borrowing is unlikely to happen. To the extent that Beijing relies on local governments to stimulate the economy, it will have to first come through increases in the on-budget debt. So far, there is little reason to expect a large increase in on-budget debt, which means the probability of Beijing loosening its grip on off-budget borrowing is small.

When it comes to the property sector, policymakers are likely to adopt a more flexible stance to ensure that the slowdown will be measured. There are already signs that the property sector is cooling. For example, land sales measured by area have declined by 12.5% in 4Q2019, suggesting a coming slowdown in property construction.

However, it should also be noted that Beijing has been careful to avoid a rapid cooling of property market. This can be seen most obviously in the way Beijing has managed mortgage lending growth. On the one hand, the central government is determined to rein in mortgage growth. For example, both in early 2017 and mid-2019, Beijing proactively choked off mortgage lending to an extent that its growth became negative. On the other hand, when the economy has weakened rapidly, such as in 2H2018 and 3Q2019, Beijing has allowed a rebound in mortgage growth (see Figure 3).

Figure 3. Change in Mortgage Lending Since 2017 (100 million yuan)



Note: : Year-on-year change is calculated as a three-months moving average.

Source: Wind.

That flexibility exhibited in mortgage lending reflects Beijing's effort to manage down cycles while preventing another policy-induced property bubble and exacerbating household debt. As a result, although the long-term property sector outlook is negative, the near-term slowdown is likely to be modest.

It has become clearer over the last year that Beijing's signature preference on both deleveraging and property is that of policy fine-tuning. In fact, the central government has deemed fine-tuning its main achievement in 2019, and one that will be sustained going forward.

This latest turn toward moderation has been deliberate, as Beijing wants to move away from the extreme vacillations that have defined its economic management. In the past, it was either going all-in on stimulus (e.g. the 2009-2010 period) or tightening aggressively (e.g. the initial phase of deleveraging in 2017-2018).

But of course this won't change over night, as policies will still exhibit extreme swings, so the emphasis on fine-tuning has to be viewed in relative terms. For example, Beijing prematurely withdrew stimulus at the end of 1Q2019 when all indicators suggested the economy was still quite weak. Given the overall restrictive policy environment, there is a risk that the current path of moderation will yield to more hawkish tightening again, especially when the economy begins to show signs of improvement.

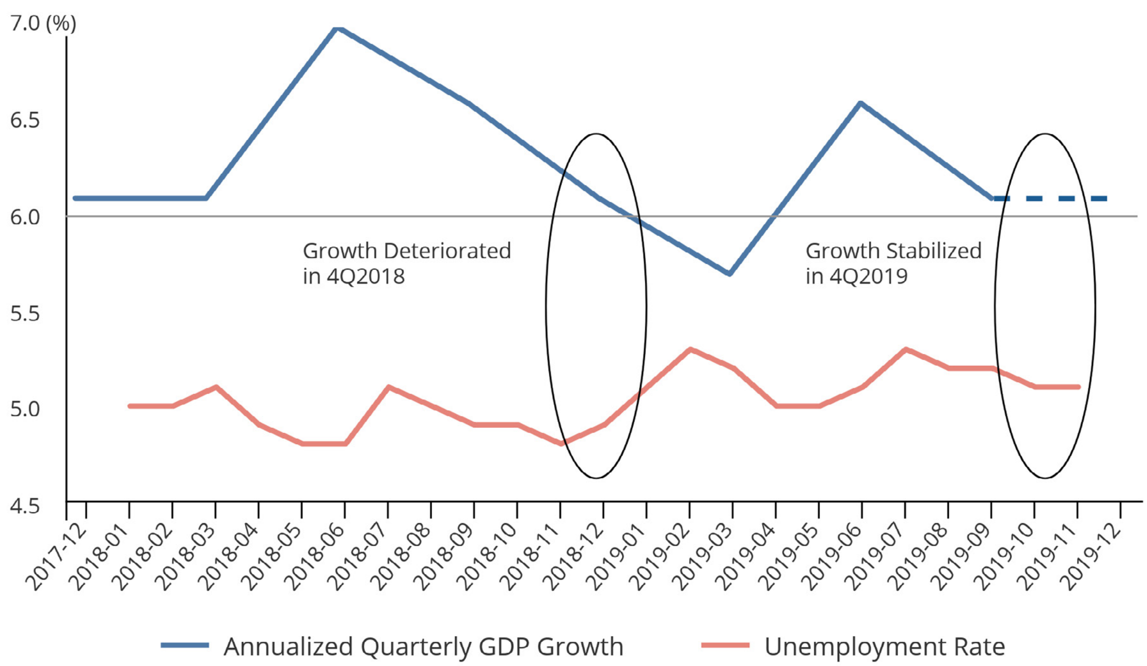
GROWTH OUTLOOK: BOTTOMED OUT BUT FLATLINED

Given the current weak state of the economy, we believe the 2020 growth picture can be best described as an anemic recovery.

Concerns of a growth downward spiral in the absence of a muscular stimulus are likely overblown. While it is true that the year-on-year GDP growth has fallen consecutively from 6.4% in 1Q2019 to 6.2% in 2Q2019 and 6% in 3Q2019, that obscures the stabilization that has taken place on a quarterly basis. Annualized growth rates don't tell us as much as consecutive quarterly growth—that is, comparing 1Q2019 to 2Q2019—about whether the economy has stabilized.

And quarter-on-quarter comparisons show that growth had indeed stabilized since the start of 2019, despite the escalation of trade tensions in both May and August 2019. The unemployment rate paints a similar picture. Much of the rise in unemployment took place after the November 2018 tariffs, after which it broadly stabilized and showed no signs of further deterioration (see Figure 4). These factors imply that the economy likely bottomed out at the end of 2019.

Figure 4. Unemployment and Growth Stabilized in 2019



Note: 4Q2019 growth of 6.1% is author's projection.

Source: Wind

While growth isn't likely to deteriorate further, don't expect a significant economic rebound either. In the context of weak policy support, organic growth will be the main driver in the coming quarters. But if left to organic growth alone, the Chinese economy will remain below its growth potential for the entirety of 2020.

As supply will continue to exceed demand, prices, wages, and profits will all see anemic growth, giving firms little incentive to invest. In addition, the impact of past policies on growth, especially deleveraging, will continue to percolate and weigh on companies. Private firms still face financial difficulties as a result of the abrupt tightening of financial conditions since 2018. For example, in 2019, more than two-thirds of private firms have repaid more debt than they borrowed from the bond market, with total net private sector bond borrowing turning negative.[2] This pattern will likely persist into 2020 and continue to put a drag on private sector activity and overall growth.

For 2020, then, low inflation and slow growth will likely persist, even if growth turns out slightly higher than in 2019. Any economic rebound will be shaky and slow at best, or as they say in Chinese, "好不了怎么，也坏不到哪里去 (paraphrase: don't expect much, but ain't gonna be terrible either)."

Endnotes

[1] On the face of it, China creates around 10 million urban jobs a year. But around half of these jobs in reality is the result of reclassifying rural jobs as urban jobs. The organic growth of urban jobs is likely to be fewer than 5 million annually.

[2] Although imposing more financial discipline and allowing defaults are the right courses of action, they have proceeded hastily and aggressively. Creditors and borrowers alike have not had enough time to adjust to the new financial environment.