May 13, 2020

China's path out of the corona crisis

First in, first out … but the economic recovery remains bumpy

As China was the first country to tackle COVID-19, its containment lessons were instructive globally. However, China has not, so far, tackled the economic downswing as vigorously as other major nations. Targeted rather than indiscriminate stimulus measures are now being applied and will be confirmed at the upcoming National People's Congress.

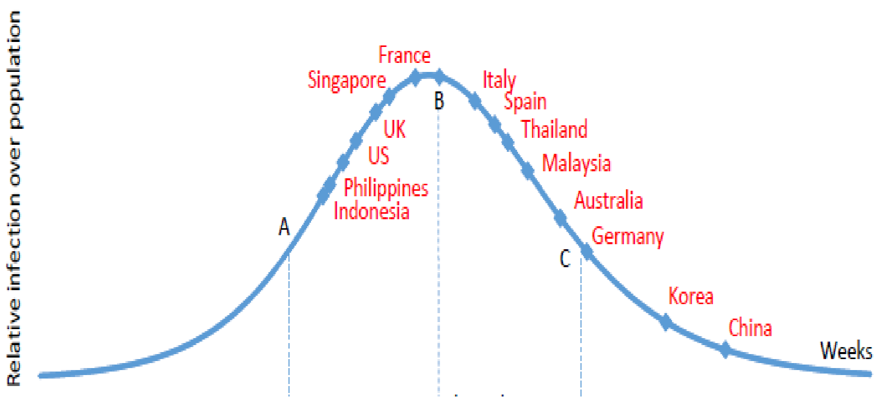
Source: iStock

We were early in publishing our February 6th Topical Thoughts paper on the outbreak of the novel coronavirus in China (Novel coronavirus: A market view). Since then, the virus has spread globally, with official tested new infection cases now surpassing four million people and a death toll of close to 300,000. In the meantime, the US, each of the five biggest European countries as well as Russia, Turkey, Brazil and Iran have now officially registered more cases than China. While there is cause for optimism as infection rates abate, uncertainty is high and the economic consequences brutal. Global lockdowns have led to a plunge in economic activity, with a global recession unavoidable, as outlined in our recent paper (Gloom, but not doom, as recession bites). The focus of this paper is on how China is handling the crisis and how its economic recovery from its deep slump may shed light on how other countries could react. According to the Chinese government, the 'battle' is already won, with lockdown restrictions first withdrawn in the most affected province of Hubei, followed by the city of Wuhan. Currently there are about 100 active cases, as 94% of all infection cases have convalesced. Even if we assume that the 'grey' number of active infection cases may be higher, it is still miniscule for a country with a population of more than 1.4 billion.

However, it was a bumpy road for China. When the first cases of novel coronavirus infections were reported in Wuhan, precious time was lost due to administrative layers and hurdles between the local and provincial government. It seems like Wuhan's local administration did not want to risk reputational damage. Important information was held back, and doctors were urged not to speak up. Before drastic lockdown restrictions were finally implemented, more than five million inhabitants had left the city to visit relatives in other provinces and countries for Lunar New Year, helping the infection to spread globally.

When asked what the most important factor is when handling an epidemic, one of China's highly respected virologists responded that it is the 'time' factor. Lessons have been learnt, and not only was the full shutdown of Wuhan finally implemented and fiercely controlled by police, public cameras and drones, but other Chinese cities and regions responded quickly. For example, Shanghai allocated 2,500

China is leading the COVID-19 pack



Source: JP Morgan (schematic path)

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First GDP contraction since quarterly statistics were published

Source: Bloomberg

medical staff workers to track down infection chains and quickly built so called 'fangcang' shelter hospitals. These are large-scale, temporary hospitals with hundreds of beds, rapidly built by converting public venues, such as stadiums and exhibition centres, into healthcare facilities in order to isolate patients with mild to moderate COVID-19 symptoms from their families and communities, while providing medical care, disease monitoring, food, shelter, and social activities. These measures helped to prevent the virus from spreading throughout the country.

However, even though there are now about 100 remaining active confirmed infection cases left in China, fears of an imported second wave of infections are lingering. For example, in order to avoid infections being brought in to the country by Chinese citizens returning from Russia, the 3,000 km long border between China and Russia has been effectively closed as the province of Heilongjiang boosts its efforts to secure the region. The border city of Suifenhe was affected the most, while Harbin, Heilongjiang's capital, tightened its rules by extending quarantine periods for certain visitors to 28 days. Only recently have some of the emergency measures been scaled back.

Economic tailspin in February

How has China's economy performed during and after the Wuhan infection wave, and can this observation offer any guidance for other major economies that are currently under pressure from COVID-19? There were some statistical problems early on as the outbreak of COVID-19 coincided with Lunar New Year. Economic data tend to be distorted during this period due to the different timing of the holidays every year, which creates an issue that cannot be accounted for by simple seasonal adjustments. That is the reason why some statistics are only reported by combining January and February. However, we now have the full set of economic data for Q1, which makes the data more relevant.

China's Q1 real GDP contracted by 9.8% QoQ or 6.8% YoY. This was not only the first contraction since quarterly data began being reported in 1992, but also the first time that growth has fallen below the +6% mark. Fixed asset investment was down 16.1% YoY while industrial production contracted by 8.4% compared to the same period last year. Retail sales tumbled 19%, despite surging online sales. Newspaper reports suggest that nearly half a million companies went bankrupt, even though this cannot be confirmed by official bankruptcy filings, while unemployment rose. In sector terms, hospitality, retail, wholesale, construction and transport were hit the hardest, while telecommunication, IT and finance were the only sectors that still showed growth in Q1.

Recovery is on track

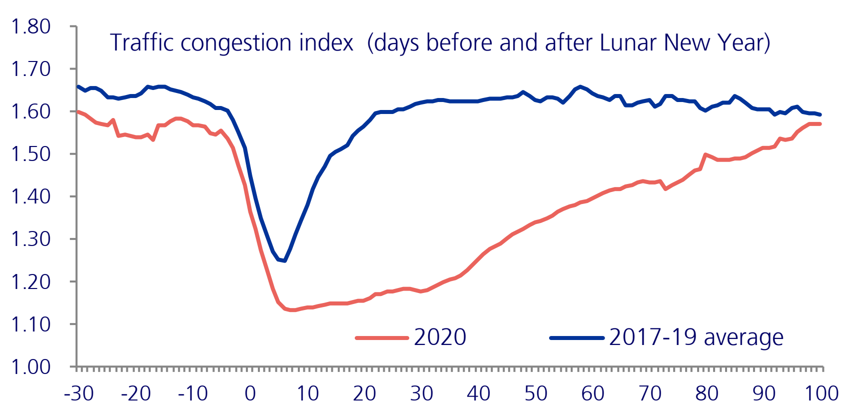
We note that the trough of the Q1 downcycle was marked in early February, as most indicators have steadily improved since then. Following a steep drop, the Goldman Sachs industrial activity index shows a trough in early February and suggests that in the meantime pre-coronavirus activity levels have already been reached, which is remarkable. The index incorporates indicators like railway loaded coal volume, air pollution, daily coal consumption by electric producers, and steel demand. Meanwhile, a similar index tracking consumer activity reflects the same pattern but is still down about 20% YoY. This index is composed of traffic congestion, movie box-office revenue, daily property sales, and passenger load factors on domestic flights.

There are various other tracking indices, but we want to highlight only a few: The latest traffic congestion index is back to pre-crisis levels for the biggest 100 cities, while subway passenger trips are down less than 20% in five major cities after the 'Golden Week' holidays, not least because passengers prefer to travel by car to avoid infection risks. Property sales in China's top 36 cities were slow to recover in the early lockdown phase but are now approaching normal levels again, with showrooms in Shanghai packed with potential buyers, despite rather cautious property market surveys. Auto sales are back to normal in the luxury segment and down only marginally in the mass market, recovering from a nearly 80% slump in February. The number of restaurants resuming business compared to the start of the year is down only 7% in early May, but revenues are still down a hefty 42%. Waiting queues in front of popular restaurants are long, and it takes up to two hours to get seated, while other restaurants remain empty. Local tourist attractions are slowly opening again but the number of visitors is tightly controlled. Domestic air travel is recovering, down only about 10% compared to the 2018-19 average, while the international airline passenger load factor stands at only 25%, down 53 percentage points.

Acute labour market pressure

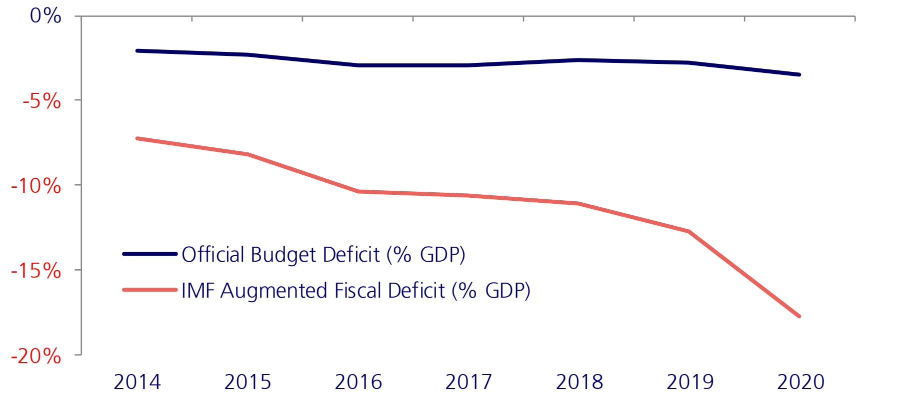
China's labour market statistics are not consistent with international standards. The registered unemployment rate rose only marginally from 3.62% to 3.66% in Q1. However, the 'surveyed' urban unemployment rate gives us some better insights, as it rose by one percentage point to 6.2% in the first two month of this year before recovering slightly to 5.9% in March. Meanwhile, the unemployment rate for 31 major cities is not showing any improvement, as it remained at its record high of 5.7% in March, versus 5.2% at the end of last year. Urban employment shrank by 6% in Q1, the first contraction in 40 years, which translates to more than 26mn workers losing their job due to the impact of COVID-19. This has intensified the trend that was already visible in industries like apparel, textiles and food processing with a trend toward automation and outsourcing to countries like Vietnam.

Traffic congestion after Lunar New Year normalised slowly in 2020



Source: UBS, ZIG

China's increasing fiscal stimulus will give a boost to the economy



Source: CEIC, IMF, BIS, Citi (2020 estimate)

Three groups have been heavily impacted: small- and medium-sized companies (SMEs), self-employed family businesses and migrant workers. In some of these segments, effective unemployment is likely to be much higher than official numbers suggest, as workers who have not returned to work either due to quarantine measures, travel restrictions or because their employers have been struggling, are not included in the statistics.

Some businesses, particularly state-owned enterprises (SOEs) are recovering back close to normal operating levels and are keeping their staff employed following 'moral persuasion' by the government. However, SMEs, many of them in the services sector, are operating at activity levels of only about 75%. Some segments, like accommodation and catering, are faring even worse, resulting in a drag on employment and household income. A rough estimate by JP Morgan puts the number of unemployed to 26mn, while another 25mn have exited the job market and 76mn are employed but not working, which brings the total number of employees affected by COVID-19 to more than 100mn. Adding millions of employed workers with a steep income contraction furthers the devastating effect on consumption by this cohort of workers and their families.

These are rough estimates based on various local sources and proxy data, such as the search for unemployment benefits on well-known internet platforms or the change of job postings by recruitment agencies, but they are also reflected in the steep drop of the 'Citi China Job Sentiment Index' for April. The labour market environment is likely to be negatively impacted in anticipation of the foreseeable hit to China's export sector due to falling overseas demand following the Q2 lockdowns in major export markets. This shows the burden China's policy makers need to tackle to alleviate the pressure on both urban and rural households and to avoid potential social unrest.

The Politburo announces swift measures to help households and SMEs

The National People's Congress (NPC), an annual convention of thousands of nationwide delegates, which was originally scheduled for early March and then postponed to early April, will now convene on May 22 and may last at least seven days. China's official growth target for the year is typically announced at the NPC. Rumour has it that the target was to be reduced this year from the prior 6-6.5% range to 'about 6%' for 2020. Amid the corona crisis this target is no longer viable. Our growth forecast stands at 2.5% for this year, which is roughly in line with consensus but higher than the IMF forecast at 1.2%. There has been speculation that a combined target for this year and next year, or only one for the second half of this year may be formulated. We would not be surprised if the GDP growth target were to be completely abandoned in favour of spending and aggregate financing targets.

More broad-based rather than specific numerical targets are likely

Growth this year was critical to China's 10-year goal of doubling GDP and income, as this is the tenth and final year of the period. Reaching the target would have required growth of at least 5.6% in 2020, which is clearly unrealistic. We believe more general targets such as the wellbeing of people, labour market stability and technological progress may be formulated. We believe that there is a widespread understanding in China that the unusual circumstances make it impossible to achieve the 10-year target, but there is also an accompanying strong conviction that China has already advanced towards a prosperous society, even if the growth target for this year cannot be met.

In its meeting on April 17, the Politburo focused on 'six areas of stability': employment, basic livelihood, food and energy security, a market-oriented economic structure, stable supply chains and operations of local governments. We note that so far these are just intentions, while other countries like the US, the EU and Japan have already taken drastic fiscal and monetary action in an unprecedented fashion to swiftly tackle the economic collapse.

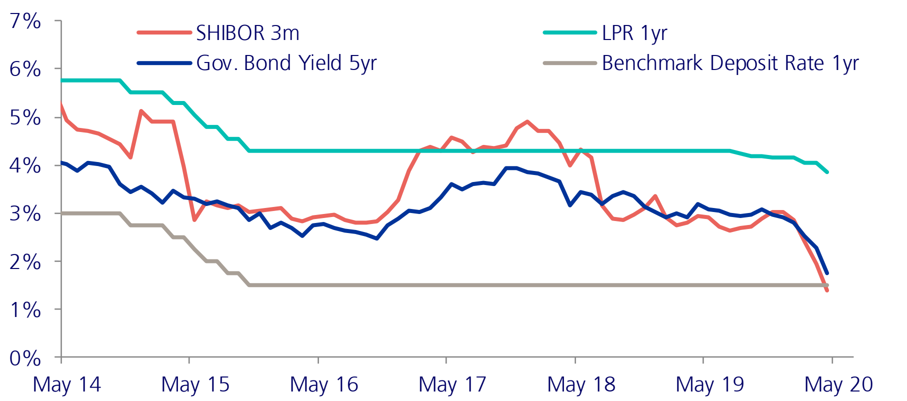
On the fiscal side, the Politburo intends to raise the fiscal deficit ratio, issue Central Government Special Bonds (CGSBs) and raise the Local Government Special Bond (LGSB) quota. Tax cuts, lower financing costs for SMEs, household subsidies and labour market measures in key industries and for university graduates will be formulated at the NPC. Both traditional and new technology infrastructure investment will be increased, while the renovation of old residential areas and development of public hygiene measures will be in focus, which makes sense.

We believe a substantial economic support package will be announced, roughly in line with what has already been set in other major countries, adding up to somewhere between 5%-10% of GDP. However, we still expect a more targeted approach, different to the broad-based measures taken after the global financial crisis in 2008. Monetary measures will accompany fiscal measures, as outlined in the PBoC's Q1 Monetary Policy Report, and we expect further cuts in the reserve requirement ratio (RRR) and other target rates, like the medium-term loan facility (MLF) and potentially even the benchmark deposit rate. Lending rate cuts will be a relief for SMEs and households.

China's global obligations in focus

As China has advanced to become the second biggest economy in the world, measures to avoid renewed outbreaks of epidemics, to stabilise its economy and to keep global supply chains intact are vital not only for China, but for the world at large. We suspect that the new focus of stimulus following the crisis stand a good chance of success.

Market rates follow lower policy rates



Source: Bloomberg

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