QUARTERLY ANALYSIS OF ECONOMIC TRENDS IN CHINA

MERICS Economic Indicators – China's economy is facing a cyclical and policy-induced downturn

Q3/2021

CONTENTS

MERICS Q3 analysis 2

Macroeconomics 4

Business 5

International trade and investment 6

Financial markets 7

Investment 8

Prices 9

Labor market 10

Retail 11

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MERICS Q3 analysis

Policy blitz to curb risks stokes downward pressure on the economy over Q3

Following a spectacular recovery over the first half of 2021, China's GDP growth rate dropped to 4.9 percent in the third quarter of the year. Overall growth across the first three quarters was 9.8 percent. More moderate growth was widely expected, but the sharper than expected slowdown across a broad range of key economic indicators is weighing down the GDP growth outlook for 2021. A combination of power shortages and Beijing's efforts to control financial risk have hit economic growth. Meanwhile consumption keeps falling behind expectations, partly due to regional Covid-19 outbreaks, giving rise to economic imbalances. As the year ends, China is facing a broadening economic slowdown.

China's government has navigated the economy through pandemic-related challenges effectively enough so far but risks over-reaching now. The policy blitz across various sectors of the economy that it launched in the second half of 2021 has raised questions about a lack of coordination within the government. Cracking down on unfavorable developments in the tech, education, and entertainment sectors while also enforcing anti-monopoly regulation, tackling financial risks and accelerating efforts to reach CO_2 emission reduction goals would be challenging if tackled individually, even at the best of times. Doing them simultaneously in current circumstance may stall China's economic engine.

Consumption cannot compensate for loss of steam in other parts of China's economy

All of these measures are sure to decelerate GPD growth in the coming months: Deleveraging in the real estate sector will slow investment and construction activity, while manufacturing and exports will suffer from energy shortages in addition to high commodity prices and supply chain shortages. Weak consumption is hardly in shape to compensate for loss of steam in other parts of the economy.

In response, the government is likely to prioritize key policies; it must balance its strategic desire to address structural issues and yet preserve economic growth. Over the coming quarters, the government's lower limit of acceptable GDP growth will be put to the test.

Defusing financial risk and a collapse in housing prices continues to be a headache

The key challenges will be addressing the biggest (gray) rhino in the room: China's financial risks. The Evergrande fallout was long in the making, as the government tightened regulations for property developers over the past 18 months. Defusing financial risk while preventing a collapse in housing prices and trimming the economy's reliance in real estate will continue to be a headache. Some policy tightening in other areas may be slackened, but the government seems committed to keeping controls in place for overleveraged property developers - it is ready to accept economic pain in order to ensure more sustainable economic growth, and rightly so.

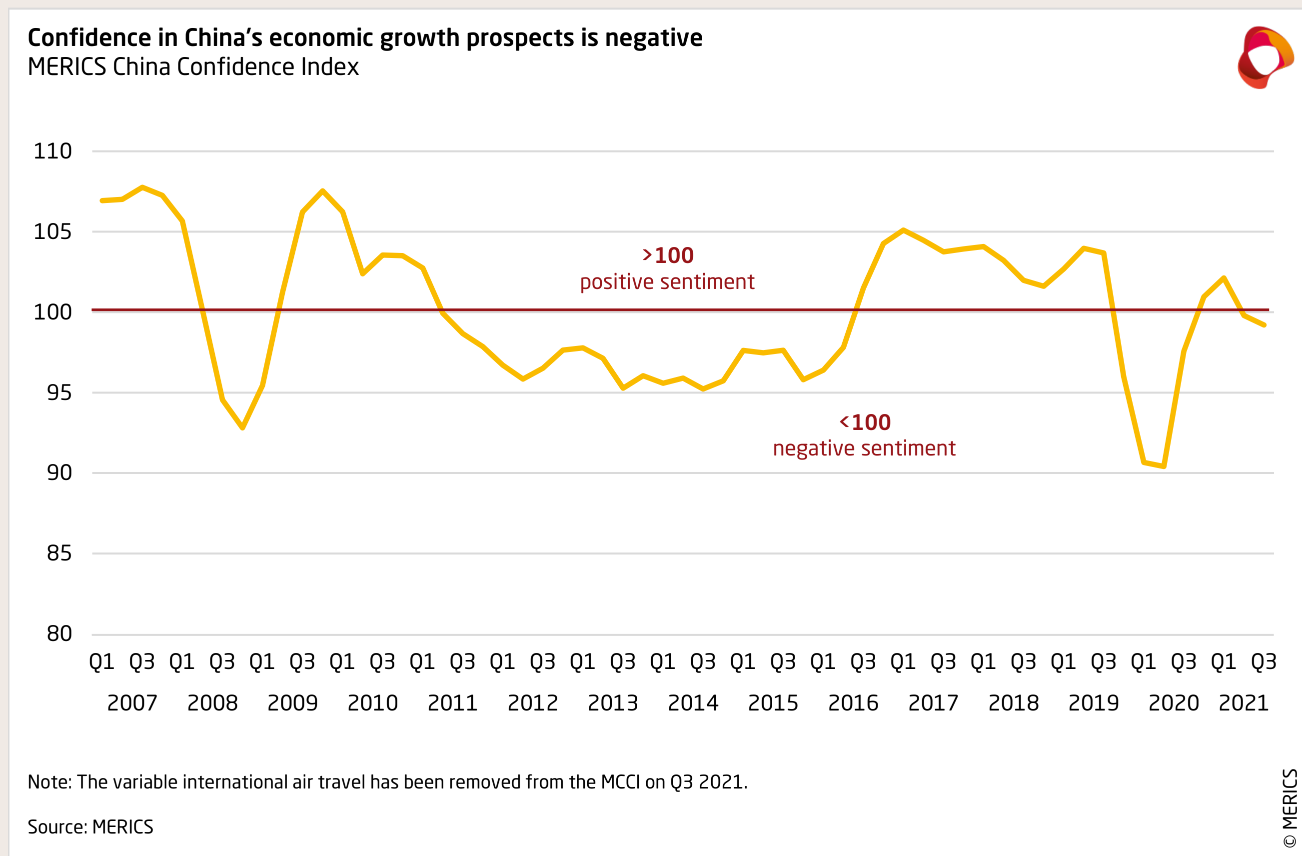
More monetary and fiscal policy support can be expected over the next quarter to support GDP growth, especially in the run up of the Party Congress in 2022. However, the government is mindful of financial risk, so support is likely to be targeted, and aligned with the CCP's long-term objectives, such as industrial upgrading and boosting innovation. The recent regulatory clampdown has underlined the government's limited trust in private enterprises and market mechanisms to deliver on these goals. The CCP's "guidance" over the economy is likely to expand.

The MERICS China Confidence Index (MCCI)

The MERICS China Confidence Index measures household and business 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, new manufacturing orders, new business in the service sector, urban households' house purchase plans, venture capital investments, private fixed asset investments and disposable income as a share of household consumption. All components have been tested for trends and seasonality.

The MCCI was first developed in Q1 2017.

Confidence in China's economic growth prospects is negative
MERICS China Confidence Index



Note: The variable international air travel has been removed from the MCCI on Q3 2021.

Source: MERICS

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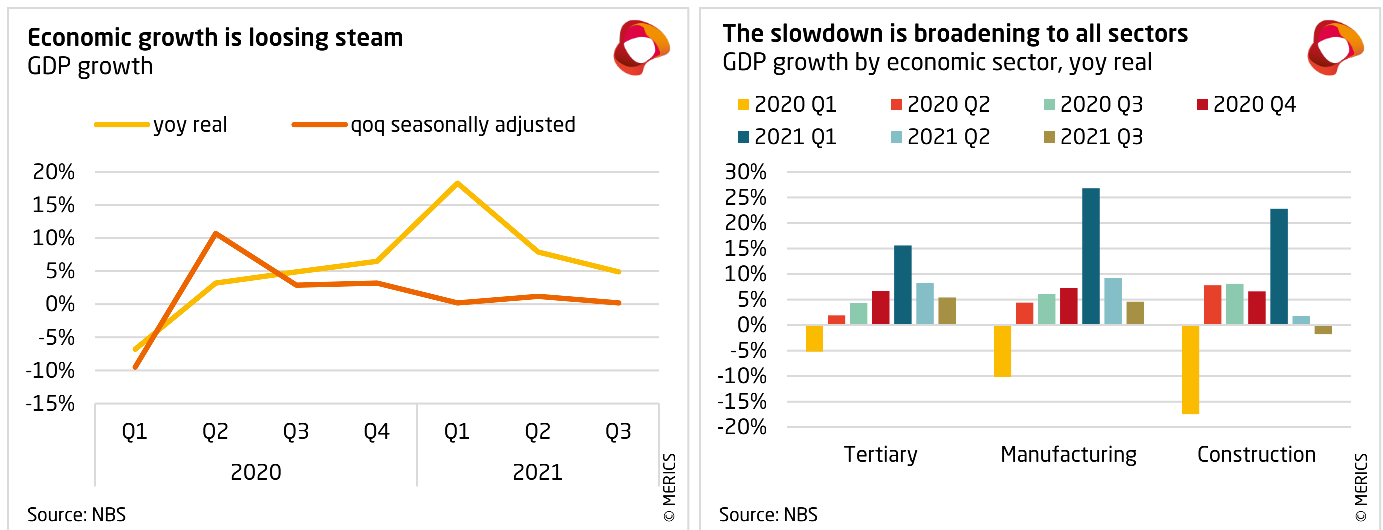
Macroeconomics

Policy induced slowdown adds to cyclical downturn

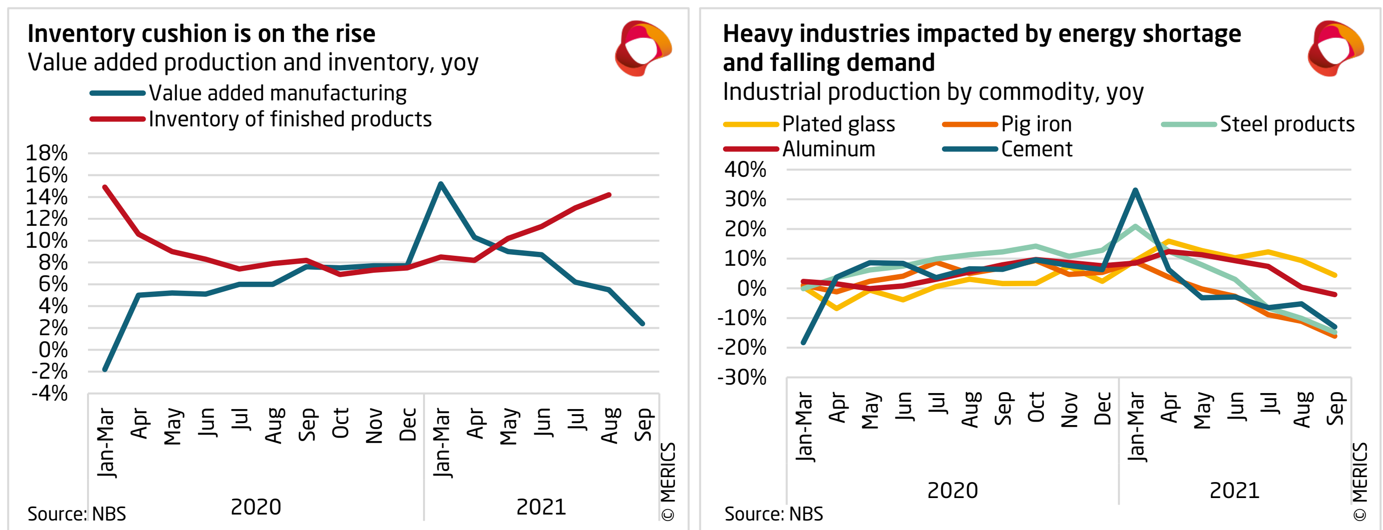


- China's economic recovery peaked during the first half of the year. Faced with a complex set of head-winds, China's economic growth slowed to 4.9 percent in the third quarter of 2021, compared to Q3 last year. For the first three quarters, GDP grew by 9.8 percent. Despite the stronger than expected slowdown, 2021 GDP is likely to be over 7 percent and well within the government´s annual GDP growth target of around 6 percent.
- Growth in investment and manufacturing was squeezed from two directions, by economic policies targeting structural problems - such as curbing high debt levels and reducing emissions - and by the cyclical slowdown in the wake of rapid expansion earlier in the year. Manufacturing slowed to 4.9 per-cent while construction contracted by 1.8 percent in Q3 year on year (see exhibit 2).
- Domestic consumption was not strong enough to compensate for the growth slowdown in other sec-tors of the economy. Regional Covid-related lockdowns in line with the government's zero tolerance policy continued to curtail consumption, especially in services. Services growth slowed to 5.4 percent in Q3, down from 8.3 in the previous quarter.
- Exports continued to be the bright spot. External demand remains a reliable and robust growth driver for China's economy. Over the third quarter, its contribution to GDP growth rose from 9.7 percent in Q2 to 21.7 percent.
- At present, the government remains committed to policies that curb financial risk and hence unlikely to unleash a massive stimulus. Policy makers seem willing to tolerate lower GDP growth as they seek to tackle long-term structural issues and rebalance the economy in line with broad policy goals. But the government's red line for the lower limits of GDP growth will be tested in the last quarter.

What to watch: A targeted monetary and fiscal stimulus is likely to be rolled out during the last quarter.

Business

Industrial production in Q3 slowed by multiple challenges

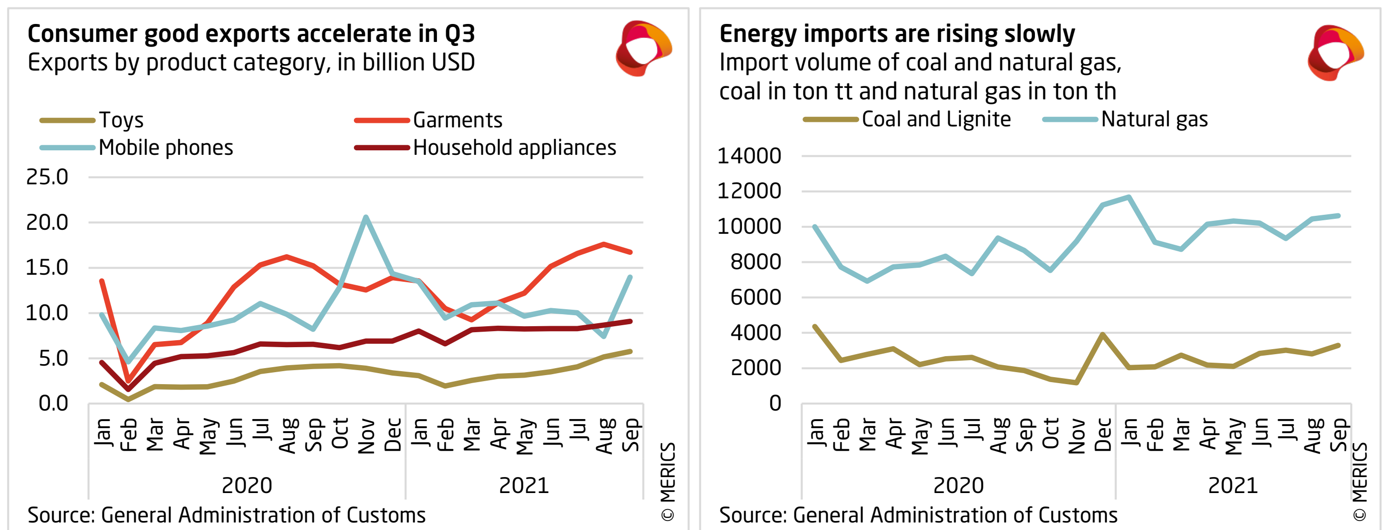


- Multiple challenges triggered the slowdown in manufacturing in the third quarter. Power outages, higher input prices for commodities and energy, shortages of key components - semiconductors, in particular - and a regulatory crackdown in real estate all played a part. Growth in value-added manufacturing fell to 2.4 percent in September year on year (see exhibit 1), the second lowest value recorded since Q1 2020.
- Energy intensive and construction related sectors had the worst of the manufacturing slowdown. The trend began in the second quarter but became more pronounced in Q3. Production of key industrial inputs, including steel, glass and cement fell sharply; all contracted in double digits in September (see exhibit 2).
- Industries less reliant on energy intensive inputs fared better. Thirty of 41 sectors tracked by the National Bureau of Statics (NBS) expanded in September. The pharmaceutical industry was the strongest, expanding 26.5 percent. In the ICT sector, September output grew only 9.5 percent.
- Automobile production continued to feel the effects of semiconductor shortages and lagging demand. Output hit a full-year-low in August, contracting by 19.5 percent on the same month of 2020. However, overall auto production was still up 9.4 percent in the first nine months.
- New Energy Vehicle production continued to be the bright spot: output was up 141.3 percent in September and 172.5 percent for the first nine months, year on year.
- The services sector continues to be vulnerable to Covid-related regional lockdowns. The effects were very noticeable in August when China faced several small-scale outbreaks. Rail travel contracted by 38 percent and air travel by 51.5 percent in August year on year.
- China's tech giants are facing regulatory scrutiny in the form of anti-monopoly investigations by the State Administration for Market Regulation (SAMR) and data security probes from the Cyberspace Administration. The fallout should become clearer over the coming months. New regulations are expected to be announced.

What to watch: Energy shortages risk moving upstream to affect a broader range of industries.

International trade and investment

Unstoppable exports: global demand for consumer goods stays strong

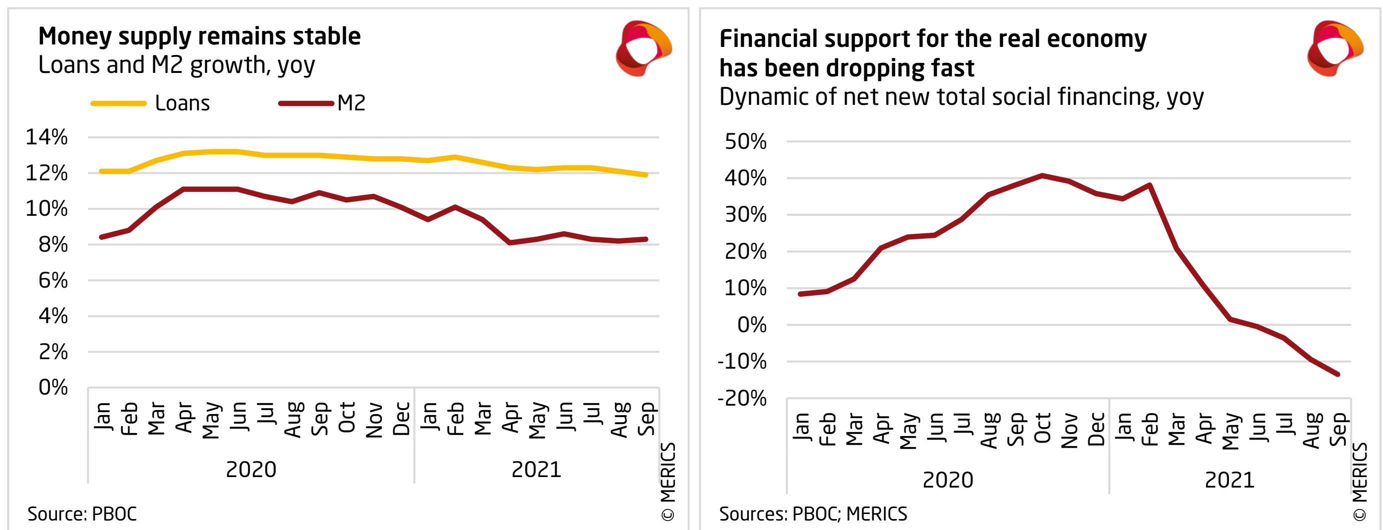


- Strong global demand offset the impact of supply chain disruption from Covid-related lockdowns, including at major ports. In September exports expanded by 28.1 percent in USD terms year on year, compared to 25.6 percent in August. Growth has eased downward moderately but is still at high levels: exports increased by 33 percent in the first nine months of 2021 compared to same period 2020.
- Demand for consumer goods and electronics held up over the third quarter (see exhibit 1). There was no sign of the anticipated slowdown in Chinese merchandise exports due to a shift towards service spending after the re-opening in major markets, such as the EU and US.
- Factory activity was disrupted by energy shortages and high input prices towards the end of Q3, though exports have not yet been impacted. In September, key industrial exports continued to expand. Exports of unwrought aluminum increased by 54.4 percent year on year, steel products more than doubled, and high-tech products, including electronic components, expanded by 28.6 percent.
- Exports continue to outpace imports, widening China's trade surplus. In September it was USD 66.7 billion, the highest level in 2021 so far. China's import growth slowed to 17.6 percent in USD terms in September compared to one year earlier. Import growth data was strongly affected by higher commodity prices, while import volume for some key industrial inputs indicates slowing manufacturing activity.
- Weaker imports of key raw materials reflected slower industrial demand. For example, imports of iron ore fell to 95.6 million tons in September, compared to 108.5 million tons a year earlier. Iron ore imports have remained sluggish over the third quarter and were down 3 percent over the first nine months.
- Foreign direct investment activity remains strong despite growing geopolitical tensions. By end of August (latest data available) utilized foreign direct investment expanded for five consecutive months. Total investment accumulated to 758 billion yuan, up 22.3 percent compared to the same period last year.

What to watch: Falling factory activity and the slowdown in real estate are likely to slow down import growth in the coming months, potentially widening China's massive trade surplus.

Financial markets

Credit growth slowdown will test PBOC's policy tightening

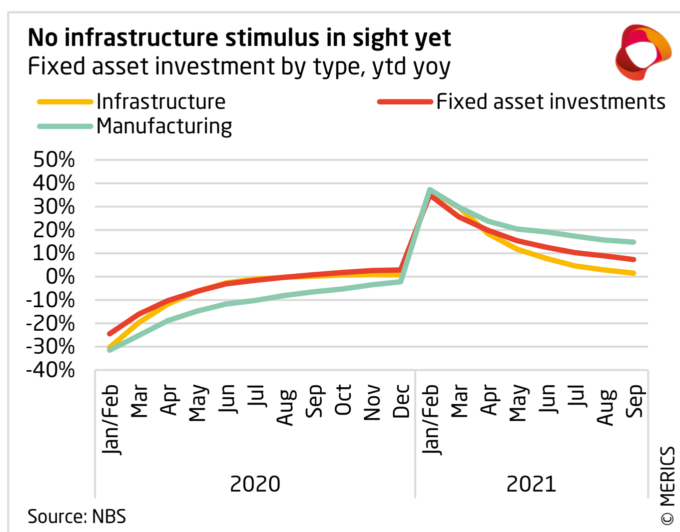


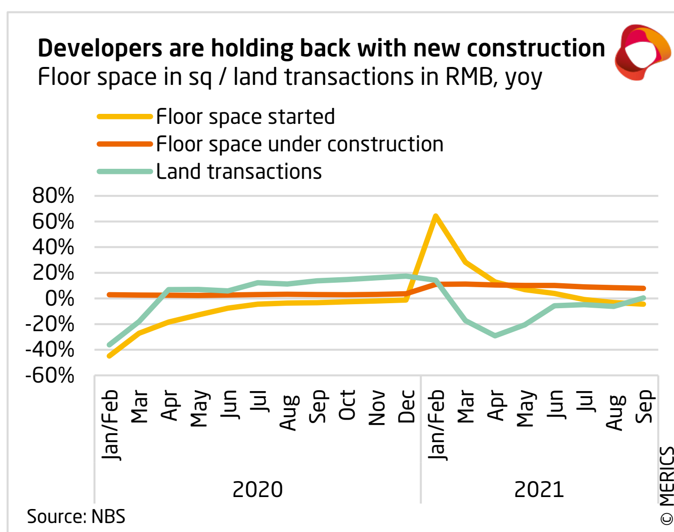
- Growth of aggregate total social financing (TSF) continued to shift downward over the third quarter. In September, TSF growth fell to 10 percent, down from 13.5 percent a year ago. Tighter monetary policy and weaker economic growth were the main reasons for the decrease in new financing to the economy over Q3.
- The People's Bank of China (PBOC) remains focused on reducing financial risk. There have only been limited liquidity injections and no sign of a shift towards looser monetary policy aimed at stimulating the economy. This may change in early 2022 should GDP growth fall further.
- The PBOC remains committed to tackling overleveraged real estate developers and local governments, despite the negative impact on GDP growth. As a result of policy tightening, the financial troubles of Evergrande, one of China's largest property developers, rattled markets in China and across the world. Nevertheless, by the end of September financial contagion remained limited to real estate developers. Overall corporate bond financing activity picked up slightly to 6.9 percent in Q3 (yoy).
- However, the turbulence in the real estate sector dented households' confidence amid fears of real estate developer defaults. New medium and long terms loans to households - mostly used to buy property - dropped by 26.7 percent in September from year-earlier. The fall contrasted sharply with growth of 22.5 percent during the first six months of 2021.
- Slower economic growth and concerns over the Evergrande crisis has had little impact on foreign investors. In Q3, they continued to make use of new investment channels, pouring an additional 100 billion yuan into the bond market and another 68 billion yuan through the stock connect mechanisms. Added to the sustained trade surplus, this has led to the yuan appreciating by 0.4 percent against the US dollar, and 1.7 percent against the reference basket of currencies by the end of quarter, to its highest level since 2015.

What to watch: How the PBOC goes about easing monetary policy will say a lot about regulators' willingness to clean up the financial markets and their tolerance for lower GDP growth.

Investment

Strong manufacturing investment prevents sharper overall slowdown



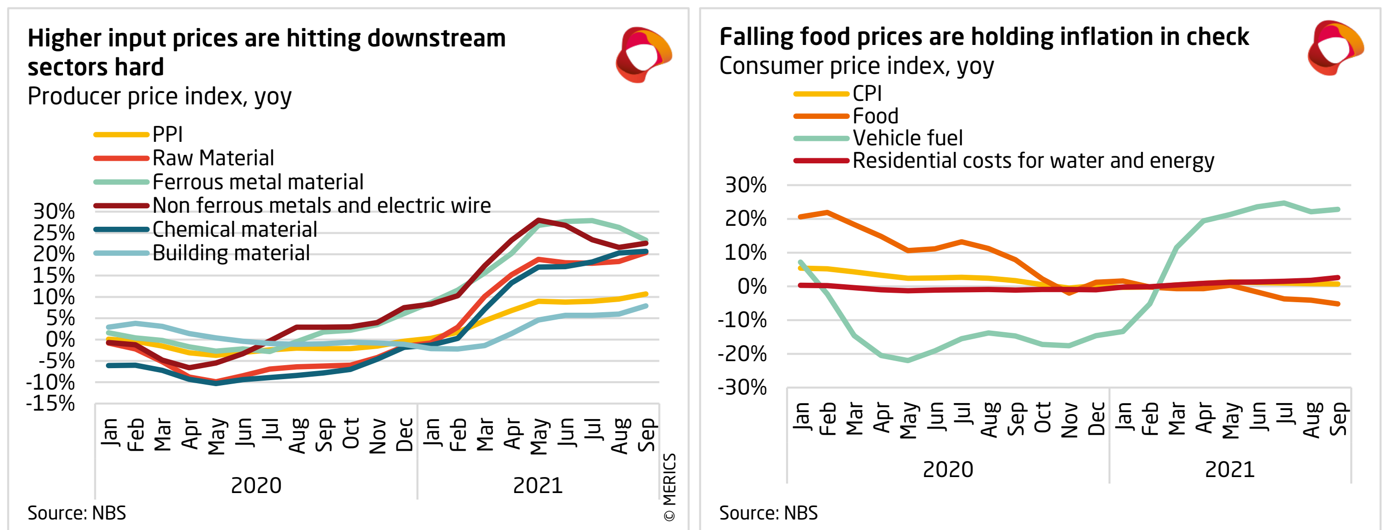


- Fixed asset investment growth continued a gradual downward shift over the third quarter. For the first nine months, it increased by 7.3 percent year on year, down from gains of 12.6 percent in the first half of the year. Despite slackening, investment activity remains a key growth diver and is stronger than in pre-Covid times, when investment expanded by 5.4 percent in the first three quarters in 2019.
- Manufacturing investments were a major reason for robust investment activity. Despite the slowdown over the third quarter, manufacturing related investments outpaced other sectors of the economy, in part due to base effects (see exhibit 1). In the first nine months, manufacturing investment grew 14.8 percent, far higher than investment in the service sector, which expanded by 5 percent.
- In August, the National Development and Reform Commission (NDRC) issued new measures to strengthen manufacturing investment. The policies targeted green investment, including technological upgrading to reduce carbon emissions, and advanced manufacturing. The policy drive underlined the government's preference for investment in China's manufacturing capabilities rather than speculative real estate investments.
- China's real estate developers are feeling the pinch of increased regulatory tightening. But the slowdown in real estate investment remains moderate. Year to date growth slowed from 15 percent at the end of the second quarter to 8.8 percent by the end of Q3. The decline was most pronounced in office buildings, where growth was down by 0.5 percent, whereas investment in residential buildings rose by 10.9 percent.
- The government's crackdown on the property sector was most visible in fewer building starts. Developers are cautious about market developments, and lack the funds needed for new construction. New building starts fell by 4.5 percent, measured by floor space under construction, in the first three quarters (see exhibit 2). Land transactions continued to rise, up by 0.3 percent.

What to watch: All eyes will be on real estate investment as the fallout from the government's regulatory crackdown continues to unfold.

Prices

Rising energy costs are driving inflation pressure

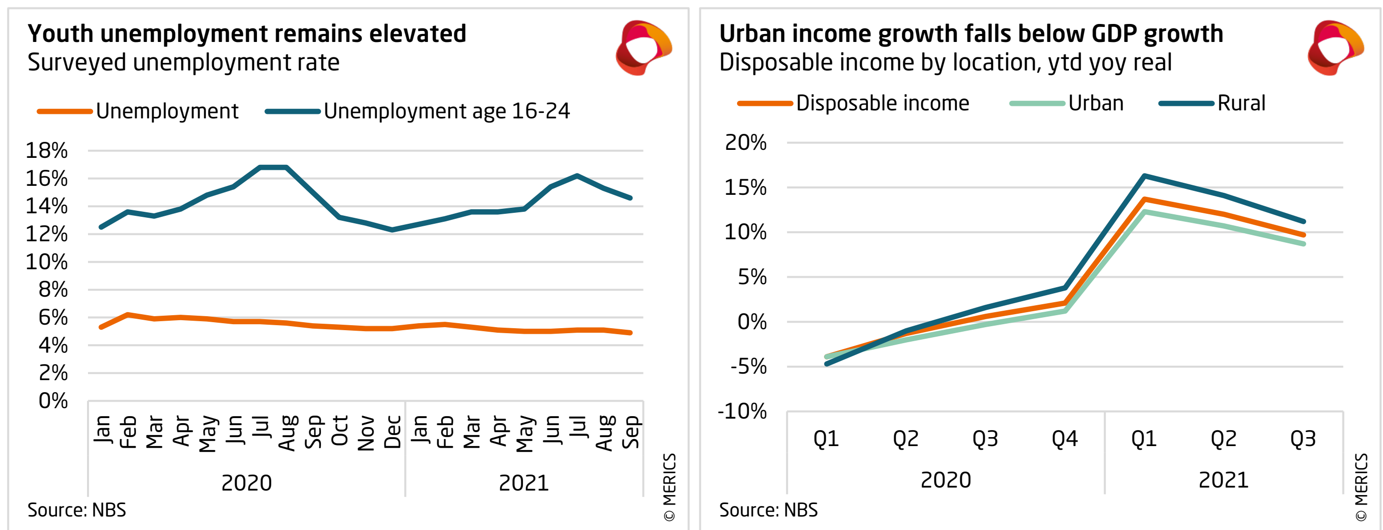


- In September, the producer price index (PPI) accelerated to 10.7 percent, compared to 9.5 percent in August – the highest level on record. Producer prices were pushed up over the quarter as manufacturers faced higher costs for energy and key industrial inputs.
- Higher energy costs impacted the prices of energy intensive industrial inputs. In September, prices of ferrous metals jumped by 30.3 percent; non-ferrous metals and wires rose 23.3 percent; and chemical materials prices increased 22.6 percent (see exhibit 1) compared to September 2020. Higher energy prices are likely to push prices up further in the final quarter.
- Faced with soaring global commodity prices and a shortage in coal, the State Council doubled the current cap within which prices charged by energy suppliers can move. The change aimed to boost supply by permitting energy producers to pass on higher input costs to users.
- So far, inflationary pressures remain concentrated in energy intensive manufacturing, with limited spill over into other sectors. Consumer prices rises eased during the third quarter, falling from 1 percent in July to 0.7 percent in September.
- Food prices are adjusting following spikes due to high pork prices caused by the swine flu outbreak in 2018/2019. This has contributed to a lower consumer price index (CPI) in 2021. Energy prices are now the main driver of consumer price inflation (see exhibit 2), as they are for PPI. Energy prices for residential electricity and heating will likely pick up further over the winter, leading to moderate rises in the CPI.
- Real estate prices for newly constructed residential buildings has been softening over the year. Of the 70 cities tracked by the NBS, only 16 cities saw sales prices picking up in August (latest data). But prices are continuing a gradual slowdown: on average prices contracted by 0.4 percent year on year.

What to watch: Preventing a sharp fall in real estate prices will be a key priority for the government.

Labor market

Economic headwinds add new labor market woes

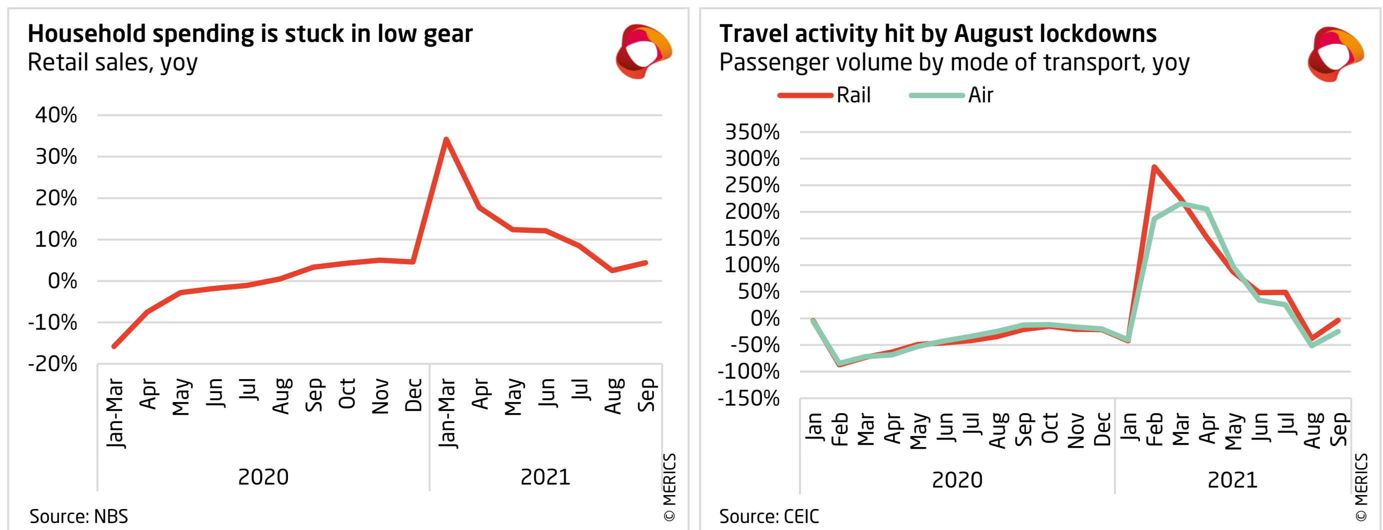


- China's employment situation remains a major concern for the government. The uneven economic rebound produced weak labor market recovery, particularly in services and retail, during the first half of the year. Over the course of Q3, the regional Covid-19 related lockdowns continued to dampen hiring in service sector. In addition, construction-related jobs are being affected by government efforts to contain financial risk in the real estate sector. Energy blackouts are threating employment in manufacturing.
- Between January and September, a total of 10.5 million new jobs were created. The government is close to reaching its 2021 target of 11 million new urban jobs despite the growing pressures. But China's labor market faces increasing structural challenges, including a skills mismatch.
- Challenges are most notable in youth employment. Unemployment among 16-24 year-olds surged to 16.2 percent in August. Peaks are usual over the summer as graduates enter the workforce, especially with a record number of 9.1 million graduates in 2021. However, the surge became more pronounced in 2020 and subsided more slowly, a pattern that was repeated this year (see exhibit 1).
- The government has responded with familiar measures: new vocational training moves to address the skills mismatch, and tax and fee reductions to support entrepreneurship among fresh graduates. However, the simultaneous crackdown on tutoring businesses and tech companies dampened graduate recruitment.
- Short-term fixes may keep overall employment stable, but wont address major problems in the labor market. As a result of increased competition for jobs some job seekers are likely to take jobs that fail to meet their expectations for their qualifications and wages.
- Falling income growth reflects the weaker labor market. Real urban disposable income fell to 8.7 percent in in the first three quarters, well below GDP growth of 9.8 percent. Slow wage growth, particularly for low-income groups will continue to be a major challenge as the government tries to curb inequality.

What to watch: Negative employment impacts from the crackdown on highly leveraged real estate developers, coupled with energy shortages, could add to pressures in the final quarter of 2021.

Retail

Household spending remains subdued and affected by lockdowns



- Consumption remains the trouble spot in China's economic recovery. The strong rebound over the first quarter was mainly due to low growth in the reference period in 2020. As these base effects wore off, retail growth continued to fall over the subsequent months; it reached a 11-month low of 2.5 percent in August, year on year. Growth rebounded slightly to 4.4 percent in September but remains fragile as households hold off from spending due to low wage growth, coupled with fears generated by insecurity in the real estate sector.
- Falling automobile sales were a major factor pulling down retail growth. Excluding auto sales, retail growth picked up to 6.4 percent in September year on year and rose 16.3 percent in the first nine months. This marked a considerable improvement over 2020. Sales of communication equipment were a bright spot in September: growth accelerated to 22.8 percent year on year, the highest level since March at the peak of the post-pandemic recovery.
- Rising energy prices also contributed to improved retail sales growth in September, rather than any strong rebound in demand. Fuel prices jumped 13.1 percent in August year on year, then gained 17.3 percent in September compared to the same month year earlier.
- Spending over the week-long National Day holiday fell yet again, after 2020's dismal figures. Tourism related revenue dropped 30.1 percent during "Golden Week" last year and was down a further 4.1 percent in the first week of October holiday this year. Holiday related tourism revenue was still only 59.9 percent of pre-pandemic levels.
- The service sector remains vulnerable to Covid-19 outbreaks (see exhibit 2). Like travel related services, restaurant spending is particularly sensitive to government-imposed restrictions. Following several regional outbreaks in August, restaurant spending contracted by 4.5 percent in August year on year, recovering to 3.5 percent in September.

What to watch: Higher energy prices could impact retail spending in the winter months.

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