Economic Research:

China's New Stop-Go Cycle

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Key Takeaways

- China is living through another stop-go cycle even though the stop, COVID-19, is different this time.
- Over the weekend, policymakers said they aren't setting a GDP growth target this year. The new target is jobs but a sluggish service sector means a slow jobs recovery and more stimulus.
- Financial conditions confirm stimulus is arriving. This will lift growth for a while (our forecasts are 1.2% for 2020 and 7.4% for 2021), but a tightening will follow in 2021.

China dropped its growth target for 2020 at its government meetings over the weekend but is still turning the dial on stimulus. Many countries are doing the same but "stimulus" is a loaded term in China and is associated with rising debt and financial risks. S&P Global Ratings believes that stimulus could be swiftly withdrawn next year if the recovery continues.

Difficulties in calibrating policies to balance growth and financial stability led to stop-go credit-driven business cycles in China's past. While not obvious from the official GDP data, powerful upturns are followed by precipitous downturns that uncover pockets of financial stress and result in market volatility. Policies then swing back to loose and so the cycle continues.

The growth target is gone but swiftly achieving full employment needs policy support. Our analysis suggests another large, credit-driven policy push has already begun. If COVID-19 remains contained, this will lift growth later this year and into early 2021. If stimulus is then withdrawn, as we expect, a typical stop will likely follow. A stop may not be reflected in GDP data but its effects will be felt in China and elsewhere. Weak spots in the economy, including overcapacity sectors or highly leveraged firms and households, could emerge.

China Is Healing--Manufacturing Leads And Services Lag

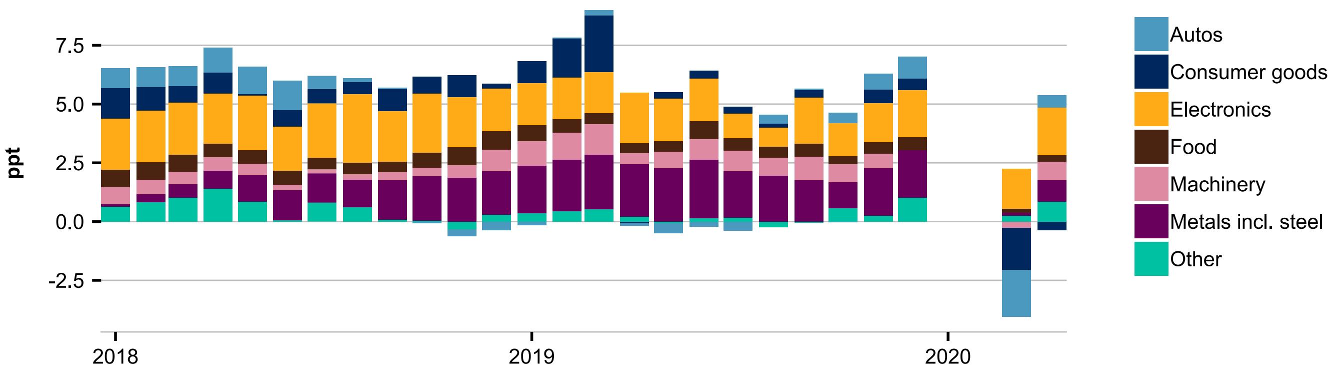
China's economy is healing. Indicators point to a U-shaped recovery assuming COVID-19 remains contained. Unsurprisingly, healing is uneven. Large firms are finding their feet faster than small firms and industry is recovering faster than the service sector.

We estimate that just three months after the peak in COVID-19 cases in early February, large industrial firms were back at 95% of normal capacity. Manufacturing output rose by 5% in April compared with a year ago. Not all industries are firing at the same time, however. The technology sector has rebounded, autos have stabilized, and consumer goods are still below 2019 levels.

Chart 1

Electronics Leads China's Manufacturing Rebound

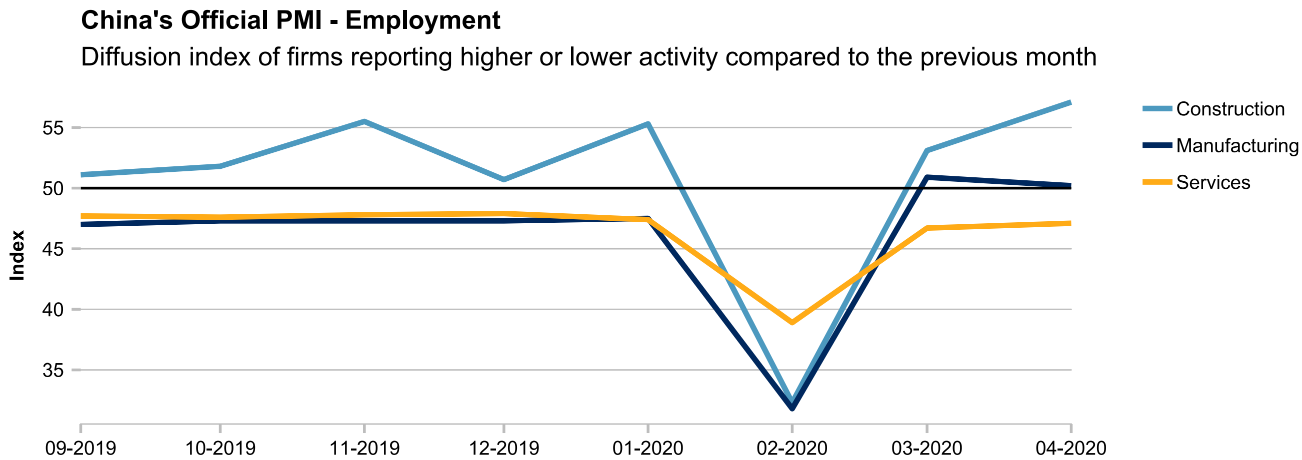
Percentage point contribution to annual growth in manufacturing output



Note: Contributions to year-on-year growth estimated using a constrained non-linear regression.
Data for January and February 2020 not reported and not interpolated as in previous years.
Source: CEIC and S&P Global Economics.

Industry's revival is good news but it is far from enough to save the economy. The service sector now accounts for about 55% of the economy and 50% of employment but its recovery is lagging as social distancing, enforced and voluntary, limits face-to-face activities. The majority of service sector firms responding to the purchasing managers' index (PMI) survey reported lower employment in both March and April, in contrast to manufacturing and construction. An uncertain jobs outlook may be encouraging households to save more--certainly retail sales remain weak, even after accounting for some switch to online shopping.

Chart 2



Note: A reading above (below) 50 is typically interpreted as a majority of survey respondents in each industry reporting higher (lower) activity compared to the previous month. Data are seasonally-adjusted.
Source: National Bureau of Statistics, CEIC, and S&P Global Economics.

We do not know how high unemployment has risen in China. The new surveyed unemployment rate, which suggests it is already at this year's target of around 6%, is an improvement on previous measures but it likely undercounts the number of people looking for work. The chief reason is that when migrant workers lose their jobs in cities, they often return to their hometowns, perhaps to work on the family farm. Such a worker should be measured as unemployed or underemployed but the statistical surveyors asking questions back in the city will not include this in their reports.

Six Securities But Employment Still Comes First

China has not set a GDP growth target for 2020. This is good news as it reduces incentives to over-stimulate to reach an arbitrary level of economic expansion. At the weekend sessions of National People's Congress (NPC), Premier Li Keqiang said that the focus is now on three critical battles, six stabilities, and six securities. This sounds complicated but from the perspective of managing the economic cycle, we might focus on one special balancing act--full employment and financial stability.

The "six stabilities" have been around for a while and employment and financial stability are prominent among them [1]. These can be mutually consistent when an economy allocates resources efficiently and policymakers carefully calibrate policies. In past cycles, these conditions have not been met in China, resulting in a trade-off between employment and financial stability. When one becomes especially important, policies can swing quickly from loose to tight and back again.

The "six securities" are new. The lineup is different from the stabilities--for example, securing continuity of the industrial supply chain--but one similarity is the primacy of employment. A People's Daily review of an April Politburo meeting listed the same securities the Premier referred to at the NPC [2]. Listed first was "ensuring employment." This was followed by securing basic livelihoods, which we interpret as a focus on household income but especially society's more vulnerable groups.

Soft Services + Employment Goal = More Stimulus

The explicit employment targets are over 9 million new jobs (from the reported addition of 13.5 million last year) and a surveyed unemployment rate of around 6%. To generate this number of jobs without relying too much on stopgap employment will need full-year GDP growth well above 1% in our view (our forecast is 1.2%). The unemployment rate target is easier to hit but the implicit target may be much broader, encompassing many of the migrant workers that are not captured in unemployment statistics.

If the engine of jobs growth is sputtering and jobs is the number one target, then it is no surprise that policymakers are dialing up the stimulus. The government could go full-Keynesian and employ more people to dig holes and then refill them. A more conventional approach would be to lift aggregate demand during the recovery this year and rely on that to accelerate hiring.

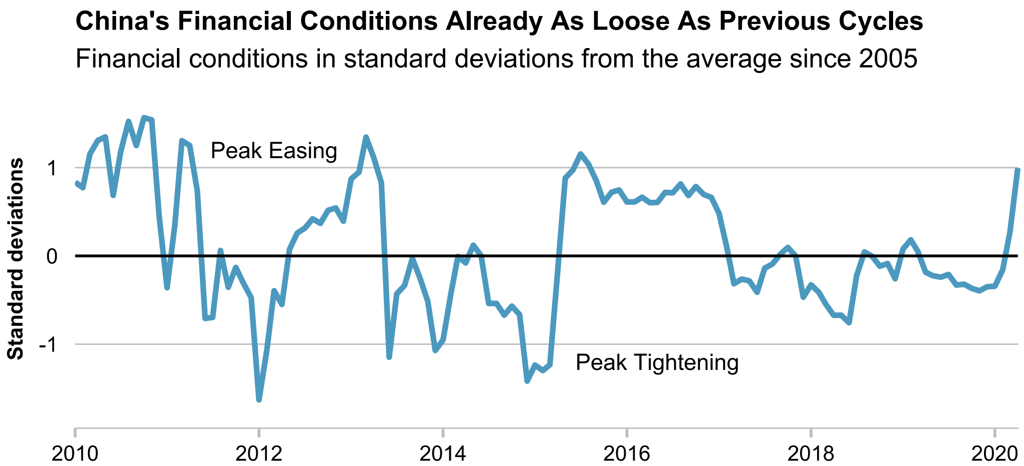
We could tie ourselves in knots measuring stimulus in China. Two IMF authors in 2014 showed how to measure fiscal stimulus and it involved a lot more than reading the budget [3]. Monetary policy is not much easier with multiple interest rates. Gauging the possible effects of the other two levers of macro-policy, macro-prudential and housing policies, is perhaps the most difficult.

Financial Conditions Show Rising Stimulus

One way we measure stimulus in China is with our Financial Conditions Index (FCI). This tracks 22 financial indicators such as real interest rates, credit flows, and bank assets. We aim to identify shifts in the supply of credit which would be consistent with falling prices (interest rates) and rising quantities (credit). This would capture the effects of monetary policy (as real interest rates are cut) and broader fiscal policies (as net bond issuance of local governments and other government-related entities rises). It can also capture changes in macro-prudential and housing policies such as more relaxed lending standards.

The FCI suggests that, notwithstanding the sober messaging of the government, stimulus is already underway. The FCI has a clear pattern of ups and downs as policies are eased and tightened (see chart 3). We find that the FCI leads economic activity by two to three quarters. The rise in the FCI is now comparable to the previous three cycles and financial conditions are now about as loose as they have been since 2009. This is due to falling real interest rates, tighter credit spreads, and rising credit.

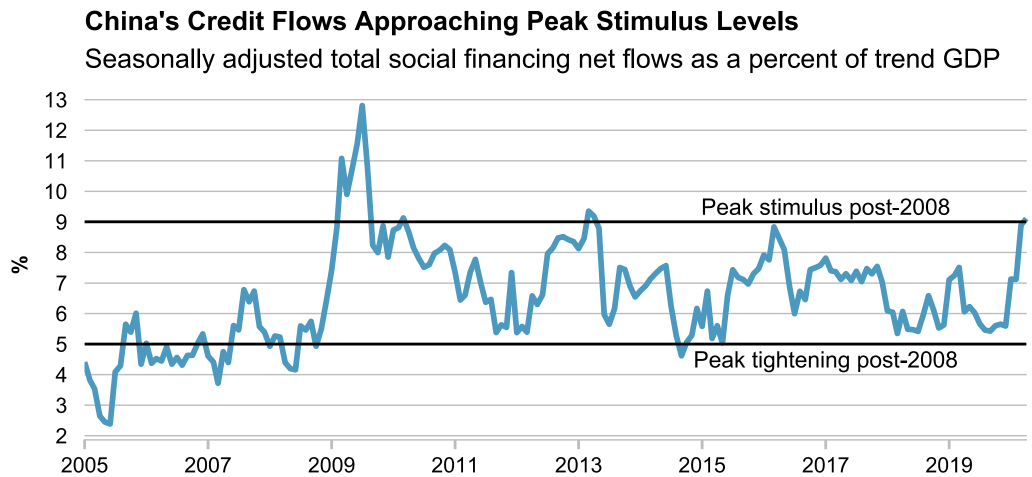
Chart 3



Note: Average of the first two principal components of 22 financial variables including de-trended real interest rates, effective and benchmark lending rates, and bond yields, credit spreads aggregate credit as a share of GDP, and financial market turnover. Quarterly data interpolated using the EM algorithm.
Source: People's Bank of China, CEIC, and S&P Global Economics.

Stimulus also shows up in credit. Chart 4 shows the net flow of new credit to the economy after adjusting for seasonality. We include bank loans, shadow bank credit, and the net issuance of corporate and local government bonds. As a share of trend GDP which smooths out the first-quarter decline, the change in new credit--referred to as the credit impulse--has reached 4 percentage points of GDP. This is comparable to the last three cycles and is about half as large as the credit impulse of 2009.

Chart 4



Note: Total social financing credit flows excluding central government net bond issuance and loan write-offs and including local government net bond issuance. Three month sum of seasonally-adjusted net flows divided by interpolated trend nominal GDP which is filtered using S&P Global's long-run forecasts through 2030 to address end-point bias.

Source: People's Bank of China, CEIC, and S&P Global Economics.

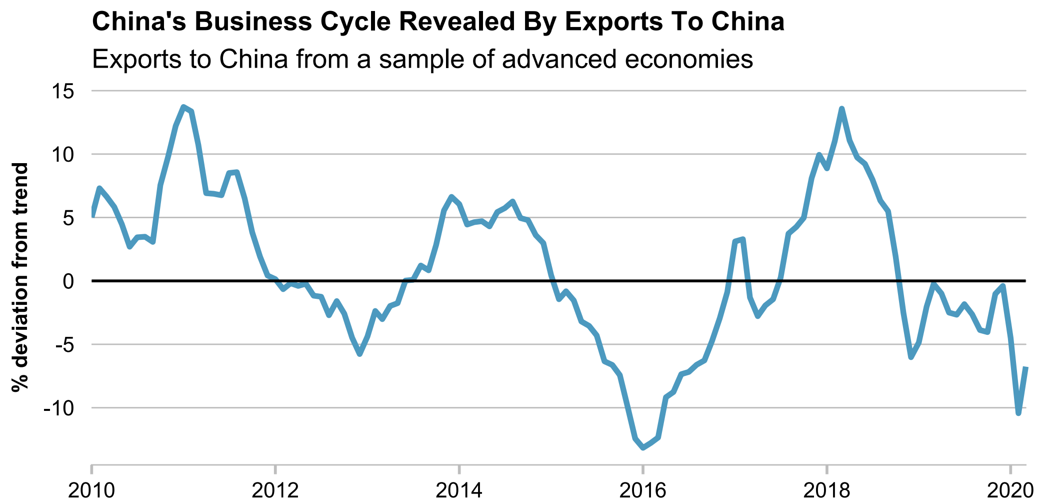
Expect More Stimulus And Watch China's Cycle

The ongoing NPC has delivered a measured tone on stimulus. There were few surprises and a broadly consistent message on monetary, exchange rate, and housing policies in the key policy documents. On fiscal policy, the impulse is substantial, adding together the change in the overall deficit and additional COVID-19 and special purpose bond issuance. It's hard to calculate but a fiscal impulse of around 4 percentage points of GDP (excluding LGFVs) sounds in the ballpark. The fiscal impulse is the net contribution the budget makes to domestic demand.

We will not know how much more stimulus is coming until we see it in financial conditions and credit. We expect both to ease further before a policy cycle turning point is reached in 2021.

The policy cycle will show up in the business cycle, even in a post-COVID-19 recovery--but maybe not so much in official GDP. One useful way to track China's cycle is through exports to China from advanced economies. These exports are mostly manufactured goods whose prices are less volatile than commodities. As a result, they help us understand what's happening on volumes. These data show a clear cycle and upturns and downturns follow easing and tightening of financial conditions with a lag.

Chart 5



Note: Cyclical component of exports to China from Germany, Japan, Korea, Taiwan, and the United States. Calculated using a simple average of the Christiano-Fitzgerald asymmetric and Hodrick-Prescott filters.

Hopes That China's Stop-Go Policy Cycle Has Changed

Optimists argue that worries about stop-go cycles in China are misplaced. The growth target has gone and that, they say, was the problem. Policymakers are now committed to deleveraging. Easing is now much more targeted.

These are all valid points but we do not think they signal the end of stop-go and they have not stood in the way of another sharp easing in financial conditions so far this year. We will continue to watch financial conditions and credit as an indicator of whether policy dynamics really have changed.

Much will depend on policymakers' patience. It may take time for the economy's job creation engine, the service sector, to get back to a growth rate that can ensure sustainable full employment. Even if this self-sustaining growth rate is less than 6%, unless a medical solution to COVID-19 is found soon we think it may not be until late 2021 that this condition may be met. If policymakers push too hard, too soon (and we will see it in credit) then a typical stop-go cycle looms ahead.

Reaching For A Reliable Playbook

China's stimulus in this cycle is more targeted. The State Council summarized the many ways policy has been eased in its April 14 meeting, including VAT exemptions for small firms, increased tax loss carryforwards for transport and catering firms, lower employer social insurance contributions, suspension of road tolls, and lower utilities charges, among others. Officials suggested this would deliver relief to businesses of about Chinese renminbi (RMB) 1.6 trillion (or 1.6% of 2019 GDP) [4].

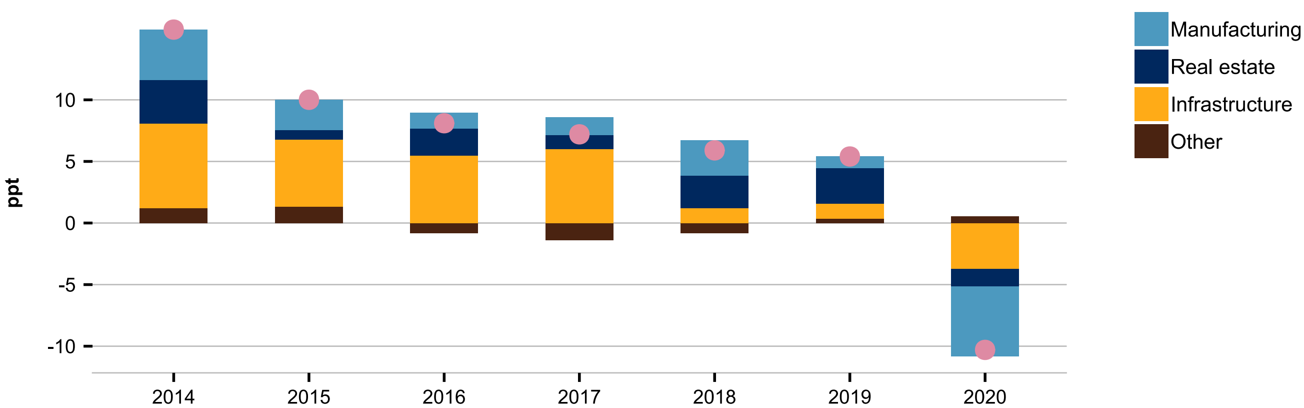
China has also sharpened its monetary policy toolkit over the last decade and is relying more on setting interest rates rather than dictating lending. Like other major economies, the central bank has set up subsidized facilities to lend to stressed sectors, including small and midsized companies. Housing policies are managed at the local level and adjust to local conditions.

Still, getting support quickly to the economy continues to rely on some old, reliable tools. The most important of these is infrastructure investment which can be executed quickly given China's structure of governance. Chart 5 shows how infrastructure has contributed to total fixed asset investment since 2014. Its countercyclical role is clearly apparent, especially how it offset weaker manufacturing investment in the last major downturn in 2015-2016.

Chart 6

Infrastructure Offset Weak Manufacturing And Property Investment In The Last Cycle

Contribution to total fixed asset investment in percentage points



Note: Data for 2020 are year-to-date. Contributions estimated.

Source: National Bureau of Statistics, CEIC and S&P Global Economics.

The financing of infrastructure investment is helpful in understanding why we expect another stop-go cycle. Financing has been brought more into the open as local government rely more on direct, on-budget issuance of municipal-like bonds. However, in a post-COVID China, S&P Global Ratings expects that off-budget local government financing vehicles (LGFVs) will once again be important to efforts to execute stimulus policies (see "Why China's LGFVs Are Back In The Spotlight," May 13, 2020.)

We expect the government to try and deleverage the LGFV sector but just not this year. Over the next year or more, LGFVs will benefit from abundant liquidity in China's onshore corporate bond market, declining funding costs, and the perception of strong continued support in many cases. But as the economy normalizes, China's commitment to deleverage will mean tighter policies and tighter credit conditions for LGFVs. We expect to see more credit divergence and more distressed LGFVs falling through the cracks quickly. While this would contribute to a healthier long-term credit culture in China, it will also constrain infrastructure investment and de-power an engine of growth.

A New Trade War May Delay The Policy Stop

A renewed trade war with the U.S. has returned as a risk to the outlook along with COVID-19. While our analysis suggests China will have a hard time meeting the U.S. import purchase commitments in the Phase 1 deal, incentives for both sides to stick with the deal seem strong for now (see "U.S. And China Kick Trade Deal Can Down The Road," May 12, 2020). But what happens to China's recovery if it unravels?

The key hit to China's economy from a new trade war would be via weaker manufacturing investment. Firms may react to higher uncertainty by delaying or shelving investment they might bring back online should pandemic risks ease. The direct hit through exports to the U.S. would be small. There may also be indirect confidence effects that could tighten financial conditions or weaken household spending.

China would likely respond to these effects by dialing up and extending policy support for domestic demand. This would mean the current round of stimulus may get larger and be sustained for longer, delaying the point at which tighter policies bring us to the stop part of the cycle.

China's currency will continue to act as a shock absorber for trade tensions. We expect the central bank to tolerate flexibility versus the dollar and focus more on anchoring the renminbi against its trade-weighted basket. This continues a policy that has proven quite successful over the last two to three years but it will mean that markets have to live with a more volatile dollar-renminbi exchange rate.

Bottom Line--Enjoy The Rebound, Prepare For The Aftermath

The parlor game of guessing what the world will be like post-COVID-19 has become popular. Most of it is speculation with some estimated guesswork thrown in. However, what is fairly certain is that if China continues healing, it will begin to withdraw stimulus, financial conditions will tighten, and growth will slow. Every easing cycle since 2008 has been followed by an abrupt policy tightening. We see the turn in the policy cycle starting sometime in mid-2021.

Managed carefully, this need not result in accidents or mishaps. However, China has found it hard to calibrate its tightening in past cycles and the higher leverage rises, the harder it becomes. Our forecasts assume that infrastructure investment hands off to private consumption as a self-sustaining driver of growth in 2021 but a smooth handover is not guaranteed.

We expect growth to slow to 5% or below in 2022. This is our forecast for official GDP but other measures of activity may slow much more as we have seen in past cycles. In turn, stress could emerge in some pockets of the economy that had been kept afloat by policy support. This seems very far in the future but history suggests that China's stop-go cycle always turns quicker than many people expect.

Endnotes

[1] The Politburo met in December 2019, on the eve of the pandemic, and again emphasized the "six stabilities." These include the stability of employment, the financial sector, foreign trade, foreign investment, investment, and expectations. Employment claims first place in the hierarchy. A Xinhua review of the December meeting, intended to convey the key messages, noted that "stable employment...ranked first. If employment is stable, the people will be stable."

[2] People's Daily, Six "Guarantees" to stabilize the economic fundamentals, April 20, 2020.

[3] Zhang, Yuanyan Sophia and Steven Barnett, 2014 "Fiscal Vulnerabilities and Risks from Local Government Finance in China," IMF Working Paper 14/4.

[4] China Government Network,
http://www.gov.cn/premier/2020-04/14/content_5502345.htm?mc_cid=b0f98bbef6&mc_eid=81d560d0f0

Related Research

- Why China's LGFVs Are Back In The Spotlight, May 13, 2020
- U.S. And China Kick Trade Deal Can Down The Road, May 12, 2020

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