MERICS ECONOMIC INDICATORS

Quarterly analysis of economic trends in China

Q2/2019

China's economy in the 2nd quarter: Controlled shift to lower growth levels

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MERICS Q2 analysis

Tough battles ahead to maintain economic stability

China's economy continues to face headwinds during the second quarter. There were some bright spots such as stronger growth in retail and manufacturing, but concerns about the state of the economy remain. Falling import growth indicates weaker domestic demand, and uncertainty surrounding the ongoing trade conflict with the United States persists. Yet the government is still attempting to sell the story that China's economy is on a stable footing. However, this does not tally with its rollout of looser fiscal and monetary policy. These policy adjustments are clearly part of an ongoing effort to steer the economy into calmer waters.

Government officials, including Premier Li Keqiang, have gone out of their way to stress that a stimulus on the scale of 2009 will not be unleashed. The hope is that by avoiding the term, they are projecting confidence. But the fact is that stimulus is already well underway.

Yet China's economy is facing a different set of challenges compared to the global financial crisis ten years ago. Efforts to support economic growth through stimulus may not be as effective as they were then. Furthermore, the stimulus package risks undoing the progress that has been made in reducing risk in the financial sector.

That is not to say that credit-fueled growth and investments in infrastructure and SOEs will not help stabilize the economy. But the old stimulus measures will not be sufficient this time as the entire structure of the economy has changed significantly since 2009.

That is one reason why the government's main priority is to increase confidence in the private sector. Operating and financing costs for domestic private companies are being reduced, and steps have also been made to improve the business environment for foreign companies including reducing the negative list, which lists sectors that are off-limits to foreign investment. The government hopes that these measures will improve the outlook of private companies and trigger more investments.

However, the Chinese economy is still facing some big difficulties, among them the ongoing trade war, reports of bankruptcies, layoffs, and the African Swine flu. In this deteriorating business climate, our economic index, MCCI, continues to nosedive. If you exclude from the index the component for plans to purchase real estate, the dive becomes even more pronounced.

The government will not want to see a sharp slowdown in GDP growth, so we can expect stimulus measures to continue to be rolled out over the next quarter. These should begin to stabilize the economy after a time lag of a few months.

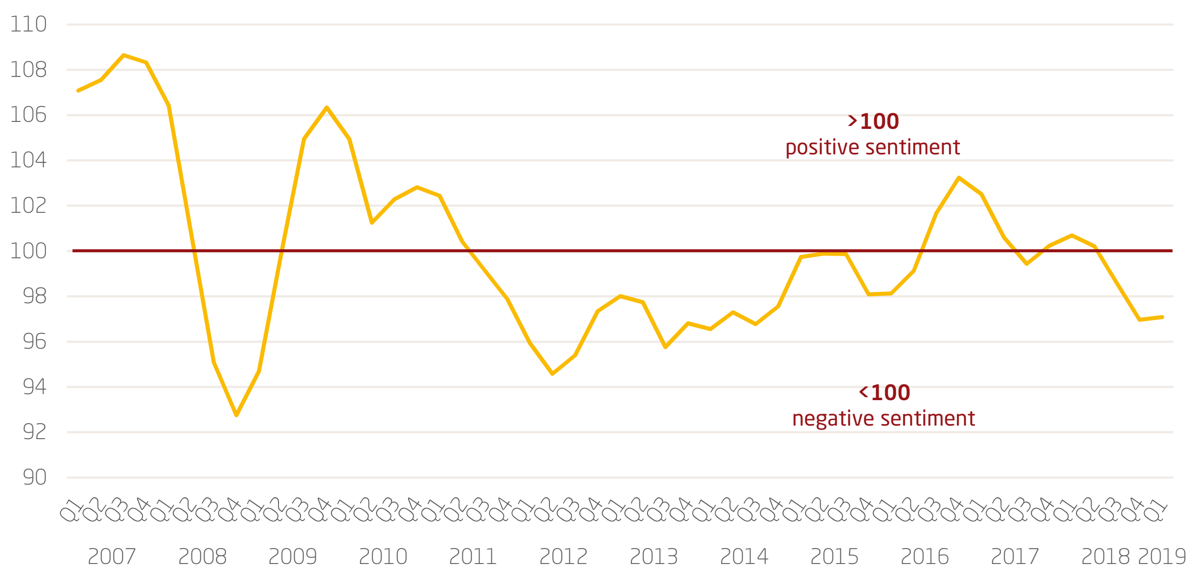
With the CCP quickly approaching its 100-year anniversary in 2021, it will not want the party to be spoiled by a struggling economy. Until then, expect further mood-lifting measures to be the order of the day.

The MERICS China Confidence Index (MCCI)

The MERICS China Confidence Index measures households' and businesses' confidence in future income and revenues. The index is weighted between household and business indicators. It includes the following indicators: stock market turnover, future income confidence, international air travel, new manufacturing orders, new business in the service sector, urban households' house purchase plans, venture capital investments, private fixed asset investments and households' consumption share of disposable income. All components have been tested for trends and seasonality.

The MCCI was first developed in Q1 2017.

MCCI stays in the negative for fourth consecutive quarter
MERICS China Confidence Index



Note: Q2 2018 index was calculated with one missing data point.

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Focus topic: Youth unemployment in China

Get yourself a job: Beijing's measures to tackle rising youth unemployment

By Kristin Shi-Kupfer and Max J. Zenglein

Looking at China's official labor market statistics, all seems well: The latest surveyed unemployment rate in urban areas fell to five percent from a peak of 5.3 percent in February. Likewise, the ratio of labor demand to supply remains close to historic high levels of 1.28. For the first five months of the year the government claims to have created 5.97 million urban jobs, up 20 percent from the same period last year. As in previous years the government seems well on track to reaching its annual target of eleven million new urban jobs.

Given this rosy picture, why then did Beijing create a new leading small group (LSG) for exactly this topic? LSGs are normally only established for major tasks that are particularly challenging. Yet in May, a State Council Employment Work Leading Group was set up, headed by Vice-Premier Hu Chunhua. Its 25 members are the vice leaders of nearly every ministry and institution. Its task: "researching as well as solving the major problem of employment."

Despite the seemingly strong labor market data there is clearly a sense of urgency among China's leadership. Employment policies have been elevated to the status of macroeconomic policy by the government for the first time. In part this has to do with a more long-term structural transformation in the labor market, including technological change, but it also has to do with the current economic slowdown.

Indeed, data from non-government sources suggests a more challenging picture. According to China's Institute of Economic Research (CIER), overall job offerings fell by 7.6 percent, while job seekers grew by 31.1 percent in the first quarter of 2019, lowering the overall ratio between supply and demand from 1.91 last year to 1.68. The Purchasing Managers' Index sub-index on employment has fallen to the lowest level since 2009 for manufacturing and is nearing the historic low for the service sector.

At the Summer Davos meeting in China's northern city of Dalian on July 2, Han Jian, an associate professor with the China Europe International Business School, spelled out the potential impact on employment of the ongoing tensions with Washington, with estimated job losses ranging from 500,000 in the best-case scenario to 27 million in the worst case, according to different institutes' calculations. However, demand for labor had already started falling before the trade war began, caused as much by the slower growth in GDP, a slowdown in the previously booming internet service sector, and by efforts to reign in risks in the financial sector. According to China Market Research Group more than 80 per cent of companies hiring graduates were not advertising for new staff. And more than half had reduced their openings, with banking worst hit.

Still, new businesses in the internet and mobile internet sector have created some 30 million jobs, which, according to Han, indicates that China should be fine. Yet what Han highlights here is both a core feature of China's employment policy for graduates and a structural problem of the labor market. How does the country create jobs for the 8.34 million students who will graduate from its universities this year? Different regions have been experimenting with different solutions. The province of Jiangsu, for example, is offering students the opportunity to apply for a two-year social service-related job. In Beijing, meanwhile, one key solution for the country is to allow the record number of graduates in 2019 to become self-employed and, ideally, drivers of mass innovation. Described as "big masses create employment (=businesses), ten thousand masses create innovation (大众创业，万众创新)", the policy was initiated by Premier Li Keqiang in May 2014.

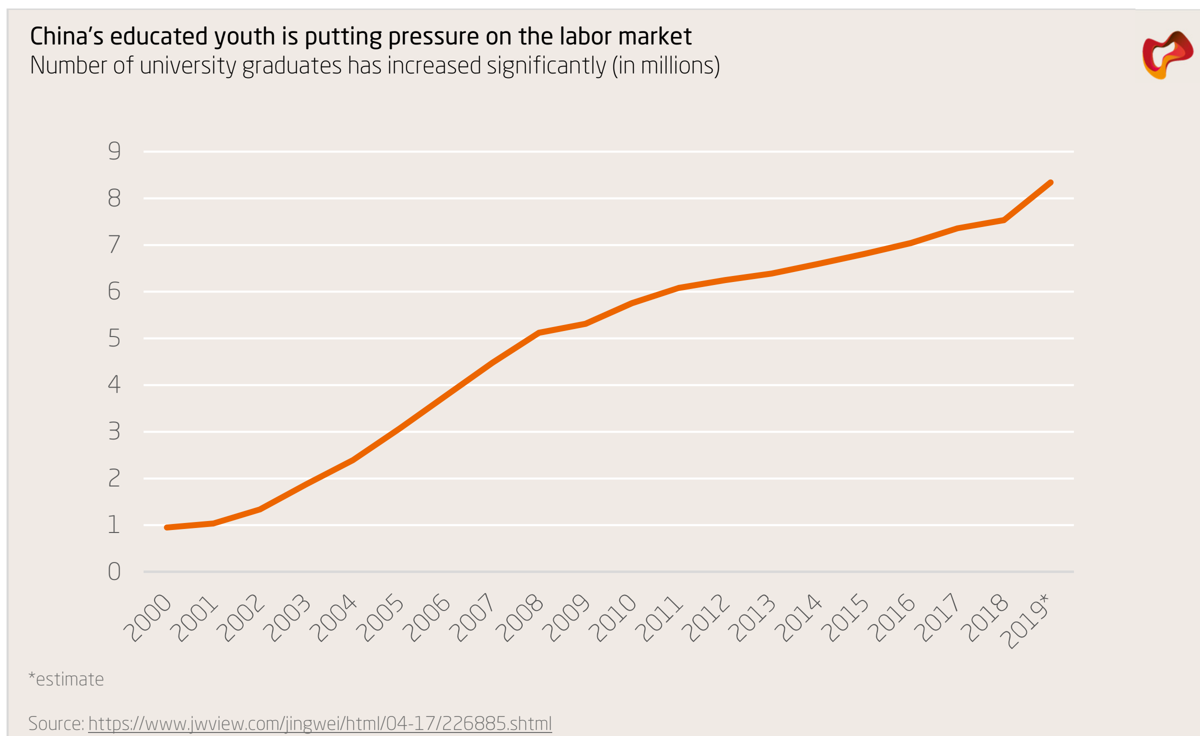
The city of Tianjin, by contrast, has decided to focus on offering special support for young graduates between 16 and 35 who have been unemployed for over a year. Among the offerings are guided tours through start-up parks, meetings with potential investors and access to specific seed funding.

The results of these employment initiatives are not easy to assess given the fierce competition in the start-up sector and the frequent race-to-the-bottom in terms of pricing, particularly in industries such as food delivery and transportation. Making a decent living in the medium term might remain a distant dream for many of those who have founded start-ups or are employed in these service industries.

This also reflects changing expectations among the young urban middle class. Many graduates end up in jobs with salaries that are a far cry from their original expectations. According to the online job platform Zhaopin, while a third of graduates are looking for monthly salaries of between 6,000 CNY (US$868) and 7,999 CNY (US$1,158), only 18 percent actually achieve this, adding to the social pressure young graduates face in finding adequate jobs. The problem, it claims, lies in a stark mismatch between what companies are looking for and what the labor market offers. For instance, even though demand for employees in the intermediate services sector increased by 25 per cent, applications from graduates declined 21 per cent.

It is not only that there is a mismatch in terms of sectors, but also in terms of expertise requirements and choice of lifestyle. Take the example of software engineers: Companies like Jingdong or Tencent offer up to 700 CNY per hour, yet still they struggle to find suitably qualified candidates. Meanwhile, the recent public outcry by young IT engineers, following Jack Ma's call to enjoy working hard from 9am to 9pm six days a week, is a clear indicator that there is also a mismatch in terms of lifestyle expectations.

Growing dissatisfaction and disappointment among graduates have led to the creation of a small, but nevertheless active group of young "leftist" students in Southern China who are committed to improving labor rights and workers' rights. Beijing is worried that this youth movement could form potential alliances and bring graduate employment perspectives to the top of the agenda. If unemployment levels among middle class graduates grow, the structural problems in the employment market could turn into a larger socio-political crisis that Beijing would struggle to control.



China's educated youth is putting pressure on the labor market
Number of university graduates has increased significantly (in millions)

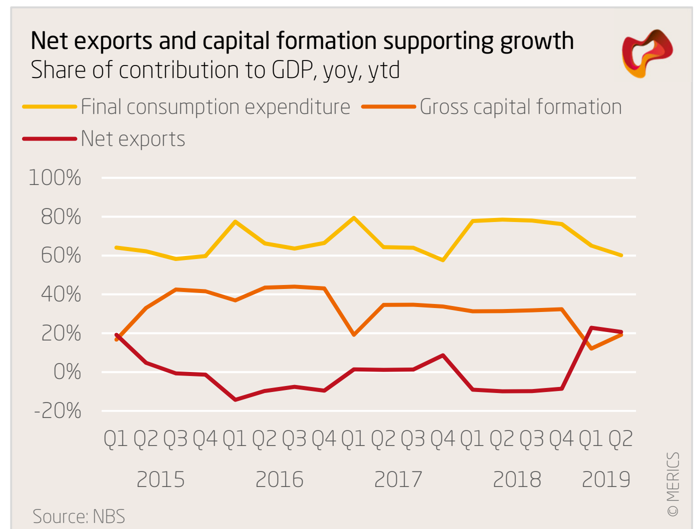
*estimate

Source: https://www.jwview.com/jingwei/html/04-17/226885.shtml

Macroeconomics

Mixed signals as GDP growth stays resilient in Q2

- Service sector and manufacturing show signs of further slowdown
- GDP growth is nearing the lower end of government growth target

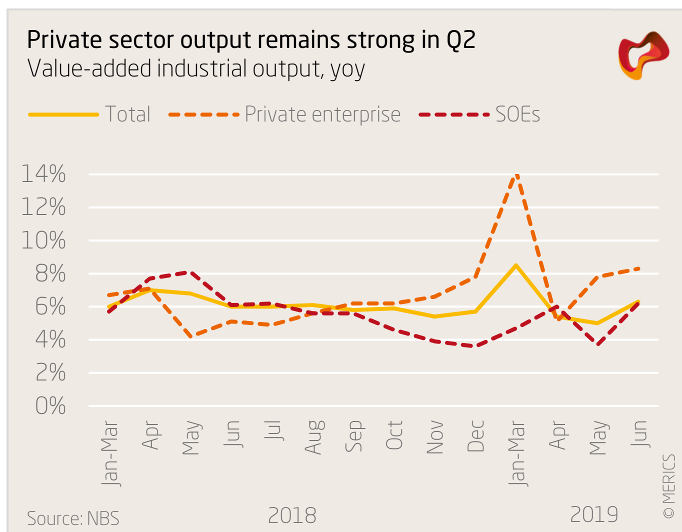


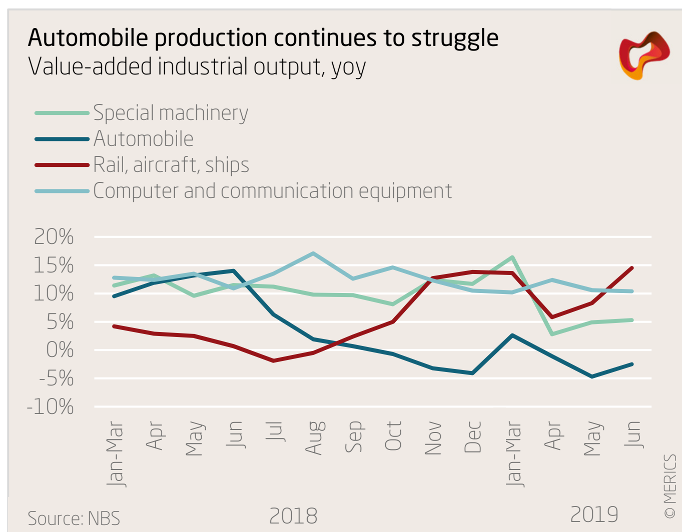
- China's GDP growth continued to slow in Q2 to 6.2 percent, its lowest rate in 27 years. The economy expanded over the first half of the year by 6.3 percent, which is well in line with the government's growth target of between 6 and 6.5 percent. For now, China's economy is continuing its gradual shift to lower growth levels in a controlled manner.
- Faced with the ongoing trade war with the US, weaker global demand, and domestic woes, the government will be concerned to ensure that growth does not fall below 6 percent. Further stimulus and efforts to increase confidence in the economy can be expected if the slowdown becomes more pronounced.
- The government has some firepower in reserve to boost growth. Total tax cuts for business and individuals amounted to almost 900 bn CNY in the first five months, but with a planned total of 2 tr CNY in tax cuts for the year, the government still has room for further fiscal stimulus.
- Compared to the previous quarter service sector growth remained stable at 7 percent. Although growth in the IT sector fell from 31.7 percent in Q2 a year ago to 20.1 percent, this is mainly attributed to base effects. Finance sector growth picked up to 7.6 percent, its highest level since Q1 2016 during the onset of the government's deleveraging campaign.
- Service sector growth was strong enough to compensate for a slowdown in manufacturing and construction, which expanded by 5.5 percent and 5.1 percent respectively.
- Measured by expenditure, final consumption's share of GDP growth fell from 78.5 percent during the same period last year to 60.1 percent. With imports falling more severely than exports, net exports continue to carry growth in 2019. Net export's share of growth was slightly down from Q1, but still accounted for 20.7 percent. The uptick in gross capital formation's share to 19.2 percent is mainly due to seasonal reasons.

Business

Manufacturing is the bright spot in the economy

- Industrial output so far unaffected by the trade war
- Negative sentiment in PMI could hint at slowdown over the next quarter



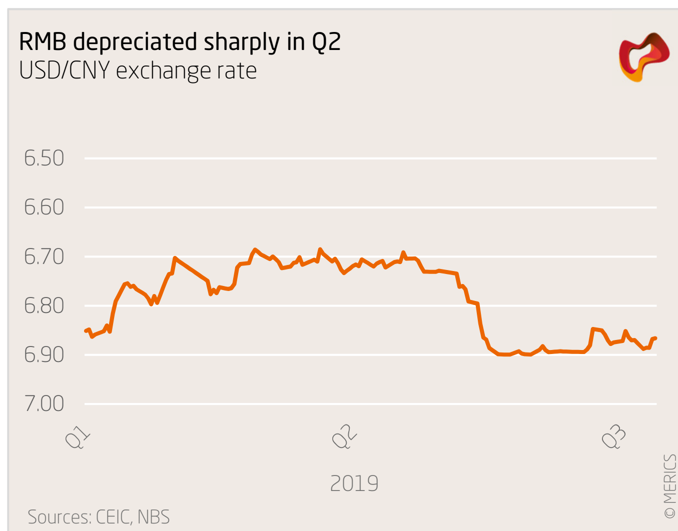


- Value-added industrial output picked up growth to 6.3 percent in June, expanding by 6 percent in the first half year. Compared to last year growth is more volatile but, so far, the manufacturing sector is robust. The private sector in particular continues to drive growth in industrial output, however SOE activity also rebounded in June.
- The strong performance in industrial output comes amid deteriorating sentiment as captured by the official Purchasing Managers' Index. The index for the manufacturing sector remained below 50, indicating negative sentiment, for two consecutive months. Outlook within the sub-category for new orders turned negative following an improvement in March and April, while sentiment for new export orders continued to fall.
- Despite the manufacturing sector's overall strong performance over the second quarter, the government will remain vigilant. Further measures in support of China's private sector manufacturers have already been announced. Efforts included better access to funding, tax cuts, reduction of administrative fees and social insurance contributions, and incentives to invest in strategically important areas, such as high-tech.
- Boosted by stronger stimulus measures, production of transportation equipment, especially rail, expanded by 14.5 percent in June. Export heavy computer and communication equipment were largely unaffected by the escalating trade war. Output in the sector grew by 10.4 percent in June.
- Automobile production continued contracting in June (-2.5 percent). This is mainly due to China introducing tougher emission standards in July 2020 and local governments already banning cars with the old standards. Another reason for the fall is continued policy support in favor of electric vehicles. This is clearly visible from a large increase in the output of e-vehicles. In June, output expanded by 50.5 percent.
- Output of machinery slowed over the quarter, hinting that companies are holding back in expanding production capacity. General and special manufacturing equipment slowed to 2.6 percent and 5.3 percent respectively in June while the production of industrial robots contracted by 11 percent last month.

International trade and investment

Trade growth stalls

- Chinese trade surplus increases as imports shrink
- Leaders reach temporary truce in trade war, but no resolution in sight

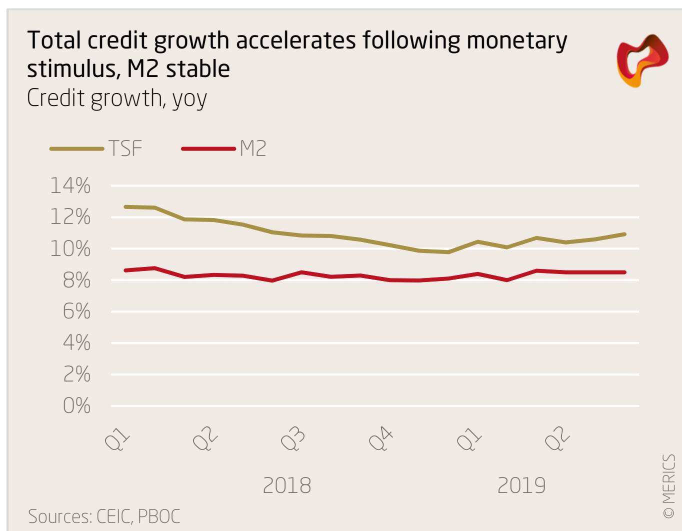


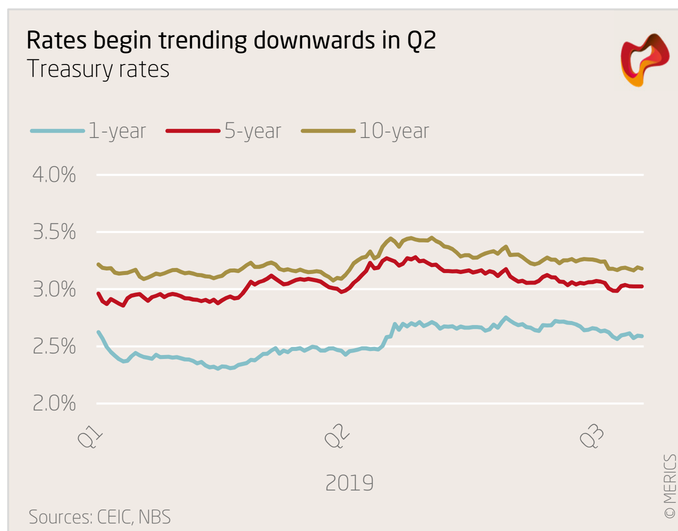
- Both export and import growth were disappointing in Q2. Exports were only 0.1 percent greater than the same time last year, imports on the other hand contracted by 4.3 percent. Weaker external demand is the most likely cause of the poor performance of exports, with both the slowdown in global growth and China's ongoing trade conflict with the US playing a part. The more pronounced negative effect on imports is likely due to the RMB depreciating in Q2. Export patterns remained stable with most exports bound for Asia and a roughly equal share bound for North America and Europe.
- The contraction in imports caused the Chinese trade surplus to increase further. In Q2 China exported roughly $106 bn more than it imported, an increase of $30 bn from the previous quarter. Interestingly China's trade surplus with the US also expanded, despite tariffs. Half of the increase in the overall surplus – $15 bn – was due to trade with the US.
- Trade tensions with the US have been volatile. On May 10, US President Donald Trump raised previous tariffs of 10 percent on $200 bn to 25 percent. The US has also targeted Chinese telecommunications giant Huawei, making it more difficult for it to operate in the US. In response, China raised tariffs on $60 bn worth of US goods in June. Things appeared to look up at the end of June, as Trump and Chinese President Xi Jinping met during the G20 summit in Osaka, Japan. A "truce" was announced, and Trump said no further tariffs would be implemented. Still, no resolution is in sight.
- The imposition of tariffs in May put the RMB into freefall against most major currencies. In May the onshore price of US dollars increased from 6.72 to 6.90 RMB, where it then stabilized. The RMB behaved similarly against the euro and a basket of currencies. However, despite the fall, official foreign currency reserves increased from 3.1 to 3.12 tr USD.
- In Q2 inbound direct investment into China remained greater than outbound investment. FDI grew by 3.5 percent in Q2 while non-financial outbound investment contracted by 5.6 percent. The difference in the growth rates is likely due to a combination of factors. Inbound investment was driven by improvements in market access for international investors including measures such as a reduced negative list, better foreign investor protection thanks to a new investment law, and more access to financial markets. The fall in outbound investment is likely related to both capital control restrictions and the reduced value of the RMB.

Financial markets

Markets respond to government stimulus measures

- Credit growth picks up again as growth becomes number one priority
- Climbing stock market and falling yields reflect a more liquid market





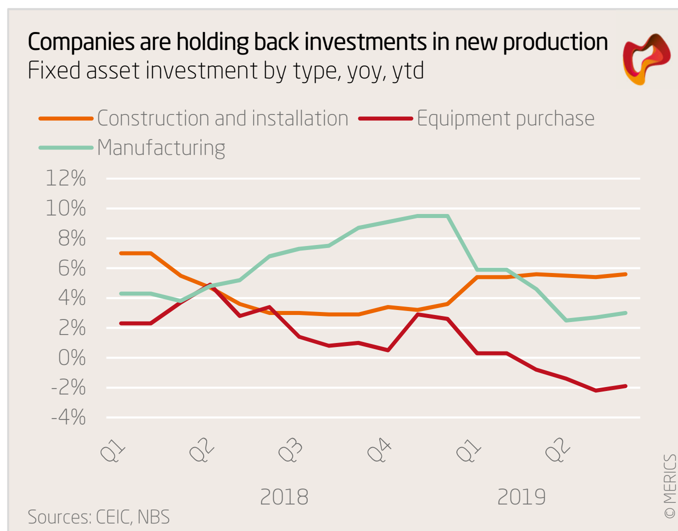
- The Chinese government has continued loosening monetary policy in support of economic growth. Liquidity has been released through both open market operations and further reductions in banks' required reserves. A continued focus of the stimulus has been to provide the private sector, specifically, with ample credit. Officials frequently describe their policy as "targeted irrigation", as opposed to flooding the market.
- As a result of the accommodative monetary policy, credit growth has begun to accelerate again. This suggests the government's deleveraging campaign is no longer the top priority. By the end of Q2 total credit as measured by total social financing, which includes several shadow banking elements, had expanded by 10.9 percent compared to the same time the year before.
- The largest part of aggregate credit remains bank lending, which grew at 13.3 percent – slightly lower than in the previous quarter. Bond issuance increased, growing at 11.24 percent, reflecting a government drive to improve transparency in the financial system by swapping debt for bonds.
- In the second quarter bond yields have been trending downwards. The yield on a five-year treasury bond has fallen by more than 20 points since mid-April. Falling yields reflect both ample liquidity conditions and weak demand for financing. They also mean that Chinese rates remain dangerously close to US rates, making it attractive to move capital out of the country.
- A big trouble spot, which is likely to continue plaguing the financial system, is defaults. The latest example is that of Baoshang bank, which could not service its debts. The government stepped in and claimed ownership of the bank, announcing that depositors' losses will not be covered completely. This sends a strong signal to the market that implicit guarantees may not be as strong as previously believed. In the second half of this year and into 2020 we are likely to see more defaults as China faces peak bond repayments.
- The stock market has performed well in 2019 so far. The Shanghai and Shenzhen stock indices have expanded by 19.2 and 25.1 percent respectively since January 1. The stock market appears increasingly to be driven by policy rather than fundamentals. When good news about the trade conflict with the US surfaces the stock market climbs, whereas bad news sends it falling. Likewise, monetary injections drive the market up.
- China has continued opening its financial markets to international investors. The latest and most prominent example of this is the opening of the London-Shanghai Stock Connect, which enables listing of depositary receipts in both markets. This is the first time that foreign companies will be able to float stocks in the Chinese market – a real milestone. Another example of improved foreign access to Chinese markets is the announcement that foreign companies will be able to take controlling shares of Chinese securities companies sooner than planned.

Related MERICS research: China's caution about loosening cross-border capital flows

Investment

SOEs help stabilize investment activity

- Despite uptick in June fixed asset investment falls in Q2
- Investment in manufacturing remains weak

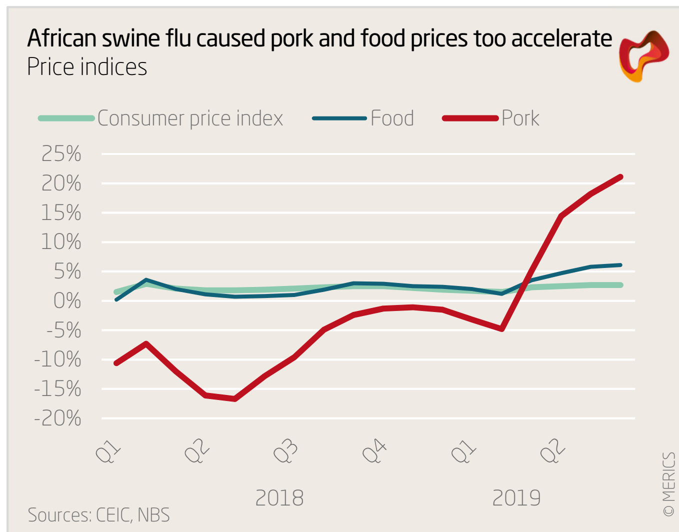


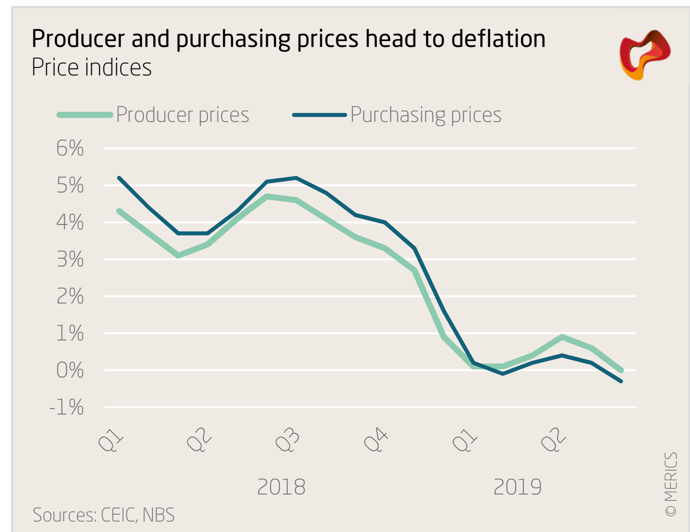
- In June fixed asset investment expanded by 5.8 percent, up slightly from the previous month. Half-year fixed asset investment expanded at 5.8 percent, down from 6.3 percent in the first quarter. The fall comes despite the growth in SOE investment, which continued growing at a faster pace (6.9 percent) than private investment (5.7 percent) in June.
- SOE investment was driven in particular by increases in mining and railway construction, expanding by 22.3 and 14.1 percent respectively. Overall infrastructure investment grew by just 4.1 percent but is likely to increase once newly approved projects start construction.
- The government has been trying to stimulate private sector investment using a range of tools, including instructing banks to increase their lending to smaller private businesses. These measures are so far only having a limited effect as private sector investment growth slowed to 5.3 percent in May, the lowest since 2016. The slight uptick in June to 5.7 percent still seems on the weak side.
- Weaker investment by the private sector is also weighing down investments in manufacturing. Growth has stabilized at around 3 percent in the second quarter after a steep slowdown over the first quarter. Weak investment growth in new equipment indicates that companies are holding back on expanding production capacity.
- Investments in tertiary industry grew by 7.4 percent, carrying overall investment. Growth was above average in IT, finance as well as real estate related services.
- A large share of the growth corresponds to residential buildings, investment in which grew by a whole 15.8 percent. It is likely that developers are responding to increasing house prices across the country. The uptick in real estate investment is not completely reflected in the real estate sector as a whole, however. Building sales remained relatively stable, growing at 5.6 percent, and land sales contracted by 37.6 percent.
- Primary industry, on the other hand, contracted for the first time since 2004. This sector, which is mostly comprised of agri-culture, contracted by 0.6 percent.

Prices

Soaring food prices hit consumers

- Uptick in consumer inflation is driven by African Swine Flu and ongoing trade war
- Producer prices return to deflationary territory



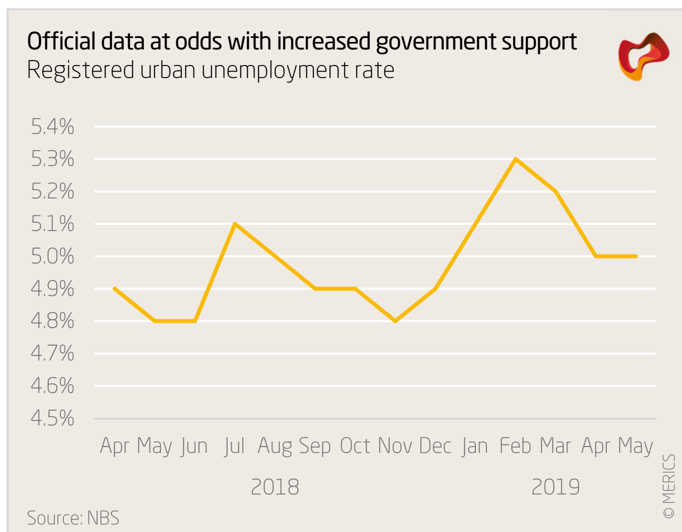


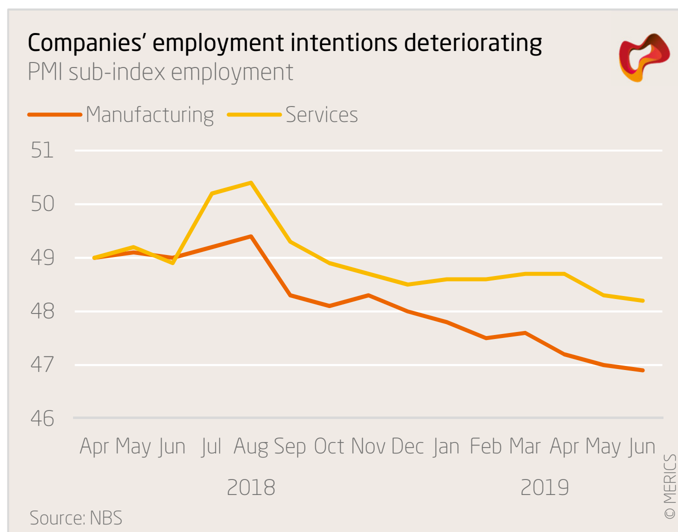
- Consumer prices, mainly driven by food prices, have begun to increase in the last four months. In June CPI grew by 2.7 percent, which is still below the official inflation target of 3 percent. The NBS's broadest index of food prices grew by 6.1 percent in June. The effect of food prices is highly visible from core CPI, which does not include food – this indicator only grew by 1.6 percent. The effect of increasing food prices is significant as Chinese households spend more than a fifth of their income on food, according to the World Economic Forum.
- There are two major reasons for accelerating food prices. First, a serious outbreak of African Swine Flu has ravaged Chinese stocks of live pigs. In June pork prices increased by 21 percent. The second reason is the trade war with the US. China has introduced tariffs on American agricultural products such as soybean and sorghum, some of which is used as feed for live animals.
- Real estate continued growing at a fast pace. Average house prices in the 70 cities tracked by the NBS grew by 10.8 percent. Only in first-tier cities such as Beijing and Shanghai, where property controls are in place, was price growth more muted.
- On the producer side the story was the opposite. Output prices have flat lined, growing at zero percent in the last two months. Mining and quarrying, growing at 4.5 percent, have kept overall producer prices from falling. Light industry contracted by 0.9 percent, and heavy industry by a whole 4.4 percent. Falling producer prices reflect weak internal and external demand.
- There is increased risk over the coming quarter that producer prices will return to negative territory for the first time since 2016. The authorities are likely to take falling producer prices very seriously as these could affect corporate profits further. Profits contracted by 2.3 percent in the first five months. This may bring further complications such as layoffs and increasing financial difficulties, potentially leading to defaults.
- Weaker industrial demand has also pushed down prices for input factors. Overall purchasing prices contracted by 0.3 percent in June. Fuels (-0.2 percent), non-ferrous metals (-3.5 percent), chemicals (-4.7 percent), timber products (-3 percent), and textiles (-0.1 percent) all contracted. Ferrous metals (4.3 percent), building material (4.3 percent), and agricultural products (1.9 percent) increased. The price increases of ferrous materials and building materials are both likely to be tied to government stimulus, which has driven up construction across the country.

Labor market

Government expands employment support measures as risks rise

- Discrepancy between official unemployment rate and non-government indicators grows
- Government claims labor market is stable, despite introducing new support measures



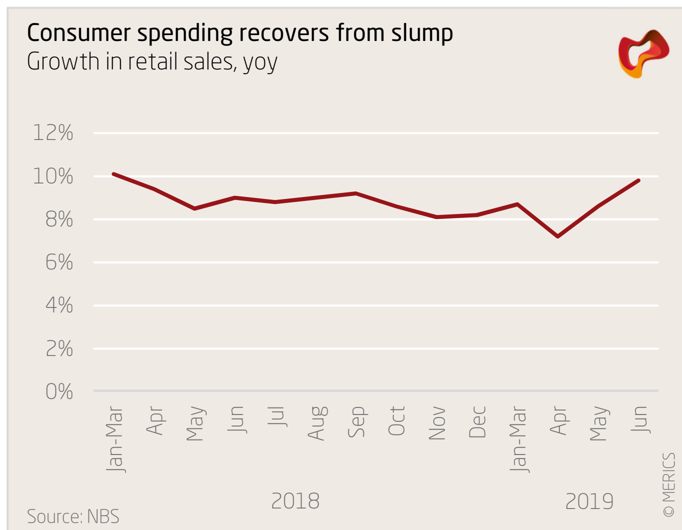


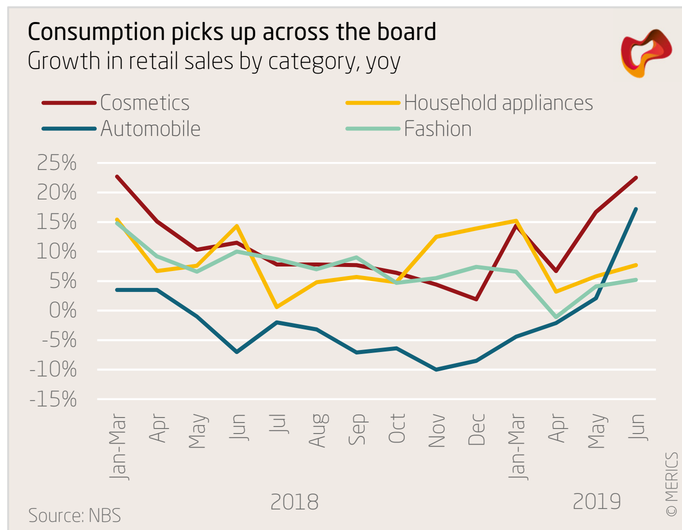
- Faced with slower GDP growth and increased uncertainty surrounding the trade war, the government is keen to communicate the message that the labor market remains stable. During the Summer Davos meeting in Dalian Premier Li Keqiang suggested that the economy would stay within a "reasonable range" of full employment.
- The highly contested official surveyed as well as registered unemployment data in urban areas have continued to fall. Between January and May, a total of 5.97 million new urban jobs were created, up by a million compared to the same period in 2018. The official employment demand and supply ratio remains at historically high levels suggesting that companies cannot fill their vacancies.
- Non-government indicators give more reason for concern. Both manufacturing and service sector companies' intentions to hire new staff are deteriorating. This can be seen from the employment PMI sub-index, which is below 50, indicating falling demand. The China Labour Market Index calculated for the first quarter (latest data available) by Renmin University and online job market Zhaopin suggests that job seekers are struggling to find employment. This is accompanied by a consolidation in the tech sector amid fierce competition and slower growth. The sector has previously been a crucial source of new jobs.
- In a sign that there is a sense of urgency, the Chinese government has for the first time raised labor market polices to the same level of importance as monetary and fiscal policies.
- Both central and local authorities have continued to roll out new policies in order to reduce labor costs for companies and to stabilize employment.
- In April the State Council announced efforts to reduce employers' pension contributions from 20 percent to 16 percent, while a possibility for temporary reduction of unemployment and work injury insurance was extended to the end of April 2020. The manufacturing and export hub Guangdong announced efforts to reduce private companies' labor costs by 20 billion CNY by the end of the year. The measures include subsidies and incentives for companies that refrain from making layoffs.
- Following the introduction of the new individual income tax, the Ministry of Finance and the State Taxation Administration exempted eleven further sources of income from taxation in order to stimulate consumption amid falling wage growth.

Retail

China's consumers defy economic headwinds

- Government rolls out action plans to boost consumption
- Strong retail sales conflicts with weaker imports





- Consumer retail spending continued to improve over the second quarter with growth accelerating to 9.8 percent in June. For the first half retail growth expanded by 8.4 percent while online sales grew by 21.1 percent. The improvement over the past three months will be a relief for policy makers.
- Over the second quarter growth across most categories picked up. Efforts to help clear inventory which was building up at car dealers helped boost growth by 17.2 percent in June, following 11 months of contracting sales. Cosmetics, fashion and household appliances expanded by 22.5 percent, 5.2 percent and 7.7 percent respectively. However, concern about the longevity of the uptick remains. In Q2 imports continued contracting, indicating weaker domestic demand.
- In June the National Development and Reform Commission (NDRC), Ministry of Ecology and Environment and the Ministry of Commerce issued the "Implementation Plan to Promote the Upgrading of Key Consumer Products and Recycling of Resources 2019-2020". The plan aims to provide incentives to boost consumption, particularly for 5G devices, new energy vehicles and environmentally-friendly home appliances.
- Other measures to stimulate consumption unveiled included efforts to upgrade online as well as brick and mortar infrastructure. Among these were plans announced by Beijing and Shanghai to expand and upgrade shopping facilities.
- The Ministry of Finance also announced reductions of tariffs on imported goods on several product categories including cosmetics and baby products. This will lower the costs consumers have to bear.
- Consumer confidence measured by the NBS remains near historic highs of above 120 points but seems to have hit a ceiling. The government continues to be highly concerned about consumption and is likely to roll out further stimulus in the form of tax breaks.