

China's two-track recovery

May's econ numbers showed a shallow recovery in economic activity last month. What is more concerning, however, is that this slight recovery was driven by production to a far greater extent than consumption.

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Key takeaways

- While “COVID bubbles” allowed factories to keep operating during lockdowns, demand for firms’ products was curtailed by movement restrictions and consumers’ job and income worries. Business spending also remained weak last month: In real terms, fixed-asset investment (FAI) fell from the previous year.
- The disconnect between production and consumption last month led to increased inventories. This disconnect risks weighing on future activity and raises the specter of Chinese companies exporting oversupply.
- The pick-up in exports in May is unlikely to continue given the headwinds facing global growth. That may force Chinese companies to reduce export prices to lift overseas demand. Exporters, however, will be constrained by the fact that profit margins are already compressed by high input costs. The firms have limited ability to lower prices further.
- Unlike in 2020, exports are not going to come to the rescue. The Chinese economy cannot remain on this two-track path, however: At some point, firms will be forced to cut production and start destocking. More stimulus is needed to avoid that damaging outcome.

China's economy recorded something of a recovery in May, but only relative to April's extremely weak levels. More concerning, it was also a recovery heavily weighted towards production rather than consumption.

Industrial value-added output eked out a 0.7% y/y increase in real terms last month, compared with a 2.9% y/y fall in April, and above consensus forecasts of a 0.7% y/y decline.

The rebound in industrial production was more impressive in m/m terms. Value-added output jumped 5.61% m/m in seasonally adjusted terms in May, reversing April's 5.80% m/m fall in production.

Factories were able to ramp production back up because "COVID bubbles" allowed them to keep staff on site and production running during lockdowns. Movement restrictions, however, curtailed demand for these companies' products. Consumer spending last month remained extremely weak. Retail sales were down 6.7% y/y in May – a minor improvement on the 11.1% y/y collapse in April. The service sector recorded an even more meager recovery. The NBS Service Production Index was down 5.1% y/y in May versus a 6.1% y/y fall in April.

It is not just restrictions on going out shopping holding back consumption. Online purchases of consumer goods and services also remained weak last month [FIG 1]. Household spending is restrained by families' worries about future income and employment. While the urban unemployment rate decreased a bit last month, it remains high in historical terms [FIG 2]. For young people, joblessness increased last month, with the unemployment rate for graduates rising from 18.2% in April to 18.4% – the highest since at least January 2018, when records for this began.

Even for those employed, the uncertainty about lockdowns and the impact that this is having on incomes means that many are choosing to cut discretionary spending and increase savings. The net increase in household deposits in the first five months of this year was the largest for this period since at least 2005.

Fig. 1 – Online sales of goods and services

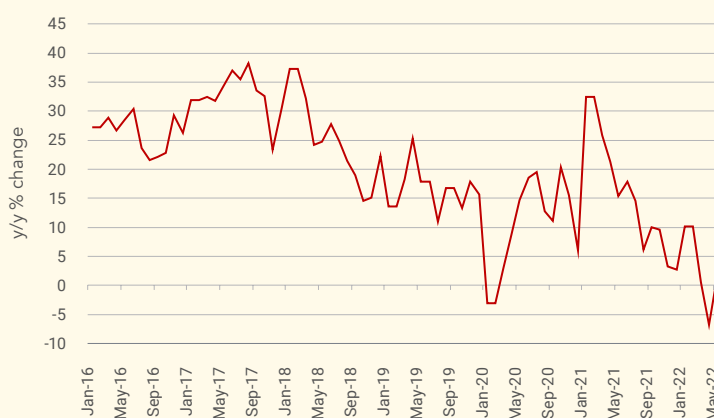
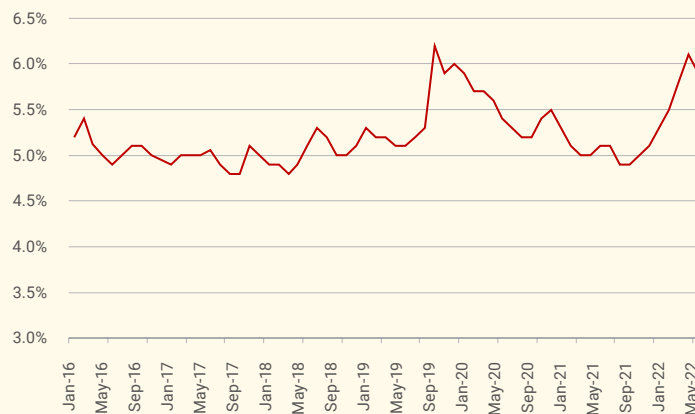


Fig. 2 – Urban unemployment rate

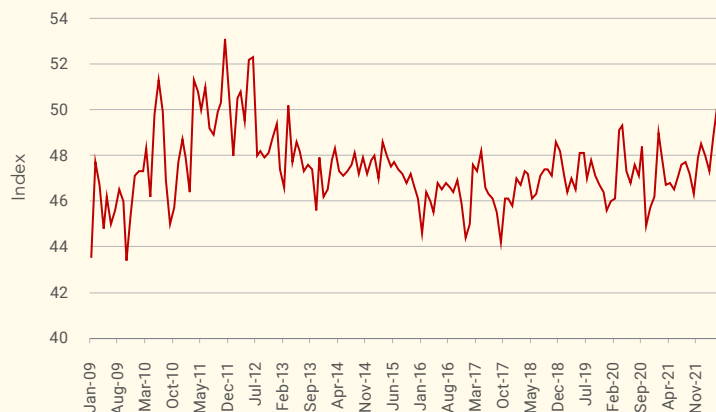
FAI also weak

Weak levels of business spending also held back demand for manufactured goods. Fixed-asset investment (FAI) in May increased 4.7% y/y. While this was up from 2.3% y/y growth in April, in real terms, capex growth is still negative. Adjusting FAI growth with the Producer Price Index (PPI) gives minus 1.7% y/y growth in investment.

Investment remains especially weak in the real estate sector. Spending by developers fell 7.7% y/y in May, compared to a 10.1% y/y drop in April. This drop was driven by the ongoing fall in real estate construction activity, with developers starting fewer new projects and completing fewer of their existing ones. Floor space newly started fell 41.9% y/y in May, and floor space completed dropped 31.2% y/y.

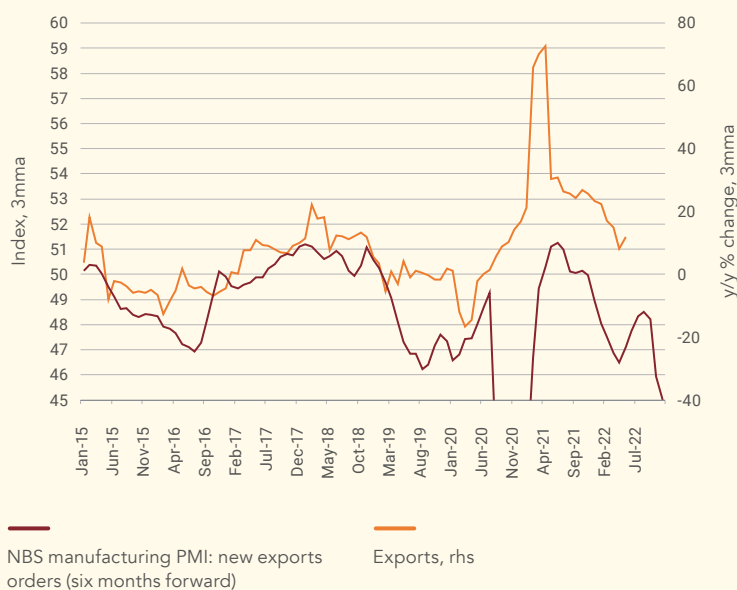
The increase in infrastructure investment was not enough to make a difference. Infrastructure FAI rose 7.9% y/y last month, up from 4.3% y/y in April. Adjusted with PPI, however, spending was up just 1.5% y/y in real terms.

This disconnect between production and consumption last month has led to an increase in inventories. The amount of steel held by traders, for example, is currently 11% higher than it was a year ago. The finished goods inventory index of the official manufacturing PMI also points to elevated stock levels [FIG 3]. At the end of April (the most recent month for which data is available), the value of finished goods inventories at Chinese industrial firms was up 20% y/y, the fastest rate of expansion since December 2011.

Fig. 3 – NBS manufacturing PMI: Finished goods inventories

Exports to the rescue?

The strong export print for May has raised the hope that Chinese manufacturers may be able to export their way out of their problems. Exports jumped 16.9% y/y in May, up from 3.9% y/y growth in April. However, this rise likely reflects ports playing catch-up with shipments as the backlogs created by lockdowns are worked through, rather than a rise in overseas demand for Chinese products. The export new orders index of the NBS manufacturing PMI, which has historically led export shipments by around six months, remains weak [FIG 4]. The index has been below the 50-point mark – separating expansion from contraction – for the past 13 months.

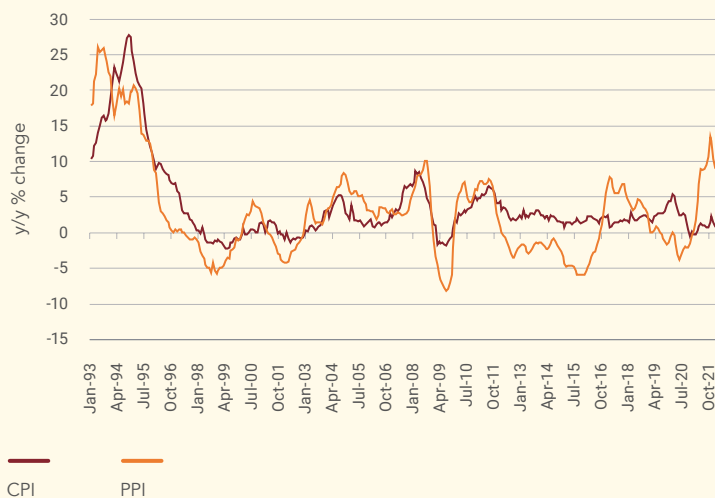
Fig. 4 – New export orders vs exports

NBS manufacturing PMI: new exports orders (six months forward)

Exports, rhs

With overseas demand set to remain weak given the inflationary headwinds in the US and Europe, the risk is that Chinese exporters will cut prices to boost orders. The RMB's recent depreciation against the USD has not done a lot to help export competitiveness. While the currency is down against the USD, it remains at multi-year highs against other currencies. The prospect of Chinese exporters slashing selling prices to boost overseas shipments is also limited. The Chinese corporate sector is struggling with high costs, with PPI continuing to outpace the Consumer Price Index (CPI) [FIG 5]; margins are being squeezed, and the ability of firms to lower selling values is negligible.

Fig. 5 – CPI vs PPI



Unlike in 2020, it is hard to see how the Chinese economy can remain on this two-track path. Without an export outlet, the faster recovery in production than domestic consumption is just cannibalizing future manufacturing output: At some point, firms will have to start cutting production and running down inventories.

There is no escaping the fact that more stimulus is needed. With overseas purchases not offering a solution, China needs to boost domestic demand. The unemployment data for May underscored that the measures taken so far have fallen short of what is needed. And with home sales down 41.7% y/y in May, it is clear also that last month's mortgage rate cut is insufficient.

May's data shows that officials have succeeded in putting a floor under the economic slowdown. However, more substantial easing will be needed to drive a recovery – let alone come anywhere near this year's GDP growth target of 5.5%.