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Insights

The slow and painful road to economic recovery : China after the pandemic

China, which is at the moment barely recovering from the covid19 crisis, already came out during March to announce that the country was slowly getting back to work, something that is more than vital for both the domestic economy and the Party-State itself. The early days of the "end" of the containment have not been easy for Chinese workers. Aside from the Hubei-Jiangxi Bridge incident on March 27, manufacturers as well as assembly lines are trying to reignite the economic engine, while the rest of the planet is entering its quarantine and self-isolation period.

Assessing the preliminary damages

For the first time in recent memory, China's National Bureau of Statistics 国家统计局 reported economic data from January and February in a combined report, and the numbers are abysmal. Some of the key takeaways from the January and February data reporting include the following[1]:

1. Industrial output shrank by 13.5% over the two months, fixed asset investment dropped by 24.5%, and retail sales were down by 20.5%[2];
2. CNY-denominated exports fell 15.9%, while imports contracted 2.4%; and
3. In addition to the above-mentioned drop in China's manufacturing purchasing managers' index, the country's producer price index fell 0.2% in February alone, while the consumer price index rose an average of 5.3% over the first two months – taken in totality, these two indexes signal substantial rising costs for consumers[3];

The three major data points all indicate that the Chinese economy was, and probably still is, in contraction. This spells major problems for the Party-State, who, as we are all well aware of, depends on the continued delivery of economic growth, and the socio-economic goods that come as a result, to its population in order to maintain its political legitimacy. Unsurprisingly, as we highlight further below, the regime understands the dire status of the economy, which has taken beating after beating beginning with the trade war, then the Chinese New Year holiday, and finally the coronavirus outbreak, and has implemented a wide-ranging series of fiscal and monetary easing programs aimed at reviving the paralyzed economy. That said, unfortunately for the Party-State, there will be no short-term fix for the economy, and it is absolutely uncertain at this point whether these easing programs will even have any effect.

We also highlight to the reader the infamous *Caixin* article published in early March, which reported on the fraudulent reopening of factories across China. According to an investigation carried out by *Caixin*, in order to meet return-to-work quotas, local companies and officials have simply "turned the lights on" at factories without actually having the facilities producing anything. The article noted, for example:

> *"[the] province of Zhejiang has been lauded as a prime example of the nation's industrial recovery from the coronavirus outbreak by China's top economic planner, which reported on Feb 24 that its work resumption rate was more than 90%. Nevertheless, a civil servant in one district of the provincial capital, Hangzhou, told Caixin that from Saturday plants were instructed to leave their industrial equipment idling for the whole day, while offices were told to keep computers and air-conditioners running, when*

[1] The data is measured year-over-year.
[2]. The industrial output contraction was reportedly the quickest pace in 30 years.
[3] Notably, food prices under the consumer price index rose 21.9% in February alone, measured year-over year.

Beijing began checking the resumption rate by examining power consumption figures.".

This level of fraud is not uncommon in China, as the Party-State has been known to push for unrealistic quotas and targets[4]. However, if this problem is widespread, then economic recovery might take much longer than previously anticipated. The unrealistic return-to-work quotas, as set out by the Party-State, seem somewhat problematic at this moment, and such unrealistic quotas have, historically, been derived from two issues: prestige, or that the problem is much worse than what we outside observers believe. In this instance, it is likely to be the former. In any event, given that the propaganda system is in full swing, it is not hard to imagine that the Party-State wants the economy to come back online as fast as possible to show the rest of the world, as well as its own citizens, the "superiority" of the Leninist state, which would be in stark contrast to how poorly the western world is handling the pandemic.

Sectoral highlights

We have already seen above the contraction of the Chinese economy on a macro scale. Here, we present several notable data points in various sectors of the economy, to further accentuate the bleakness of the current situation:

1. China's coal output dropped 6.3% over January to February compared to the year before, while coke – used in steelmaking – production also fell 5.5%;
2. Automobile sales in February were almost 80% lower than the year before, the worst of which was General Motors' joint venture with SAIC Motors上海汽车集团, which saw a 92.2% drop;
3. In the housing market, 30 publicly traded real estate firms reported an average 19% drop in sales in the first two months of this year, and in early March – ten of the country's largest real estate companies disclosed plans to issue a total of CNY 52.13 billion (USD 7.45 billion) worth of debt.

Unsurprisingly, these sectors, which we expected to be hit hardest by the pandemic, suffered the most. Nonetheless, the underlying issue affecting all sectors will remain in place for the time being – that is, the overall lack of consumption and demand. And this issue will continue to strain companies in China – be it local or foreign – until the global economy returns to a somewhat stable condition.

While publicly traded companies in China can issue more equity and debt to help ease their financial problems, private firms will have to rely on either the shadow banking system or government help to pull through this period, maybe even this year. We at Cericus Group believes that the Chinese financial system could see a revitalization of the shadow banking sector during this period of economic recovery, as governments – from Central to local – would be far unable to fulfill the massive liquidity demands needed to keep the wider Chinese economy afloat.

Already, we are seeing automakers seeking desperate government help[5]. Green energy automakers, especially, witnessed a contraction in sales for the eighth month in a row, which was made worse by a recent rollback in government subsidies for these types of vehicles. This is without mentioning the fact that the Chinese automobile sector was already in pretty bad shape, in part due to the US-China trade war, but also in part due to the general fall in consumer demand. That said, the automobile sector has seen its sales fall for 20 months in a row now.

It is unclear at this moment to what extent the Party-State is ready to deploy policies specifically aimed at helping individual sectors, or whether it will become a free-for-all as firms apply for funding as part of larger, economy-wide stimulus packages. In any event, as 2022 looms over China, the Party-State will have its hands full putting out fires in the wider political system, as well as having to keep its eye

[4] See: The Great Leap Forward.

[5] It appears the local governments have started offering cash incentives to its residents in order to boost car sales. For example, in Foshan, the government is offering people CNY 2 000 (USD 285) in cash for new car purchases, and CNY 3 000 (USD 430) in cash to replace existing cars.

constantly on the economy. In a similar fashion, this will simultaneously be a test of President Xi Jinping's leadership, and the ultimate outcome for the economy will dictate the extent to which Xi can consolidate factional support beyond 2022.

Some positive indicators?

Despite the doom and gloom situation of the Chinese economy, there are some slivers of hope lurking beneath the surface. Albeit, the negatives still far outweigh the positives at this moment in time.

For one, the China Federation of Logistics & Purchasing 中国物流与采购联合会 showed a rebound in its logistics prosperity index and its warehouse index, suggesting that business activity has picked up a slightly since the nationwide lockdown. At the same time, the coronavirus outbreak has given new life to China's non-life insurance providers. A large part of this is due to the fact that no one was commuting or traveling – auto insurance claims and settlements have dropped substantially. Ironically, financial analysts have raised the target share price of major non-life insurers in China, like PICC Group 中国人民保险集团. On the contrary, the insurance industry as a whole is likely to be suffering from the coronavirus outbreak. It is not a stretch to assume that claims for life insurance as well as commercial insurance and reinsurance ought to be skyrocketing during this period.

On the macroeconomic front, the National Bureau of Statistics reported that, despite the overall drop in industrial output, China added 1.08 million new jobs between January and February, and that the overall employment situation is "basically stable". Furthermore, it appears that over 80% of medium to large-sized manufacturing enterprises have become operational again, which have analysts hopefully that March could see a rebound in the purchasing managers index. Some manufacturers and exporters have also caught a respite, as the US waived tariffs on a variety of medical products, such as masks and stethoscopes.

Another unintended consequence of the nationwide lockdown is the significant improvement in air quality. On the one hand, while the pandemic has claimed many casualties, the temporary reduction of air pollution might actually end up save more people in the long term. That being said, air pollution will likely become much worse than pre-pandemic times as the Party-State will aim to have all cylinders of the economy firing as fast as possible, and environmental concerns go out of the window once the stability of the economy itself is jeopardized as it is now.

Fiscal and monetary easing to continue for the foreseeable future

As we have alluded to earlier, the Party-State has opened up its policy toolbox[6] and launched wide-ranging fiscal and monetary easing programs to help the economy survive this difficult period. We list below some highlights:

1. On March 16, the People's Bank of China (PBoC) 中国人民银行 released CNY 550 billion (USD 79 billion) into the country's financial system after it cut the reserve requirement ratio by 50 to 100 basis points for banks that hit inclusive financing targets, and an additional 100 basis point cut for qualified joint-stock commercial banks;
2. One the same day it lowered the reserve requirement ratio, the PBoC injected another CNY 100 billion (USD 14.3 billion) into the country's financial system by way of medium-term lending facility operations, one of the key benchmark rates for determining the loan prime rate, but otherwise kept the facility at 3.15%;
3. The country's banking and insurance regulator, the China Banking and Insurance Regulatory Commission (CBIRC) 中国银行保险监督管理委员会, gave all small and medium-sized enterprises a grace period from January 25 to June 30 during which loans could be rolled over without being penalized[7];

[6] China-focused pundits and analysts often point out that as an authoritarian regime, the Party-State's has an unlimited amount of policy levers to pull on to deal with any crisis. Unfortunately, if we take into consideration factional balancing, as well as the relationship between the Central government and its provincial and local counterparts, the range of policy options become self-limiting.

[7] The CBIRC did specify that an agreement would have to be reached between the debtor and its bank.

4. The National Development and Reform Commission (NDRC) has issued draft rules aimed at streamlining the bonds issuance process;
5. The State Council has temporarily altered the tax revenue split between the Central and local governments – giving the latter a 5% increase until the end of June, which earmarks approximately CNY 110 billion (USD 15.72 billion) worth of extra funds for local governments;
6. The State Council has given local governments more authority with regards to land rights – provincial and municipal governments will be allowed to independently assess whether farmland, excluding "permanent basic farmland" 永久基本农田, can be repurposed for other uses;
7. The NDRC has also issued guidelines aimed at increasing domestic consumption, such as reducing import tariffs on certain goods and to increase license plate quotas in regions where there are restrictions;
8. The Central government has increased its contributions to provincial and local governments with regards to medical insurance, public health services, and unemployment insurance, by CNY 1.26 trillion (USD 180 billion from the previous year, reaching a total of CNY 6.28 trillion (USD 897.24 billion);
9. Finance departments at provincial and local governments across China have allocated a combined total of CNY 110.48 billion (USD 15.78 billion) to contain the pandemic – the Ministry of Finance directly contributed CNY 25.75 billion (USD 3.68 billion) of the total amount; and
10. The State Council has relieved approximately CNY 1 trillion (USD 142.87 billion) worth of social security benefits payable by enterprises, lessening the latter's financial burden

Of course, these are but a few of the key highlights that we have come across. That said, we expect this trend of fiscal and monetary easing to continue throughout most of 2020, until at least the pandemic can be said to be stabilized on a global scale. Nonetheless, if these programs are a taste of what is to come, 2020 one can expect a year of major structural reforms in the People's Republic. And to give credit where credit is due, the Party-State understands that these are extraordinary times, and it has proven itself to be quite the reformer when push comes to shove.

So confident is the Party-State in these programs that the NDRC, led by He Lifeng 何立峰 – Xi's old time ally – has publicly stated that the economy would return to "normal" in the second quarter, when these programs are expected to take full effect. This type of optimism and confidence is sure to put on display by the Party-State. However, such statements leave us wondering what is "normal"? And if these statements suggest that the Party-State believes that China's economy can recover in the absence of a global economic recovery? In any event, despite these large-scale fiscal and monetary easing programs, it appears that the Party-State has, to a large extent, reverted to its old habits of throwing money at the problem until it goes away.

For example, provincial and local governments have issued a total of CNY 1.2 trillion (USD 171.45 billion) worth of bonds over the January to February period, nearly 70% of which have been funneled towards financing for infrastructure, while only 14% went to local public services. It is understandable, of course, from the Party-State's perspective: it is absolutely essential to keep large state-owned businesses running and its workers employed, and the best way to do so is through infrastructure projects.

Steering the Chinese ocean liner through shallow waters

However, if the stated end goal for the Party-State is to shift the economy away from excess production and an over-reliance on investing in infrastructure projects which, more often than not, end up being inefficient[8], then it must – eventually – find new economic measures to stimulate the economy in down times. To be fair, these are indeed exceptional times, and Keynesian economic policies may be just what

[8] We allude here to the infamous rail and airport examples. While China has the longest rail system in the world, there are many routes which see very low passenger loads, as well as stations in the middle of nowhere. Similarly, we can find airports throughout China which are built in relatively close proximity to one another, which thereby makes air travel severely inefficient, not to mention costly.

the People's Republic needs to kick-start its economy. Yet, the underlying concern is, and always has been, that the Party-State would "relapse" and become hooked on investing in infrastructure projects. Nonetheless, what is puzzling is why the Party-State, in this particular instance, opted not to earmark more funding for local public services. If the stated goal of the Party is to shift the economy towards one that is more consumption and service-based, then it will need to begin with improving the quality, access to, and provision of public services[9]. If the coronavirus has taught us anything about the state of public services in China, it is that they are severely underfunded, understaffed, and undertrained.

In any event, keeping unemployment levels low is definitely the top priority for the Party-State until the economy recovers to the point where the Party-State feels it is safe to partially let go of the reins – although, this does not seem likely for the rest of 2020, as there are economic headwinds aplenty on the international scene. For the time being, the old tactic of throwing money at infrastructure projects will suffice.

Furthermore, not just provincial and local governments, but companies have issued a total of CNY 173.4 billion (USD) worth of corporate bonds, the proceeds of which will reportedly be used "pandemic containment" 用于疫情防控. While it is unclear exactly what is meant by the latter phrase, the intention of allowing companies to issue such bonds is clear: let the market handle corporate liquidity issues. Of course, this is made more evident by the fact that the major financial regulators had established a fast track channel for companies wishing to issue these types of bonds.

The intention is commendable, as it is always encouraging to see the Party-State opt for more market-oriented approaches to solving problems. However, the question remains – can these companies actually repay these debts? These bonds would not be a problem in normal times when the global economy is moving forwards. Yet, given the current environment, one in which the domestic economy is just starting to come back online and the rest of the global economy is on the verge of completely shutting down, one ought to wonder if these bonds will only add to more systemic financial risk in the long run. Perhaps the Party-State has already implicitly accepted such a trade-off: exchange short term market liquidity for more risk in its financial system in the long run.

To be fair to the Party-State, the immediate concern is that if companies have a difficult time issuing debt in the current environment to front their liquidity issues, it could result in nationwide corporate defaults and bankruptcy. Such an event could be the last straw that breaks the Chinese financial system's back, a system which has already been strained due to the US-China trade war, and the economic shutdown as a result of the Chinese New Year holidays and the subsequent coronavirus outbreak. Despite these concerns, allowing struggling companies to issue debt *en masse* is a risky move at best, especially when the pandemic is now affecting western "buyers".

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[9] In order to improve the nation's public services system, the Party-State will need to revamp the entire taxation structure, something which we hope the economic consequences of the pandemic could bring about.