

## Why China's surprisingly strong economic growth isn't sustainable

China's GDP growth rebound in the second quarter exceeded our expectations by a considerable margin, but we think the rate of growth is unsustainable. Though exports have improved, there are challenges from geopolitics and widespread flooding. Nonetheless, we revise our growth forecasts upwards for 2H20 and the full year



Source: Shutterstock

### Big questions on GDP growth with slow stimulus progress

China is recovering from the impact of Covid-19, but the detail suggests that GDP growth of 3.2% year-on-year in 2Q20 may not be sustainable despite improvements in foreign demand and infrastructure investments. However, we do now expect better growth numbers than our previous forecasts.

**GDP growth of 3.2% YoY in 2Q20** looks very good after a 6.8% YoY contraction in 1Q20, and is a lot better than our expectation of -3.1% YoY. But we doubt that the main sources of growth were just inventories and net exports - which were lower because of slow import growth. We see this as unsustainable as we expect imports to grow faster in 3Q with improving domestic demand. We

don't have the breakdown of GDP growth by components, so our guess is that some industrial production output that had not been used by infrastructure projects has been placed into the inventories category.

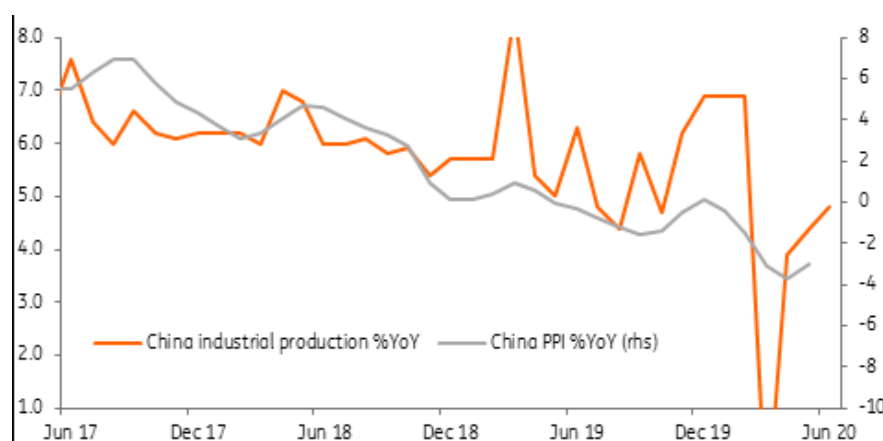
**Industrial production grew 4.4% YoY in 2Q20**, and most of the growth came from raw materials, technology components and energy production. Some will have gone to exports but we expect that some raw materials also went to inventories as infrastructure projects progressed slowly in 2Q20 in general. This would tie in with the negative year-on-year growth of the producer price index. If manufacturing was doing well in 2Q20, PPI should be rising.

**Net export growth was faster at 8.8% YoY in 2Q20** due to the lower growth in exports and imports. Foreign demand seems to have rebounded as shown in the June data, and hopefully, this will form a recovery path for 2H20. This could help not only exporters but also manufacturers producing export goods, and therefore migrant workers' unemployment rate should come down. We previously estimated a 10% overall unemployment rate for April to May, including migrant workers, which has now come down to 8% in June due to more export orders for factories.

**Retail sales contracted by 3.9% YoY in 2Q20.** Consumption has not picked up on a yearly basis despite the relaxation of social distancing measures. This suggests consumers remain cautious and this continues to impact the hospitality sector. Spending on automobiles dropped on a yearly basis, which could be due to the one-off demand for cars (to avoid taking public transport) has been fulfilled following a pick-up in automobile sales for a few months at the peak of the Covid-19 outbreak.

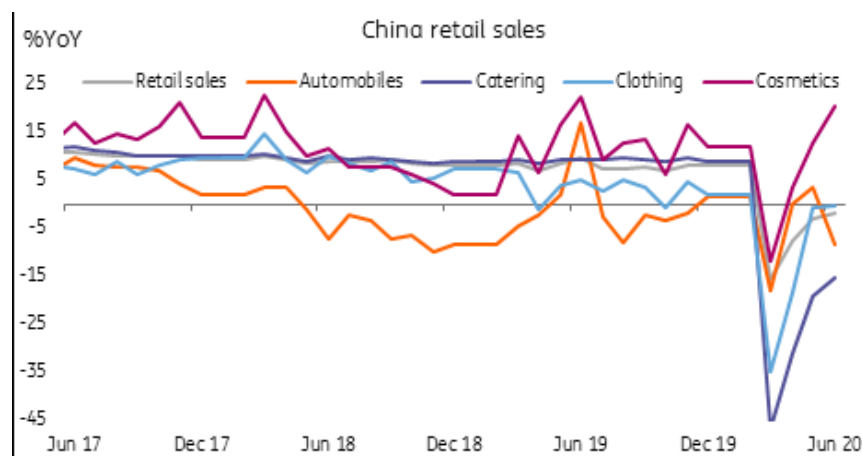
**Fixed asset investments contracted by 3.1% YoY YTD in June**, which was a smaller contraction than in May. The impact of fiscal and monetary stimulus on investments was small in 2Q20 due to the slow kick-off of transportation infrastructure projects but investment in R&D in advanced technology has started. The increased growth of investments from May to June could be due to more infrastructure projects being kicked off after the Two Session meetings held in May.

## Chinese industrial production rebounds but PPI continues to be negative



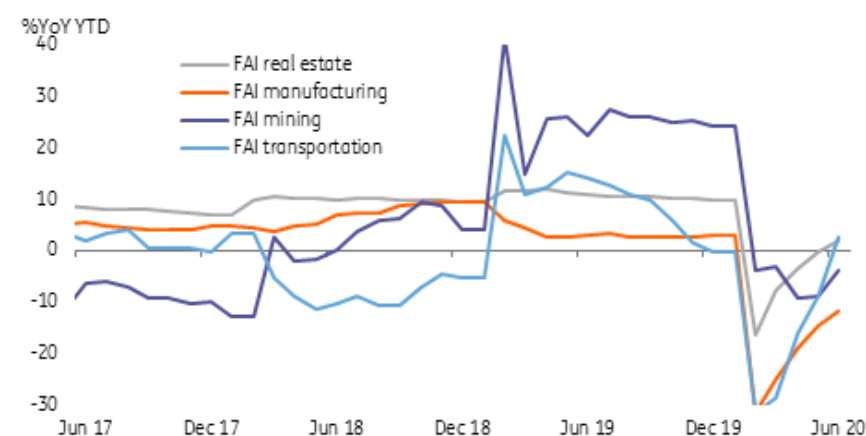
Source: National Bureau of Statistics of PRC, ING

## Chinese retail sales were dismal but should improve with exports



Source: National Bureau of Statistics of PRC, ING

## Chinese infrastructure investment improved in June



Source: National Bureau of Statistics of PRC, ING

## The three main challenges ahead

Even though the economy is recovering, we see further challenges for China in the second half of 2020.

- The biggest risk we see is the technology war, not just with the US but also with the rest of the world. China has put a lot of money into R&D in advanced technology to achieve self-reliance on the most advanced semiconductor chips but it will take time to yield results.
- Following weeks of abnormally high rainfall, the most imminent risk domestically comes from the widespread floods, which are some of the worst seen in China for decades. The government has been able to reduce the death toll through early warnings to local communities. However, food prices increases as a result of the floods will not change the People's Bank of China's stance on monetary policy as this is a one-off event. The floods have been so widespread that infrastructure projects will be delayed as the majority of schemes are related to construction activities. As such, investments in July and even August will be affected by the floods.

- The possibility of another round of trade wars could be on the rise, with the US using Hong Kong to punish Mainland China. Though China continues to import agricultural products from the US we note that the growth of imports from Brazil was 34% MoM, higher than the 11% MoM imports from the US, which signals that China is continuing to diversify sources of agricultural imports in case political tension with the US increases.

## GDP forecast for 2H20 revised upwards

We revise our GDP forecasts upwards to 0.5% YoY for 3Q20 and 5.0%YoY for 4Q20, from our previous forecasts of -0.5% YoY and +4.5% YoY, respectively. Our full year 2020 forecast is revised upwards to 0.48% due to:

1. Better foreign demand from countries coming out of Covid-19 lockdowns
2. Faster implementation of infrastructure investment projects
3. Better job market situation in the manufacturing sector when foreign demand improves

Our forecasts rely on improvements in the major economies and if that doesn't happen then China's GDP growth will be undermined.

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