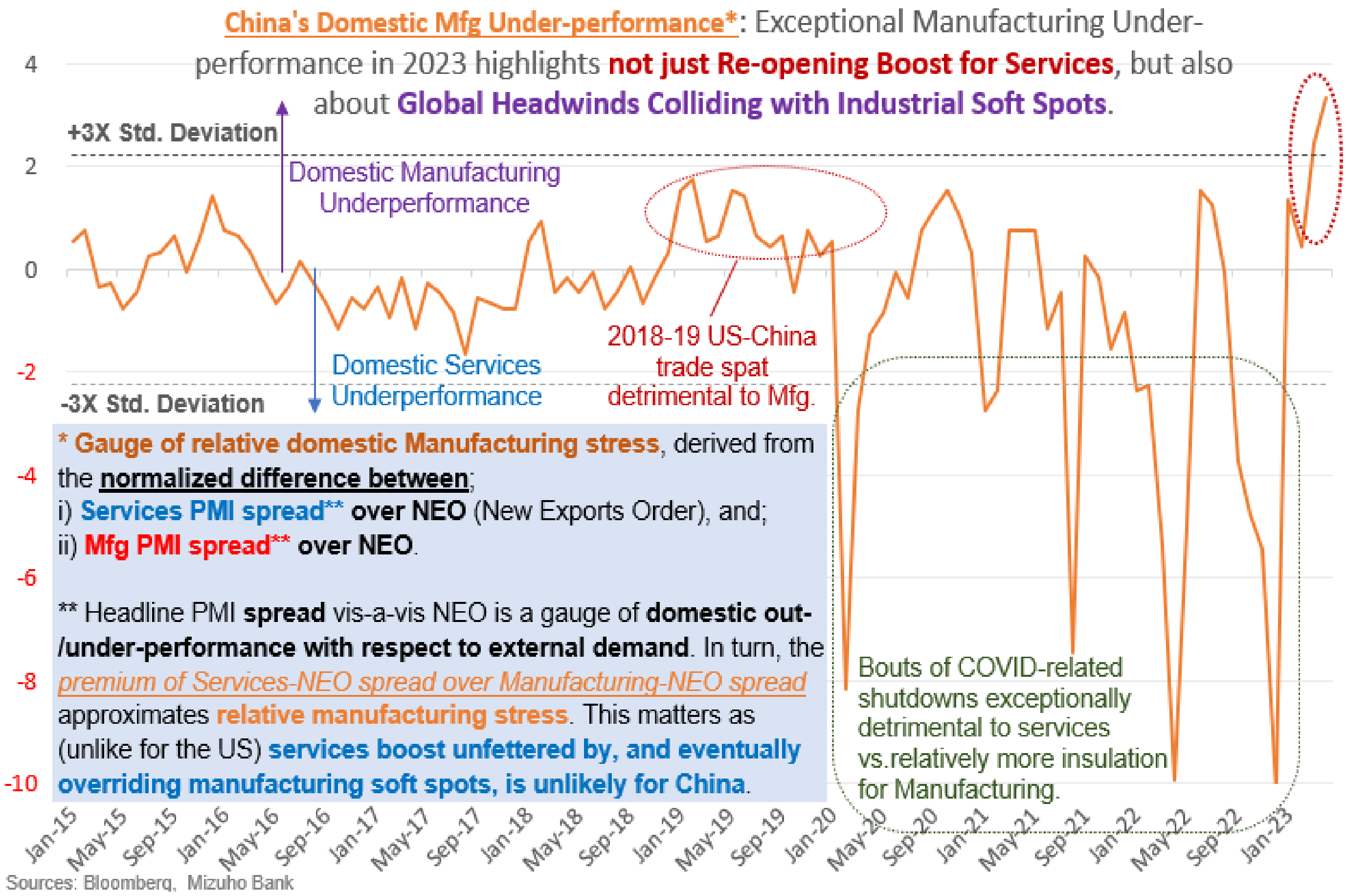
Mizuho Chart Speak: China

Economics & Strategy | Asia ex-Japan

17 May, 2023 | Vishnu Varathan | Head, Economics & Strategy

Manufacturing Pain



"*Hard to see, the dark side is*" – **Master Yoda**

In a Nutshell: A **conspiracy of** *self-inflicted policies undermining confidence*, *inherited structural risks* (such as credit/financial stability constraints and demographics) imposing binding constraints and *imposed geo-political stresses* infer are **manufacturing pain for the Chinese economy**. And so, the current **travails of the manufacturing sector should not be dismissed as a passing headwind** owing to the global goods-to-services re-balancing compounded by global inflation-driven policy tightening crimping aggregate demand. Instead, it should be recognized for risks associated with **political, structural and binding geo-economic dimensions** that may impede, if not **chronically impair**, **prospects of restoration to pre-COVID strength**. The "*dark side*" of manufacturing pain may be "*hard to see*"; but that doesn't mean it's not there.

- **Underwhelming China activity** data in April **validate our repeated warnings* of overstated re-opening optimism**, and resultant **blind spots to China's structural and geo-political challenges**.
- Sure, **earlier exuberance hinged on unsustainable "revenge consumption" has been tempered by retail sales disappointment** that followed worryingly soft credit and imports. But despite this reality check, the **extent of industrial sector stress and attendant spill-over economic pain**

imposed by confidence deficit and geo-political risks that **may not be fully appreciated**.

- For one, the **extent of manufacturing under-performance is unprecedented**; at least by some compelling measures (Chart). Specifically, not only has this **manufacturing stress gauge exceeded three standard deviations**, *qualifying as a "tail risk" proper*, but is notably *even more acute than* what was experienced *during the 2018-19 US-China trade spat*.

- Admittedly, it may be **tempting to (mis-)attribute *relative* manufacturing under-performance to benign optics of comparative shortfall of sharp services catch-up**; **as** unexpected and abrupt **lifting of "Zero COVID" restrictions provide disproportionate services boost**. In particular, flattered *by reversal of asymmetric tail-risk territory of service sector pain* (from COVID lockdowns slamming shut services, even as manufacturing bubbles were maintained).

- But such "*it's not you, it's me*" **type of brush-off of manufacturing woes as comparative optics due to stellar services** would be **a fatally-flawed mischaracterization**. Crucially because it **fails to recognize binding structural and geo-political impediments that may linger long after the cyclical headwinds to global goods demand**, be it from the goods-to-services re-balancing on a global scale or from global policy tightening dampening aggregate demand, **pass**.

- A key factor that may result in **endemic, underlying weakness denying a complete reversion to pre-COVID strength in manufacturing** is arguably **shortfall in private sector confidence**, which amongst others, **notably accrues from** *home-grown and self-inflicted uncertainty from the long shadow of "Common Prosperity"*. The property sector fall-out, whose negative industrial spill-over from the convergence and possible resonance of; i) supply-chain/peripheral activity drag; ii) impaired business investment appetite and; iii) adverse household wealth effects; is but one manifestation.

- Another is **pre-existing structural constraints**. These prominently include, but are not limited to; i), *elevated leverage* sharpening trade-off between credit stimulus and financial stability credit, therefore restraining scope for stimulus boost for the economy, and; ii) *ageing demographics exacerbated by skills mismatch*, resulting in high youth unemployment despite labour strains in manufacturing that drive up costs and drag productivity. such as elevated leverage

- Above all, geo-political risks manifesting as proximate **geo-economic threats** as *US clamping down on China's industrial dominance* from the higher-end (starting with high-tech chip sanctions). Broadening conflict spilling over into the economic arena will *drive up costs* from **sanctions**, **strategic stockpiling** of, and **competition** for, key resources and inevitably *impair supply-chain efficiencies* as well as *impede unfettered global market access*.

- The upshot is that expectations of China's industrial sector returning to the rude health of last decade is a failure to recognize the dark clouds of **political, structural, and binding geo-economic risks** that credibly threaten impede, if not **chronically impair**, China's underlying growth drivers. The "*dark side*" of manufacturing pain may be "*hard to see*"; but that doesn't mean it's not there.

* Please see Mizuho Flash - China: Flattered Growth & Flustered Commodity Bulls, 18th Apr 2023