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Trivium China

Markets Note

May's data shows stimulus must target consumption

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Key takeaways:

→ May's econ numbers show that measures to boost economic growth must focus on the root cause of China's weaker-than-expected post-COVID recovery: Depressed household consumption levels.

→ The expectation that dropping zero-COVID would unleash a wave of revenge spending and encourage households to draw down excess savings has not materialized. Post-COVID spending has been strongest in the service sector, but – unlike purchases of goods, which boosts manufacturing activity – this spending has limited feedthrough to the broader economy. The other problem is with household savings, which, far from falling, have been increasing.

→ Still-weak consumer spending explains why private firms remain reluctant to spend, with capex at these companies still falling y/y despite reopening. The rise in graduate unemployment also suggests businesses are reluctant to create new positions for inexperienced workers.

→ The economy risks becoming trapped in a downward spiral where households won't increase spending until the economy has recovered, but weak consumption levels depress growth. Beijing hoped that increased infrastructure spending would break this cycle by reviving confidence in the economy, but the collapse in real estate construction has undermined this stimulus.

→ Officials are, therefore, at a policy crossroads: Double down on the current strategy of trying to restore confidence via infrastructure stimulus or try something new?

→ The problem with the former is that financing will need to be substantially ramped up for infrastructure stimulus to make a difference, especially as local governments start to run out of special-purpose bond issuance quota in H2. However, it is not clear that officials are willing to commit to a large enough increase in infrastructure funding to drive stronger economic growth – particularly given the mounting concerns over local government debt.

→ Policymakers will likely, therefore, explore other mechanisms to restore confidence in the economy and persuade households to reduce savings and increase spending. This will likely include efforts to stabilize housing markets – given the links between household wealth and property – as well as the more direct measures to increase household income that officials have said they are working on.

→ What the exact mechanism for stimulating the economy will be is still unclear. However, it is abundantly clear that stimulus measures must focus on boosting consumption.

All eyes are on Beijing's next move after another month of disappointing econ data. However, understanding why China's economic recovery after the end of zero-COVID has fizzled out so quickly is critical to figuring out what Beijing needs to do next.

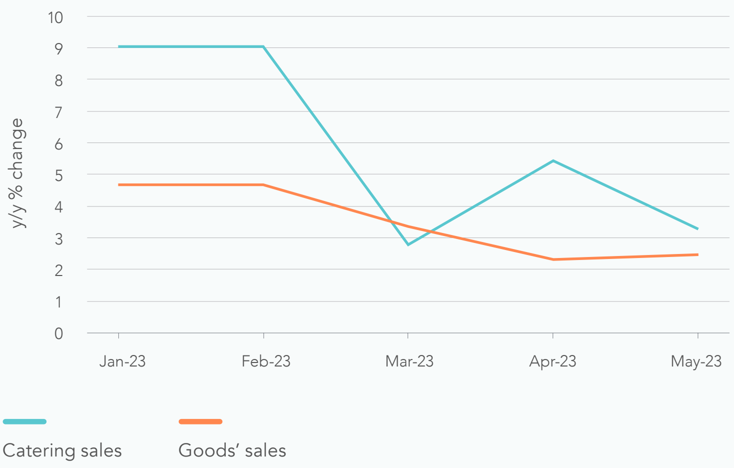
The household sector is at the heart of the country's disappointing reopening rebound. The expectation was that removing COVID-19 restrictions would lead to a wave of revenge spending as consumers made up for lost time. This spending would supposedly be supported by the savings households accumulated during the pandemic.

However, this is not quite how things have panned out.

Firstly, revenge spending has mainly manifested as increased service sector activity. Taking a two-year geometric mean of y/y growth in the first five months of 2022 and 2023 – to account for the distortions to the data from last year's lockdowns – shows that retail sales in the catering sector have outpaced those of goods **[FIG 1]**. The problem with this is that an increase in leisure activity has a limited feedthrough to other sectors compared with goods purchases, which drive an increase in manufacturing activity. There has been a noticeable difference this year between value-added output growth at state-owned enterprises (SOEs), which generally operate in the heavy industry sector and so have been more exposed to strong infrastructure investment, and private industrial firms, which tend to be more focused on consumer goods **[FIG 2]**.

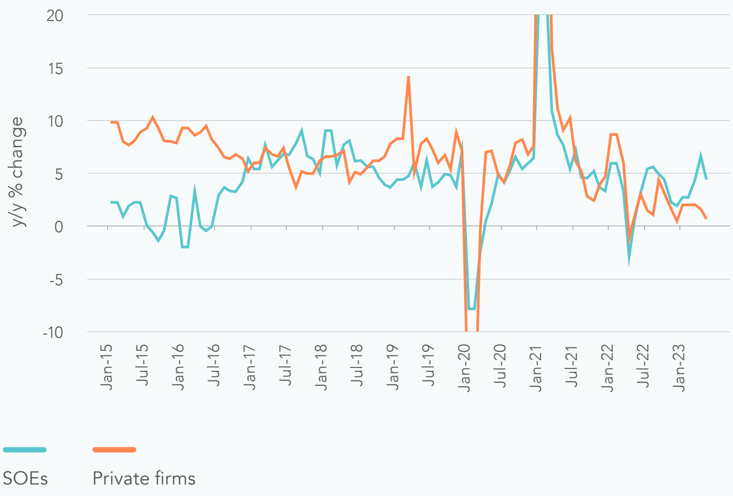
The other problem is that households have not been drawing down excess savings. In fact, the net increase in household deposits in the first five months of the year was even more than at the same time in 2022 **[FIG 3]**. This has limited the scale of the recovery in consumer spending. While retail sales have been increasing sharply relative to last year, this mainly reflects 2022's low base. In May, sales increased 12.7% y/y, but relative to the same period in 2021, they were up only 5.1%. This was a smaller increase than was seen in April when retail sales were 5.3% more than at the same time in 2021.

Fig. 1 – Retail sales, catering vs goods, two-year geometric mean



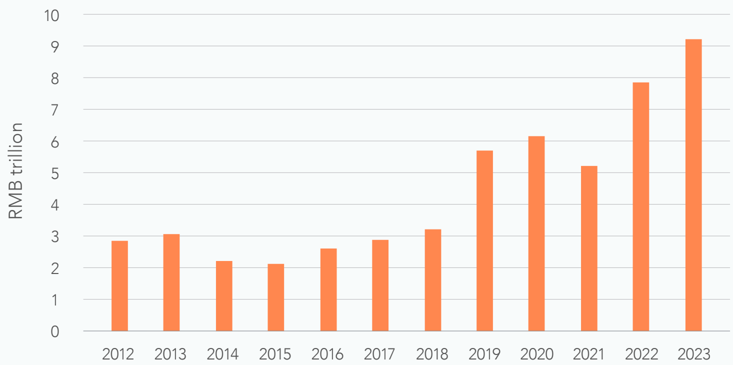
Sources: NBS, Trivium

Fig. 2 – Industrial value-added output



Sources: NBS, Trivium

Fig. 3 – Jan-May net increase in household deposits



Sources: NBS, Trivium

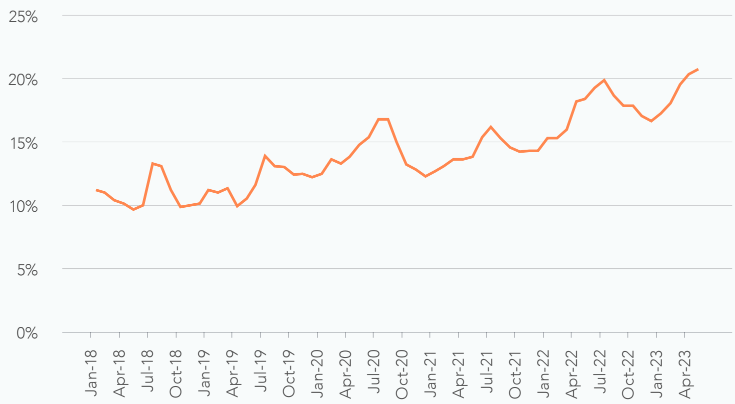
Stronger consumption is key

Reopening has, therefore, not unleashed the hoped-for recovery in consumption. This, in turn, has limited a critical source of demand for the manufacturing sector, amplifying the pain for Chinese factories from the downturn in overseas purchases.

Key to reviving economic activity, then, is boosting consumer spending. This would resuscitate consumption as a growth driver and help bolster confidence in the corporate sector, particularly among private firms. The latter's reluctance to increase capex has been a major drag on economic growth this year. In the first five months of 2023, private fixed-asset investment (FAI) fell 0.1% y/y. The only other time year-to-date growth in private investment has turned negative (since at least 2011, when this data started to be published) was during the early stages of the pandemic. What's more, retrenchment at these companies is getting worse. FAI was down 1.8% y/y in May compared with a 0.2% y/y contraction in April.

Weak private sector confidence is also reflected in high graduate unemployment. Joblessness among 16-24-year-olds was 20.8% last month, the highest since at least January 2018 **[FIG 4]**.

Fig. 4 – Urban unemployment rate: 16-24-year-olds



Sources: NBS, Trivium

Exiting a downward spiral

Boosting household spending is, therefore, key. The high level of household savings suggests that a major barrier to this is a lack of confidence: Households have excess savings, but they need to be confident enough in the country's economic prospects to draw them down.

In this sense, the economy is trapped in something of a downward spiral. Households won't increase spending until the economy has recovered, but weak consumption levels are depressing growth. The economy needs an exogenous intervention to drive faster economic growth, unlocking more household spending.

Infrastructure stimulus has traditionally played this role, but the countercyclical boost this is providing to economic activity is being undermined by the struggling real estate sector. While growth in infrastructure investment (including utilities) has remained strong, increasing 8.8% y/y in May, up from 7.9% y/y in April, real estate construction has collapsed.

The amount of floor space under construction last month was down 41.2% y/y. This was on top of a 39.4% y/y fall in construction at the same time the previous year, meaning construction activity last month was down 61.4% from May 2021. This reflects that developers are not starting new projects, faced, as they are, with extremely weak sales. While the value of new home sales in May was up 12.3% y/y, this was flattered by last year's low base. Relative to May 2021, transactions were down 41.5%. Developers have, consequently, significantly scaled back the number of new projects they are starting, with the floor space of new developments down 27.3% y/y in May.

The extent to which this collapse in real estate activity has undermined infrastructure spending is reflected in last month's fall in the production of building materials. Steel output fell 7.3% y/y in May, cement production was down 0.4% y/y, and plated glass dropped 9.4% y/y.

Policy crossroads

The case for more stimulus is now compelling. But officials are at a policy crossroads: Double down on the current strategy of trying to restore confidence via infrastructure stimulus or try something new?

If officials opt for the former option, they must take measures to substantially increase infrastructure financing. The 15.7% y/y increase in the first four months of the year in local governments' special-purpose bond issuance – one of the main channels for funding infrastructure projects – was not enough to offset the drop in real estate activity and lift overall construction activity. This means that absent a recovery in property construction, infrastructure financing will need to be scaled up significantly over the remainder of the year to make any difference at the macro level.

The problem, however, is that infrastructure funding is set to tighten in the coming months. Without any change to local governments' special-purpose bond quota for this year, issuance between May and December will drop 17.4% y/y. One option would be to repeat last year's trick of utilizing unused quotas from previous years to expand local governments' debt-raising capacity. This, in itself, will not be sufficient, however. Another possibility, which is reportedly being discussed, is to use the central government's balance sheet to finance infrastructure investment by issuing special treasury bonds. Beijing also has the option of increasing policy bank financing for infrastructure projects, as it did last year.

However, it is not clear that officials are willing to commit to a large enough increase in infrastructure funding to drive stronger economic growth – particularly given the mounting concerns over local government debt. Policymakers will likely, therefore, explore other mechanisms to restore confidence in the economy and persuade households to reduce savings and increase spending.

One area of focus will likely be housing markets, given the links between household wealth and property. Stabilizing real estate transactions and allaying concerns about a drop in property values would go some way to bolstering household confidence. Beijing has also hinted that it is working on more direct measures to boost household income, although officials have still not done anything concrete on that front.

What the exact mechanism for stimulating the economy will be is still unclear. However, it is abundantly clear that the focus of these measures must be on boosting consumption.

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