China's Uneven Economic Recovery[1]

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Abstract: While China's economy is slowly recovering from the COVID-19 pandemic, it would be quite difficult for it to return to the pre-pandemic level. Besides the lingering effects of the anti-pandemic measures and expectations, the weak external and domestic demands are also impediments to economic recovery. For the economy to return to the pre-pandemic level, a loose policy environment is essential. Specifically, the policy should be focused on maintaining a low and stable interbank interest rate. Meanwhile, China should explore new growth drivers by establishing pilot reform zones

China's economic recovery at present is akin to a postoperative recovery—the condition is continuously improving but still far from normal and is at risk of deterioration with a weak foundation. The deterioration of external economic environment will continue to put a damper on China's export; the drastic worsening of corporate sector's balance sheet in early stage of the pandemic will hinder investments; and the contribution of fiscal expenditure to economic growth is limited. A loose policy environment will be essential for the economy to return to normal and the policy focus should be on keeping the interbank interest rate low and stable so as to indirectly bring down the financing costs. Meanwhile, China should seek new drivers of growth by establishing various pilot zones.

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I. The economy is on the mend

The latest data show that major macro indicators are improving. Industrial production has seen the fastest recovery, followed by investment and consumption. The average daily coal consumption of China's six electric power generation companies in May was 627,000 tons, surpassing that of the same period last year. The work resumption rates of many industries including steel, textile and tyre in May were basically on par with the historical average, with the weekly output of deformed steel bar reaching a record high of over 3.91 million tons. The fall in completed total social fixed asset investments has also narrowed significantly compared with a few months ago. **As for investment, infrastructure investment has seen the strongest recovery, followed by real estate investment, while the recovery of manufacturing investment was the weakest.** The recovery of retail sales has been relatively weak, and the recovery of automobiles sales has seen divergent trends—while the year-on-year (yoy) growth of passenger car sales remained roughly the same, that of commercial car sales in April was over 30%. Meanwhile, the growth of commercial house sales is also improving with a continuously recovering yoy growth rate.

Economic recovery mainly benefits from two factors—the removal of supply constraints and demand postponement. On the one hand, as the novel coronavirus gets under control inside China, many provinces have lowered the emergency level. Thanks to this, the constraints on companies' normal production have mostly been removed, and the supply has seen faster recovery. On the other hand, some of the consumptions, exports and business expenditures which should have been realized in the first quarter were postponed due to the pandemic, for example the consumption of cars and homes, production orders of export companies and the construction of new houses. **The aggregate demand at present in fact consists of two parts**—new demand in the current quarter and the demand postponed from the peak of the pandemic. These two forces together are driving China's current economic recovery.

II. China’s economy hasn’t yet returned to its normal condition

The economy can be seen as having rebounded to normal when economic activity returns to the pre-pandemic trend level. At present, **a large part of the economy hasn’t yet returned to normal**.

Surveyed urban unemployment remained high, reaching 6% in April, much higher than the historical average around 5%. According to the Ministry of Commerce, the work resumption rate of businesses which provide daily life services has reached 80%, but as consumers are still cautious about attending offline economic activities, customer traffic and income still remain low for many businesses. It is evident that many restaurants and taxi businesses are underperforming compared with pre-pandemic period.

The yoy growth rates of investment and consumption have not yet turned positive and are still far from their pre-pandemic normal levels. Even the industrial sector which has seen a relatively faster recovery has not yet completely recovered. The revenue growth of industrial enterprises yoy in April was 0.4%, but the yoy growth of profit was -7.25%. There is significant performance divergence in the industrial sector: among the 39 subsectors, 18 saw negative yoy growth of revenue and 19 saw negative yoy growth of profit in April, most of which were middle- and up-stream enterprises. The situation is expected to be improved in May.

III. The foundation of economic recovery is weak

Besides the residual effect of anti-pandemic measures and expectations, weak external and domestic demands are also impediments to economic recovery.

As the impact of the COVID-19 pandemic on global economy has surpassed that of the

2008 global financial crisis, the negative effect of the pandemic on China's export is also significant. The growth of US dollar-denominated exports was 3.5% in April and -3.3% in May. The spread of the virus outside China began to accelerate in March but has not yet been contained so far. Meanwhile, the negative effects of the decrease of external demand and restrictions on the movement of people, capital and goods on China continue to fester, and the performance of export is expected to continue to deteriorate.

Domestic demand is also worrisome, which is reflected in the marginal change of balance sheet of each economic sector.

The drastic deterioration of corporate sector's balance sheet will continuously dampen its investment demand. As the most important financial assets and liabilities of non-financial institutions are loans and deposits at banks, the difference between loans and deposits of non-financial institutions can be used to measure the marginal change in their balance sheets. Over the past ten years, the loan-deposit gap has displayed significant cyclicality, moving between -4 trillion yuan and 2 trillion yuan. Though it had been narrowing since 2018 to a 10-year low right before the outbreak, the gap further decreased to -12 trillion yuan after the outbreak, indicating a severe deterioration in the balance sheet of the corporate sector.

The reason for this phenomenon is that business revenue amid the pandemic has been greatly reduced, while the operational spending including the cost of labor and other production factors have not decreased much. In comparison, the overall expenditure of the residential sector during the outbreak has fallen sharply, more so than the drop in income, so the net assets of this sector have actually increased. Similar changes in the balance sheets of the corporate and residential sectors have been observed in other countries during the pandemic.

The widening of the loan-deposit gap has brought pressure on enterprises to repair

their balance sheets, which will further suppress the investment needs of the corporate sector. Historically, the loan-deposit gap of enterprises has shown obvious periodicity, and it is basically consistent with the periodicity of industrial enterprises' revenue, profit and investment. From 2011 to 2015, the loan-deposit gap in the corporate sector kept expanding, and the growth rate of manufacturing investment during the same period saw sustained decline. In 2016, the profitability of the industrial sector improved significantly, and the loan-deposit gap quickly narrowed, but investment remained sluggish and did not increase accordingly. It was not until the end of 2016 that the loan-deposit gap returned to the historical average level before the investment in manufacturing started to increase steadily.

The government sector is seeing the largest scale of government borrowing but the lowest growth rate of public fiscal expenditure since 1994. According to data released at the two sessions, China will add 8.5 trillion yuan to its government debt in 2020. Both the deficit scale and deficit ratio are at the highest level since 1994. However, these debts by large are to make up for the loss of government revenue caused by the pandemic (from January to April 2020, public financial revenue totaled 6.2 trillion yuan, a decrease of 1 trillion yuan from the same period last year) and maintain its normal expenditure. According to the latest fiscal budget report, China's public fiscal expenditure in 2020 is set to be 24.785 trillion yuan, a yoy growth rate of 3.8%, the lowest since 1994. A yoy growth rate of 4.1% of public fiscal expenditure can hardly drive the nominal GDP growth rate this year. When local government special debt is taken into account, the yoy growth rate of general government expenditure will be higher, reaching 9.6%. This growth rate can positively drive the normal GDP growth, but it is still lower than that of 2019, being a relatively low level in recent years.

The net assets of the residential sector increased. During the outbreak, the expenditure of the residential sector has drop much more than the income. Residents' deposits minus loans rose sharply. In the first quarter, the residential sector's deposit-loan gap reached a record high, increasing by 5.3 trillion yuan in a single quarter. This provides important support for the rapid recovery of household expenditure. Although the overall balance sheet of the residential sector has been strengthened passively, there are also significant differences within the sector. The middle class has increased savings passively as their wage income remains stable, while migrant workers have suffered a greater loss of income, whose savings are likely to decline and the corresponding balance sheet will be deteriorating rather than improving.

At present, the construction industry where a large number of migrant workers are employed is in a relative boom. The overall PMI and employment of the construction industry have rebounded rapidly, significantly higher than other industries. This helps alleviate the cash flow pressure of migrant workers. If new demand fails to grow, the construction industry will slump quickly, and the migrant workers will again face unemployment pressure.

IV. Restoring the economy still requires a loose policy environment

Judging from the changes in the external environment and the balance sheets of various departments, we believe that consumption will pick up relatively slowly; exports will continue to face tremendous pressure; corporate investment will be sluggish. The current situation of infrastructure investment and real estate investment is fairly well, but **whether the improvements can last will depend on the future policy environment.** Overall, the Chinese economy maintains a normal unemployment rate of about 5%, and a desired inflation level of about 2-3% (which reflects the GDP deflation factor or core CPI of most goods and services). In addition, it is necessary to consider the possibility of recurrent outbreaks and unexpected deterioration of the external environment. **Under such circumstances, a loose policy environment is indispensable for future economic recovery.** As fiscal policy decisions are generally fixed after the two sessions, the key to maintain a favorable policy environment will lie on monetary policy and reform measures.

We need to maintain a low and stable interbank market interest rate so as to drive down financing costs in an indirect way. In the early stage of the outbreak, the People's Bank of China responded in a timely manner and injected more than 1 trillion yuan of liquidity into the market through various monetary policy tools. The DR007 (seven-day repo rate in the inter-bank market) for depository financial institutions dropped rapidly from 2.5% to 1.5%, and the LPR rate was lowered twice, which drove the entire yield curve downward. These measures not only stabilized market sentiment, but also greatly reduced the financing costs and financing constraints faced by the corporate sector, helping companies fill in the liquidity gap caused by the sudden drop in income and successfully weather the crisis.

The interest rate has been much lower than its pre-pandemic level, but it's still too early to send it upward again. The monetary policy moves since mid-May have led the market to expect a policy tightening. DR007 has seen much more violent fluctuations, with the average level back at 2%, 0.5 percentage points higher than in April. As a result, the market found it hard to determine a benchmark interest rate. That could stir up worries among market participants and lead to redemptions and underselling activities which could elevate the interest rates of long-term bonds.

In early June, yield rates of almost all bonds circled back to the level in early March when this wave of monetary easing measures got started. If DR007 remains in such big swings with the current average level, bond rates will likely continue with their upturn, which could possibly counter some of the decrease in loan rates brought by lowered LPR. Besides, the rally in bond rates has also stemmed the issuance of corporate bonds to some extent, as reflected by fewer medium-term notes (MTNs) coming out daily in May than in April or March. **With low inflation and unstable basis for economic recovery at present, monetary policies will have to remain in ease for a rather long period of time**, and maintaining a low and stable level of interbank rate will be the most important factor in reducing the overall financing costs.

China still enjoys huge space for reform to unleash the potential of economic growth. It may as well **explore new growth drivers by establishing pilot reform zones**. This unique way to promote reforms, a most precious experience that the country gathered during its years of reform and opening-up, embodies China's wisdoms in political, economic and social governance. Faced with mounting uncertainties and diverged understandings of future economic growth, pressing ahead with reforms by building pilot reform zones remains an effective way that could avoid aggravating conflicts and incurring high costs of failures.

An important step forward in China's reform and opening-up is the building of the pilot free trade zone (FTZ) of Hainan, which has a unique positioning and serves special experimenting purposes. In addition to Hainan, China could consider launching similar plans in different cities with different positioning and missions, each targeting a specific field of reform in the early stage. For example, cities with sky-high house prices can implement pilot reforms of land policies, especially residential land policies, as well as public transportation to increase the supply of new houses and raise the use value of existing ones. Pilot reforms in cities with big population inflows can focus on providing dwellings for migrant people, especially low-income groups such as rural migrant workers, and supporting them with preferential housing, public service and unemployment insurance policies. What's more, pilot reforms targeting industries with huge growth potentials such as education, public health, sports and entertainment could be carried out in cities with proper conditions. These industries will offer the greatest forces driving the upgrading of household consumption, but their current developments are far from satisfying. The pilot reform zone programs could shed some light on their future paths of growth.