China's Economy Contracts in First Half of 2020, but Bounces Back as Pandemic Eases

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1. CHINA'S ECONOMY REBOUNDED IN Q2 AFTER SIGNIFICANT CONTRACTION IN Q1

According to China's National Bureau of Statistics (NBS), China's GDP (Gross Domestic Product) decreased year-on-year by 1.6% in the first half year of 2020. The decrease was largely caused by the unprecedented contraction in the first quarter, which saw a year-on-year decrease rate of 6.8%. This was the first decline in China's GDP since 1976. However, with the resumption of production, China's economy began a strong recovery in the second quarter with a year-on-year growth rate of 3.2%. As shown in Figure 1, all sectors including the primary, secondary and tertiary sectors saw positive growth in the second quarter from their decrease in the first quarter.

Figure 1: GDP Growth Rate for all Sectors

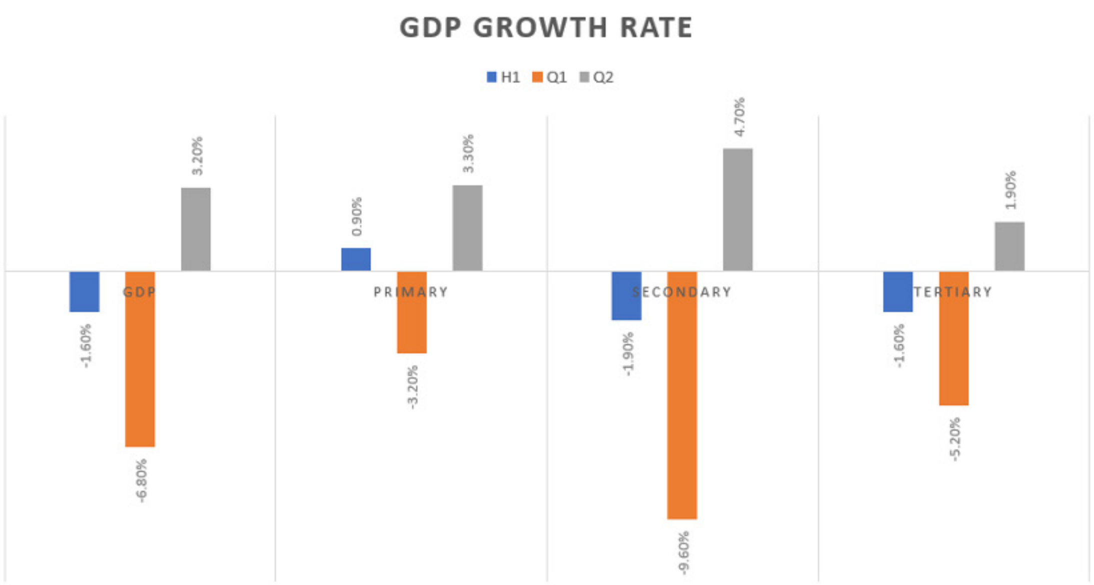
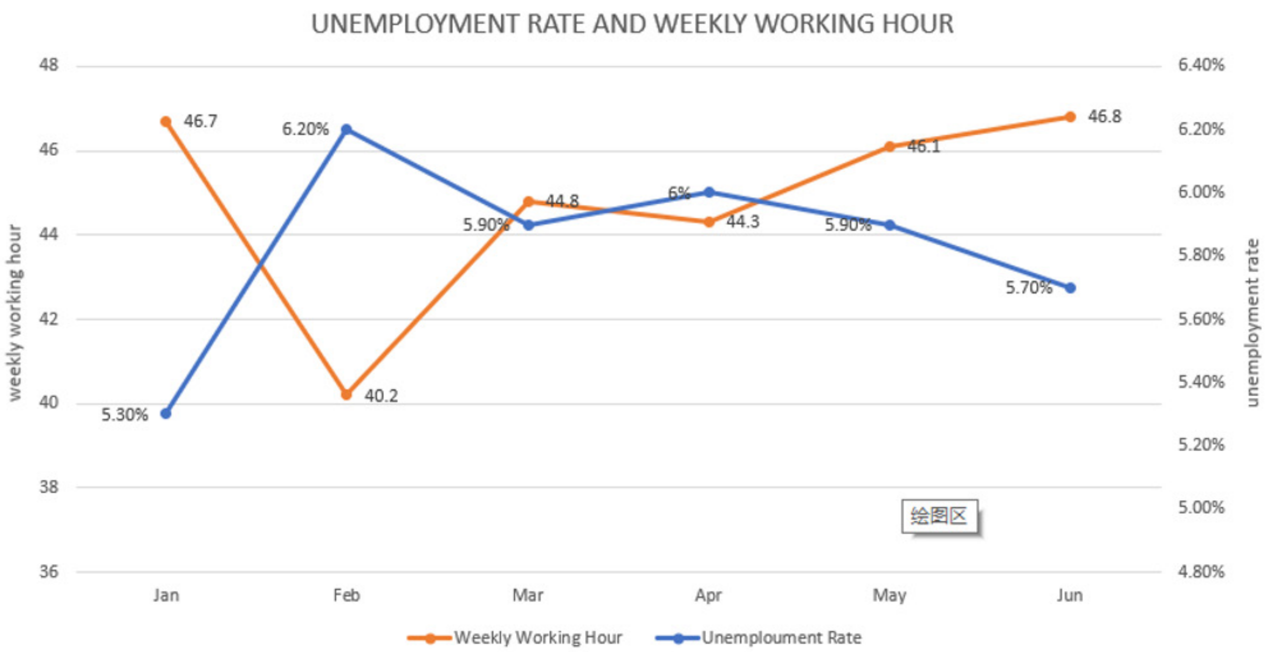


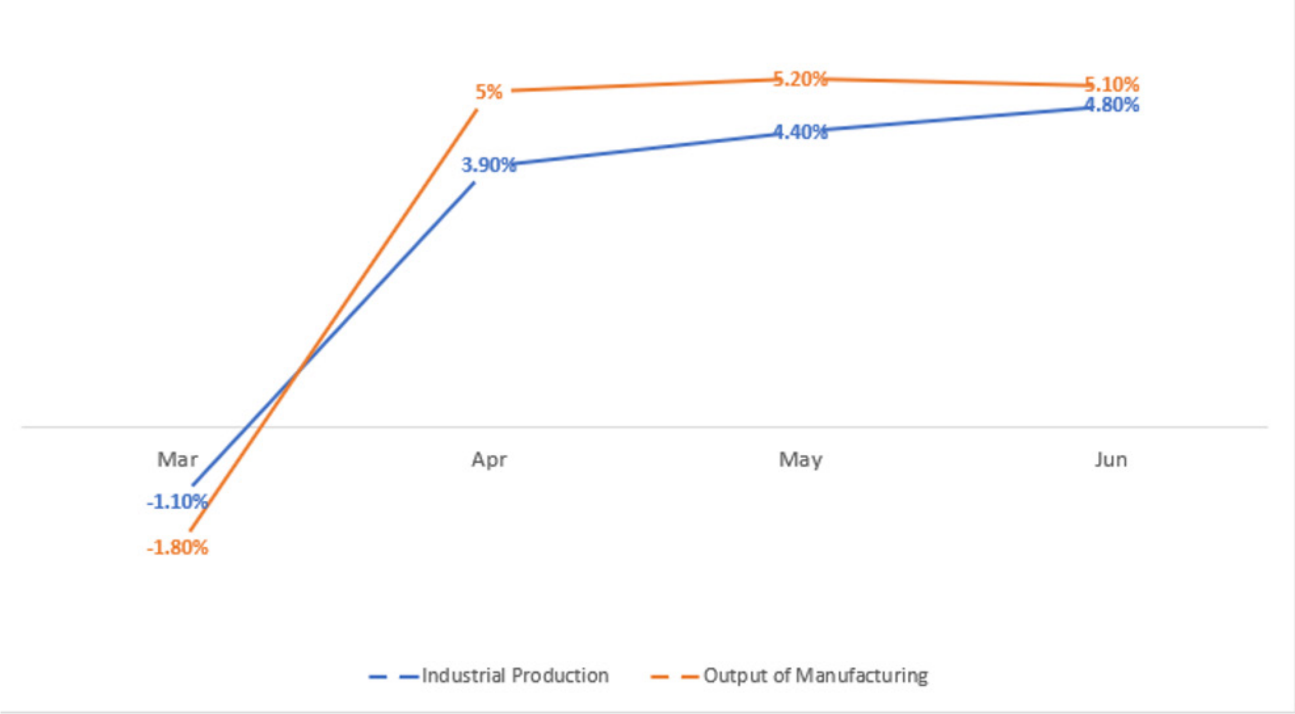
Figure 2: Unemployment Rate and Weekly Working Hour for Each Month



Industrial production[1] in China grew by 4.4% in the second quarter but decreased by 8.4% in the first quarter, resulting in an overall decline of 1.3% for the first half of 2020. According to Figure 3, industrial production rebounded dramatically to 3.9% in April from its previous value of -1.1% in March and kept growing through to June. Meanwhile, the output of the manufacturing industry experienced a similar growth pattern. Manufacturing output increased greatly in April, rising 5% compared to -1.8% fall in March. The negative performance of both industrial production and the manufacturing industry in March corresponds to the implementation of quarantine and the widespread shut down of factory production. Accordingly, the growth of industrial and manufacturing production followed the revision of quarantine policy in late March.

[1] Industrial production refers to the gross value of industrial output, including manufacturing industry, mining industry and the industry of supply of water, heat and electricity. Output of manufacturing is a subset of the industrial production.

Figure 3: Growth Rate for Industrial Production and Output of Manufacturing



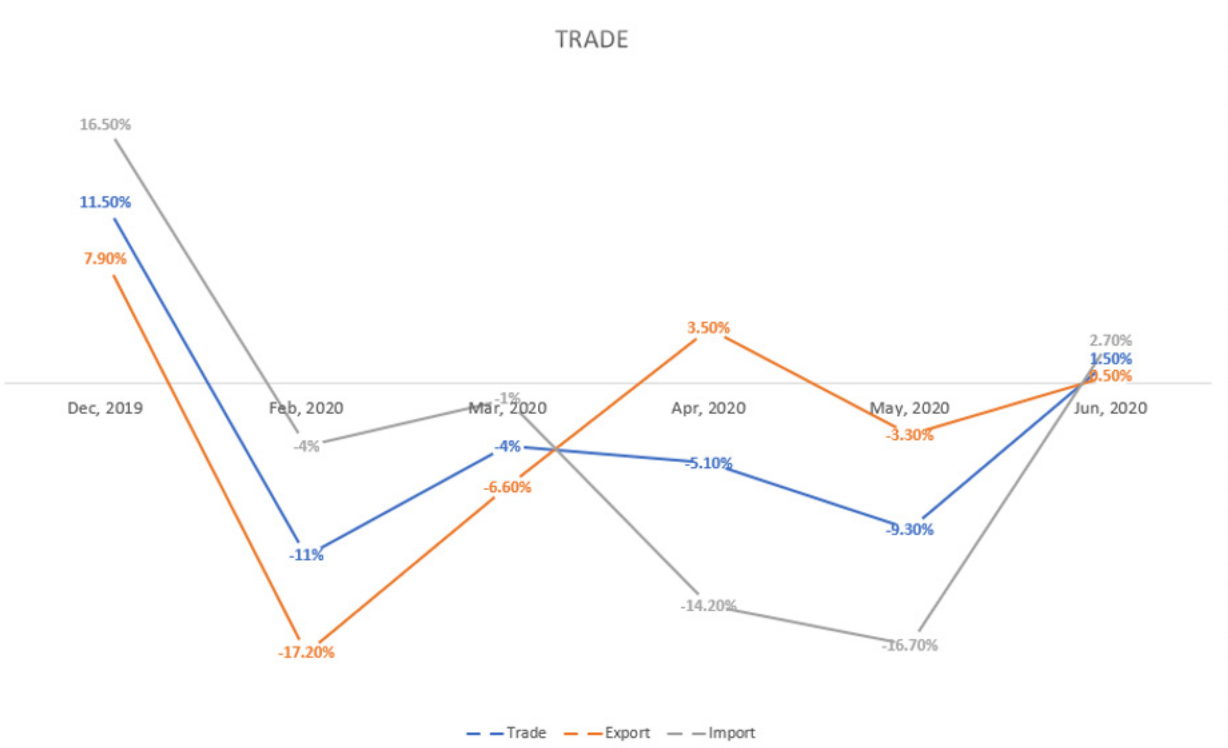
Consumer demand was also considerably affected by the pandemic. Retail sales of consumer goods and services declined by 3.9% year-on-year in the second quarter of 2020. This was a great improvement when compared with the first quarter, which saw a slump of 19% in retail sales. Combining the first two quarters, retail sales decreased year-on-year by 11.4% over the first half of 2020. As shown in Figure 4, the slump in January-February from its previous rate in december was significant, at 27.5%. In the second quarter the growth of retail sales increased but remained negative. It should also be noted that online sales contributed greatly to the retail recovery. For the first half year, online sales rose by 7.3% year-on-year as consumers switched to online shopping while quarantined.

Figure 4: Growth Rate for Retail Sales

2. CONCERNS AS CHINA'S ECONOMIC RECOVERY PICKS UP MOMENTUM

Along with China's GDP recovery, China's trade, foreign direct investment and price indices also showed signs of recovery in the second quarter. In the first half of 2020, China's trade volume reached US$ 2034 billion, a year-on-year decrease of 3.2%; exports decreased by 3% to US$ 1101.4 billion and imports decreased by 3.3% to US$ 932.6 billion. As Figure 5 illustrates, the year-on-year change in China's trade volume decreased from 11.5% growth in December to an -11% contraction in February. Until May, the growth rate for trade remained negative, only reaching slightly above zero (1.5%) in June. There are some emerging trends relating to this topic that are worth noting. First, ASEAN (Association of Southeast Asian Nations) has surpassed the EU (European Union) and the United States to become China's leading trade partner. China's trade with ASEAN countries increased year-on-year by 5.6% in the first half of 2020, accounting for 14.7% of China's total trade. However, China's trade with the EU and the United States decreased year-on-year by 1.8% and 6.6% respectively in the first half of 2020. Exports of goods related to virus protection contributed to China's trade rebound in the first six months of 2020. For instance, textile exports, including masks, expanded by 32.4%, and export of medicines and medical instruments and equipment increased by 23.6% and 46.4% compared to the same period of last year.

Figure 5: Growth Rate for Trade



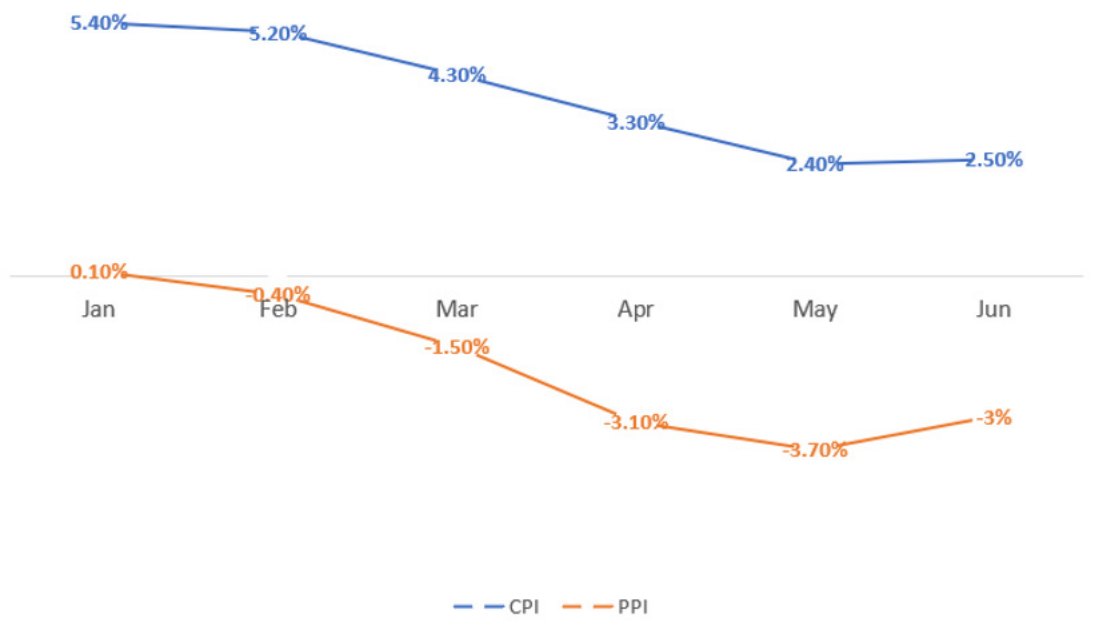
From January to June, China's inbound FDI (Foreign Direct Investment) totaled US$ 67.9 billion with a year-on-year decrease of 4%. In congruence with the development of COVID-19 in China, FDI dipped to its lowest level, -12.8%, in March before improving steadily in the second quarter. However, the high-tech service industries witnessed a remarkable expansion of 19.2% in new foreign investment, which could be attributed to both the growing reliance on information technology in Chinese society and workplaces and the Chinese government's actions to further develop the sector. On the other hand, the development of China's OFDI in the first six months of 2020 did not present any patterns related to the pandemic. As illustrated in Figure 6, China's OFDI flow erratic. For the first half of 2020, the total value of China's OFDI (Outbound Foreign Direct Investment) amounted to US$ 51.5 billion, decreasing by -4.4% year-on-year. Among the investment destinations, ASEAN countries received the largest share of Chinese investment, with a total of US$ 6.2 billion and an astonishing year-on-year increase of 53.1%. Investments in countries along the BRI (the Belt and Road Initiative) also experienced a growth of

19.4% year-on-year. Additionally, China's M&A (Mergers and Acquisitions) in North America increased by 15% in the first half of 2020, focusing on financial services, TMT (Technology, Media, Telecom) and mining. However, Chinese investment faces geopolitical risks and challenges caused by the coming US election in November.

Figure 6: Growth Rate for Accumulated FDI and OFDI Flows

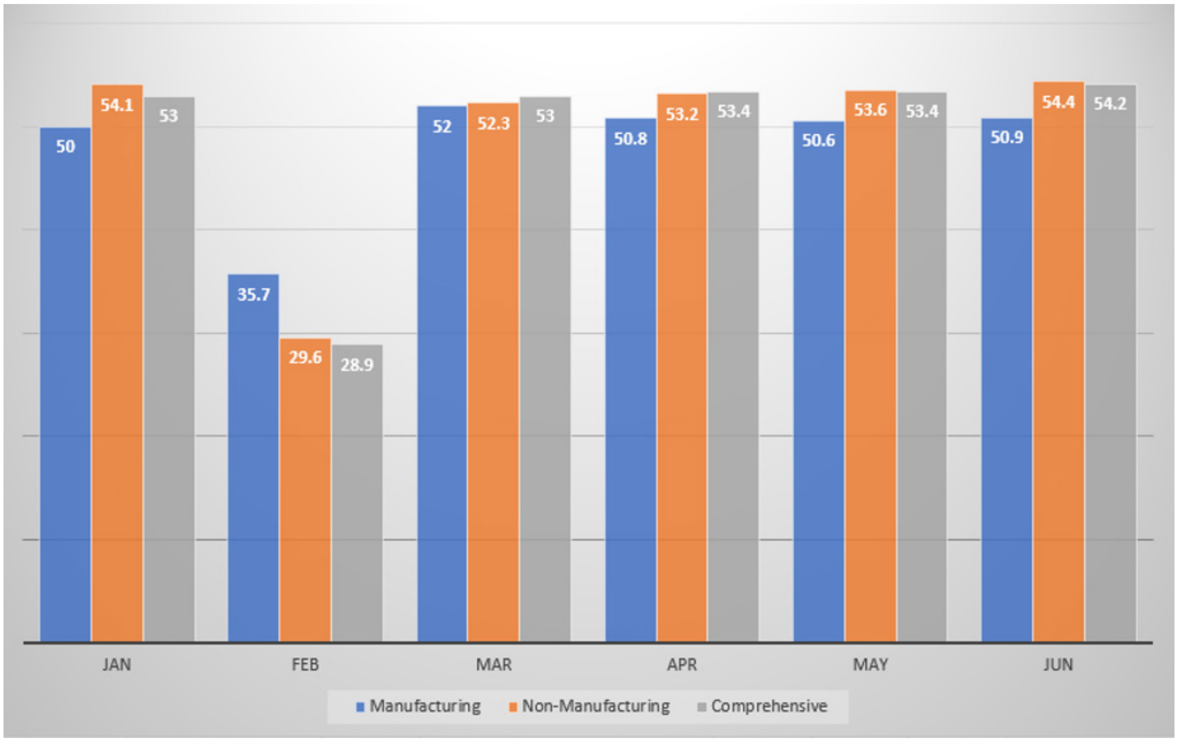
For the first half year, China's CPI (Consumer Price Index) increased year-on-year by 3.8%. More than 80% of the increase was generated by the hike in pork prices due to the swine fever outbreak. According to Figure 7, the growth rate for CPI in the second quarter was much less than that in the first quarter which could be attributed to the resumption of production as well as the recovery of transportation. The core CPI (excluding the prices of food and energy) was stable in the first half year, with a year-on-year growth rate of 1.2%. Meanwhile, China's PPI (Producer Price Index) decreased year-on-year by 1.9%. A relatively high PPI baseline in 2019 and a major drop in energy prices in March and April are believed to have caused this decrease of PPI.

Figure 7: Growth Rate for CPI and PPI



China's economic recovery is also clearly reflected in its PMI (Purchasing Managers' Index). As shown in Figure 8, China's manufacturing PMI has remained above 50 since March, a significant increase from its bottom value of 35.7 in February. Additionally, the non-manufacturing business activity index reached even higher numbers when compared to manufacturing PMI, with all values exceeding 52 since March, a significant improvement from its lowest value of 29.6 in February. As for the comprehensive PMI, it has been above 53 since March and reached its peak of 54.2 in June, rising from a bottom value of 28.9 in February.

Figure 8: Manufacturing, Non-Manufacturing and Comprehensive Purchase Managers' Index



Despite a strong performance in the second quarter, there are still some concerns regarding China's full economic recovery. To start, supply side recovery was more significant than that of the demand side. As stated above, China's industrial production experienced growth in the second quarter while the growth of retail sales remained negative. The manufacturing industry has experienced expansion for three successive months, and the service industry has been growing for two continuous months, although some sectors such as accommodation and catering are still contracting. However, the demand side did not mirror an equivalent level of recovery, which may suggest that production could have been boosted by government's stimulus policies rather than by real demand. The underwhelming performance of the demand side was validated by the decrease in China's national consumption per capita, with a year-on-year decrease of 9.3%. This could partly be attributed to the decline in its national income per capita, with a year-on-year decrease of 1.3%.

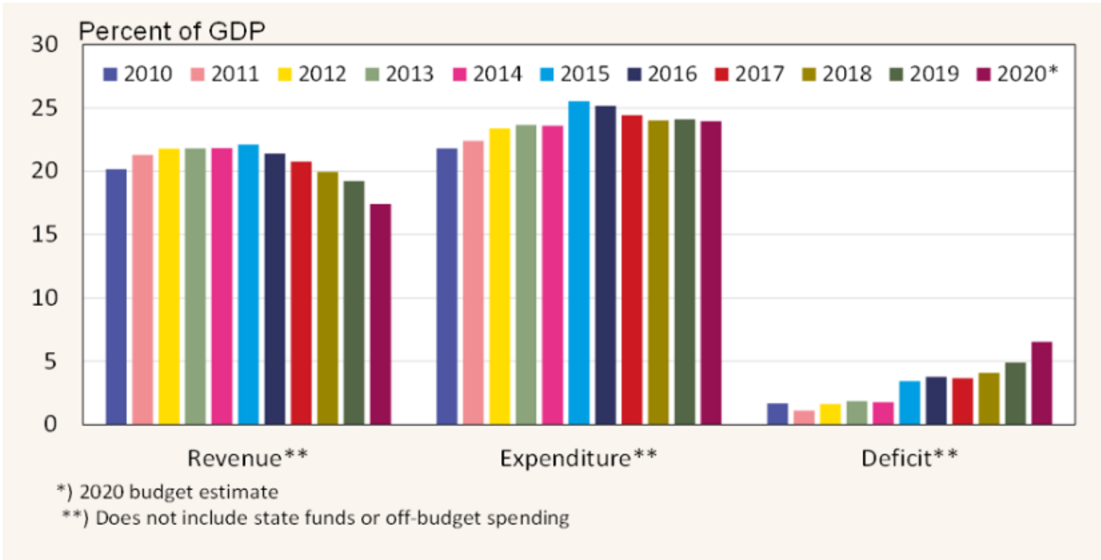
Meanwhile, China's urban surveyed unemployment rate was still 0.6% higher year-on-year in June, though it has been decreasing since April. The unemployment rate of rural migrants was also 0.7% higher year-on-year, which indicated that labour-intensive industries and unskilled labours were disproportionately affected. More time is needed for private enterprises, especially small businesses, to recover, which will likely sustain only weak employment rates for the near future. According to China's NBS, employment in small business was 3% lower in June compared to January. The employment challenge for rural migrants and the loss of job opportunities in private enterprises will affect the income levels of many workers and further impede the demand recovery for goods and services.

3. China's macro-policies to shore up economic recovery during and after COVID-19

The Chinese government considers strong economic policy responses the key to limiting the damage from the COVID-19 crisis and pull the economy back onto a growth trajectory. Since February, after the coronavirus dramatically hit China's factory activities and consumer demand, China's central government has rolled out a wide range of measures to bolster the economy through the ongoing pandemic shock. Easing monetary and fiscal policies were introduced to support the real economy and help businesses and people affected by COVID-19.
A loose monetary and credit stance has played a key role in boosting economic recovery in China, especially from February to April. Trillions of yuan (up to 9 trillion yuan) of liquidity were injected into the market to stimulate economic growth through multiple monetary tools by the PBOC (People's Bank of China). Most of these tools, including central bank lending and central bank discounting, RRR (Reserve Requirement Ratio) rate cutting, open market operations, standing lending facility (SLF), and a focus on short-and mid-term financing to provide immediate liquidity to the real economy. Structural financing is a key component of China's monetary strategy. A substantial amount of liquidity targeted manufacturers producing personal protective and medical supplies and small & medium & micro-sized (SMM) businesses, especially in the first quarter. Along with expansionary monetary policies, active fiscal policies are also being adopted to mitigate the pressure of the economic downturn. The main fiscal measures include increasing government expenditure on epidemic control, cutting cooperate tax rates and fees, and issuing special government bonds. Fiscal support for public health, SMM businesses and employment of rural migrant workers is also an important component of China's recent fiscal policy focus. The total corporate tax cut and fee reduction in 2020 is expected to be 2.5 trillion yuan, beating the record of 2.36 trillion yuan in 2019.

Data has shown early sign of economic rebound that is believed to be the results of the expansionary monetary and fiscal policies in the second quarter. Adequate liquidity and credit in the financial system provides firms with multiple points of access to loans that help them recover from COVID-19 damage. China's "two sessions" (annual parliamentary meetings) announced that China needs a more active fiscal policy to stimulate the economy, setting expectations of continual fiscal easingt for the second half of 2020. The central government's deficit was raised by 1 trillion from last year. The deficit ratio was set to 3.6% of GDP, going above 3% for the first time since 1949. Figure 9 shows a trend for China's government expenditure and deficit situation in the past ten years. A significant uptick in the government deficit is observed in 2020. China has also begun to auction 1 trillion yuan of special treasury bonds to help fund economic recovery in the wake of the COVID-19 pandemic.

Figure 9: Realised Budget Expenditures, Revenues and Deficits of China's Central and Local Governments (2020 estimate included)



Source: The Bank of Finland Institute for Economies in Transition (BOFIT)

Despite the benefits of expansionary monetary and fiscal policies on countering the economic damage inflicted by COVID-19, the aggressive policies also aroused concerns regarding inflation, financial bubbles and excess debt. While ample liquidity plays an active role in hedging coronavirus-induced risks in China over the near term, extra liquidity may elevate CPI and hinder economic growth in the long run. As Figure 10 shows, China's CPI growth has declined to 2.5% in June from January's high of 5.4%, indicating additional room for continued fiscal easing. Fueled by relaxed monetary policy, the Chinese stock market hit the five-year high after a rapid rally from early February when share prices were hard hit by the epidemic. On the other side, analysts have warned that too much liquidity could accumulate risks in the equity and housing markets and distort the growth of the real economy.

Figure 10: China's CPI from June 2019 to June 2020

Chinese economists also warned that the government should be mindful of the lessons learned in 2008-09 when a massive stimulus package saddled the economy with a mountain of debt. China's macro leverage ratio, a gauge of the overall level of debt in China, saw a spike of 21% in the first half of 2020 from last year's 245.4%. Low-interest rates, increased lending, and a ramp-up in government bond issuance were the top drivers of new debt. The PBOC said in its second-quarter monetary policy implementation report the rise in the macro leverage ratio is expected as a result of massive policy support on the economy in the counter-cycle period. They anticipated macro leverage ratio would stabilize in the second half of the year, thanks to the growth of the economy, as opposed to debt expansion.

The central government also declared that they have been mindful of the side effects of the massive monetary pumping on the economic recovery, and are prepared to exit the expansionary macroeconomic policy in a timely fashion. In its second-quarter monetary policy implementation report, the PBOC said it will continue to make prudent monetary policy more "flexible and appropriate", and provide more direct and targeted support to the real economy in the second half of 2020. Expectations are that China's monetary and fiscal policies will continue to be "loose" to facilitate economic growth, albeit in a more structural approach aimed at stimulating domestic demand, improving employment, and bolstering the agriculture sector.

4. CHINA'S ECONOMY IS FACING A CHALLENGING OUTLOOK IN THE SECOND HALF OF 2020

China's V-shaped economic recovery is already underway in the first half of 2020, bouncing back from an unprecedented slump of 6.8%, and appearing to be back on track.

COVID-19, however, still poses a threat to China's economy, despite the fact that it has been contained to a relatively low-risk level since late March. Due to some recent coronavirus outbreaks in areas such as Beijing, Xinjiang, and the northeastern region, China has been very cautious with reopening businesses and allowing economic activities to resume. Restrictions remain in certain areas, limiting business and trade activities. It will likely take an extended period of time for China's economy, especially demand-driven sectors, to recover to the pre-pandemic levels.

With a growth rate of 3.2% in the second quarter, China's economy outperformed what economists had predicted. However, challenges that come from both inside and outside of the world's second-largest economy lurk beneath the accelerating recovery and weigh on future economic growth. The primary concern on the reported V-shaped bounce is the structural imbalance in the recovery of different sectors of the economy. Market analysts see the economic rebound in the April-June period driven by the eased lockdowns, the resumption of activities in factories, ports, shops, and restaurants, as well as stimulus packages from the government. On the other hand, the troika of growth drivers -consumption, exports and investment- appeared to be on a slow track of growth. More importantly, data from NBS show that the demand-side recovery significantly lagged behind the supply-side recovery. Consumption remains sluggish due to the resurgence of COVID-19 in some Chinese cities and declining real income (adjusted for inflation). The growth is mostly driven by capacity improvement, rather than a rise in domestic demand, which could lead to a similar outcome of the 4-trillion-yuan stimulus package in 2008 that resulted in serious supply side problems. The weak consumer demand may take an extended period of time to recover, posing uncertainties for China's economic recovery in the second half of the year.

Although China's industrial production is poised to rebound in the first 6 months, firms appear less profitable than last year. NBS data shows that profits earned by industrial firms fell by 12.8% year-on-year. Low prices, increasing costs, sluggish demand, and disrupted supply chains are the main contributors to firms' profit loss. While China's industrial firms are slowly returning to profitability, the pandemic still poses a threat to the recovery of the global market at least in the rest of the year. Also, weak demand will likely remain a major hurdle to profit growth for Chinese firms in the second half of the year.

While China's economy was on the track of recovery, the unemployment rate remained stubbornly high in the first half of 2020. China's labour market has undergone substantive stress since the pandemic broke out, and continued to suffer from an increasing number of job losses among the group aged between 16-24, most of whom are fresh college graduates. The slowing economy, firms' weak recruitment needs and an increasing number of new graduates are three key contributors to a gloomy labour market. Employment is the top priority of the "six priorities" strategy which is central to China's recovery plan.[2] Waves of job losses and pay cuts from earlier this year have impeded the income growth[3] and attenuated the spending power of consumers that the government has increasingly counted on in recent years to stimulate GDP growth.

Mounting external challenges may slow down China's economic growth in the next few months. First of all, the impact of the COVID-19 pandemic has seriously weakened global demand and disrupted global supply chains. As the pandemic persists, China's exports are recovering slowly; however, sagging demand in developed markets poses a major hurdle for China to achieve an export-led recovery. Many Chinese manufacturers are still facing and may continue to face reduced or cancelled overseas orders. China's imports, which have already struggled to keep pace with exports, are further lagging due to weak demand and perceived risks associated with imported foods such as salmon and poultry for their potential exposure to coronavirus.

Deteriorating geopolitical relations with some major economies also adds uncertainty to China's ambitious recovery. The US-China conflicts, sparked in 2018, have continued to worsen during the pandemic and is a key contributor to China's deteriorating geopolitical environment. The US-China trade war remains a threat to China's trade and investment activities, although the Phase One agreement signalled a temporary truce. China's tech giants (e.g. TikTok and WeChat) have been recent targets of the broadening U.S. boycott of China, in part due to this intensifying geopolitical struggle. The U.S. is not the only country whose ties with China are deteriorating. In the first half of 2020, China experienced tension with many of the world's major economies including the EU, India, Canada, and Australia. The consequences included sanctions on Chinese businesses operating in these countries and the interruption of goods distribution in the global supply chain. The worsening geopolitical environment is an ongoing threat to China's sustainable recovery in the next two quarters.

After China released data indicating a strong recovery in the second quarter, many economists have upgraded China's full-year GDP forecast. Projections of China's 2020 growth by major international economic research groups for 2020 fall between 2%-3%. A survey conducted by Bloomberg shows that China's economy will expand 2% this year. A Reuters poll of 42 analysts predicted an economic expansion of 2.2% in 2020. UBS Group AG raised its forecast from 1.5% to 2.5%, due to the steady recovery in investment and consumption. Economists in China have predicted an average growth rate of 2.9%, which are more optimistic based on their confidence in the government's stimulus efforts and significant improvement in major economic indicators. However, the International Monetary Fund (IMF) was pessimistic about China's annual growth in 2020, with a projected rate of only 1%. Given the internal and external challenges China is still facing while recovering from the impact of the pandemic, the country's economic outlook in the second half of 2020 is far from certain. Although the official data indicates a strong recovery in the second quarter, stimulus-driven growth may not be sustainable. Given the ongoing challenges, China is using a calibrated policy approach which is summarized as "six stabilities" and "six guarantees" instead of setting a numerical growth rate for the year.[4] The economic slowdown due to the coronavirus outbreak has made it more challenging for China to accomplish its self-identified goal of building a "moderately prosperous society" by 2020, especially in poverty eradication and doubling per capita income.

[2] "Six priorities", also known as "six stabilities", referring to ensuring stability in employment, finance, foreign trade, foreign investment, domestic investment, and market expectations.
[3] The NBS data shows that the real disposable income (adjusted for inflation), per capita fell by 1.3% in the first half of 2020.
[4] "Six stabilities" mean to ensure stability in employment, finance, foreign trade, foreign investment, domestic investment, and market expectations; "six guarantees" refer to guaranteeing employment, basic livelihoods, market order, food and energy security, the stability of industrial supply chains and the operation of local government functions.