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Ascertaining the truth of China's Economic Recovery

China's economy headed for a stall or a second coming of the bubble?

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Summary

- The writer of this report visited China just as the curtain rose on the National People's Congress from March11 to March 15. The writer surveyed the situation in Beijing, Xiong'an New Area, and Qingdao, and exchanged opinions with local experts. In this report we share insights gained on this research trip.

- First of all, US-China trade friction was not a major factor in the loss of momentum in China's economic growth in 2018. It would be more accurate to say that China was hit with tariff hikes right at a time when domestic demand was losing speed due to policy changes, thereby adding to a preexisting condition. The stalling of domestic demand can be attributed to the following: (1) strengthening of regulations regarding wealth management products, (2) putting the squeeze on infrastructure projects, (3) introduction of regulations regarding inter-individual consumer finance, and (4) suspension of tax reduction on automobile purchases. The first two items in this list have a political aspect, and once into the current year (2019) have been on the way to being relaxed somewhat. This has contributed to a turn toward recovery for the Chinese economy.

- However, China's domestic inventory level is high. Hence it will take time before China's economic recovery begins to bring benefits to Japanese corporations. Meanwhile, factors (3) and (4) remain, so it is highly possible that recovery in consumption will be delayed. Therefore, it will take some time for Japanese corporations with a high dependence on Chinese consumption to recover. Possibilities are great that the pace of recovery will be relatively slow.

- On the bright side, inventory adjustment is progressing for some Japanese corporations. For instance, electronic parts and devices saw its inventory levels increase through the middle of 2018, and then inventory adjustment progressed throughout the second half of that same year. Meanwhile, it is quite possible that the transport equipment, and electrical machinery and Information and communication electronics equipment industries have already completed adjustment of excess inventory. These industries had already reached a high level of inventory by the first half of 2018. Reduction of inventory through the adjustment process is remarkable, reaching as far as the production machinery industry. The comeback for China's economy may very well lead to the bottoming out of Japanese corporate business results in these industries.

1. Survey of business conditions in Beijing, Xiong'an New Area, and Qingdao

The degree of reliability with which the Chinese economy is recovering is also one of the major keys to the future of Japan's economy[1]. It is with this understanding that the writer of this report visited China just as the curtain rose on the National People's Congress from March11 to March 15. The writer of this report surveyed the situation in Beijing, Xiong'an New Area, and Qingdao, and exchanged opinions with local experts. In this report we share insights gained on this research trip. To describe our conclusions in the briefest way possible, we would say that first of all, the trade talks between the US and China will likely be tougher going than it has been assumed. However, China is determined to shore up its economy through the use of fiscal and monetary policy. The recent move toward recovery in China's economy shows the influence of government policy in shoring up the brisk financial market, improvements in corporate finance, and the increase in orders for infrastructure projects. We were had the strong impression that this plan can, through policy measures, offset the shock of the *New Economy's* bubble bursting, and allow China to return to the days of restoring the *Old China*.

US-China trade talks may be tougher going than expected

One of the things the writer learned on this research trip is that some are of the opinion that the US-China trade talks represent a negative surprise for China. To put it simply, China's domestic expected value is too high. In other words, local opinion has it that China has already made concessions to the US on many points. Anymore demands on the part of the US would constitute interference in another nation's domestic affairs. President Trump is a businessman, so he should know that, considering economic rationality, a suitable agreement has been reached. There is even a good possibility that the tariffs imposed last year may be abolished. The writer was given the impression that a consensus has formed.

US-China Summit – US Talking Points **Chart 1**

Statement from the Press Secretary Regarding the President's Working Dinner with China

1st, Dec 2018

The President of the United States, Donald J. Trump, and President Xi Jinping of China, have just concluded what both have said was a "highly successful meeting" between themselves and their most senior representatives in Buenos Aires, Argentina.

Very importantly, President Xi, in a wonderful humanitarian gesture, **(1) has agreed to designate Fentanyl as a Controlled Substance, meaning that people selling Fentanyl to the United States will be subject to China's maximum penalty under the law.**

On Trade, President Trump has agreed that **on January 1, 2019, he will leave the tariffs on $200 billion worth of product at the 10% rate, and not raise it to 25% at this time**. **(2) China will agree to purchase a not yet agreed upon, but very substantial, amount of agricultural, energy, industrial, and other product from the United States** to reduce the trade imbalance between our two countries. China has agreed to start purchasing agricultural product from our farmers immediately.

President Trump and President Xi have agreed to **(3) immediately begin negotiations on structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture**. **Both parties agree that they will endeavor to have this transaction completed within the next 90 days. If at the end of this period of time, the parties are unable to reach an agreement, the 10% tariffs will be raised to 25%.**

(4) It was also agreed that great progress has been made with respect to North Korea and that President Trump, together with President Xi, will strive, along with Chairman Kim Jong Un, to see a nuclear free Korean Peninsula. President Trump expressed his friendship and respect for Chairman Kim.

(5) President Xi also stated that he is open to approving the previously unapproved Qualcomm-NXP deal should it again be presented to him.

President Trump stated: "This was an amazing and productive meeting with unlimited possibilities for both the United States and China. It is my great honor to be working with President Xi."

Source: https://www.whitehouse.gov/briefings-statements/statement-press-secretary-regarding-presidents-working-dinner-china/ (Colors, underlining and numbers added by writer.)

[1] For details see the following DIR report dated 26 March 2019. *Japan's Economy: Monthly Outlook (March 2019), Doubts regarding five prevailing views on Japan's economy*, by Shunsuke Kobayashi & Yota Hirono.

Four out of five of the terms demanded by the US had already reached concession at the US-China summit held in December. These include China's agreement to place controls on the export of highly toxic substances, to purchase more agricultural products from the US, cooperate on the North Korean problem, and to stop interfering in US telecommunications companies attempts to do business in China (Chart 1). Remaining problems are associated with structural reforms associated with the protection of intellectual property, but China insisted that this issue was already settled by its having enacted the Foreign Investment Law.

However, China's Foreign Investment Law merely provides guidelines. Considering China's twenty years of fending off US criticisms by implementing deliberately ambiguous measures, or by raising the issue of the China Threat Theory in US public opinion and politics, without a commitment to real improvements it seems that the US would think first before agreeing to a settlement.

But with the expected value of Chinese public opinion on the high side, making any more concessions could cause the Chinese government to lose face. On the other hand, the US cannot make any concessions regarding the terms submitted by the Chinese government as of this point. This creates concerns that the US-China trade talks will be tough going.

Of course, the reassuring point is that neither China nor the US have any incentive to break off negotiations as of this point. As will be explained further in this report, China is eager to provide more support for its economy. Neither is the US in a position to allow the talks to go down in flames with midterm elections now in progress, and the presidential primary elections to follow. This is a political phase in which it will be important to encourage recovery in the economy and the financial markets, as well as to provide increasing support for the Trump administration. Hence the talks may be rough going, but negotiations will not be broken off. On the other hand, they could be delayed or prolonged. And if the talks go on for too long, then they will drag on into 2020, which is when the primary election for the US presidential election takes place, and at that point the option of breaking off negotiations or using a "flaming" strategy will arise.

US-China Summit – Results Published by China **Chart 2**

Xi, Trump hold 'very successful' meeting on ties, trade

2nd, Dec 2018

President Xi Jinping and his US counterpart Donald Trump held a "very successful" meeting in Buenos Aires, Argentina on Dec 1 and agreed to continue to maintain close contact.

At the working dinner after the conclusion of the 13th Group of 20 summit, Xi and Trump had an in-depth exchange of views on China-US relations and international affairs of mutual concern in a friendly and candid atmosphere, **reaching important consensus and agreeing not to impose new additional tariffs**.

The two sides agreed to expand cooperation based on reciprocity and mutual benefit and manage differences based on mutual respect so as to jointly advance China-US relations with coordination, cooperation and stability as the defining features.

Xi pointed out that China and the United States shoulder important responsibilities in promoting world peace and prosperity.

Sound China-US relations, Xi said, are in line with the fundamental interests of the two peoples and the general expectation of the international community.

Cooperation is the best option for the two countries, Xi said.

Xi called on both China and the United States to handle the development of bilateral relations from an overall perspective and push for long-term, healthy and stable development, delivering more and better benefits to the two nations and people around the world.

Trump said he agrees with Xi on his evaluation of bilateral relations.

US-China relations are very special and important, Trump said, adding that it is in the interest of the two countries as well as the world that the United States and China, both countries of significant influence, maintain a good cooperative relationship.

The US side, he added, is ready to increase cooperation with China through consultations and actively seek mutually beneficial solutions to their problems.

The two heads of state are willing to maintain close exchanges in various forms to jointly chart the course of the development of China-US relations.

Source: http://english.gov.cn/news/top_news/2018/12/02/content_281476415821808.htm (Colors and underlining added by writer.)

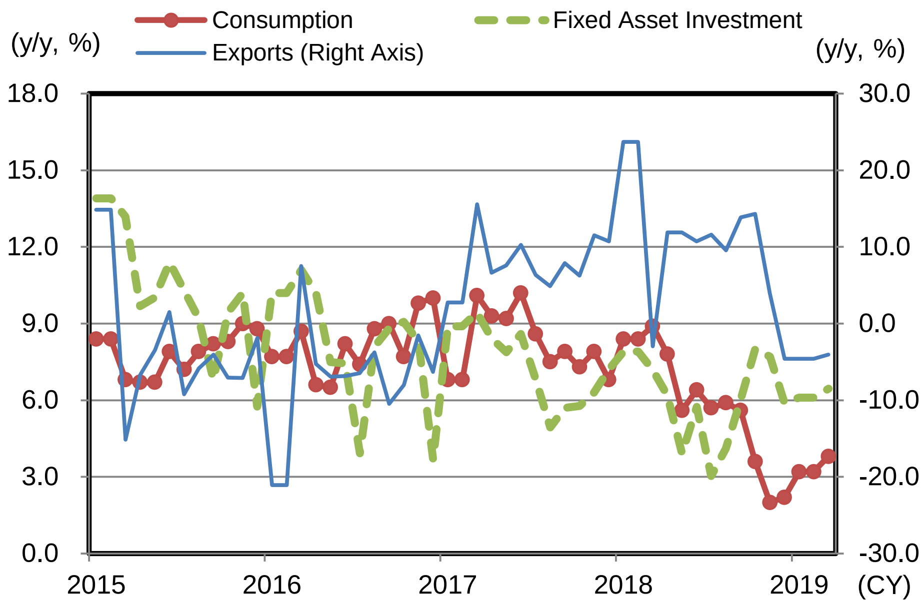
The true reason China's economy stalled in 2018, and degree of seriousness in providing support for the economy in 2019

The fact that US-China trade talks may be tough going is of course not good news for the Japanese and the global economies. However, on this research trip the writer discovered a positive surprise which more than offsets the negative surprise of the talks. That is the intense determination of the Chinese government to implement measures to support the economy.

But before covering these in more detail, let us take a quick look at the past. As is shown in Chart 3, Chinese exports began to decline significantly in November of 2018. In contrast, consumption and fixed asset investment began losing speed at the beginning of 2018. Consumption slowed further in October of the same year. In other words, domestic demand became distorted before overseas demand. It is difficult to associate the slowdown in domestic demand with US-China trade friction. It is a fact that concerns in Qingdao, a major port for shipping household electronic exports, were more for the falling back of domestic demand than overseas demand.

Changes in China's own policies were behind the slowdown in domestic demand. The major causes were (1) strengthening of regulations regarding wealth management products, (2) putting the squeeze on infrastructure projects, (3) introduction of regulations regarding inter-individual consumer finance, and (4) suspension of tax reduction on automobile purchases.

China: Changes in Fundamental Economic Statistics **Chart 3**



Source: National Bureau of Statistics, General Administration of Customs; compiled by DIR.

The essence and power of deleveraging (strengthening of regulations regarding wealth management products)

First we look back at what was behind the strengthening of regulations regarding wealth management products. In November 2017 the authorities announced government guidance regarding standardization of asset management business of financial institutions. Legislation went into effect in April 2018. This measure prohibits "rigid redemption" and management of pooled funds.

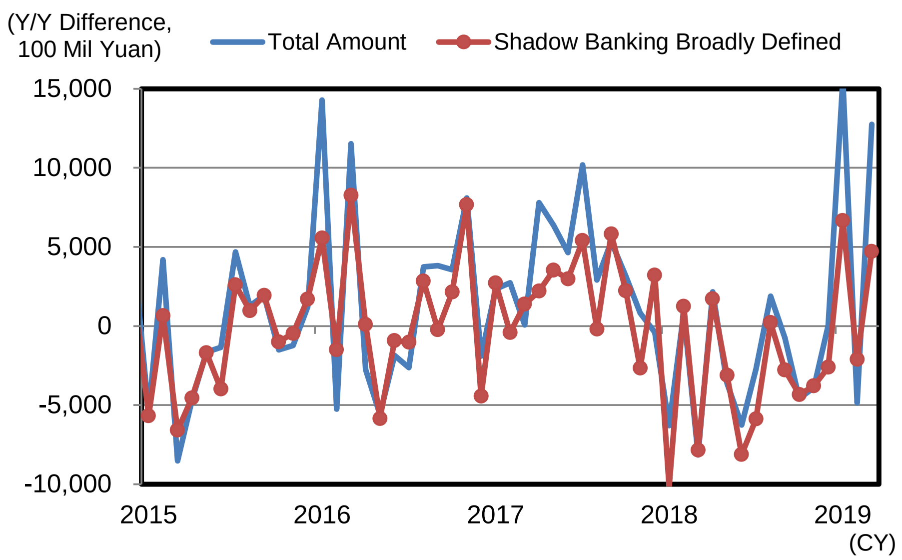
Both of these are wealth management products. In other words, the purpose of the new ruling is to regulate shadow banking. The term "rigid redemption" indicates the practice of guaranteeing the principal. Management of pooled funds is where multiple asset management products are placed together and batch managed. When managed in this way, earnings and risk associated with individual products becomes unclear.

As is shown in Chart 4, there is little room to doubt that investment in wealth management products of this sort ballooned between 2016 and 2017, causing risk in the financial system to expand significantly. Sensing a crisis in the making, the authorities strengthened regulations and punished financial institutions that were carrying out compensation for losses. The authorities began to demand one-to-one correspondence in the handling of asset management products.

As a result, the growth rate in investment in wealth management products, as well as the total amount of social financing experienced a major slowdown in 2018. This generates the collapse of asset prices on the financial markets. Then the collapse in asset prices causes the circulation of funds through private equity to deteriorate, and the number of private corporations struggling with financing increases. Meanwhile, the deleveraging activity of banks due to operating losses progresses. This describes one of the important factors behind China's stalled economy in 2018.

At the same time, the strengthening of financial regulations and the slowdown in infrastructure investment are not exactly unrelated. It is not difficult to deduce that the situation was such that the banking system, whose risk tolerance had decreased, could not increase credit to provincial governments. Meanwhile, with the central government seeking debt relief and environmental measures, it became difficult to gain authorization for infrastructure investment projects in the first half of 2018.

China: Increase and Decrease in Total Amount of Social Financing **Chart 4**



Source: People's Bank of China; compiled by DIR.
Notes: 1) Increase and decrease in amounts of fundraising in social capital is based on net growth and decline in capital supplied to the economy by the banking system.
2) Shadow banking in the broad sense is the total minus lending in Chinese renminbi and lending in foreign currency.

The major factors that stalled consumption were the strengthening of regulations regarding P2P consumer financing and abolishing the vehicle purchase tax reduction

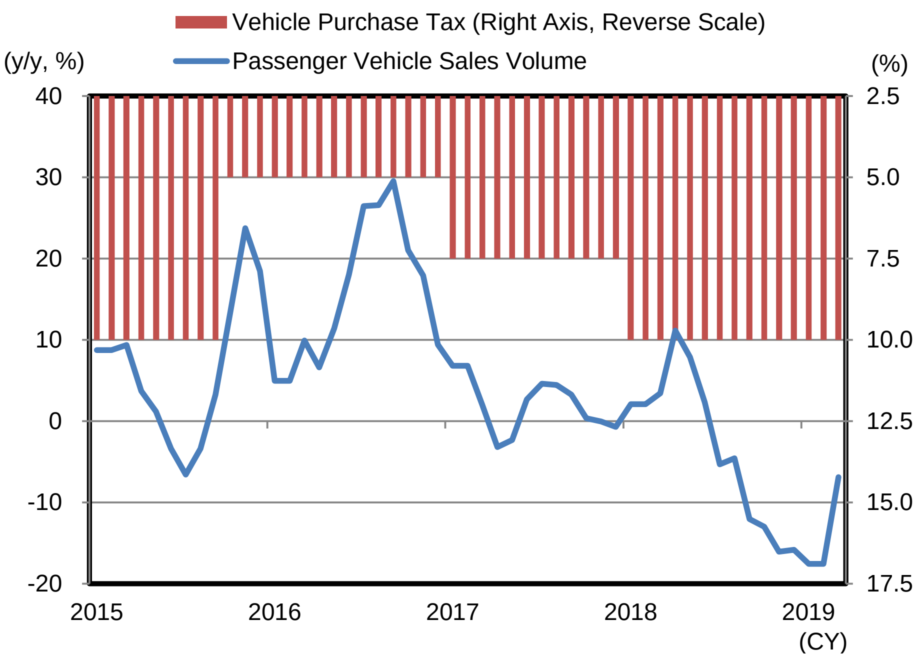
Of course, all of these developments are associated with the slowdown in fixed asset investment and the slump in the financial markets. It is also a fact that most likely, this has had an indirect relationship with the slowdown in growth in employment and improvement in wages, as well as suppression of consumption through the negative wealth effect.

Another lesser-known fact was also present, having an even more direct effect on holding down consumption, and that is regulations regarding P2P consumer financing. P2P consumer financing is the carrying out of lending and borrowing between individuals. There were many businesses in China providing platforms for the matching of loans. During the time we have been discussing here, the scale of that market had already reached 20 tril yen. The Chinese government was concerned about the unbridled expansion of this market, and therefore strengthened regulations. The policy to regulate this market was itself announced in August 2016, but details of the regulations were not indicated until August 2018. Businesses involved in this market were then forced to deal with the new regulations by the end of 2018.

As a result, most of the unscrupulous businesses were pushed out of the market, but it appears that the businesses that remained were unable to avoid the devastating blow to the balance sheet total. Of course, consumption on the part of borrowers was therefore impeded, but lenders who got burned may also have contributed to the holding down of consumption.

In addition to these developments, the purchase of automobiles, which was supported between 2015 and 2017 by a tax reduction measure, returned to the normal tax which had been charged before that time. It is apparent that this decision may also have contributed to the slump in automobile sales in 2018 (Chart 5).

China: Overview of Automobile Sales **Chart 5**



Source: CEIC; compiled by DIR.

Unexpected (and unembarrassed) reversal of regulatory decision brings expansion in financing

In a complete turnaround from 2018 when factors contributing to economic slowdown were piled high one on top of the other, 2019 saw the Chinese government launch policies to support the economy in rapid succession beginning early in the year.

First, as can be confirmed to be especially evident by taking a look at Chart 4, soon after entering the year 2019, the total amount of social financing was increased significantly. The government adopted the stance that they would not be averse to the fact that most of that would likely flow into the shadow banking market. This actually provides backup for the recovery of the financial market. Not only does it provide indirect support for the recovery of the asset effect, but the implications are that it can bring a stop to unemployment in startup companies (young highly educated white collar workers).

However, the government guidance previously mentioned has not yet been abolished. The term for that measure ends on January 1, 2021. Therefore, it should be kept in mind that the more one carries out a sudden, unembarrassed expansion of financing, the tougher going will be the coming adjustment phase in 2020.

Two important political dates in 2019

But the real reason that the Chinese government has been so eager to shore up the economy is more likely two important political dates in 2019.

One of these is October 1, China's National Foundation Day and the 70th anniversary of The People's Republic of China. A huge parade and ceremony are planned to celebrate this day, and the government needs to demonstrate that the economic slowdown has been overcome by this date.

The other date occurs around June. This is the date that a new stock market is established, the Science and Technology Innovation Board oriented toward high tech startups. If stock prices are still low when the new exchange opens and funding stagnates, the country's leadership will completely lose face.

Assuming that the Chinese government is eager to support the economy due to these political concerns, then policy could experience a major turnaround early in 2019.

Recovery and expansion of infrastructure investment triggers tax reduction policy

Infrastructure investment is getting going again in addition to monetary easing. Net issuance of local government special bonds in 2019 is expected to reach 2 tril, 150 bil yuan, 800 bil yuan more than last year. Everywhere one goes one hears about major infrastructure projects getting started. This includes new airports and highways in the major cities, as well as development projects in the south, such as the Yangtze River Delta development, the Pearl River Delta development, and construction of the Xiong'an New Area.

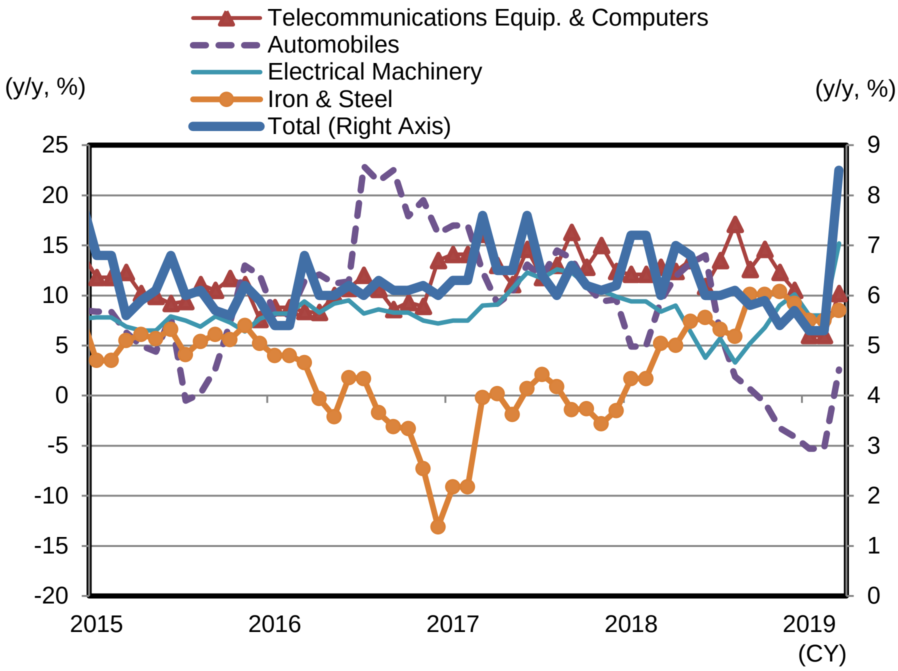
Meanwhile, the scale of the tax reduction is also major. The 2019 tax cut totals 2.0 tril yuan (approximately 33.4 tril yen), including a reduction in the value-added tax (the manufacturing industry tax will be cut from the current 16% to 13%, while the transportation and construction industries will be cut from 10% to 9%). The social insurance burden of corporations will also be reduced significantly.

Time lag expected before Japanese corporations reap benefits

There is just one thing to remain aware of – there will be a natural time lag before Japanese corporations reap the benefits of the Chinese economy's recovery in infrastructure projects and other areas. The reason is simple – China's domestic inventory level is still high. As is shown in Chart 6, the Chinese government provided support to accelerate iron & steel production during the second half of last year due to the economic slowdown. As a result, inventory accumulation of raw materials produced at that time has likely occurred. Japanese corporations are expected to reap the benefits of China's economic recovery after this excess inventory has been reduced somewhat.

One possible conclusion we can draw from the previous arguments is that a recovery of consumption will likely take a while. This will be a heavy burden for Japanese corporations which have become dependent on final consumption demand in China. In comparison with the recovery of the stock market and infrastructure demand, which are hoped to experience an early recovery associated with the change in deleveraging policy, the factors behind the slowdown of 2018 were the regulation of consumer financing and the halting of the tax reduction policy. What remains now is the recovery of consumption, but there is a very good chance that this will remain sluggish for some time. A representative item closely linked with China's consumption is cosmetics. Demand for cosmetics has been unexpectedly slow, and as can be seen in Chart 7, even in Japan's domestic market, inventory accumulation in the chemical industry, which includes cosmetics, has continued since 2018. Assuming that recovery in demand will be gradual, there is a very good possibility that inventory adjustment in this industry will continue to be difficult for some time to come.

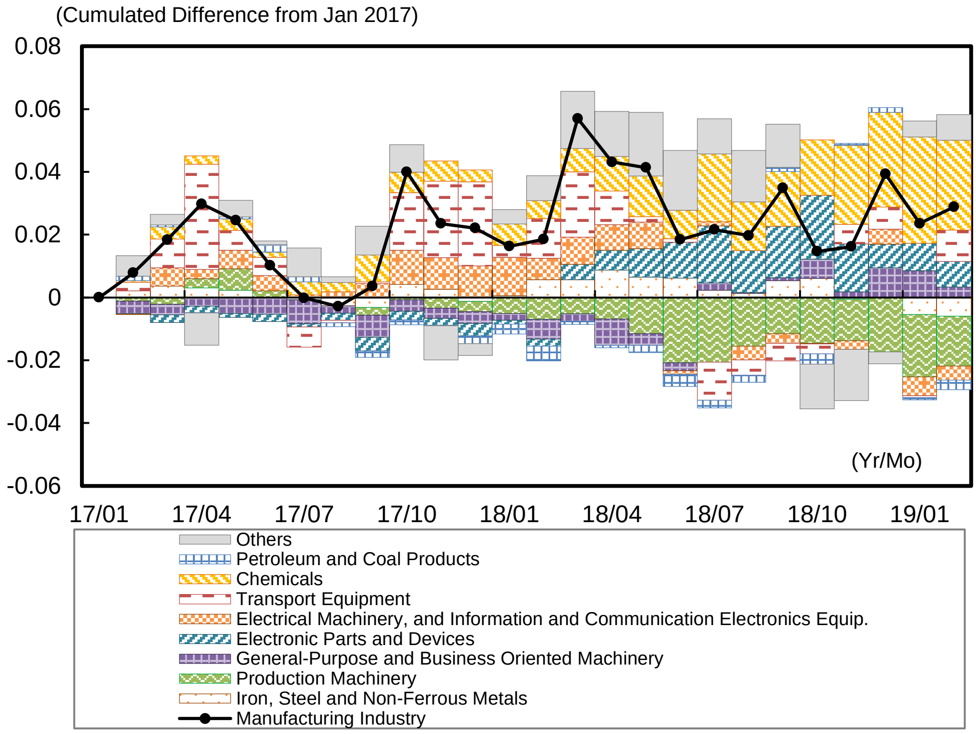
China: Status of Industrial Production **Chart 6**



Source: National Bureau of Statistics; compiled by DIR.

On the bright side, in contrast to the chemical industry, inventory adjustment is progressing for some Japanese corporations. For instance, electronic parts and devices saw its inventory levels increase through the middle of 2018, and then inventory adjustment progressed throughout the second half of that same year. Meanwhile, it is quite possible that the transport equipment, and electrical machinery and Information and communication electronics equipment industries have already completed adjustment of excess inventory. These industries had already reached a high level of inventory by the first half of 2018. Reduction of inventory through the adjustment process is remarkable, reaching as far as the production machinery industry. The comeback for China's economy may very well lead to the bottoming out of Japanese corporate business results in these industries.

Japan: Number of Inventory Months – Breakdown by Industry **Chart 7**



Source: METI; compiled by DIR.

Notes: 1) Inventory months = real inventory value (end month balance) / real shipment value (monthly amount, 12-month backward moving average).

2) Real inventory value and real shipment value were calculated using values from the METI Census (2015) and extending those figures using the Indices of Industrial Production.