China's GDP downgraded as electricity policy hits growth

China's restriction of electricity supply and power shutdowns in some regions have hurt manufacturing activity, as well as the daily lives of many households. Taking into account other policy measures which are weighing on growth, we are downgrading our GDP forecasts for 2021

Electricity grid construction in east China, Mingguang, Anhui - 15 Sep 2021

Source: Shutterstock

Electricity shock follows aggressive local government decisions

There has been an abrupt cutback in electricity supply in many regions of China as a result of decisions made by a number of local governments. Power problems have occurred because the regions have been pressured to reduce emissions, having previously failed to meet tough reduction targets for the first half of the year. The target levels are set by a combination of the energy consumption level and energy consumption intensity imposed by the central government.

The reduction of carbon emissions is clearly good for both the Chinese and the global environment but the move has also created challenges. Recent actions have adversely affected around one-third of China's manufacturing sector, as Guangdong and Zhejiang, which are major manufacturing locations in China, were under strict electricity supply restrictions that have hampered their production ability. The electricity supply cuts also coincide with the export production season, which is very bad for exporters' and manufacturers' revenue. If this persists, it could also increase account receivables, which means bad loans will increase, and the jobless rate will probably also rise.

In order to alleviate some of the pressure on businesses, as of 29 September, officials encouraged electricity generating companies to buy more coal from, for example, Mongolia and Indonesia, to reduce or eliminate the power problems.

What the power problems reveal

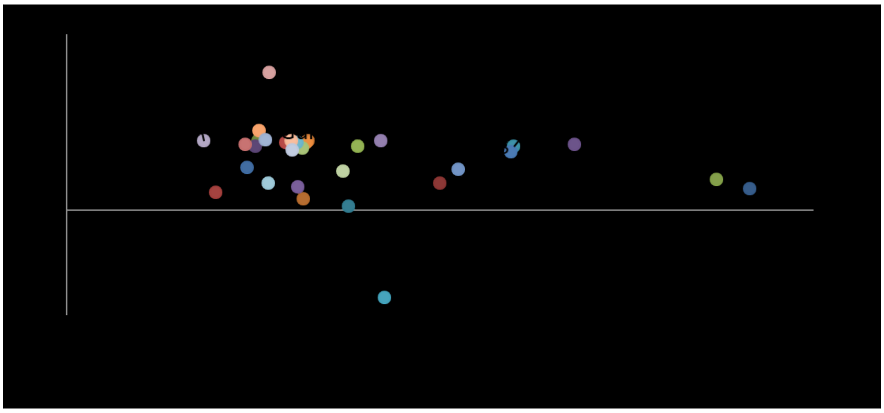
This episode reveals that reducing carbon emissions remains a top priority of the government, but that it also carries a cost.

Even if the electricity cuts stop, control of electricity demand by suspending production in high electricity usage factories will continue. In other words, policymakers are prepared to sacrifice short-term growth to achieve their environmental goals.

We expect that high electricity usage factories may only operate at two-thirds of capacity from now on. This will affect both the jobs and the wages of factory workers. And it will probably also exert a negative impact on the consumption of lower-income groups.

On the other hand, investment in improving electricity efficiency and raising the contribution of renewable energy should result in a reduction in overall energy consumption. This will take some time, but will eventually feed into stronger GDP.

Zhejiang and Guangdong province GDP per capita and GDP growth as of February 2021



Source: National Statistics Bureau of PRC, ING

The implications of the Evergrande crisis

We believe the Evergrande incident will mean that the government will provide a capital injection to the company and that Evergrande will either become a State-Owned Enterprise or come under the umbrella of an existing SOE. At a macro level, the impact of any redundancies or problems for the company's suppliers will be negative for consumption. But to provide some offset to this, some SOEs may be required to absorb redundant workers, though most likely at lower wages than they were previously receiving.

Questions remain about whether Evergrande will pay debtors first or continue to complete its residential property projects. The evidence so far suggests completion of already sold properties is a priority, which ties in with the government's common prosperity goals of protecting individuals before big businesses.

Combining all the policy hits, we have to downgrade our GDP forecasts

In the second quarter, the GDP of the secondary and tertiary sectors in China was CNY10.4 trillion (+7.5% year-on-year) and CNY14.718 trillion (+8.3% YoY), respectively. Both sectors have been hit in the third quarter. Electricity shortages and the suspension of factory operations have affected the secondary sector. Covid-driven port suspensions mainly affect the tertiary sector. Tech data privacy, limits of online game time, and the shutdown of tuition centres also belong to the tertiary sector.

We expect a deep contraction of 7% quarter-on-quarter before seasonal adjustment, and that means 4% year-on-year growth for the third quarter from our previous estimate of 4.5% YoY.

Furthermore, we expect some of the policy hit to still be affecting growth in the fourth quarter of 2021. For example, we may see more tuition centres shut down and more people lose their job or take a salary cut as a result of the Evergrande incident. We expect China's central bank, the People's Bank of China, to respond to all this with a reserve requirement ratio (RRR) cut of 0.5 percentage points in October. Taking these factors into account we are also reducing our fourth-quarter GDP forecast to 4.5% YoY from 5.0% YoY.

Our GDP growth forecast for 2021 is now 8.7%, down from the previous forecast of 8.9%.

A final word. Most of these policies have good intentions - namely, to improve the quality of life for ordinary people. The government has decided to take this sharp short-term pain in exchange for higher quality growth in the future. The government may consider that it is better to suffer the short term consequences of something like the Evergrande property business collapse now than to keep propping it up with easy money and suffer an even bigger collapse later on.

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