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The Risks of a Two-Track Recovery

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Exec summary

- → The end of April and beginning of May have marked a turning point in how China's central leadership is conceptualizing the challenge of the economic recovery.
- → Policymakers' attention has turned squarely toward the challenge of boosting consumer demand – but coaxing consumers back to the market is a much more difficult task than ordering steel plants and manufacturers to resume operations.
- → Government officials can force-feed supply-side stimulus via policy fiat, but they can't force Chinese consumers to spend.
- → The challenge for the leadership is now to improve consumer and business sentiment such that households have the confidence to return to normal behavior.
- → The risk is that China is heading for a two-track recovery, wherein industrial output returns in force via policy mandate, but end-demand does not rebound at the same rate. If this supply-demand mismatch continues, deflationary price pressures will build.
- → That said, there are also reasons for optimism on the consumer front. Survey evidence suggests Chinese households have come through the pandemic with sufficient savings to resume normal spending, if they so choose.
- → The reopening of schools and the formal announcement of the Two Sessions for late May could be the "all clear" signal that consumers were waiting for. As such, the trend for consumer spending over the next month is critical.
- → From a macro standpoint, after ramping up policy support over the past month, the government wants to pause and assess the efficacy of those measures.
- → Finally, an unexpected theme has emerged: policymakers are increasingly focused on rooting out fraudulent use of stimulus monies and policies. This marks a significant change from the last major stimulus in 2009.

The main story

The end of April and beginning of May have marked a turning point in how China's central leadership is conceptualizing the challenge of the economic recovery.

Even as the reality of the first quarter's devastating -6.8% y/y GDP print settled in, positive signs of unstuck industrial production and resuscitated supply-side indicators have begun to proliferate (see April 30 Macro Monitor). Unfortunately, this good news has been offset by counterbalancing bad news: the demand side of the economy has not kicked back into gear with the same force. Consumption has lagged and spending has remained cautious, at best.

Policymakers' – and businesses executives' – attention has turned squarely toward this challenge, but coaxing consumers back to the market is a much more difficult task than ordering steel plants and manufacturers to resume operations.

While government officials can force-feed supply-side stimulus via policy fiat, they cannot force Chinese consumers to spend or require service sector enterprises and SMEs to ramp up operations – especially if they are not ready, willing, and able. Therefore, the challenge for the leadership is now twofold: improving national sentiment – such that consumers and consumer-driven businesses have the confidence to return to normal behavior – and ensuring both cohorts can afford to do so.

Within this context, two major developments took place over the past two weeks that, in our view, will help to boost household sentiment and business confidence:

- Reopening of schools in all provinces and major cities
- The announcement of formal dates for the Lianghui (the annual "Two Sessions" of the NPC and CPPCC) in late May in Beijing

The mental, emotional, and practical signal sent by school reopening is obvious, but it should not be underappreciated. Local governments displaying confidence that schools can keep students safe and healthy is a huge step toward returning to normal life for many families. On a practical level, it will provide more flexibility for working adults and should boost many consumers' ability to get out of the house and spend money.

Meanwhile, the National People's Congress and the Chinese People's Political Consultative Conference have officially been scheduled to begin on May 22 and 21, respectively – after being delayed from early March for the first time since the government set fixed dates for the meetings in 1995. Collectively known as the Two Sessions, these meetings mark the largest annual convening of government officials, and the announcement that they will finally be held sends a strong message of confidence in the containment of the virus to the population at large. The optics will send even more positive signals once the event begins.

These types of signals will become increasingly important in supporting overall consumer and business sentiment, especially if increases in macroeconomic indicators level off in the coming months – see our business activity indices below for further discussion.

Indeed, the risk now is that China is heading for a two-track recovery, wherein industrial output returns in force via policy mandate, but demand does not rebound at the same rate, leading to oversupply and excess inventories – throughout a host of industries, both upstream and downstream. If this supply-demand mismatch continues, upstream price deflation is inevitable and broader downward pressure on prices may emerge as companies seek to offload inventories.

The bad news on this front is that the first major test of consumer sentiment fell flat. According to the Ministry of Culture and Tourism, the recent Labor Day holiday saw year-on-year declines of 41% and 60% for total trips and total tourist spending, respectively – numbers that are even worse if you consider that last year's holiday was one day shorter. The Ministry of Commerce similarly reported that restaurants and hotels saw a 30% decline in revenues compared to last year over the holiday.

That said, there are also reasons for optimism on the consumer front. Survey evidence suggests Chinese households have come through the pandemic with sufficient savings to resume normal spending, if they so choose. Specifically, a study from Southwestern University of Finance and Economics and Ant Financial found that 50% of households increased their savings during Q1 (at the expense of consumption) while 40% held their savings steady.

These numbers underscore that it is not a question of if consumers can spend, but of when they choose to do so. This, again, suggests that sentiment is the key to economic recovery. And while consumers have been understandably cautious and slow to come back to the market throughout April, the resumption of school and the holding of the Two Sessions may be the "all clear" signal that households have been looking for. As such, mid-May to mid-June will be a critical period for monitoring consumer behavior – to see whether consumption is potentially at a positive inflection point.

Policy focus: the latest from Beijing

Now that every province has been labeled by authorities as "low risk" for COVID-19, Beijing's technocrats are turning their focus towards figuring out how else they can help the economy revive.

The central leadership spent the weeks before and after Labor Day prioritizing:

- **Employment:** 3.2 million companies have received a total of RMB 42.3 billion in unemployment insurance payments, which serve to reimburse companies for up to 50% of their 2019 unemployment insurance contributions – as long as they commit to keeping all their workers. A total of 86 million jobs are being supported by the program at this point.
- **SMEs:** The State Council announced that loan loss coverage ratios for small and medium-sized banks – that is the reserves they must set aside to cover bad loans – will be cut by 20 percentage points, and the Macroprudential Assessment (MPA) framework will be reweighted to encourage banks to make loans to small companies. Also, small businesses that rent from state firms are now entitled to a three-month rent exemption.
- **Local government financing:** The Ministry of Finance announced that it will allow local governments to issue another RMB 1 trillion worth of bonds under an "advance" quota. Note that as of April 15, local governments had issued RMB 1.57 trillion worth of bonds, or 85% of the previously announced advance quota.

Notably, one additional policy theme that has emerged in recent weeks is cracking down on fraudulent use of stimulus monies and policies. Numerous policy meetings, inspections, and regulatory warnings over the past month have signaled that authorities intend to closely monitor recovery policies for fraud and to quickly eliminate abusive practices. The two most recent meetings of the Financial Stability and Development Committee – a State Council body led by Vice Premier Liu He and charged with coordinating economic and financial policies – focused specifically on these issues.

This stands in stark contrast to the stimulus package rolled out in 2009, after the Global Financial Crisis (GFC). At that time, central leaders exercised little oversight of stimulus deployment – prioritizing the speed and size of the rescue package. It was only years later that much attention was paid to the level of corruption and malfeasance that characterized that time period.

In 2020, however, senior officials and regulators are paying close attention to whether or not targeted policies are accomplishing their goals, and whether or not financial relief is reaching the designated targets. The recent crackdown on the Shenzhen housing market is a case in point. Financial officials found that loans meant to guide SMEs through the pandemic were being used as down payments for apartments in the city, and they quickly moved to rectify the situation. This dynamic stands in stark contrast to the GFC stimulus, and while leakage is undoubtedly still occurring, the shift in mindset from 2009 is undeniable.

Policy focus: selected provincial storylines

Wuhan and Hubei deemed "low-risk"

On April 19, the Hubei government announced at a press conference that Qiaokou District, the last "medium-risk" district in Wuhan, had been assessed as "low-risk" on April 18. This means that the entire province is now "low-risk."

Beijing lowers emergency response level and relaxes movement restrictions

On April 29, the deputy general secretary of the Beijing municipal government announced at a press conference that:

- Beginning on April 30, Beijing would lower its emergency response level to the public health crisis from Level 1 (since January 24) to Level 2.
- As a result, beginning on April 30, Beijing will no longer require incoming travelers from other low-risk regions to quarantine at home for 14 days.

Wuhan tests high school seniors

On May 1, the Wuhan Health Commission conducted RT-PCR tests on 19,178 high school seniors in Wuhan, of which all showed negative results. On May 6, 57,800 high school seniors in Wuhan returned to campus.

Suifenhe, Heilongjiang, lowers risk levels

On May 5, the Heilongjiang epidemic command center announced that it would lower Suifenhe's and Nangang District's risk levels from "medium-risk" to "low-risk" starting on May 6. The two areas should now resume normal business operations. As of May 6, there were no incoming overseas travelers being quarantined in Suifenhe.

Meanwhile, Linkou County, Heilongjiang, was the only "medium-risk" region in China as of May 6, and was adjusted to "low-risk" on May 7.

On May 7, the entire country was, therefore, deemed "low-risk."

Shandong and Henan lower emergency response levels

On May 6, the Shandong and Henan governments lowered their public health emergency response levels from Level II to Level III.

As of May 6:

- There are no provinces with Level I emergency response levels.
- There are eight provinces with Level II emergency response levels.
- There are 21 provinces with Level III emergency response levels.
- There are two provinces with Level IV emergency response levels.

Additional high-impact policy meetings and announcements

As per the April 17 Politburo meeting that rolled out the "six ensures" – Xi Jinping's new framing device for post-COVID-19 policy priorities – a series of important meetings were held in recent weeks with the goal of moving China's re-normalization forward.

Premier Li pushes for school resumption and normalized epidemic prevention measures

On May 7, Premier Li Keqiang chaired a meeting of the central leading small group on COVID-19, and stressed the importance of:

- Learning and promoting effective epidemic control and prevention measures for regular use under normalized circumstances
- Promoting the orderly resumption of schools, classes, and learning
- Accelerating and improving express COVID-19 testing capabilities

State Council promises to stay the course

On May 6, government officials listened to a report on current economic support policies, which consist of 90 distinct measures. Notably, at the meeting, Premier Li stated that "the support policies introduced earlier are adequate."

That said, the government did specify a few tweaks:

- Tax breaks for small businesses will be extended
- The latest RMB 1 trillion of special project bonds must be issued by the end of May
- Loan deferments for small and medium-sized business will be extended

The key takeaway from the meeting, and Li's comment, is this: after ramping up policy support over the past month, on the back of the April 17 Politburo meeting, **the government wants to pause to assess the efficacy of those measures.**

PBSC warns against continued epidemic risks

On May 6, Xi Jinping chaired a Politburo Standing Committee (PBSC) meeting and warned against the continued threat from the COVID-19 pandemic.

Xi demanded some fixes to the public health system to deal with that uncertainty, calling for:

- Reforming the disease prevention and control system
- Improving epidemic monitoring and early warning capabilities
- Improving public health emergency laws and regulations
- Enhancing the response and treatment systems for major epidemics and public health emergencies

Xi Chairs CCCDR meeting

On April 26, Xi Jinping chaired a meeting of the Central Commission for Comprehensively Deepening Reform (CCCDR). The meeting passed:

[1] In case you forgot, the Six Ensures are: ensure employment, ensure people's basic livelihood, ensure companies' survival, ensure food and energy security, ensure stability of the production chain and supply chain, ensure the operation of grassroots governments and public institutions (i.e. maintain enough fiscal resources to keep them running).

- A plan for securing public health emergency supplies
- Guidelines on reforming the system for regulating medical insurance funds

The meeting also discussed priorities for the economic policy response to the epidemic. They were focused on:

- Resumption of work and production
- Employment
- Investment and consumption
- The development of small, medium-sized, and micro enterprises
- People's basic livelihoods
- Poverty alleviation

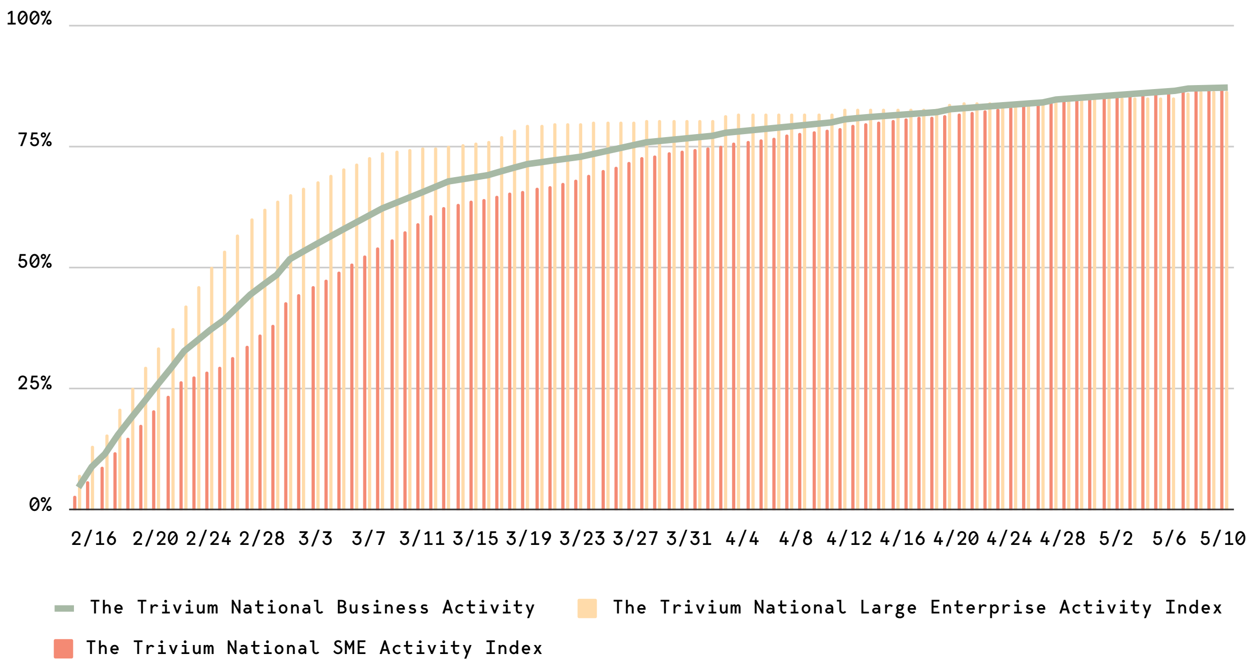
Business resumption: the national view

The pace of increase in our business activity indices has continued to slow throughout May.

This continues to represent a significant challenge; if China's economic re-opening stagnates somewhere in the 80-90% range throughout Q2, reaching positive GDP growth for 2020 will become ever more difficult, if not impossible.

As of May 12:

- The Trivium National Business Activity Index indicates that China's economy is operating at 87% of typical output. That's up from 84.8% on April 30.
- The Trivium National Large Enterprise Activity Index indicates that China's large enterprises are operating at 86.4% of typical output. That's up from 85.2% on April 30.
- The Trivium National SME Activity Index indicates that China's small businesses are operating at 87.4% of typical output. That's up from 84.5% on April 30.



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