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Economic Conditions in China / Hearing

Rapid Recovery after Lifting Zero-COVID Policy and Uncertain Outlook

<Report on business trip to Beijing and Shanghai (April 17-28, 2023)>

The Canon Institute for Global Studies
Kiyoyuki Seguchi

<Key Points>

○ Real GDP growth in 1Q/2023 was +4.5% y/y, an increase from the previous quarter (+2.9% y/y), but below 5% for seven consecutive quarters.

○ Although exports to Japan, the U.S., and Europe declined, those to ASEAN increased as exports of parts and other products advanced on the back of the accelerating horizontal division of labor that shifted production bases from China to ASEAN countries. This is mainly due to low production costs and low tariffs on exports to the U.S. in ASEAN countries.

○ Fixed asset investment in manufacturing and infrastructure construction remained strong, while real-estate development improved more than expected at -5.8% y/y compared to last year (-10.0% y/y for full-2022).

○ A look at market trends by industry finds that sales of durable goods such as automobiles, smartphones, PCs, and other electronic devices, home appliances, furniture, and other real-estate-related products have been weak. In addition, owing to the Common Prosperity policy and the aftereffects of the zero-COVID policy, there is a view that it will take two to three years for the private sector to regain confidence in the government and its strong pre-pandemic investment enthusiasm.

○ This year, making economic stability its number-one national policy and emphasizing its commitment to further strengthening its aggressive fiscal policy, the Chinese government is expected to focus on expanding infrastructure construction even more than in last year.

○ As for the real-estate market, real-estate sales are showing an unexpectedly rapid recovery, chiefly in first- and second-tier cities. However, given the fact that real-estate developers remain cash-strapped, real-estate development investment is unlikely to begin recovering until the second half of this year or later.

○ Total retail sales of consumer goods jumped 5.8% y/y, a sharp turnaround from the previous quarter (-2.7% y/y). This was supported by a rapid recovery in consumption of services such as wining and dining and accommodation as a result of the lifting of the zero-COVID policy. With that being said, consumers continue to be cautious in their purchasing attitudes as they are still uncertain about their future income.

○ Majority of the observers expect real GDP growth to be in the 5% range this year. But the faster-than-expected growth in 1Q has led to an upward revision of the outlook, with some expecting it to reach 6% or higher.

○ Forty-three percent of U.S. companies have seen their executives visit China since the beginning of this year. A large number of European companies have also visited China together with German Chancellor Scholz and French President Macron. Both the U.S. and Europe companies are showing an aggressive investment stance toward China. On the other hand, an increasing number of Japanese companies have postponed their management-level visits to China following the detainment of a senior pharmaceutical company employee. This cautious stance is in contrast to the positive attitude of Western companies.

○ The Chinese market is large in size and requires a high level of technology. Without the financial resources to make the huge investments necessary to ensure high quality and supply volume, it will be impossible to survive in China.

1. Current Macroeconomic Conditions and Outlook

(1) Overall condition

The National Bureau of Statistics announced on April 18 that real GDP growth in 1Q/2023 was +4.5% y/y, a recovery from the previous quarter (+2.9% y/y). Although 1Q saw a sharp recovery mainly in wining and dining, accommodation, and other service consumption against the backdrop of the lifting of the zero-COVID policy, it still fell below 5% for the seventh consecutive quarter since 3Q/2021 (see Chart 1). The recovery in both investment and consumption of goods has lacked momentum because the economic outlook remains uncertain.

The 4.5% y/y real GDP growth in 1Q exceeded prior market expectations (around 4.0% y/y) thanks to the following two factors: 1) exports decreased by less than previously expected; and 2) the decline in real-estate development investment slowed down. These factors are discussed in more detail in a later section.

[Chart 1] Major Economic Indicators (y/y (%))

	Real growth rate	Exports	Imports	Fixed asset investment (YTD)	Total sales of consumer goods	Consumer prices	Real-estate sales prices (YTD)
2019	6.0	5.0	1.6	5.4	8.0	2.9	6.7
2020	2.2	4.0	-0.7	2.9	-3.9	2.5	5.9
2021	8.1	21.2	21.5	4.9	12.5	0.9	2.8
2022	3.0	10.5	4.3	5.1	-0.2	2.0	-3.2
1Q/2021	18.3	38.6	19.0	25.6	34.2	0.0	15.0
2Q	7.9	19.8	31.9	12.6	13.9	1.1	8.8
3Q	4.9	14.1	16.7	7.3	5.0	0.8	4.7
4Q	4.0	17.6	19.3	4.9	3.5	1.8	2.8
1Q/2022	4.8	13.2	8.7	9.3	-3.5	1.1	-10.4
2Q	0.4	13.1	2.6	6.1	-4.6	2.2	-8.6
3Q	3.9	15.1	5.3	5.9	3.5	2.7	-5.3
4Q	2.9	1.9	2.2	5.1	-2.7	1.8	-3.2
1Q/2023	4.5	8.4	0.2	5.1	5.8	1.3	6.8

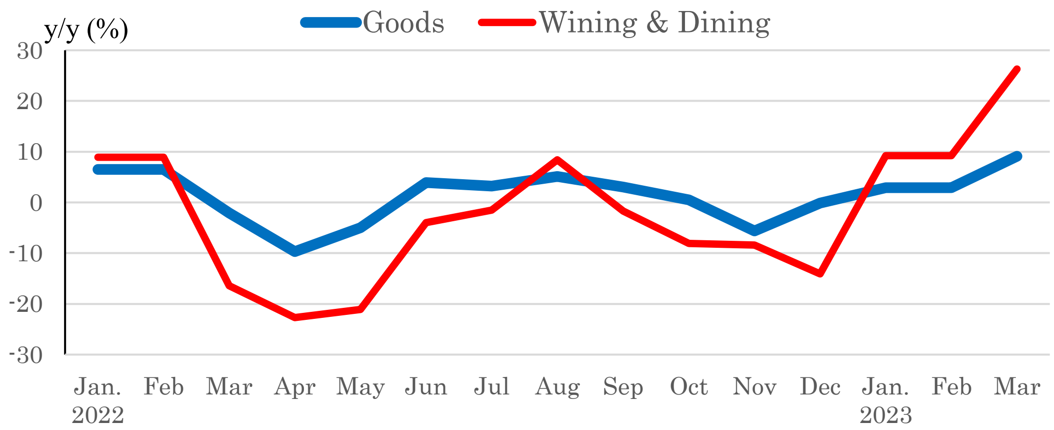
(Note) Quarterly data for imports/exports are calculated by the author based on the original figures; total sales of consumer goods and consumer prices are averages for each quarter. Import/export figures are y/y changes in yuan.

(Sources: National Bureau of Statistics and CEIC.)

(2) Service consumption-led recovery in 1Q

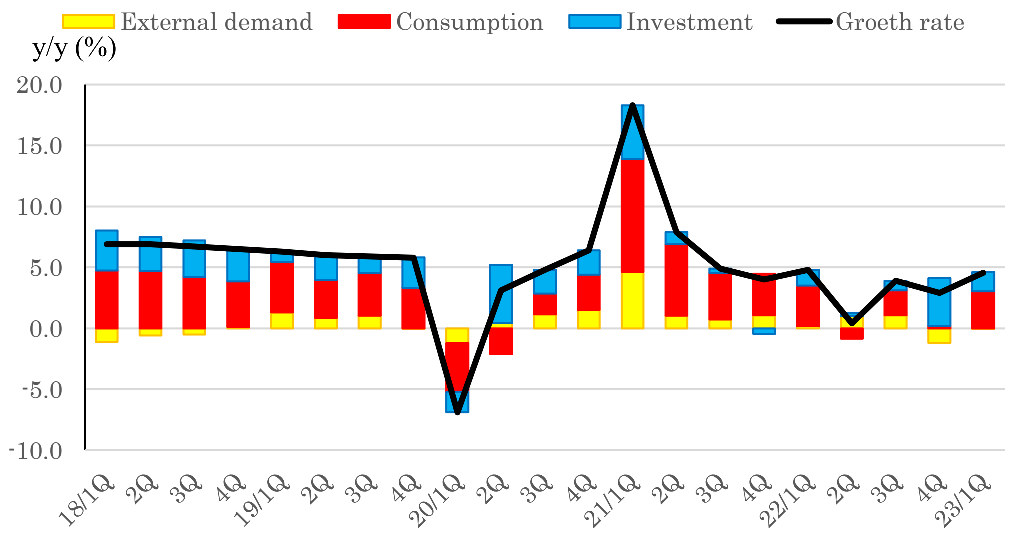
The zero-COVID policy was actually lifted in early December. Although the disease spread explosively throughout China during December, it subsided after the New Year and there were no longer any restrictions for domestic travel. Consequently, consumption of services such as wining and dining, accommodation, and transportation recovered sharply after the Chinese New Year in February. In the meantime, sales of goods also recovered but at a slower pace than the recovery in service consumption (see Chart 2). Nevertheless, with consumption as a whole showing a recovery trend, 1Q saw a consumption-led recovery. The contribution to real GDP growth rate by component revealed that contribution from consumption made up two-thirds of the growth rate at +3.0%, with investment at +1.6% and foreign demand at -0.1% (see Chart 3).

[Chart 2] Total Retail Value Growth by Goods / Wining & Dining



(Source: CEIC)

[Chart 3] Contribution to Real GDP Growth Rate by Component



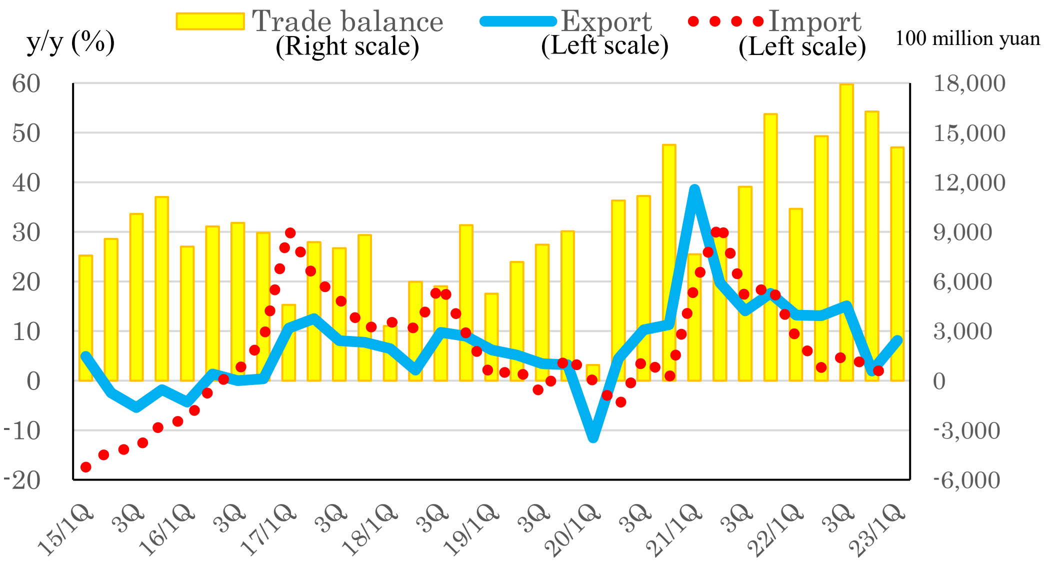
(Source: CEIC)

2. Trends by Component

(1) External demand: Exports to ASEAN and Russia comparatively brisk

Exports (in yuan terms) were reported at +8.4% y/y in 1Q/2023, higher than in the previous quarter (4Q/2022, +1.9% y/y), while imports, at +0.2% y/y, lower than in the previous quarter (+2.2% y/y). During this time, the trade surplus shrank to RMB1,409.0 billion from RMB1,627.1 billion in the preceding quarter (see Chart 4).

[Chart 4] Y/Y Change in Imports and Exports and Trade Balance (in Yuan Terms)



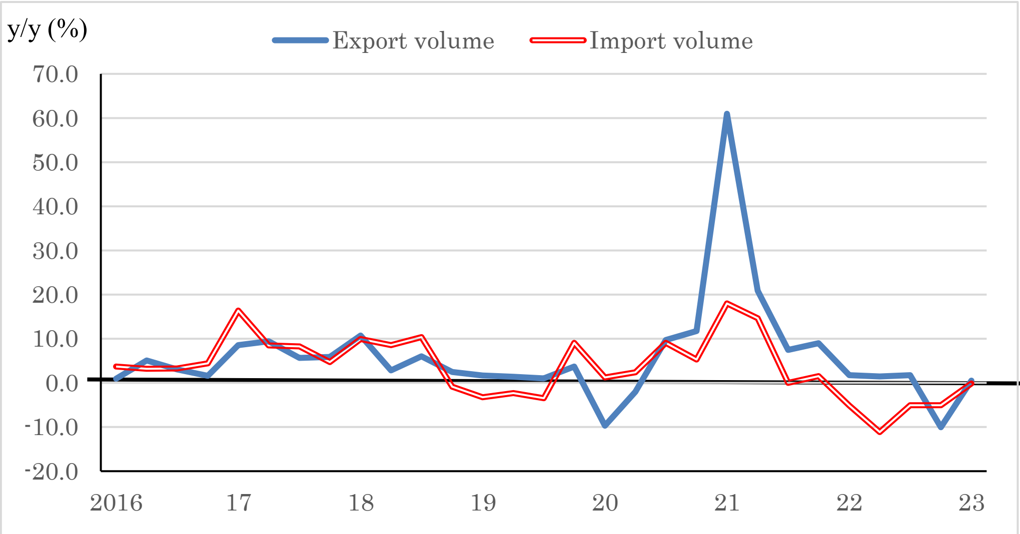
(Source: CEIC)

The above figures are on a value (RMB) basis and therefore include price factors. On a volume basis, export growth turned slightly positive to +0.6% y/y in 1Q from the significant negative growth in the prior quarter (-10.0% y/y) (see Chart 5).

In the meantime, import volume remained below the year-earlier level at -0.1% y/y in 1Q, but as with the case of export volume, the negative growth rate narrowed compared to the previous quarter (-5.1% y/y).

As seen above, as both the value and volume of exports recovered at a faster pace than those of imports, the contribution from foreign demand to real GDP growth rate (+4.5% y/y) in 1Q was -0.1% y/y, a smaller negative contribution to GDP growth rate than in the preceding quarter (-1.2% y/y).

[Chart 5] Import/Export Volume



(Source: CEIC.)

Exports (in dollar terms) to the U.S. (-19.2% y/y and -17.9% y/y in 4Q/2022 and in 1Q/2023, respectively), Europe (-12.5% y/y and -7.2% y/y), and Japan (-1.8% y/y and -2.7% y/y) all continued to fall short of their year-earlier levels. On the other hand, exports (in dollar terms) to ASEAN were +17.9% y/y in 1Q, faster growth than in the previous quarter (+10.4% y/y). This was due to a shift of production to the ASEAN region, where costs are lower, mainly in labor-intensive industries, as a response to rising production costs in China, and to the transfer of final assembly processes to the ASEAN region to avoid tariffs on exports to the U.S. This move to expand the horizontal division of labor between China and ASEAN countries is common among both Chinese and foreign firms. Exports to Russia also soared 46.5% y/y in 1Q (+18.6% y/y in 4Q/2022). This was due to the fact that Russia was forced to rely on imports from China as imports from Western countries stagnated on account of economic sanctions imposed by Western countries. China's exports to ASEAN and Russia are expected to remain strong for some time to come.

Meanwhile, the decline in imports slowed as consumption and investment began to recover on the back of the lifting of the zero-COVID policy, boosting domestic demand (contribution from domestic demand, i.e., investment + consumption, to GDP growth rate: +4.1% y/y in 4Q/2022, +4.6% y/y in 1Q/2023).

Exports are likely to continue to grow at a slow rate as the global economy is forecast to slow down due to interest rate hikes in developed economies. However, robust exports to ASEAN and Russia are anticipated to prop up China's overall exports to some extent. On the other hand, imports are likely to follow a recovery trend as domestic demand continues to edge up against the backdrop of the lifting of the zero-COVID policy. Therefore, the trade surplus is expected to decrease this year, and the contribution from external demand to GDP is likely to remain negative (adding downward pressure on GDP).

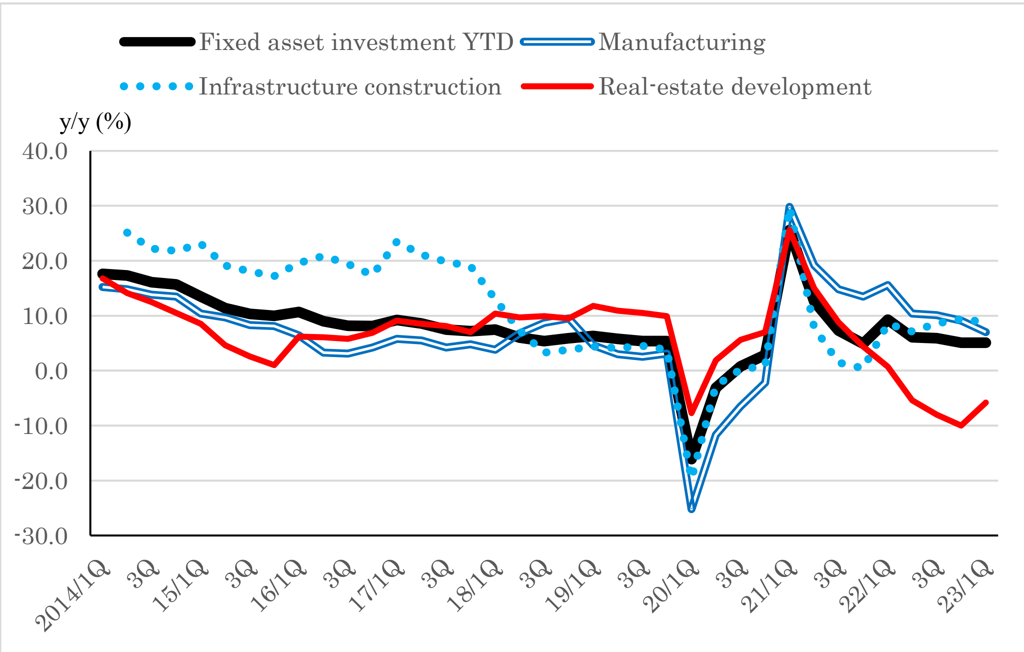
(2) Investment: Manufacturing and infrastructure construction investment solid, while real-estate development investment recovering more than expected

Fixed asset investment in 1Q was +5.1% y/y, unchanged from the previous year (+5.1% y/y for the January-December period). However, given that the y/y increase for the January-September period last year was 5.9%, the quarterly y/y change for the October-December period is thought to have been in the upper 2% to 3% range. Compared to this, the results for 1Q are considered to have exceeded those for the preceding quarter.

Fixed asset investment growth by industry sector in 1Q (see Chart 6) indicates that manufacturing rose by 7.0% y/y, down from 9.1% y/y in the previous year, while infrastructure construction gained 8.8% y/y, down from 9.4% y/y in the previous year. Meanwhile, real-estate development was -5.8% y/y, a smaller decline than in the previous year (-10.0% y/y).

However, since all figures for the previous year are cumulative y/y changes from January to December, a y/y comparison for the October-December period would have been in the 6% range for manufacturing, the 11% range for infrastructure construction, and the -15% range for real-estate development. Based on these figures, i.e., figures for 4Q/2022, it is assumed that in 1Q, fixed asset investment in manufacturing increased slightly, that in infrastructure construction grew at a lower rate, and that in real-estate development recovered significantly.

[Chart 6] Fixed Asset Investment (YTD y/y)

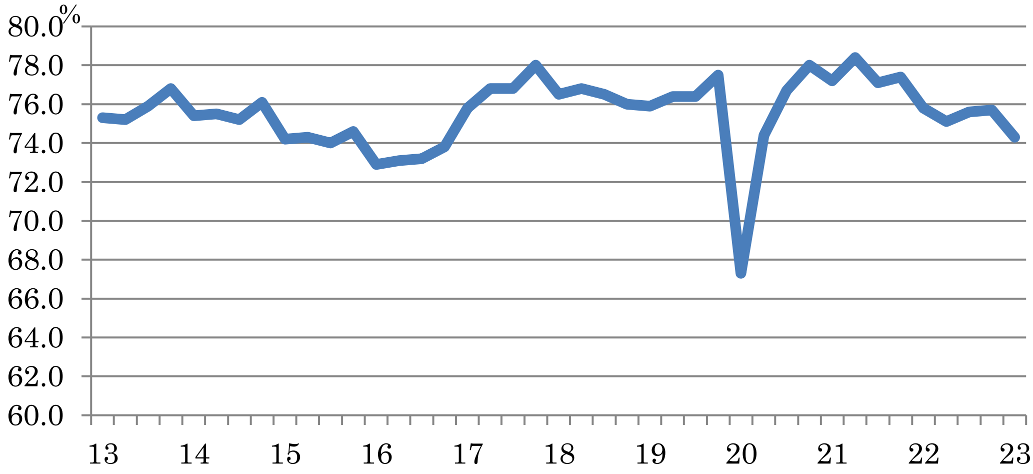


(Source: CEIC.)

<Capital investment in manufacturing>

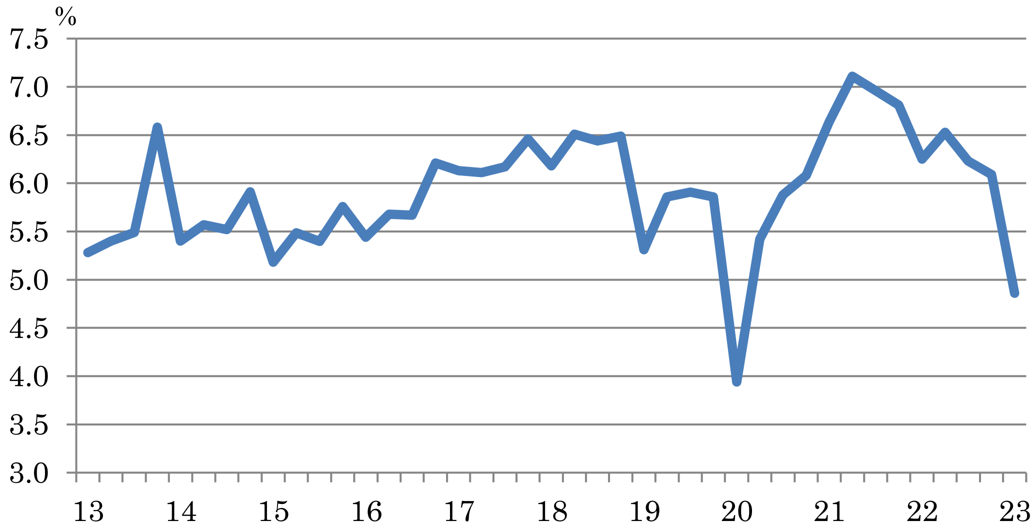
Capital investment in manufacturing remained firm. However, the lifting of the zero-COVID policy and the removal of severe restrictions on logistics and human flows appear to have little effect on capital investment in manufacturing. The capacity utilization rate was 74.3%, the lowest level since 4Q/2016 (73.8%), except for 1Q/2020 (67.3%) when a nationwide urban lockdown was implemented immediately after COVID-19 broke out (see Chart 7). The corporate profit margin was 4.86%, the lowest level since 2Q/2009 (4.63%), except for 1Q/2020 (3.94%) (see Chart 8). In addition, investment attitudes have generally become more cautious as the economic outlook has been revised downward.

[Chart 7] Industrial Capacity Utilization Rate



(Source: CEIC.)

[Chart 8] Corporate Profit Margin (Industrial Enterprises' Main Operating Revenue Margin, YTD Y/Y)



(Source: CEIC.)

The y/y changes in production in 1Q by major industry sector show that production of major products decreased from the same period of the previous year: automobiles -5.1%, integrated circuits -14.8%, PCs -22.5%, flat glass -8.0%, and chemical fibers -4.1%. The following factors are pointed out as negative market trends by industry:

First, in the automobile industry, the end to tax breaks on passenger car purchases, which had been in effect until the end of last year, has led to a decline in consumers' willingness to buy cars. In addition, price cuts due to the dumping of models that cannot meet the new emission regulations that will apply from July onward are dampening automobile manufacturers' business performance.

Second, demand for PCs and smartphones, which grew as people spent more time at home during the COVID-19 pandemic, has lost steam, and it is taking time to clear the excess inventory that has built up. It had previously been expected that inventory would reduce to the appropriate level by the end of this year, but it is now widely believed that this is unlikely and that inventory adjustments will continue until the first half of next year.

Third, demand for home appliances, furniture, and interior furnishings has slackened off, hurt by a stagnant real-estate market. 1Q home sales increased 7.1% y/y, but the growth in home sales area was slow at +1.4% y/y. This reflects the fact that while real-estate demand is recovering in major first- and second-tier cities, it remains in the doldrums in regional third- and fourth-tier cities.

On top of these industry-specific factors, due also to the implementation of strict measures under the Common Prosperity policy to prevent private companies from earning excessive profits, and to the aftereffects of numerous corporate bankruptcies under the zero-COVID policy, management sentiment has not returned to its pre-pandemic state. Since last December, the government has emphasized its support for private companies, but some experts argue that it will take two to three years for the private sector to regain confidence in the government and its strong investment enthusiasm.

In the meantime, while the government has been focusing on industrial promotion measures in areas such as EVs, solar panels, semiconductor-related products, and high-tech materials, the materials industry, including steel and cement, has maintained a certain level of growth, supported by robust investment in infrastructure construction. The effects of these policies are supporting manufacturing capital investment to a certain extent.

Going forward, with many uncertain factors remaining, including the outlook for the global economy, the timing of recovery in the real-estate market, and the timing of recovery in the markets for passenger cars, electronic equipment, and other major products, manufacturing capital investment, chiefly by the private sector, is expected to continue to increase by around 5%.

<Infrastructure construction investment>

Last year, local governments' special-purpose bonds were issued ahead of schedule to increase investment in infrastructure construction. This year, making economic stability its number-one national policy, the Chinese government intends to further strengthen its aggressive fiscal policy to enhance its effectiveness in supporting the economy. In order to achieve this, the Chinese authorities raised their budget deficit target to 3.0% of GDP this year, from last year's initial target of 2.8% and is expected to funnel more efforts than in last year into expanding infrastructure construction through tax reduction policies, fiscal subsidies to local governments, etc. With that being said, the policy of preventing funds from being invested blindly in inefficient infrastructure construction projects and resulting in huge amounts of non-performing loans, which commonly occurred before the Xi Jinping administration, is expected to be maintained, and the rigorous examination of individual projects is likely to continue. The growth rate of infrastructure construction investment for full-2023 is forecast to be more or less the same as or higher than that of last year.

<Real-estate development investment>

The real-estate market recovered better than expected in 1Q. As mentioned above, 1Q home sales jumped 7.1% y/y, a sharp turnaround from -28.3% y/y for full-2022. Although home sales space grew at a lower rate (+1.4% y/y) than the sales value, it showed a similarly sharp turnaround from -26.8% y/y for full-2022.

The number of cities out of the 70 largest cities where home sales prices rose or dropped during this period clearly indicates the magnitude of the change.

<Number of cities out of the 70 largest cities which saw new/used home sales prices increase m/m>

	Dec. 2022	Jan. 2023	Feb.	Mar.
New home sales prices	15	36	55	64
Used home sales prices	7	13	40	57

(Source: National Bureau of Statistics.)

As described above, the recovery in the home sales market was remarkable. However, new housing starts in 1Q were -17.8% y/y (-39.8% y/y for full-2022), a greater improvement from last year, but still significantly below the previous year's level, and far from a recovery. This is due to the fact that even though real-estate sales have picked up, real-estate developers continue to face tight cash flows, and most of them cannot afford to start new real-estate developments. Given this situation, even if the real-estate sales market follows a steady upward path, it will not be until the second half of this year or later that real-estate developers will solve cash flow problems and start investing in real-estate development. Accordingly, it is generally viewed that real-estate development investment for full-2023 will decrease from the previous year.

Some experts say that the outlook for the real-estate sales market, which is showing a better-than-expected recovery, is not necessarily bright. The areas where real-estate sales are recovering are limited to the first-tier cities of Beijing, Shanghai, Guangzhou, and Shenzhen, as well as the second-tier cities with a stable industrial base (capitals of each province) and surrounding cities. In regional cities with a weak industrial base, such as those in the northeastern region and the western part of the country, there is a continued outflow of population due to a lack of employment opportunities, and a recovery in real-estate demand is unlikely over the next several years. Therefore, real-estate prices will continue to slide and real-estate development cannot attract buyers. Unable to earn fiscal revenue from real-estate development, the regional cities will continue to be saddled with a budget deficit. Such a fiscal situation makes it difficult for them to strengthen their industrial base because they cannot afford infrastructure construction.

These regional cities are expected to continue to face an increased risk of financial failure for a long period of time due to local fiscal difficulties and the accumulation of non-performing loans caused by a weak real-estate market.

(3) Consumption: Rapid recovery in service consumption bolstered by the lifting of the zero-COVID policy

Total retail sales of consumer goods in 1Q increased 5.8% y/y, a sharp recovery from the preceding quarter (-2.7% y/y). The main reason for this recovery was the lifting of the zero-COVID policy; restrictions on travel were removed, which led to a rapid recovery in consumption of services such as wining and dining, accommodation and transportation (see Chart 2).

In line with the recovery in service consumption, employment is also on the rise, thus increasing income and supporting consumption of goods. As for consumption of goods, however, as seen earlier, the recovery momentum is still weak at present because of excess inventories of major durable consumer goods such as passenger cars, PCs, smartphones, home appliances, and furniture. This leads to the difference in the speed of recovery between consumption of services and consumption of goods.

This year, the Chinese economy is expected to show a consumption-led recovery, as the sharp recovery in the restaurant, travel, transportation, and other service industries deriving from the lifting of the zero-COVID policy will propel the economy.

That being said, there are many causes for concern: the real-estate market is expected to remain in the doldrums for a long time in many regional cities; the unemployment problem of college graduates due to a glut of graduates in the job market will remain difficult to solve for some time to come; and it will take a while for companies that went bankrupt hit by the COVID-19 pandemic to recover. Accordingly, consumers are revising their income outlook downward and becoming more cautious in their purchasing attitudes, which is feared to be a drag on the consumption recovery.

Given the above, even if consumption were to recover, the growth rate of total retail sales of consumer goods is likely to remain slightly below the pre-pandemic rate of +8-9% y/y.

(4) Outlook for the Chinese economy

Most experts expect real GDP growth to be in the 5% range for full-2023. But the better-than-expected growth in 1Q has led to an upward revision of the outlook for full-2023, with some expecting it to reach 6% or higher. As for trends on a quarterly basis, since the growth rate declined in 2Q and 4Q of last year, it is expected to rebound this year; accordingly, quarterly trends are forecast to show a zigzag growth pattern of low in 1Q, high in 2Q, low in 3Q, and high in 4Q.

After next year, considering that it will be difficult for China to secure a growth rate of 5% or higher, many believe it will remain in the 4% range for several years, dropping to the 3% range around 2030.

3. Gap between Japanese and Western companies regarding investment stance toward China

During intensive online interviews conducted in late January and early February, almost all of the Japanese company executives stationed in China pointed out to me a lack of understanding of China by headquarters management. It was found that a common problem for most Japanese companies was an overly cautious stance toward investment in China, which was triggered by concerns about economic security and the risk of a Taiwan contingency. This is mainly due to the fact that the management of the headquarters had not been able to visit China for more than three years because of the pandemic and had lost touch with the realities of the Chinese market. Many companies were therefore trying to remedy the problem by arranging business trips to China for presidents, executives, etc., at an early stage.

However, a new risk factor was added on March 25 when an Astellas employee in his 50s was reportedly detained by Chinese authorities in Beijing for allegedly violating China's anti-espionage law. Since the reason for the detention has not been disclosed, many employees of Japanese companies are highly concerned that they and other business travelers from Tokyo may also be detained.

When I visited Beijing from April 17 to 23 and Shanghai from April 23 to 28, many

Japanese people stationed there were surprised, saying to me, "How brave of you to come at such a time!" Thinking only of the joy of meeting with people I had not been able to meet in person for the past three years and three months, I entered the country without feeling any anxiety. However, after being in direct contact with many Japanese people in Beijing and Shanghai who voiced their concerns, I came to share the same concerns. Fortunately, I was able to get back home in one piece, so I plan to continue my regular quarterly business trips to China from this point onward as well.

Meanwhile, fully aware of the risks associated with economic security, Taiwan contingencies, and detention by Chinese authorities, Western companies are actively expanding their business in China by gathering information through their excellent human resources. I reported on the gap between the overly cautious and negative attitude of Japanese companies toward Chinese business and the proactive attitude of Western companies in my previous online interview report in January, but the gap between them in specific actions taken in China is widening further and further.

The American Chamber of Commerce in the People's Republic of China, an association of U.S. firms operating in China, conducted a survey of its member companies from April 18 to 20, and 109 companies responded. The survey found that 43% of the companies have already had executives or higher-level officers visit China since the beginning of this year, and 31% are planning to do so.

As for European companies, the CEOs of 12 major German companies together with German Chancellor Scholz visited China in November last year. In April this year, executives from 50 French companies visited China with French President Macron, showing an even more proactive stance than their U.S. peers.

In contrast, an increasing number of Japanese companies have postponed visits to China by their executives and other senior staff since the Astellas incident, widening the gap between Japanese companies and their Western counterparts.

The reason that Western companies' executives personally travel to China is the sheer size of the Chinese market, the huge revenue likely to be gained from that market, the speed at which the market is changing, and the considerable risks involved. According to the IMF's World Economic Outlook (April 2023), China's GDP is expected to reach 4.4 times that of Japan this year and five times by 2027. Not only is the market size expanding, but China is also creating world-class technologies one after another in the fields of digital technology and the environment, such as EVs, automated driving, solar panels, smartphone payments, and facial recognition. Recently, exports of these technologies have also been growing, and the number of automobiles exported by China is likely to surpass that of Japan this year.

Meanwhile, given the sizable impact of changes in policy on business, we cannot take our eyes off the Chinese policy trends. Because China is such a unique market, leading company executives from around the world make frequent visits to China to assess opportunities and risks with their own eyes to build business strategies.

End