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Trivium China

Markets Note

Damaged balance sheets: The challenge of designing effective consumption support

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China's sluggish economic recovery has markets worried about the outlook for the rest of the year. However, it will be difficult to develop a picture of this outlook until Beijing has unveiled its policy response.

So, what is it waiting for?

Beijing's silence is particularly strange given that it outlined its strategy for supporting consumption months ago.

- At the beginning of March, the macro planner (NDRC) laid out in its report to the National People's Congress (NPC) multiple ways the government would support consumption.
- The NDRC doubled down on the same points a month later in Qiushi, the Party's leading theoretical journal.

The measures broadly fell into two categories:

- Measures that would boost household incomes
- Supply-side measures that would improve access to the goods and services consumers want

The problem is that the latter are unlikely to work – and while the former will work, they face funding challenges and might take time to translate into higher consumption.

Why won't supply-side remedies work but income-based ones will? Because Chinese household balance sheets are "damaged."

Damaged balance sheets

The central bank (PBoC) used the phrase "damaged balance sheets" in its Q2 Monetary Policy Report last year to explain why households were reluctant to spend. The PBoC hasn't used the expression again, but it has gained wide currency since.

- Most notably, on May 20, Wang Yiming, vice president of the China Center for International Economic Exchanges – a think tank under the NDRC – and an academic member of the PBoC's monetary policy committee, referred to "damaged balance sheets" in diagnosing the reasons for weak household spending.

Why are household balance sheets "damaged?" It's partly because income for many households took a hit during the pandemic, the result of pay cuts and bonus reductions.

- Additionally, high urban youth unemployment – which hit 20.4% in April – negatively impacts the financial wellbeing of families with young adults.

However, the weak property sector has likely caused greater damage.

- Before Beijing introduced the three-red-line policy in 2020, people expected their properties' values to appreciate rapidly and indefinitely. It wasn't unreasonable to expect the market value of a family's home to double over a decade.
- Given that property is most households' biggest financial asset – with between 60% and 70% of household wealth tied up in housing – people's saving decisions were heavily influenced by the expected future appreciation of housing prices.

- However, households can no longer expect outsized returns on their property investments. In fact, they can no longer be sure their properties will appreciate at all.

In other words, households' expectations about the future value of their assets have declined, and with that decline, so has their sense of financial wellbeing.

According to Wang, households are fortifying their balance sheets in response. That means two things. Households are:

- Saving more
- Paying down debt

We've seen both this year.

- At the beginning of 2023, the consensus was that Chinese households would start spending down the "excess savings" they accumulated during 2022 when stringent zero-COVID lockdowns limited consumption opportunities.
- Instead, savings continued to soar during Q1, with households' bank deposits increasing RMB 9.9 trillion, the same as for all of 2021.

Meanwhile, banks have been under pressure from mortgage holders paying down their loans ahead of schedule.

What do "damaged balance sheets" mean for government policy?

First, it means that a big part of Beijing's approach to boosting consumption isn't going to work.

Beijing has traditionally preferred to boost consumption with supply-side remedies. This was its primary approach throughout the pandemic, and it remains a vital part of the NDRC's strategy. The approach's rationale is that people will spend more if the types of goods and services they want are available to them.

- They include NEVs, education, healthcare, aged care services, cultural goods (like music festivals), and sporting events – all areas the NDRC has identified since March as warranting support.

What might such support look like? Take NEVs.

- NEVs require infrastructure like charging stations. If charging infrastructure isn't widely and conveniently accessible, fewer people will purchase an NEV.
- Beijing has said this year that it wants to boost purchases of NEVs by expanding recharging infrastructure in rural areas. By expanding the geography in which it's feasible to operate an NEV, the size of the potential market increases.

Regarding services, the rationale is similar, albeit with a slight twist.

- Beijing sees these services (like childcare, healthcare, etc.) as being in high demand but short supply, particularly at a price and quality that the public demands.

- By increasing the supply of these services, authorities hope that the total level of consumption will increase.
- Increasing supply involves providing support and incentives to firms. For example, last year, the PBoC created a relending facility to reduce the cost of building elderly care facilities. Subsidies and tax relief are other ways Beijing might encourage firms to provide key services.

While there's some logic to the approach, it's not likely to work in an environment where the primary impediment to reviving and expanding consumption is "damaged balance sheets," i.e., households' increased propensity to save.

Repairing balance sheets

To boost consumption, household balance sheets need to be repaired. The only way to do that is to increase people's expectations of future income or increase their expectations of future asset prices.

- Reviving the housing market would go a long way, but authorities don't seem to have a clear vision of how to do that. The only option left is to boost incomes.

The Politburo said as much in the readout of its April meeting on the economy, which argued that reviving demand requires:

"Increasing the income of urban and rural residents"

In its March report, the NDRC said authorities would boost incomes by:

"Refining the mechanisms for reasonable pay increases and guide local governments to appropriately adjust minimum pay"

"Adopting multiple measures to increase rural incomes"

"Ensuring the payment of wages for rural migrant workers"

"Enhancing income distribution" through taxation, social security, and transfer payments.

So, if the NDRC has a plan, and the Politburo agrees incomes need to rise, why haven't we seen any action? It could be because designing consumption support poses many challenges.

- The burden of increasing minimum wages would fall disproportionately on the private sector – which accounts for about 80% of urban employment – which is already under severe financial stress.
- Increasing social security allowances – particularly for migrant workers – would be effective but would also put a heavy burden on already overstretched local government finances.
- Cutting income tax won't have much of an impact as less than 10% of the population pays it.

We don't think any of those are likely, at least not this year.

While there's broad consensus among officials and economists that incomes need to increase, we've been struck by the lack of explicit suggestions for how to do it. We've been scouring Chinese publications for policy recommendations, and so far, we've come across only one:

- In February, three researchers with the China Finance 40 Forum – a think tank focused on economic and financial issues – published an essay advocating for a negative income tax, much like the Earned Income Tax Credit in the US, the Working Tax Credit in the UK, and the Prime D'activite in France.
- Under a negative income tax, low-income households receive a direct transfer from the government if they earn below a certain threshold.
- It would have the advantage of being funded by the central government, which is in a far better financial position to take on the burden than local governments or firms. Moreover, the stimulatory impact on the economy would be felt immediately after the first transfer.

Is this on the shortlist of potential measures? We think that's unlikely, as Beijing usually likes to roll out sweeping reforms on a limited, trial basis first. Still, it's the best solution we've come across.

Final thoughts

While Beijing is working out how to increase incomes, we expect authorities to roll out a range of other measures.

- Vouchers designed to boost spending on autos, appliances, and home improvements – three areas regulators are particularly worried about – are possible.
- The PBoC might push interest rates down further.
- There may be some additional support for infrastructure investment.
- There will be support for small- and medium-sized firms to help keep them afloat until demand returns.
- There will be further efforts to deal with unemployed youth by warehousing them in internships or at state-owned firms until the private sector recovers and demand for young workers returns.

However, a sustainable recovery requires creating long-term, sustainable increases in household disposable income. Reviving housing demand would go a long way, but authorities don't seem to have a clear vision of how to do that.

China's authorities have repeatedly said they intend to raise household incomes this year. We believe higher incomes are the key to delivering a consumption-led economic recovery. But designing policy to do that is difficult, and likely helps explain why we haven't seen meaningful policy support from Beijing yet.

Need anything more?

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