CHINA: Q1 GDP GROWTH SURGES ON BASE EFFECT

MOMENTUM MODERATES FROM PEAK BUT STILL SOLID

Author

DONG CHEN
dochen@pictet.com

SUMMARY

- Chinese GDP rose by 18.3% y-o-y in Q1, mainly due to a large base effect. The rate of growth was slightly below consensus expectations but still solid.
- According to our estimate, Chinese growth was probably above its potential in Q4 2020 and is now converging back to its long-term trend. We have made a minor downward adjustment to our Chinese GDP forecast in 2021 to 9.2% from 9.3% previously.
- The industrial sector led growth in Q1, rising by 24.4% y-o-y, followed by the services sector at 15.6% y-o-y. Manufacturing was the strongest of all industrial activities, driven by solid external demand. The latest trade data show that Chinese exports remained resilient in March, up by 30.6% y-o-y.
- The improvement in retail sales is encouraging, rising by 34.2% y-o-y in March, compared to 33.8% in the first two months of the year. The consumption of services seems to be picking up too, as indicated by a surge in online sales of services (+60.4% y-o-y) and a rising services PMI.
- Momentum in fixed-asset investment differed between sectors. Infrastructure and manufacturing investment improved more than property investment. Given the government's desire to curb speculation, we expect property investment to moderate further going forward, while manufacturing investment may rise as firms expand capacity.

Chinese GDP came in at Rmb24.9 trn (USD3.8 trn) in Q1. This represents a jump of 18.3% from last year in real terms and 21.2% in nominal terms. These eye-popping growth rates are, of course, mainly due to the unusually large base effect caused by the coronavirus-induced slump in Q1 20. Sequentially, growth declined to 0.6% quarter-over-quarter (q-o-q) in Q1 from 3.2% in Q4 2020, according to estimates by the National Bureau of Statistics of China.

Several points from the latest GDP report are worth highlighting.

China's GDP plunged by 6.8% year-over-year (y-o-y) in Q1 2020, the largest quarterly contraction since 1970s. Given such a low base for comparison, while this year's Q1 growth figure is very high it was already largely expected. Actually, the reported growth fell slightly short of the the market consensus forecast of 18.5%. This difference may not be significant given the large swing caused by base effects, but it has led us to make a minor (mechanical) adjustment to our Chinese GDP forecast for 2021, which passes to 9.2% from 9.3% previously.

In our view, the most rapid stage of China's recovery is likely behind us. After a sharp rebound since Q2 last year, the economy grew above its potential in Q4. But now the growth rate is converging back to its long-term trend, which should be about 5-6% in

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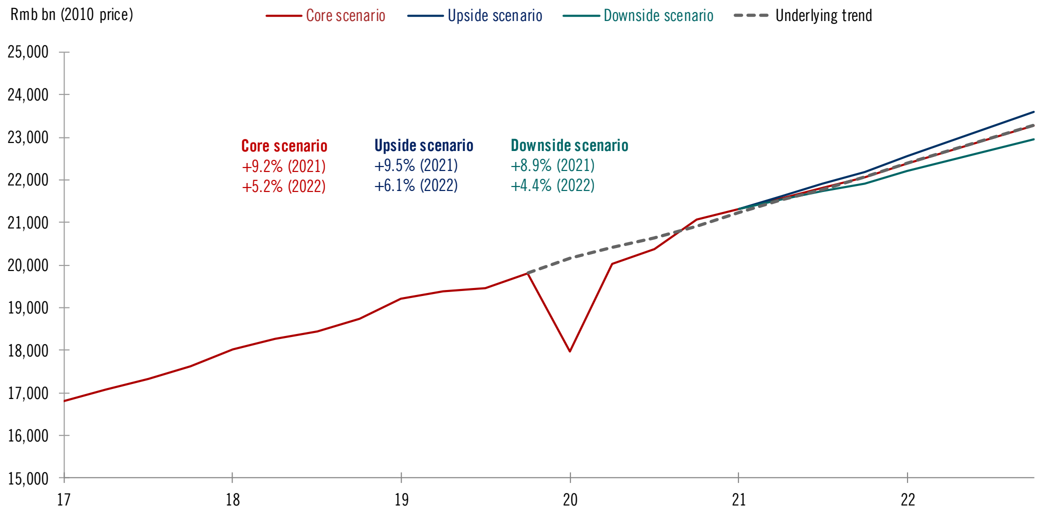
2021. Quarter-on-quarter Chinese growth will likely come back to levels that are consistent with such an annual rate going forward, i.e. about 1.2-1.5% *(Chart 1).*

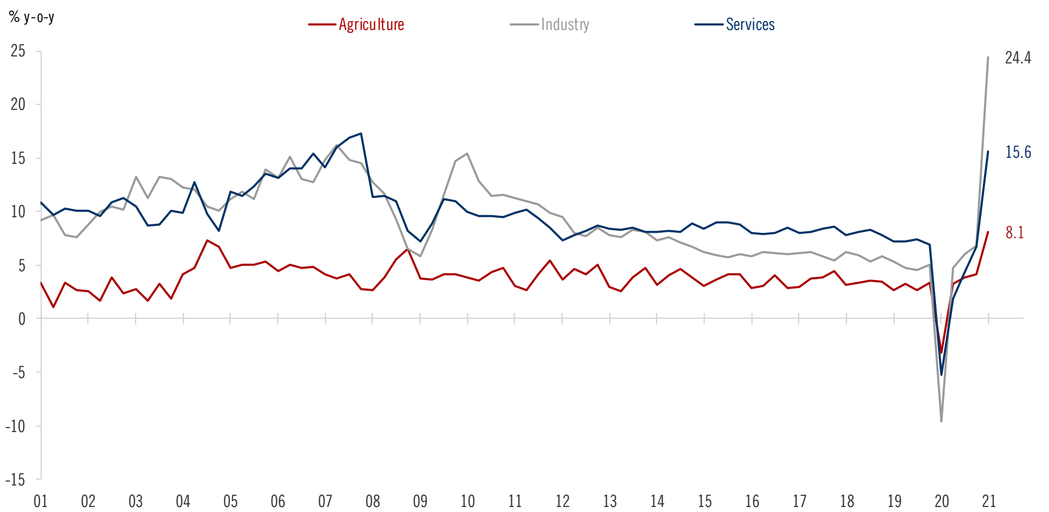
Chart 1: Scenarios for Chinese real GDP (2017-2022)



Source: PWM - AA&MR, National Bureau Statistics of China. Data as of April 2021.

While the economy as a whole has returned to trend growth, large sectoral differences still exist. In other words, the 'K-shaped' recovery persisted in Q1. The industrial sector remained in the lead, rising 24.4% year-over-year (y-o-y), while services expanded at a much slower 15.6% y-o-y *(Chart 2).* To gain a better understanding of growth momentum that excludes base effects, we annualised the Q1 growth rate, taking Q1 19 rather than Q1 20 as our reference. On this basis, the industrial sector expanded by an average rate of 6.0% between Q1 2019 and Q1 2021, while the services sector grew by 4.7% on average during the same period.

Chart 2: Growth in Chinese GDP by sector



Source: PWM - AA&MR, National Bureau Statistics of China. Data as of April 2021.

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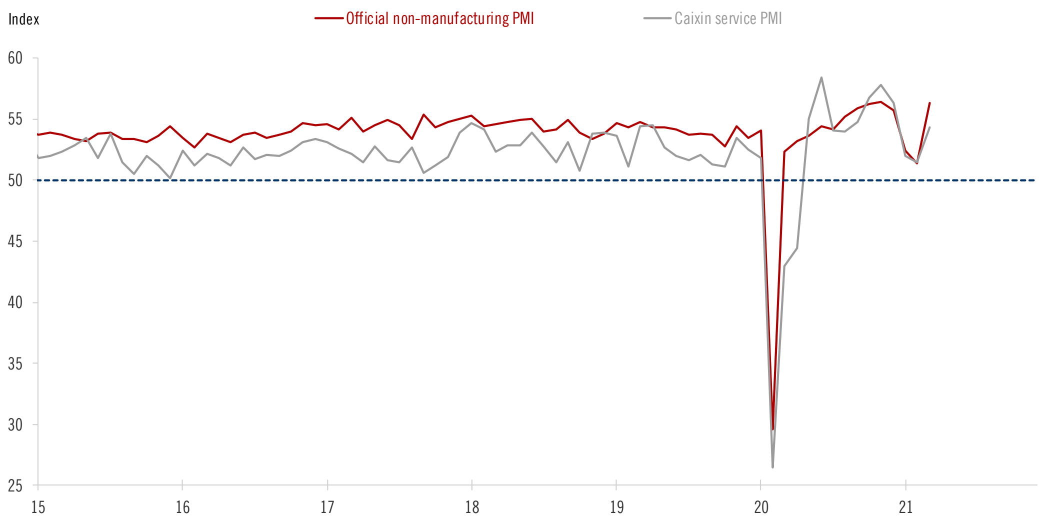
Within the industrial sector, manufacturing performed the strongest, rising by 27.3% y-o-y in Q1. In our view, this was mainly driven by strong external demand for Chinese goods. Recent trade data show that Chinese exports remain strong, although the growth rate has moderated from its peak. In March, Chinese exports grew by 30.3% y-o-y, down from 60.6% in the first two months of the year. Looking forward, we expect Chinese export growth to remain resilient over the next quarter or two on rising global demand fuelled by the US massive fiscal stimulus and accelerated vaccination campaigns in developed countries.

Growth remains slow in the services sector, meaning there is further room for it to pick up. In 2019, services accounted for 54% of Chinese GDP, up from 44% 10 years before. In the absence of herd immunity, many service industries such as travel and tourism are still quite sluggish due to restrictions imposed by the government and people's own caution. For example, the number of domestic air passengers in February, which was the month of the Chinese New Year, came to 240 million, less than half the figure for 2019 as the government advised people not to travel to their hometown during the holidays. The room for further improvement is huge in areas like travel. The latest purchasing-manager indexes (PMIs) are showing some encouraging signs in this regard. Both the official non-manufacturing PMI and the Markit services PMI picked up notably in March after having been soft in the first two months of 2021 *(Chart 3)*. As the pace of vaccination in China is also picking up, we expect services to recover further over the rest of the year.

Chart 3: Chinese official non-manufacturing and Caixin (Markit) services PMI



Source: PWM - AA&MR, National Bureau of Statistics of China, Markit. Data as of April 2021.

On the consumption front, the recovery in retail sales seems to be accelerating. In March, retail sales grew by 34.2% y-o-y, compared to 33.8% in January and February combined. Average y-o-y growth since 2019 (using the method previously described to smooth out the distortions caused by the pandemic) indicate that the growth rate of retail sales is picking up, reaching 5.8% in March compared to 2.7% in January and February.

Online sales of services rose by a strong 60.4% y-o-y in March, up from 28.1% in January and February. Compared to 2019, the growth in online sales of services in March jumped to 21.4% y-o-y from 3.0% in January and February.

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The expansion in fixed-asset investment (FAI) in Q1 was stronger than we had expected. In Q1, total FAI grew by 25.6% y-o-y and by 5.4% compared to Q1 2019. The improvement in infrastructure investment was especially notable. In March, it rose by 25.5% y-o-y, or 11.0% above the 2019 level. This represents a significant improvement from the figure for January-February, which was still 4.8% lower than in 2019. Manufacturing investment also shows encouraging signs of revival, contracting by 0.8% in March from the 2019 level compared to a drop of 5.9% in the first two months of the year. Finally, property investment remained resilient, rising 25.6% y-o-y in Q1 and 15.9% y-o-y over Q1 2019.

Looking forward, we believe there is a high chance that manufacturing investment will continue to improve strongly on Chinese industrial firms' rising capital investment. Since 2016, growth in corporate capex in China has been relatively sluggish due to the government's efforts to cut excess capacity in certain industries (such as steel) and a tightening of financial conditions to encourage deleveraging. A strong cyclical recovery of the global economy fuelled by unprecedented fiscal responses world-wide, especially in the developed countries, means there is room for Chinese manufacturers to expand their capacity, especially in industries benefiting from structural tailwinds (such as green technologies).

By contrast, growth in property investment may gradually moderate as the Chinese government moves to curb property speculation and restrict developers' leverage ratios.

Finally, the Chinese government seems to be stepping up efforts to vaccinate the population against covid. While China was the first country to bring covid-19 under control and among the earliest to develop covid vaccines, it has lagged behind many developed countries in deploying these vaccines among its own population. There are many reasons for this. First, having successfully controlled the virus domestically, the Chinese government put more emphasis on supplying vaccines to other emerging-market countries. In addition, the general public has shown no great urgency to get vaccinated since their lives are already mostly back to normal.

But this seems to be changing, especially as many developed countries are moving ahead on the vaccination front and a fuller re-opening of international travel is on the horizon. By 17 April, 188 million single vaccine doses had been administered in China (equivalent to roughly 14% of the population), up from 24 million at the end of January. According to our sources, it has now become almost mandatory for employees of state-own entities (government agencies, state-owned enterprises etc.) to be vaccinated and some local governments are resorting to shopping vouchers to encourage residents to take the jab. We expect the pace of inoculation to pick up gradually going forward, and the government may reach its target to have 40% of the population vaccinated by the end of June.

In conclusion, China's Q1 GDP report confirmed our expectation for another quarter of solid recovery, although growth momentum likely has peaked. Strong exports, together with continued recovery in consumption and services and corporate capex, will likely boost Chinese growth in the rest of 2021.

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