

China has not returned to potential growth yet

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- Despite the record 18.3% yoy growth in 1Q, China's economy only grew by 5% yoy on two-year average after adjusting for base effect, still below potential growth.
- Improvement in domestic demand is encouraging thanks to recovery of offline activities. For example, revenue for catering and restaurant returned to positive growth for the first time since pandemic. This will further underpin growth in the coming quarters.
- Manufacturing investment has not returned to pre-pandemic level yet, but is expected to play catch up, which will offset the uncertain outlook of infrastructure investment due to China's leverage management.
- The slower than expected vaccination rollout may also cap PBoC's room to remove prior easing policies. We think China will not hike interest rate in the next two quarters.

The Chinese economy grew by a record 18.3% yoy in the first quarter of 2021, though it is slightly shy of market consensus of 18.5%. Does this record setting number really mean China has returned to pre-pandemic growth potential?

We would like to offer two perspectives. First, in order to remove the distortion from the pandemic induced base effect, we compare China's growth in the first quarter of 2021 with the same period in 2019. Then we calculate the growth on two-year average basis. The 18.3% year-on-year growth in 1Q translated to about 5% yoy growth on two-year average.

Second, we compare the calculated two-year average growth with China's potential growth. China's central bank PBoC has lowered its estimation for potential growth for 2021-25 to 5-5.7%. Nevertheless, China's potential growth for 13th five-year plan from 2016-2020 was higher at around 6.2%. As such, we think China's potential growth for the transitional phase to 14th five-year in 2020 and 2021 may be around 5.8-6.0%.

Table 1: China's growth adjusting for base effect

| | 1Q 2021 | Two-year average |
|--|---------|------------------|
| GDP | 18.3% | 5% |
| Industrial production | 24.5% | 6.8% |
| High-tech industrial production | 31.2% | 12.3% |
| Retail sales | 33.9% | 4.2% |
| Fixed asset investment | 25.6% | 2.9% |
| Manufacturing investment | 29.8% | -2% |

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As such, the two-year average growth rate of 5% for the first quarter showed that China's economy has not returned to pre-pandemic potential growth yet.

Improving domestic demand

Probably the most encouraging data from today's release is better than expected retail sales, which soared by 33.9% yoy in the first quarter. After adjusting for base effect, retail sales grew by 4.2% yoy on two-year average in the first quarter, up from 3.2% yoy on two-year average in the first two months of 2021. This shows improvement of domestic demand in March after China successfully contained a few rounds of mini virus outbreak before Chinese New Year holiday.

This was also echoed by strong import data in March, which rose by 38.1% yoy beating market expectation. Other than higher commodity prices and stock up activity for electronics chips, the stronger than expected import was also attributable to improving domestic demand.

The rebound of retail sales was mainly supported by three factors. First, demand for sports, entertainment products and ICT products remained strong, growing by more than 10% on two-year average. Second, online sales remained resilient. E-commerce sales rose by 15.4% yoy on two-year average in the first quarter. Third, offline activity recovered. Revenue for catering and restaurant business in March grew by 0.9% yoy on two-year average, returning to growth for the first time since the pandemic.

Manufacturing is playing catch up

Nevertheless, not all sectors have returned to pre-pandemic level. Manufacturing investment fell by 2% yoy on two-year average in the first quarter of 2021 albeit improving from the decline of 3.4% yoy on two-year average in the first two months.

However, given China has mentioned clearly in its 14th five-year plan that China will aim to maintain the share of manufacturing in GDP to avoid the mistake of pre-maturing de-industrialization, we expect manufacturing investment to recover further in the coming months on the back of fiscal support. In addition, the resilient industrial activities, which tend to lead the manufacturing investment, will also be supportive to rebound of manufacturing investment.

Looking ahead, we keep our 2021 GDP forecast for China unchanged at 9.2% for three reasons. First, external demand is likely to remain supportive. Second, domestic demand is likely to improve further as offline activities are expected to rebound. Third, manufacturing investment growth is likely to accelerate, offsetting the uncertain outlook of infrastructure investment due to China's plan to lower government leverage ratio this year via clamping down on hidden debt.

On policy, expectation on possible interest rate hike heightened recently due to concerns about rising inflation and economic overheat. However, as

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we highlighted above, China's growth has not returned to potential growth after adjusting for base effect. As such, there is no urgency for U-turn of macro policy. We think the chance of interest rate hike is low in the next two quarters.

In addition, the slow vaccination rollout may also cap PBoC's room to remove prior easing policies. Although China has reported highest daily inoculation globally taking over that in the US and India, the daily inoculation is still far from government's target to vaccinate 40% populations by June. Our own estimation shows that China needs to administrate 8-9 millions doses per day in order to achieve its target. Base on the current pace of vaccination due to low willingness, China is likely to miss its target. This may create additional uncertainty to Chinese economy should the US reach vaccine induced herd immunity this summer, which may give US upper hand in terms of economic and border reopening. Therefore, we think PBoC may take a wait-and-see stance to avoid the negative spillover effect from the pre-maturing tightening.

Chart 1: Expected growth trajectory in 2021

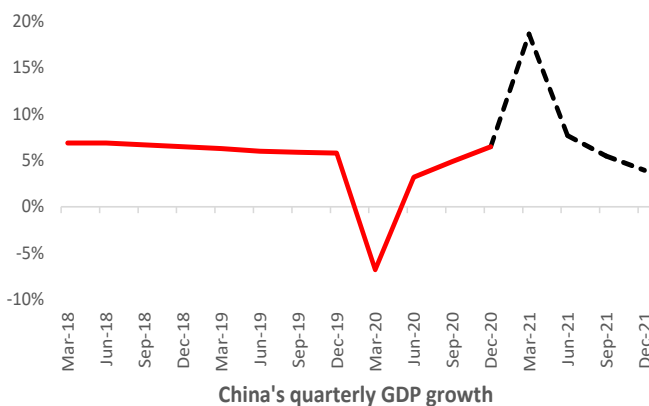
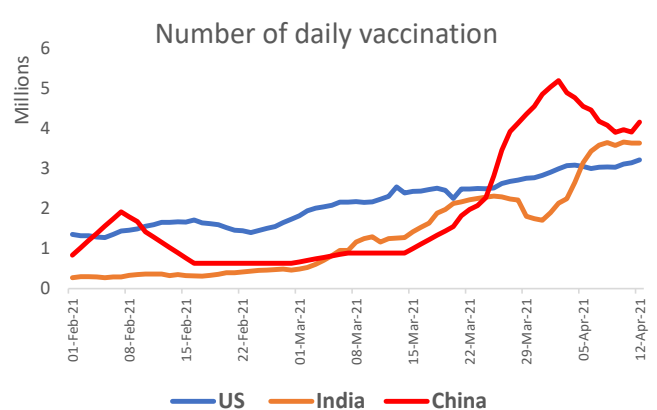


Chart 2: China's daily inoculation failed to pick up



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