MERICS ECONOMIC INDICATORS

Quarterly analysis of economic trends in China

Q1/2019:

Stable economic growth in China: Government support prevents slowdown

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MERICS Q1 analysis

Government support prevents economic slowdown in China

Government intervention helped prop up growth in China's economy and prevent a further fall, but the stability remains fragile. GDP growth in the first quarter of 2019 was 6.4 percent, unchanged from the previous quarter. Some macroeconomic indicators including industrial production, retail sales and stock market indices have shown signs of improvement.

Reports that a trade deal with the US is in reach have also contributed to lifting the mood. But the optimism is tainted by a drop in industrial profits and increasing reports of layoffs in the private sector. Weak import data are another sign of weak domestic demand. It is a reminder that there is still much uncertainty on the horizon for 2019. Maintaining its vigilance toward further threats to growth, the government has announced a raft of additional support measures.

Efforts to reduce financial risk are not to be rolled back yet, but credit growth and money supply have picked up in the first quarter. At the same time the financial system has seen increasing numbers of non-performing loans and defaults. If credit allocation is not improved, further government stimulus measures could worsen the situation in the financial system.

Restraints on infrastructure spending by provincial governments have been relaxed. New rail projects and major regional developments in the Greater Bay Area as well as Xiong'an have been kicked off. But the government is aware that massive new infrastructure spending will not be enough and could even prove damaging to gains made to control risk in the financial system.

To ensure the stimulus is put to more productive use, emphasis has been put on improving the business environment by reducing taxes, red tape, and providing small business better access to credit. These efforts aim to boost investment and consumption by private companies and households.

The government is also seeking foreign investment to support the economy. It has announced a further opening up of the market, made changes to the foreign investment law and introduced improvements to IPR protection. This is partly in response to increasing pressure from the US and EU. But it is also due to the fact that China needs continued investment from foreign companies. Further steps toward incremental opening can be expected in 2019.

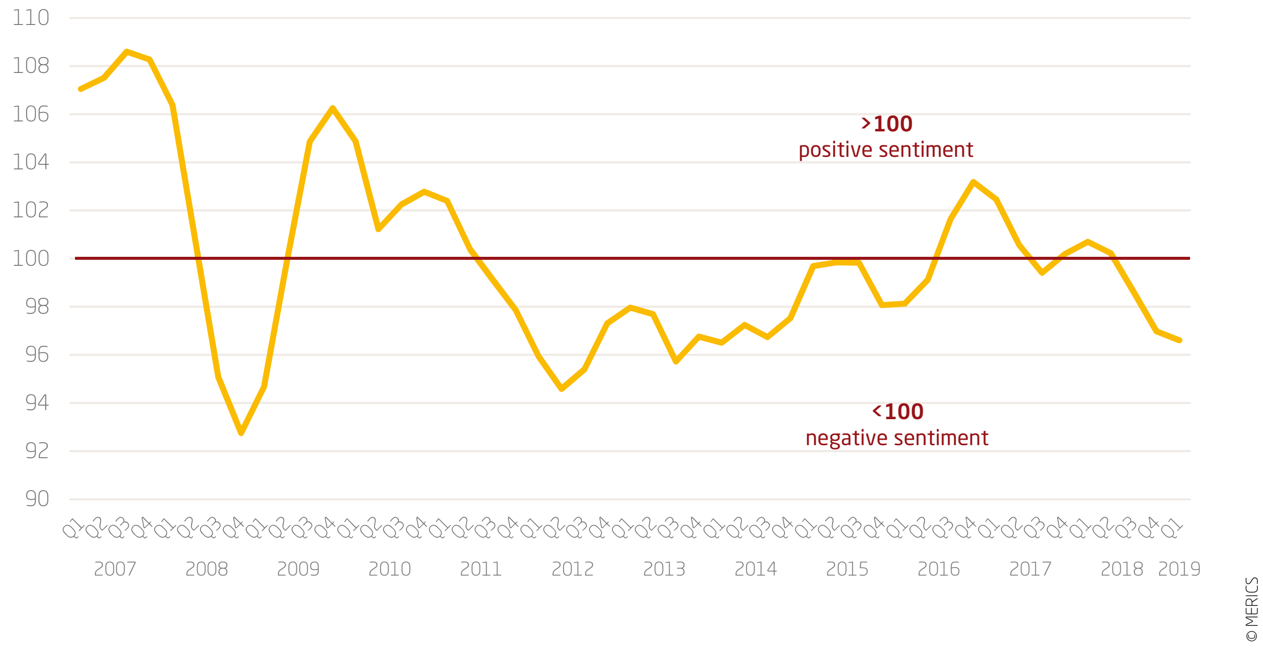
Looking ahead, a sharp slowdown in GDP growth is not likely, but the economy remains on a weak footing. The government is trying carefully to balance progress made in reducing risks in the financial sector with maintaining stable growth. Should growth continue to show signs of weakness, more expansionary policies can be expected.

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 MC CI was first developed in Q1 2017.

Confidence not rebounding in MERICS China Confidence Index
Note: Q2 2018 index was calculated with one missing data point



Focus topic: Demographic change and economy in China

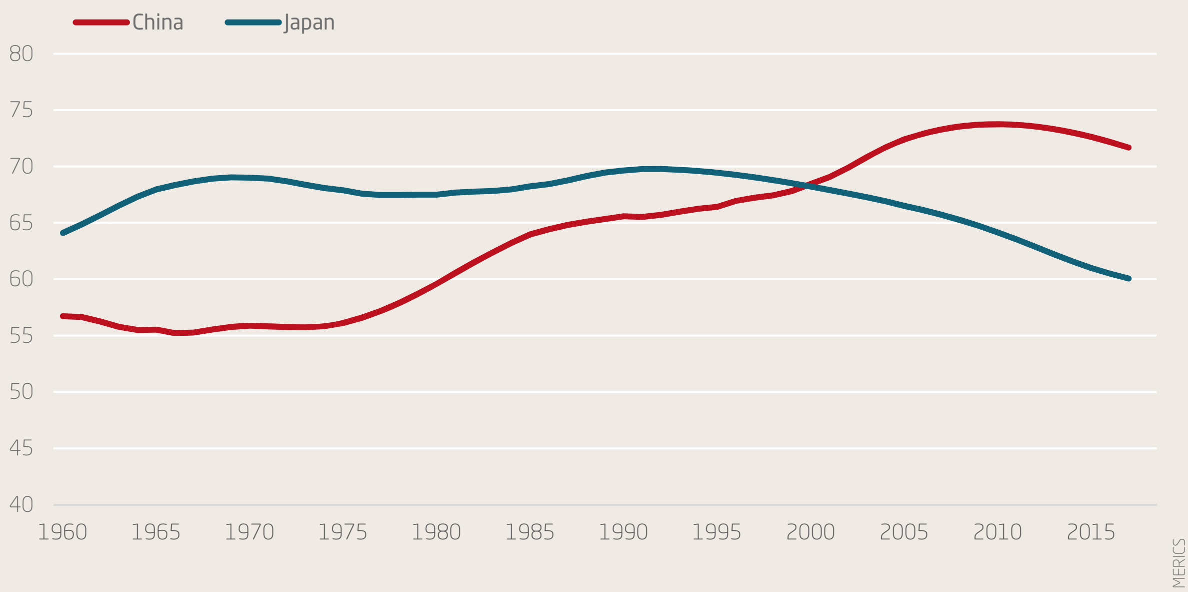
Is ageing China facing a Japanese-style "lost decade"?

By Lauren A. Johnston

Before we write off China's economic dynamism for a decade, we should consider the significant ways in which it differs from Japan. Differences in the timing of demographic change in two countries in particular suggests that China's experience will not mimic Japan's. With appropriately targeted polices, China will avoid a "lost decade".

China's leaders have recently set a growth target for 2019 of 6–6.5%, marginally lower than the target of 2018. Intensifying population ageing is one factor attributed to fears of an emerging Chinese 'lost decade', akin to Japan from the mid-1990s. The comparison is especially worrying in that like Japan then China today sits mid a trade war with its most important economic partner, the United States. Lesser obviously, like Japan then, China sits a few years past its peak workforce population share (see figure 1).

Working-age population share on the decline in China
1960 – 2017, in percent



Source: World Bank, World Development Indicators

Population ageing and the economy

An ageing population poses many economic challenges: rising labor scarcity in sectors and regions where labor was once bountiful; fiscal and corporate resources increasingly directed towards pensions; more human capital directed toward caring for the old. In other words, national resources are diverted away from more productive economic endeavors.

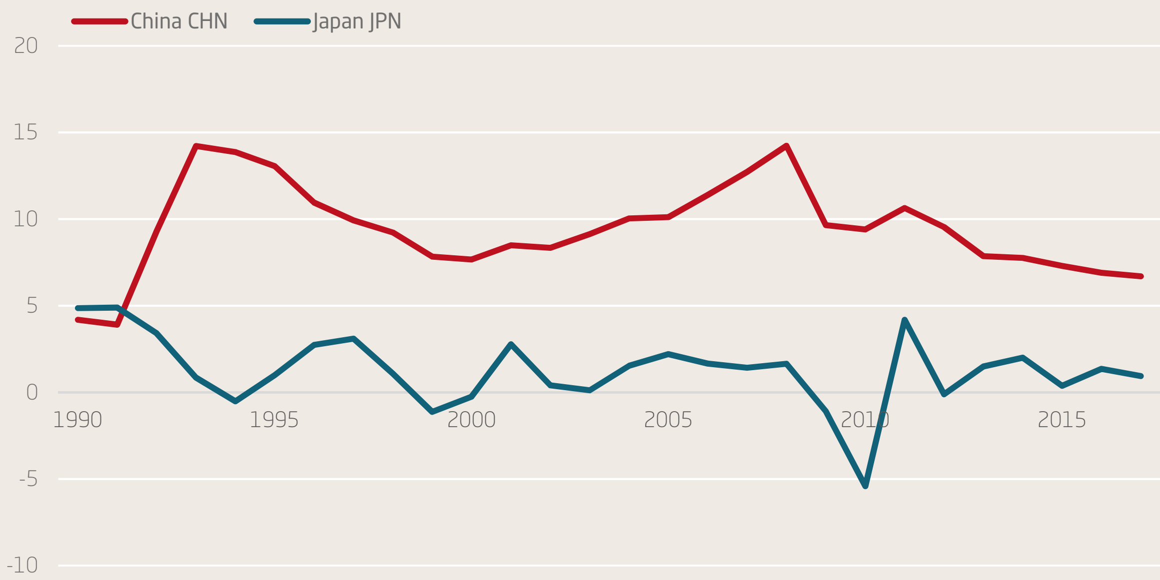
Demographers use several different definitions for population ageing onset. China passed all the leading such indicators between 1987 and 2002. China's workforce population share has meantime been in decline since around 2011 (Figure 1) when the workforce peaked at some 925 million workers. Despite the onset of later stage demographic transition, however, China's per capita income remains that of just a middle-income country.

Although China is old before it is rich, it hence retains convergence growth potential. GDP is still growing at some 6% annually (Figure 2). This means the resource envelope available to households and the government is also growing at a relatively fast rate.

Japan, on the other hand, was already an advanced industrial economy when its population ageing intensified, amid a more established slower, steady state growth rate.

China experiencing demographic transition as a developing country in turn means the economic impact of population ageing is likely to be different to the Japanese case.

Higher overall GDP growth softens China's demographic challenges
Comparison of growth rates of China and Japan (1990 – 2017, in percent)



Source: World Bank, World Development Indicators

Ageing in developed Japan vs. developing China

Digging into the demographic data reveals other key differences. Whereas in Japan the older cohort dominated the economic agenda through their adulthood, in China the older generation have never – not even in their prime – been important drivers of consumption. Just as China puts greater emphasis on consumption as a new growth engine, it meets a newly enriched, higher-spending younger consumer class for whom a more affluent level of consumption has been a relatively norm from the get go. In Japan, in contrast, the lost-decades younger cohort feels less economically prosperous than the older population segment.

In the same way, when the older Chinese generation leaves the workforce the impact will be different. Unlike in Japan where the education gap between generations is narrow and the human capital embodied in the older cohort deep, in China human capital is dramatically skewed in favor of the young. The lower fertility rate from the 1970s combined with rising household and national incomes means that over recent decades dramatically more resources have been invested in each child's education. As China's population share of workers falls, just maintaining output per capita requires improved productivity per capita. China's younger cohort, at least theoretically, are well-positioned to utilize their relative skills to maintain, if not increase, productivity levels.

Finally, China's dependency ratio, as measured by the ratio of youth (<15 years) and elderly dependents (>64 years) over the total working population (aged 15 to 64) will remain lower than Japan's for some years to come. Both countries have persistent below replacement level fertility, but Japan's demographic transition process began earlier and so the trends are more established. Japan moreover, has one of the longest life expectancies in the world, and is already home to some 70,000 centenarians, ranking it among a handful of super-aged societies.

Ageing with Chinese characteristics

China may not be facing a "lost decade" akin earlier Japan, but it nonetheless must overcome its own challenges. As a developing country, it still retains pockets of poverty. Eradicating these requires consuming fiscal resources. It also awaits to be seen if the younger cohort are sufficiently educated to realize elevated national per capita productivity.

Pension sustainability is also a major challenge. The 2019 Work Report promised to reform the management of aged-care insurance funds and guaranteed the payment of pensions on time and in full. In March, the Ministry of Finance transferred a nearly 7% stake in the People's Insurance Company of China into the state pension fund. This is one step in what is expected to be a standard pattern as China sets aside assets to cover its emerging pension-related liabilities. New opportunities in the sector are also emerging for foreign investors.

Avoiding the downward pull of an ageing population will not be easy. In April China's State Council released a set of Opinions on promoting the development of pension services, which set out 28 policy proposals for addressing a breadth of issues presently or imminently expected to affect 'ageing' China.

There are grounds for hope that, given the right policies, China will not suffer Japan's recent fate. Whether it succeeds or not otherwise, only time will tell.

This focus piece is based on Johnston, L.A. (forthcoming). The Economic Demography Transition: Is China's "not rich, first old" circumstance a barrier to growth? Australian Economic Review (to be published in a 2019 issue).

Macroeconomics

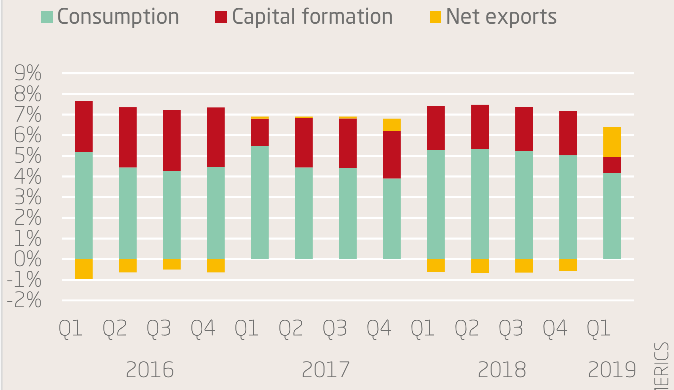
Economic growth is stable, but there are signs of trouble

- Net exports make the largest growth contribution on record
- Government stimulus will increase budget deficits and macro leverage ratios

Services and manufacturing move in opposite directions
GDP growth by category

Source: CEIC, NBS

Net exports stabilize GDP grown
Contribution to GDP growth



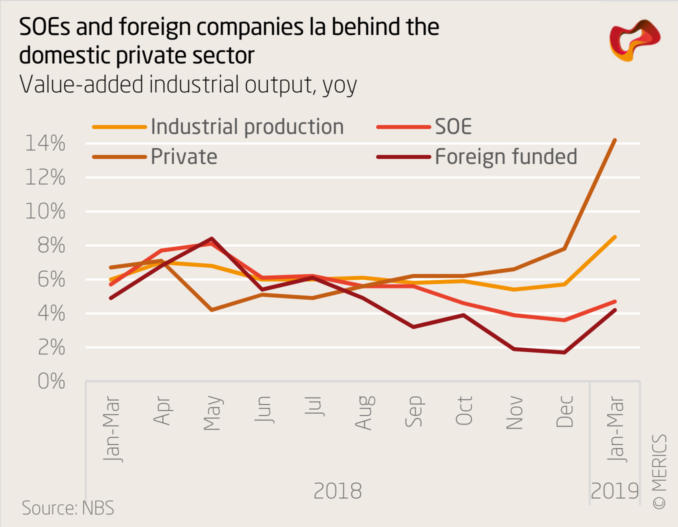
Sources: CEIC, NBS

- First quarter growth data paints a complicated picture. On the one hand, the real economic growth rate has been maintained at 6.4 percent. But there are signs of trouble. Much of the growth came from net exports. First quarter net exports were in turn driven by contracting imports, which is an indication of weak domestic demand. Stimulus measures implemented by the government to support the economy have also contributed to growth. However, these measures are causing increases in macro leverage and budget deficits.
- The list of government support measures is already long, with more to come. On the fiscal side, the government has announced it intends to increase the budget deficit to 2.8 percent. To stimulate the economy infrastructure expenditure will be increased while the tax burden will be reduced. On the monetary side, banks have been provided with greater liquidity to lend to the economy and controlling rates have remained unchanged. These measures are not yet fully visible in the economic growth data but will become more pronounced later in the year.
- In contrast to real GDP, nominal GDP growth fell from 9.1 to 7.8 percent. With some price indices trending downward, the fall in growth may indicate deflationary tendencies. Nominal GDP is now below both M2 and aggregate credit growth, indicating that debt levels are increasing. With both leverage and deficits rising, it is unclear how long the government can sustain economic support measures. Speaking to such concerns, the Polit Bureau has announced that support measures are to be targeted and focused on improving the structure of the economy.
- With stimulus in the air, investment has begun to pick up after hitting a historical low in 2018. Yet gross fixed capital formation only corresponds to little more than a percentage point of Q1 growth. Falling from 4.6 to 4.2 percentage points, consumption expenditure contributed less to overall growth than in the previous quarter. Net exports, which in 2018 grew by 0.6 percentage points, contributed in Q1 nearly 1.5 percentage points. This is their largest contribution to growth since records began in 2009. The increase is almost entirely due to falling imports, which drive net exports up. The fall in the contribution of consumption to growth, combined with falling imports, indicates domestic demand is contracting.
- The services industry remains the fastest growing sector, at 7 percent, although it is beginning to slow. Manufacturing, on the other hand, is picking up, growing at 6.5 percent. This development may indicate a stall in China's transition to a consumption economy.
- There have been many reports that regional statistics have been falsified. To prevent this in the future, the National Bureau of Statistics will take over increasingly more of regional GDP calculations. Unreliable provincial economic data was considered less of a problem during China's rapid economic growth period. It is now being seen as a risk as it could lead to errors in policy making.

Business

Industrial production off to a strong start in Q1

- Growth in private sector drives manufacturing rebound
- Strong growth in cement output and demand for equipment indicate impact of stimulus measures



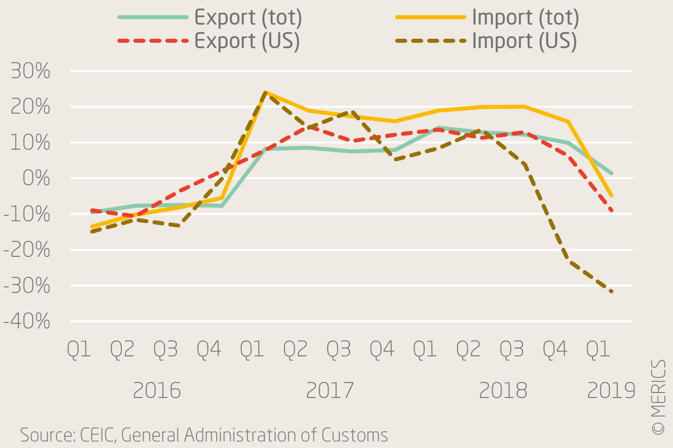
- Industrial production growth gained further momentum in the first quarter. Following a steady decline over the previous two quarters, value-added production grew by 6.5 percent in Q1 with growth reaching 8.5 percent in March.
- The improvement in manufacturing can be attributed to increased output by private companies. Whereas growth was just 7.8 percent in December, it exceeded 14 percent in March. Despite improved output at SOEs and foreign companies, their growth rates remained below overall growth of industrial production.
- China's private sector has felt the squeeze caused by efforts to reduce financial risk and by the expansion of the state sector. However, the government understands it needs a strong private sector in order to maintain stable growth in 2019.
- During the NPC, the government vowed to provide further policy support for the private sector in an effort to shore up growth. Measures include massive tax cuts, improved access to financing, steps to reduce bureaucracy as well as a reduction in electricity costs.
- These measures, together with the anticipated trade deal with the United States, have contributed to lifting business sentiment. The Purchasing Managers' sub-index for new orders in the manufacturing sector returned to above 50, indicating expansion. The outlook for export orders remains negative but is improving now following a ten-month decline.
- Output for industrial equipment, including general, special and electrical machinery, expanded by 8.4 percent, 12.6 percent and 11.0 percent respectively in the first quarter. Growth in all categories accelerated further in March.
- Strong growth in transportation equipment in March, including railway (13.6 percent) and cement (22 percent), may be an indication of increased construction due to new infrastructure-related projects that have already started or are planned.
- Output for other goods, including semiconductors (-2.3 percent), smartphones (-7.4 percent), industrial robots (-14 percent), and automobiles (-2.6 percent) point to a number of underlying problems in the industrial sector.
- Over the next quarter data should provide some answers as to how far the rebound is related to government stimulus measures and how far it is down to demand.

International trade and investment

Foreign trade contracts, especially imports from the US

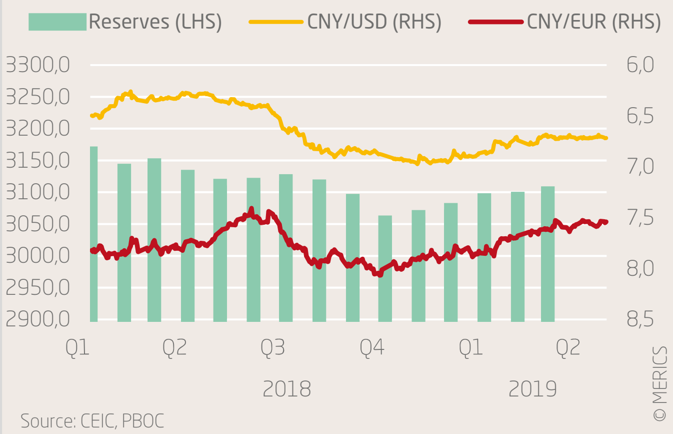
- Net exports remain strongly positive as imports decline at a more rapid rate than exports
- Trade between US and China slowing significantly

Growth momentum in merchandise trade dips
Chinese trade in USD terms, ytd yoy



Source: CEIC, General Administration of Customs

External position is improving
Exchange rates and foreign currency reserves



Source: CEIC, PBOC

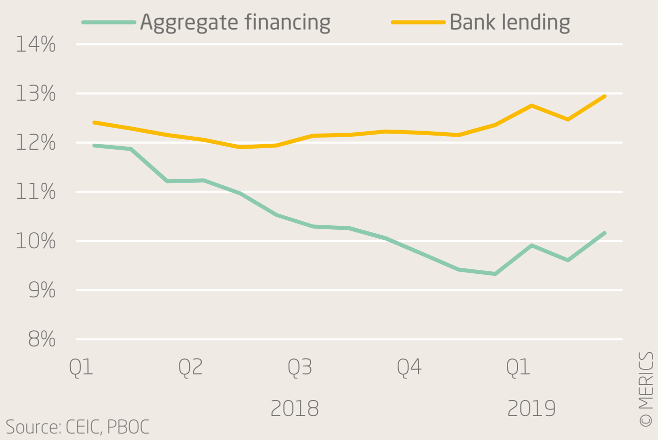
- In the first quarter, year on year export growth has slowed sharply from 9.9 to 1.4 percent in USD terms. After growing at 15.8 percent in the previous quarter, imports contracted by almost 5 percent.
- Exports to most parts of the world increased, including to Europe and Asia, which grew by 8 and 1 percent respectively. By contrast, exports to the US declined by 9 percent.
- The forward-looking new export order component of PMI has been below 50 for ten consecutive months. In March it reached 47. Values below 50 indicate a contraction. It is unlikely export growth will pick up much in the coming quarter.
- First quarter imports from Asia, Europe and North America all contracted, with imports from the US falling by almost 32 percent. The fall in imports has been noted by several large foreign companies, many of which have reported slowing sales in China.
- At the end of the first quarter, China had exported 76.3 bn USD more than it had imported. This is the highest level of net exports since 2016. The increase in the net figure was primarily a result of lower imports of foreign goods. China's sales to the rest of the world have not increased significantly.
- In Q1 almost a quarter of GDP growth came from net exports. The lower level of imports played a key role in maintaining growth at 6.4 percent.
- The US and China have postponed resolving their trade talks until May at the earliest. Both sides claim most points of disagreement have already been resolved. China has taken steps to open its markets.
- Foreign direct investment into China expanded 3.7 percent in the first quarter, whereas outbound investment contracted by 1.1 percent. The low growth of outbound investment is most likely associated, at least to some extent, with remaining restrictions on Chinese companies' purchases abroad.
- China's external position improved both in terms of the value of the currency and the amount of foreign reserves accumulated. The CNY/USD exchange rate went from 6.85 to 6.71 and the CNY/EUR rate from 7.85 to 7.55. Foreign currency reserves increased for the fifth consecutive month, reaching almost 3.1 tr USD.
- The improved position has several likely causes: the PBOC continues to maintain the 'counter-cyclical' factor into its fixing regime and markets have responded positively to both government stimulus and perceived progress in trade negotiations.

Financial markets

Credit growth accelerates again as government stimulus kicks in

- Record levels of liquidity injected into the financial system in January
- Stock market responds with sharp climb upwards

Credit growth picks up again
Growth bank credit and aggregate financing



Source: CEIC, PBOC

Easy liquidity drives stock market recovery
Shanghai Composite Stock Index

Source: CEIC, Shanghai Stock Exchange

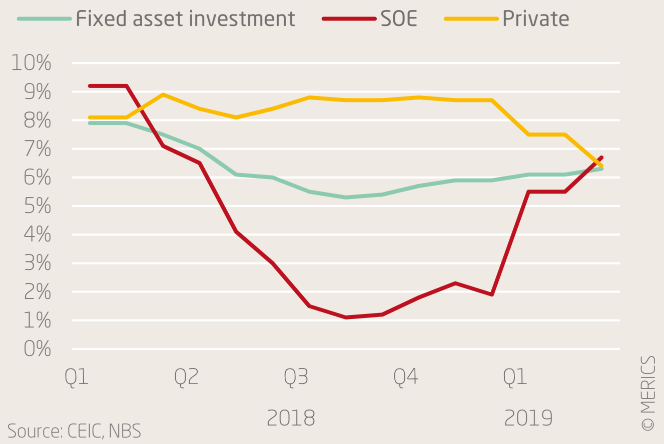
- Monetary policy became looser to support the economy. Banks' reserve requirements were cut twice in January, releasing a large amount of liquidity into the system. Furthermore, the PBOC made a record injection of 1.3 tr RMB. PBOC governor says the support of the economy must not flood markets and has specifically instructed banks to lend to smaller businesses.
- Banks extended 3.2 tr RMB worth of new loans in January, the largest amount ever recorded in a single month in China. Both aggregate financing and M2 growth accelerated in the first quarter. In March they grew at 10.7 and 8.6 percent respectively. Liabilities have continued moving on-balance sheet, with key shadow banking aggregates such as Trust loans (-7.9 %) contracting significantly, while bank lending (13.8 %) and corporate bond financing (10.5 %) grew in double digits. Consumer lending further accelerated, growing at 19 percent, indicating household leverage is still growing quickly.
- A large part of the government's drive to improve the financial system has been to turn local government debts that were raised through financing vehicles into bonds. This is very obvious in terms of issuance. A quarter of local governments have issued bonds so far this year, which together already amount to one third of the total bonds issued in 2018.
- There are some signs of shakiness in the financial system. Corporate bond defaults have been on the rise. Bloomberg reported that in the first two months of 2019 there were more than 12 billion yuan of bond defaults. This number is likely to grow quickly as 4.8 tr yuan worth of bonds will mature in the final 10 months of 2019.
- Incremental efforts to open up capital markets have continued. For example, China has approved a new investment law which improves the business environment for foreign businesses, and several foreign securities companies have been granted operating licenses.
- The stock market has responded very positively to the monetary and fiscal measures, growing 32 percent since the beginning of the year. Other developments have also helped equities. The Shanghai Stock Exchange has launched a new board for tech companies which aims to improve companies access to funding. Additionally, MSCI has announced it will increase China's weighting in its global equity indices.

Investment

Investment starting to accelerate as stimulus hits

- State sector invests heavily in rail and road
- Residential property takes off

Private investment continues to fall
Growth fixed asset investment by type (yoy, ytd)



Investment in real estate picks up
Fixed asset investment in real estate (yoy, ytd)

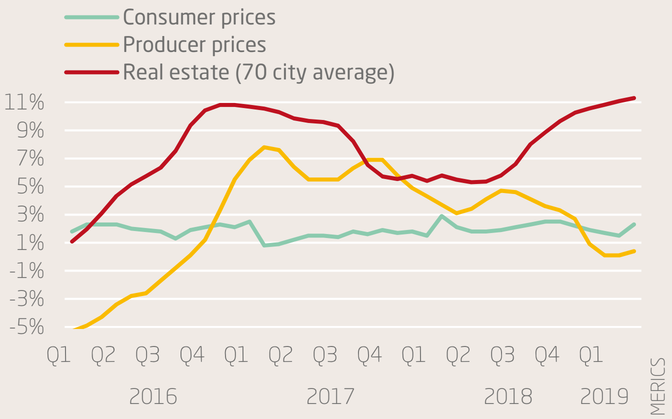
- In order to support the economy the government has implemented fiscal and monetary stimulus, both of which have affected investment. Government investment guidelines outline large investment in infrastructure. Among other things railways, highways and airports are all to be expanded. The NDRC has approved projects worth at least 500 bn CNY with 120 bn worth of railways also approved.
- Much of the infrastructure will likely be used for government development projects such as the Xiong An New Area, on which work recently began, and the Greater Bay area, a plan for which was released in January.
- The broader category of infrastructure investments picked up only slightly to 4.4 percent from 3.8 percent at the end of last quarter. However, its sub components – railway and highway transports – have begun to accelerate, growing in double digits. Infrastructure investment overall is likely to pick up in the course of the year.
- With restrictions on local government investment now relaxed, already in Q1, local governments have issued a record of 1.4 tr CNY worth of bonds. This move toward bond financing represents a major change. Up to now, local governments have relied primarily on land sales and financial vehicles. A large share of the capital raised will be used to support the economy. However, the mechanism for assessing the risk associated with these bonds is unclear.
- Investment has already picked up as a result of the stimulus, but private sector investment is now expanding more slowly than that of the state. At the end of Q1, fixed asset investment had grown by 6.3, an increase from 5.9 percent at the end of the previous quarter. The state sector has been driving investment, with state-owned enterprise investments growing at 6.7 percent while private investment expanded slightly slower at 6.4 percent.
- Investment in manufacturing fell from 9.5 percent in December to 4.6 percent in March. In part this was a result of investments in the automobile industry contracting by 1 percent, the second lowest level on record.
- The service sector recovered from a slump over the previous quarter, accelerating to 7.5 percent in March. Strong investments in IT (18.1 percent) and telecommunications (31.3 percent) contributed to the mild recovery.
- Real estate investment, particularly into housing, has picked up sharply and has helped carry the economy. Construction started on new floor space is about 12 percent higher than this time last year. This is likely due to the large amounts of capital that the central bank has injected into the economy through reserve cuts. Overall, real estate investment grew at 11.8 percent, up from 9.5 percent. Investment into residential property jumped from 13.4 to 17.3 percent.

Prices

Stimulus is having uneven effects on prices

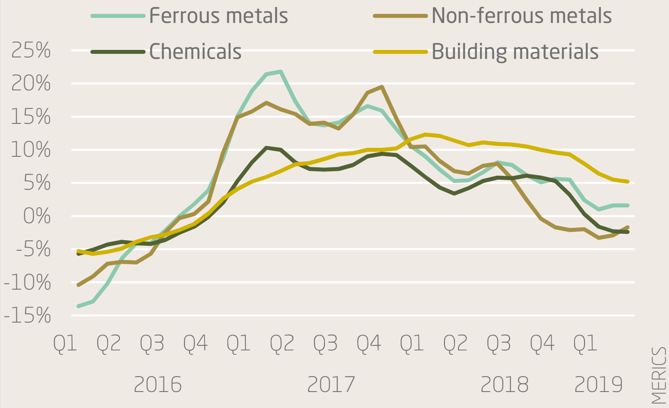
- Consumer and producer price growth far below target
- Real estate prices take off

Real estate prices take off as PPI is near deflation
Price index for costumer, producer, real estate



Source: CEIC, NBS

Price growth for key inputs deging towards zero
Price index producer inputs



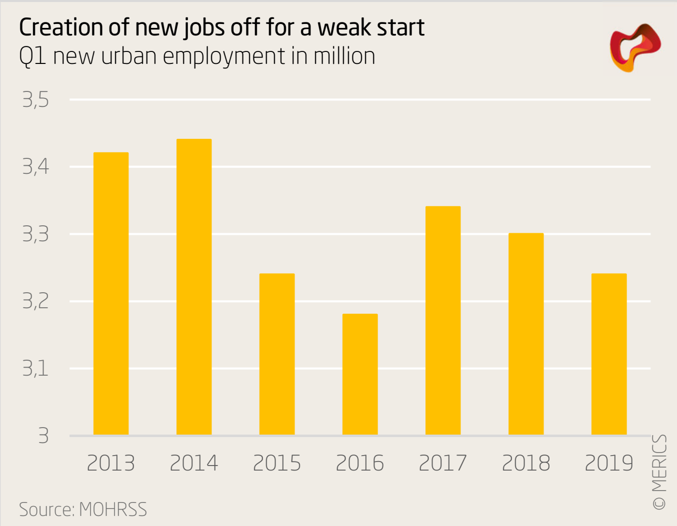
Source: CEIC, NBS

- Since late 2018, the government has introduced many fiscal and monetary stimulus measures. They are meant to support the economy in the face of internal and external headwinds. Prices that reflect consumption have not been affected. Both consumer and producer price indices indicate the inflation target of 3 percent was missed. The price of assets and building materials, which better capture the investment side of the economy, are increasing.
- Headline CPI picked up slightly towards the end of the quarter, reaching 2.3 percent in March. Most of this rise was due to fluctuations in food prices which picked up towards the end of the quarter. The growth of core inflation remained stable at 1.8 percent, similar to rates seen in the last seven months.
- Increases in producer prices were close to zero for the entire quarter. The prices of some goods even fell. Price growth of non-ferrous metals, manufactured goods, and durable goods were all negative. Monetary conditions were loose, with record bank lending in January. Quarterly export growth slowed, both in USD and RMB terms. So, it is very likely that low producer price growth reflected weak external demand.
- Weak demand also affected input prices, which grew 0.2 percent in March. The growth of input prices dipped slightly below zero in February but was otherwise slightly above. The prices of electrical wire, chemicals, and paper pulp were all slightly lower than in the same period 2018. The prices of building materials increased by 5.2 percent in annual comparison, reflecting rising construction volumes.
- Asset prices increased sharply, probably thanks to looser credit conditions. The average price of new residential units in 70 cities monitored by the NBS grew 11.1 percent year-on-year. Only in 8 of the 70 cities did prices increase less than three percent. Many of those cities were tier one cities - like Beijing, Shanghai, and Shenzhen - that have introduced property-price controls to deter property speculation. Rising asset prices were also reflected in the growth of stock market indices (see finance section).

Labor market

Government concerned about employment conditions

- Available data provide a mixed picture on state of employment
- Li Keqiang vows to put employment first in effort to boost confidence

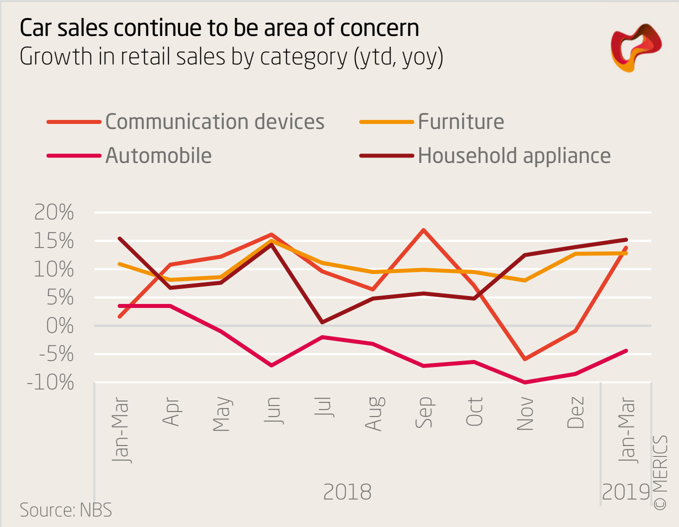


- Recent data on the number of registered unemployed individuals fell slightly to 3.7 percent, down from 3.8 percent in the last quarter. This number however remains highly contested due to its remarkable stability. Another figure, based on surveyed urban unemployment, points to a slight increase, rising from 4.9 percent in Q4 to 5.2 percent.
- In the first quarter of 2019, the number of new urban jobs continues to decline, with 3.24 million new jobs added. The government's target is to create 11 million new jobs this year, a figure that was easily surpassed in previous years.
- Reports of layoffs and hiring freezes in the private sector have been on the rise, including some notable IT giants such as Tencent and JD.com. This is a sign that the highly competitive internet economy, which has provided many of the new service jobs as well as more highly paying jobs, is now hitting the first road blocks. Added to the current trouble was growing discontent of workers about the long working hours in IT-related industries.
- The PMI sub-index in companies' employment intentions picked up slightly for both manufacturing and the service sector after falling during 2018. Both sub-indices, however, remain below 50, indicating contraction.
- Unemployment data in China is considered highly unreliable, making it difficult to assess the actual situation. However, the government is concerned labor demand is softening as GDP growth continues to slow. At the National Peoples' Congress in March, Premier Li Keqiang stressed the need to put employment first and called for a job strategy.
- The government has announced further support measures aimed at maintaining a stable employment situation. For example, in an effort to reduce costs for companies, employers' share of basic pension premiums is set to be cut down from 20 to 16 percent.
- Rising insecurity in the labor market could potentially negatively affect future investment and consumption by private households. Addressing these concerns will remain a high priority for the government.
- Measures to boost the labor market seem to have contributed to a positive change in employees' income sentiment. Future income confidence, however, has again dropped. As the economy shifts to a lower growth level in 2019, more moderate wage growth should manifest itself.
- Shanghai was one of the few provinces, along with Chongqing and Shaanxi, to announce minimum wage increases. Effective April 1st, minimum wages in those jurisdictions are set to increase by 2.5 percent – just slightly above the rate of inflation. The number of other provinces to follow suit and the increases they set will be indicative of the health of the labor market over the coming quarters.

Retail

Consumer spending shows timid signs of recovery

- Government aims to boost consumer confidence with tax cuts
- Sales of automobiles continues to suffer from weak demand amid policy uncertainty



- Retail growth recovered over the first quarter, expanding 8.7 percent. Growth had fallen to record lows towards the last quarter of 2018. In an effort to keep growth within a range of 8-9 percent the government has rolled out a number of support measures which should boost consumption in 2019.
- Subsidies for upgrades, including 4K TVs and refrigerators, resulted in sales of home appliances and electronics accelerating to 15.2 percent in March. Taxes for a number of personal goods frequently bought overseas were also reduced. Although the tax break was fairly minor, ranging from a reduction of between 5 and10 percentage points, it is, however, part of a second round of tax breaks since November last year.
- Sales of consumer goods related to the real estate market remained strong with decoration material and furniture picking up, expanding 10.8 percent and 12.8 percent respectively in March. Following a slowdown in the second half of 2018, sales of mobile communication devices rebounded to 13.8 percent in March.
- Demand for automobiles continues to contract. The current debate about whether the government will cut taxes or ease restrictions on qualified combustion engine vehicles may be causing some consumers to hold back on purchases. Meanwhile the recent announcement of cuts of up to 60 percent to the substantial subsidies available for e-vehicles is likely to suppress sales of new energy vehicles (NEV).
- Online sales of goods and services fell sharply over the first two months of the year but recovered to 15.3 percent in March. The slowdown was mainly driven by lower demand for online services, while demand for physical goods including food items outpaced growth in total online sales. Despite the minor slowdown, China's online consumption continues to grow at a rapid pace.
- Tourists from Mainland China were responsible for a surge in visitors to Macau. The number of same-day visitors increased by more than 21 percent in the first three months. Visits to the gambling destination may reflect a return to a more positive outlook among Chinese consumers.