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Questioning market optimism around the Chinese economy

16 February 2022

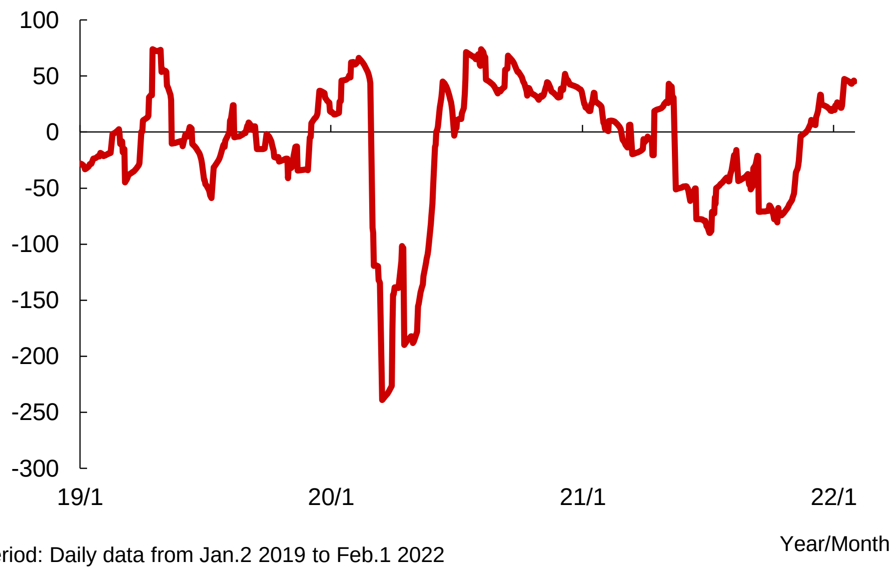
- Market consensus has become that the Chinese economy will pick up after mid-year given the growing number of data indicating that the economy has bottomed out.
- AMO believes otherwise; given limited scope for the Beijing government to expand fiscal spending and monetary easing, and the extent of downward pressure on the economy, we believe it is difficult to be optimistic about the Chinese economy.
- The Chinese economy is currently in a policy recession, with significant downward pressure from government policy - particularly the zero-Covid policy and property regulations. Growth trajectory of the Chinese economy, which has significant influence on the global economy, heavily depends on the Beijing government's zero-Covid policy.

Yukinari Sukada, Economist

"Optimism on the rise"

Before we dissect how and why Asset Management One's view differs, let us look at some of the factors behind market optimism. A growing number of statistics suggests that the Chinese economy has bottomed out. The Economic Surprise Index, which measures the gap between market expectations and actual economic data (i.e. surprises), has been rising since October last year and has remained in positive territory (Figure 1). This shows that there have been a succession of stronger than expected economic indicator releases, suggesting that the Chinese economy may be moving beyond its worst phase.

Figure 1: China Economic Surprise Index



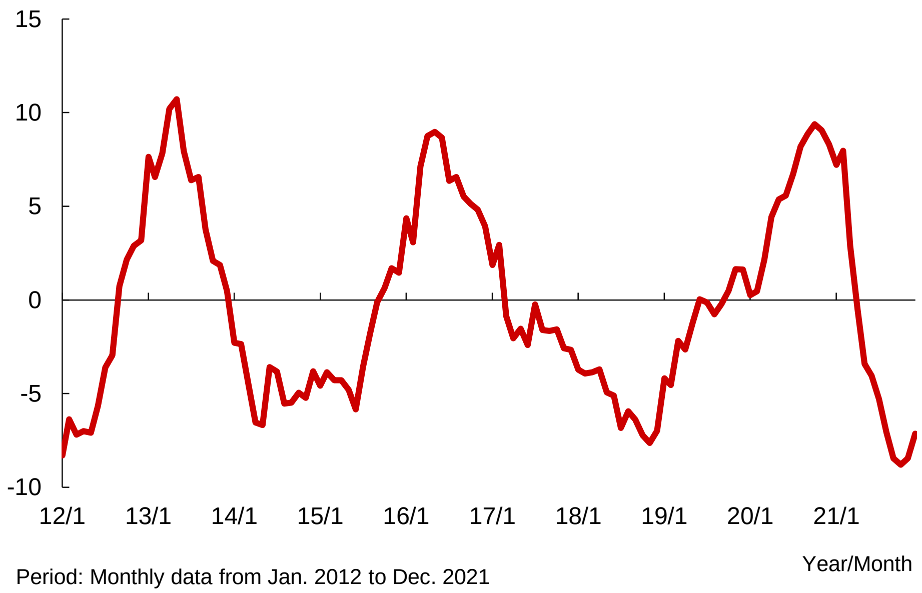
Period: Daily data from Jan.2 2019 to Feb.1 2022
Source: Bloomberg

During the January-March quarter, many economists believe that the reintroduction of social restrictions in response to the spread of the virus in China will temporarily increase downward pressure on the economy. Looking further ahead beyond this period, some optimistic economists have begun to turn positive on the economy, with a Bloomberg survey suggesting that the economy is likely to pick up from mid-year onwards.

Optimists point out three factors underpinning the economy: (1) monetary easing by the People's Bank of China (PBOC) and a recovery in credit growth; (2) various future policy measures by the government aimed at achieving economic stability as the top priority; and (3) the political schedule ahead of the five-yearly 20th National Congress of the Communist Party of China (CPC) set for autumn 2022.

Firstly, in terms of monetary easing, the PBOC has made its easing stance clear by cutting the one-year loan prime rate (LPR; most preferred lending rate) in December last year and again in January, although the rate cut since December has been modest at just 0.15 percentage points. The fact that China's credit impulse measurement (the year-on-year difference in credit growth relative to GDP), a leading economic indicator, is showing signs of bottoming out is also seen as a positive factor (Figure 2). Many believe that the effects of monetary easing will become apparent and that credit growth will continue to move upwards, supporting China's economic recovery.

Figure 2: China Credit Impulse 12 Months Change



Period: Monthly data from Jan. 2012 to Dec. 2021
Source: Bloomberg

Secondly, on the policy support front, at the Central Economic Work Conference in December last year, the government announced that its economic policy for 2022 would be to "focus on stabilising the economy". Since that meeting, there has been an increasing number of references by senior government officials to the easing of some of the real estate regulations that had cooled China's economy in the second half of last year, consumption stimulus, and tax cuts. In this context, expectations for policy support from the government are rising.

The third commonly cited point is the political schedule for 2022. The 20th National Congress of the Communist Party of China, which is a major political event held every five years set for this autumn, is expected to appoint Xi Jinping for an unprecedented third term and elect other leadership members. With this political timetable in mind, it is unlikely that Xi Jinping will take additional tightening measures that will hurt the economy, and many believe that top local officials will be looking for promotions by stabilising the economy. Many local governments have announced higher growth targets, and there is an emerging view that they will be more serious about supporting the economy this year.

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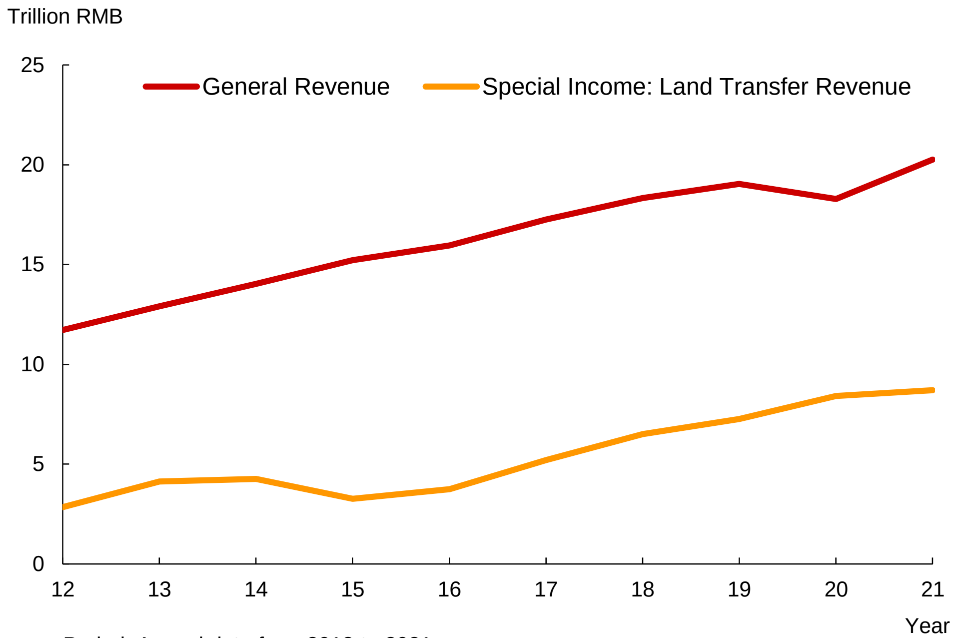
Our main scenario also assumes that the economy will bottom out in the January-March quarter and pick up in the April-June quarter. However, there are some optimistic assumptions baked into this scenario, and we believe that market consensus of 5.2 per cent year-on-year growth for the full year 2022 according to a Bloomberg survey as of 2 February, 2022, may be skewed in the direction of over optimism.

“Blind spots of market optimism”

Although the role of local governments in supporting the economy is significant in the expected pick-up, there may be limited scope for this.

For example, there are concerns that the slowdown in revenues from the transfer of land use rights, which is a major source of funding for local governments, will narrow room for fiscal spending as real estate regulations slow related investment (Figure 3). As a result of the central government’s tightening of real estate regulations, land use rights transfer income in 2021 is expected to grow by around 3% year-on-year, a lower growth rate than in the past. This year, with a de facto cap on the growth of loans for real estate development and investment, land use rights transfer income will continue to grow at a slower rate, narrowing room for fiscal spending by local governments. Therefore, it is unrealistic to expect any bold consumption stimulus measures.

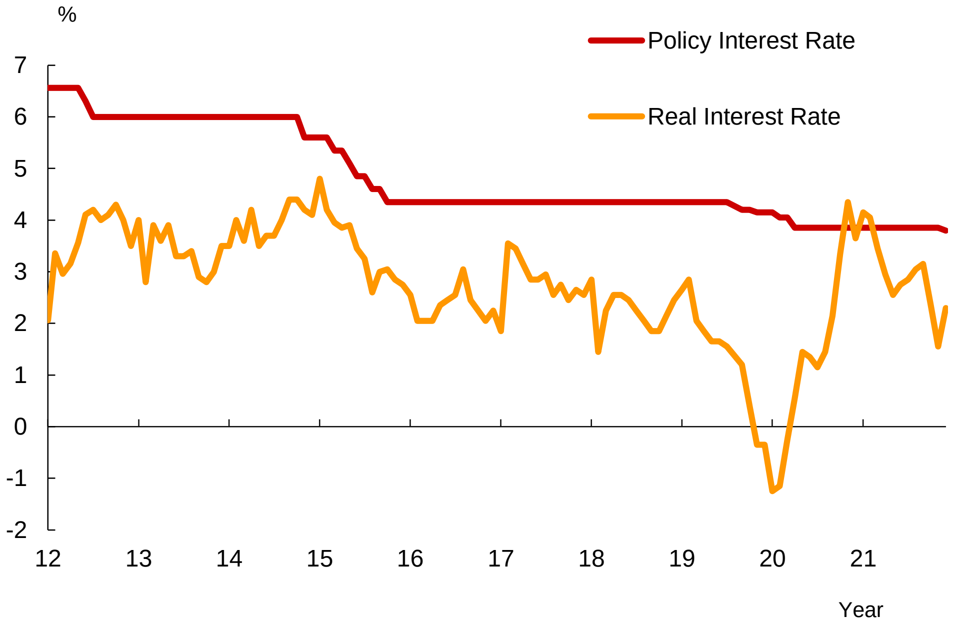
Figure 3: China Government Revenue



Period: Annual data from 2012 to 2021
Source: Bloomberg

With regards to monetary policy, the PBOC has been to cutting interest rates since late 2019, even before the Covid-19 pandemic began. The real policy rate, net of inflation, has fallen to almost the same level as the lower bound, which can be interpreted as already low, if we exclude the period between autumn 2019, when inflation was elevated due to higher pork prices, and the first half of 2020, when the country’s response to Covid-19 was ongoing (Figure 4). In this context, we believe it is unlikely that the PBOC will continue to cut interest rates. The divergence in the direction of monetary policy between the U.S. and China should also limit the scope for rate cuts to some extent.

Figure 4: China Real Interest Rate



Period: Monthly data from Jan. 2012 to Dec. 2021
Note: China policy interest rate refers to 1-year benchmark lending loans until Jul. 2019. Figures from Aug. 2019 are LPR for 1-year loan. Real interest rates are inflation-adjusted by CPI.
Source: Bloomberg

We believe the main factors causing the current slowdown in China's economy stem from policy responses such as (1) policies to curb real estate investment, (2) tightening regulations on emerging industries, information and technology in particular, and (3) the continuation of the zero-Covid policy. In other words, the Chinese economy is in a policy recession.

“Necessary remedies to end policy recession”

In these circumstances, our current view is that the scope for fiscal and monetary policy is small and that it is difficult to be optimistic about the Chinese economy. However, the fact that the Chinese economy is in a policy recession means that a change in any of the policies that are holding the economy back could contribute to some degree to the economic recovery.

In evaluating the situation, we believe investors need to ask two key questions: How likely are each of the above policies to be relaxed and what kind of effects can to be expected. Real estate regulations are apparently the most significant and would have the greatest effect area if reversed. However, it is unrealistic to assume that the government would pivot on its stance towards curbing speculation by lifting restrictions completely. Next, with regards to regulation of emerging industries, information and technology in particular, we believe that the government have become wary of the rapidly growing sphere of influence of these industries, thus, making it difficult to expect a major change in direction. This leaves us with the zero-Covid policy. Easing of this policy, we believe, is very realistic and effective at the same time.

Repeated social restrictions due to the zero-Covid policy have led to reduced consumption and supply chain disruption, including plant shutdowns. Relaxation or reversal of this policy would have significant impact and is a realistic possibility as vaccines have become more widely available in the country.

However, the National Health Commission, the health authority in China, has denied any intentions to relax this policy, citing potential for new strains to become more virulent and the fact that the nation is still in the process of acquiring immunity.

"Covid response is again the biggest uncertainty this year"

The success or failure of China's Covid response will have major implications not only for the Chinese economy but also for the global economy. If China were to relax its zero-Covid policy, this could accelerate normalisation of supply chains and reduce inflationary pressures. If, on the other hand, China fails to respond to the Covid crisis and introduces more restrictive measures, there will be significant downward pressure on the domestic economy and, through increased supply constraints, on the global economy.

It is difficult to predict when and under what conditions the authority will relax its policy on Covid. Most believe that the current policy will remain in place at least until the National Party Congress, when Xi's appointment will be finalised, but there are other possibilities, such as after the National People's Congress in March or after outbreak of the Omicron variant has died down.

With the government's monetary easing and fiscal space limited, the economic scenario in China this year will be very different depending on the Covid response. In this context, the Chinese authorities need to be flexible in their approach, e.g. by loosening the level of social restrictions, if not reversing the zero-Covid policy completely.

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