CHINA ECONOMIC UPDATE AUGUST 2020

Mixed signals – some risks from China's incomplete recovery

National Australia Bank

NAB Group Economics

The latest Chinese economic data showed that its economy recovered in Q2, however the results were highly mixed – with a range of sectors still struggling. The uneven recovery has the potential to build on existing issues within the economy, which could have economic and social ramifications in the longer term.

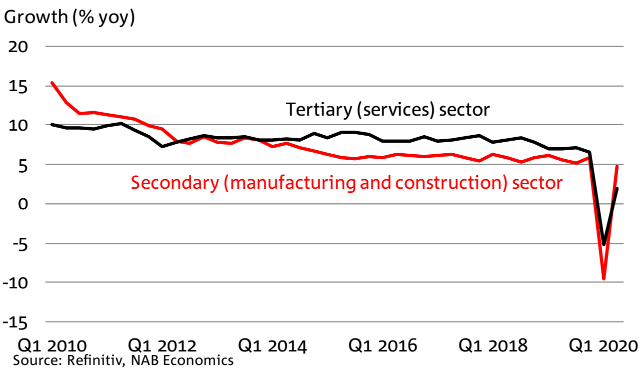
CHINA'S UNEVEN RECOVERY

According to the latest national accounts data, China's economy recovered in second quarter of 2020 – with quarter-on-quarter growth of 11.5% (on a seasonally adjusted basis). This rapid increase followed on from a 10% qoq fall in Q1, leaving the economy around 0.4% larger at the end of Q2 than it was at the end of 2019.

However, this recovery was quite uneven, with different parts of the economy growing more rapidly than others. At a high level, it was the secondary sector – comprising manufacturing and construction – that provided the strongest growth, at 4.7% yoy. This was a throwback to China's old growth model, when the industrial sector provided the bulk of growth in the early stages of the country's multi-decade economic boom.

CHINA'S RECOVERY IN Q2

Growth led by 'old economy'



Source: Refinitiv, NAB Economics

High levels of investment in this sector during the first decade of this century led to large scale overcapacity in a range of different industries, particularly heavy industrial areas such as steel, glass and chemicals but more recently in areas such as solar panels, semi-conductors and high tech batteries.

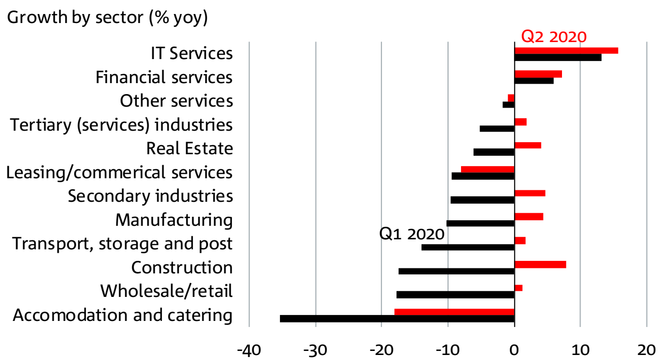
Given the softness in domestic consumer demand (with retail sales remaining historically weak) and export markets, further strong growth from the industrial sector in the near term would not appear sustainable.

As we highlighted last month, recent fixed asset investment trends have been dominated by state-owned enterprises. While this allows the government to rapidly support the recovery from COVID-19 shutdowns, it could exacerbate these capacity issues and delay reforms to underpin longer term growth.

In contrast, the services sector (which had been the key engine for growth since the global financial crisis) grew relatively modestly – up by just 1.9% yoy. Many personal services require close physical contact and many Chinese residents chose to maintain social distancing, even as authorities eased mandatory restrictions.

GROWTH BY SUB-SECTOR

China's recovery was not broad based



Source: CEIC, NAB Economics

By subsector, there has been a wide divergence in growth. The output of accommodation and catering services contracted by 18% yoy in Q2, following on from a 35% fall in the first quarter. This sector

Date **August 2020** | Author **Gerard Burg** – Senior Economist – International

remains heavily impacted by travel restrictions and caution from consumers. In contrast, IT related services grew by 15.7% yoy in Q2, having increased by 13.2% yoy in Q1. Financial services also grew strongly – up by 7.2% yoy in the second quarter.

Should the trends exhibited in Q2 persist for some time, there is a risk that existing imbalances within China's economy will be exacerbated, including concerns around inequality.

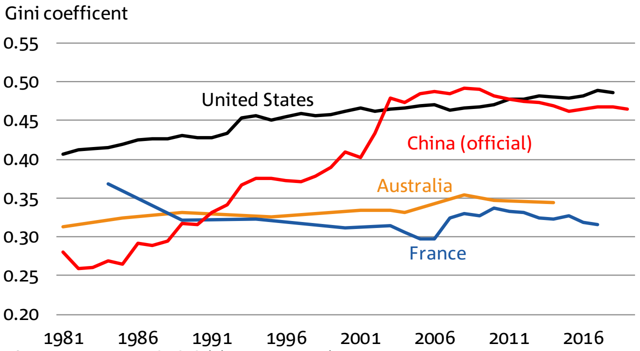
INEQUALITY STILL AN ISSUE IN CHINA

The Gini coefficient is the most common measure of income inequality – measuring the distribution of income across the population on a scale from 0 to 1, with higher values indicating greater inequality. As a rough guide, a Gini coefficient greater than 0.4 is considered high, with the potential for negative social impacts.

China's officially reported Gini coefficient has exceeded 0.4 since 2000 and peaked at 0.491 in 2008 (however it is worth noting that unofficial measures based on private household surveys have estimated even higher levels of inequality). China's Gini coefficient eased between 2009 and 2015, but has subsequently stabilised at a high level – at 0.465 in 2019.

INCOME INEQUALITY BY COUNTRY

Chinese inequality has stabilised at a high level



Source: Datastream, CEIC, Caixin, NAB Economics

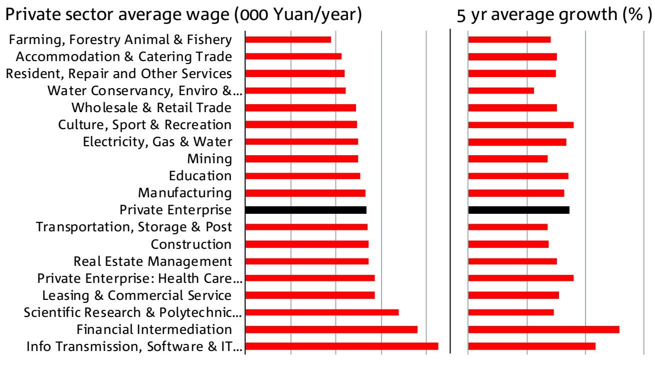
In part, this trend reflects the different phases of development across the country, which started in the country's coastal eastern provinces. These provinces benefited from preferential policies (such as the development of special economic zones), as well as geographical advantages that allowed for easy importation of raw materials and export of finished products to global markets.

As China rapidly industrialised across the past two decades, income inequality rose – in part due to higher paying manufacturing jobs luring surplus labour from low income agricultural regions. These migrant labourers typically lack access to social services in the cities they settled in, creating three tiers of disparity between themselves, rural residents (who have lower income) and residents with an urban household registration (who have higher). More recently, efforts to move manufacturing from basic products to higher value-added ones, as well as the growth of services, has contributed to this trend.

Average incomes vary considerably across individual industry categories in China, as have the growth of these incomes over recent years. According to official data of private sector wages, the highest occur in IT services and Financial services – earning around 1.6 times and 1.4 times the private sector average respectively. Wages in this sector have also grown more strongly than the average – increasing by 10.8% a year and 12.9% a year respectively over the past five years. These were also the sectors to record the strongest growth in the services sector in Q2.

AVERAGE WAGES BY SECTOR

Wages growth strongest for highest income sectors



Source: CEIC, NAB Economics

In contrast, a range of lower income sectors – such as hospitality services, household services, retail & wholesale and cultural & recreational services – recorded weaker economic growth in Q2 and are yet to return to their pre-COVID-19 levels. Should weak growth trends in these sectors persist, this could lead to widening income inequality, which could negatively impact longer term, consumption based economic growth.

CONCLUSIONS

While headline economic data for Q2 showed that China's economy has recovered from its COVID-19 related downturn, the detailed breakdown shows a very mixed picture. Growth driven by heavy industry – China's old economy – does not seem particularly sustainable and, should the growth trends exhibited in Q2 persist, risk building on existing imbalances and inequality concerns.

CONTACT THE AUTHOR

Gerard Burg
Senior Economist – International
Gerard.Burg@nab.com.au
+613 8634 2788
+61 477 723 768

Group Economics

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Jacqui Brand
Personal Assistant
+(61 3) 8634 2181

Dean Pearson
Head of Economics
+(61 3) 8634 2331

John Sharma
Economist
+(61 3) 8634 4514

Australian Economics and Commodities

Gareth Spence
Senior Economist – Australia
+(61 4) 36 606 175

Phin Ziebell
Senior Economist – Agribusiness
+(61 4) 75 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

International Economics

Tony Kelly
Senior Economist
+(61 0) 477 746 237

Gerard Burg
Senior Economist – International
+(61 3) 8634 2788

Global Markets Research

Ivan Colhoun
Global Head of Research
+(61 2) 9237 1836