Economic Analysis

Disappointing activity indicators in July add to China's currency woes

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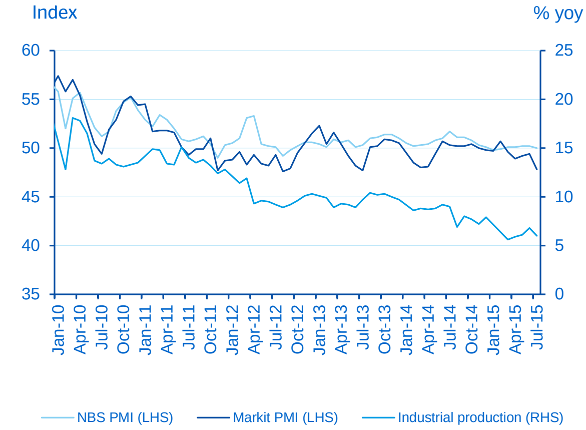
Today, China's National Bureau of Statistics (NBS) announced a batch of economic activity indicators for July, including industrial production, retail sales and urban fixed asset investment (YTD), disappointing the market to the down side. In particular, industrial production, which is the backbone of economic activities, slid to 6.0% y/y in July from 6.8% y/y in June. Disappointing activity indicators exacerbated the RMB's depreciation, which was initiated by the authorities' claimed "one-off" devaluation of 1.9% yesterday and its accompanied reform of the daily fixing rate. (see our yesterday's China Flash) The onshore CNY/USD closed at 6.422 today, implying a cumulative of 2.8% depreciation over the past couple of days. Looking ahead, we anticipate that the authorities will deploy more policy easing (in particular more cuts in Required Reserve Ratio) to spur domestic demand and ensure banks' liquidity.

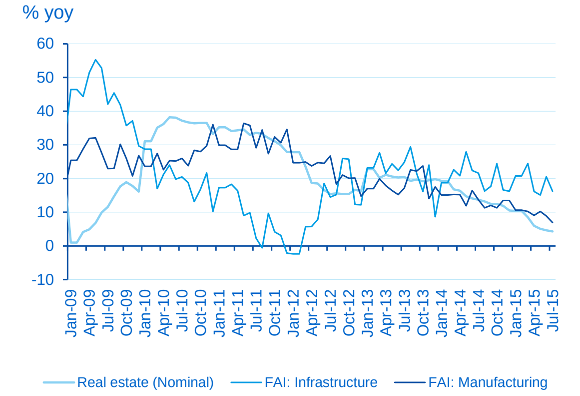
- **Industrial production and FAI further fell down significantly.** Industrial production (Figure 1) significantly slowed down to 6.0% y/y in July (Consensus: 6.6% y/y; Prior: 6.8%). A number of factors are at play, including sluggish external demand, anemic real estate investment as well as slowed consumption of durable goods, in particular automobiles. In the meantime, urban total fixed asset investment growth declined to 11.2% y/y ytd (Consensus: 11.5% y/y ytd), down from 11.4% ytd y/y in June (Figure 2). We suspect that the drop of investment demand is related to the corporate sector's financing squeeze due to the stock market selloff starting from mid-June. The only silver lining come from retail sales, which slightly dropped to 10.5% y/y in July (Prior: 10.6% y/y; Consensus: 10.6% y/y).
- **The RMB exchange rate fall sharply on the second day of devaluation.** Although the People's Bank of China (PBoC) clarified yesterday that the devaluation is a one-off issue, today's onshore and offshore markets continued to push down the RMB's exchange rate. More importantly, the gap between the onshore (CNY) and offshore (CNH) markets widened further as the overseas investors become more pessimistic towards the currency value. We believe that the authorities have already intervened the market today to stabilize the RMB exchange rate. But the turbulence in the FX market is set to last for a while.
- **On the policy front, we expect more easing measures in the remainder of 2015 to sustain growth.** With July outturns of activity indicators, it seems increasingly likely for the authorities to miss their growth target of 7.0% this year. In this respect, we have recently adjusted our growth projection to 6.7% for this year. (Figure 4) On the front of monetary policy, we envisage that the PBoC will implement an additional interest rate cut of 25 bps (likely in the third quarter), along with other targeted policy tools such as direct refinancing to banks, reverse repo, short or medium term lending facilities. Moreover, the RMB exchange reform could trigger more capital outflows in the short term and therefore prompt the PBoC to employ the RRR cuts to supple the banking sector's liquidity. Therefore we increase our projection of the RRR cuts to additional four times (cumulatively 200 bps) in the rest of this year.

Figure 1
Industrial production slowed down significantly



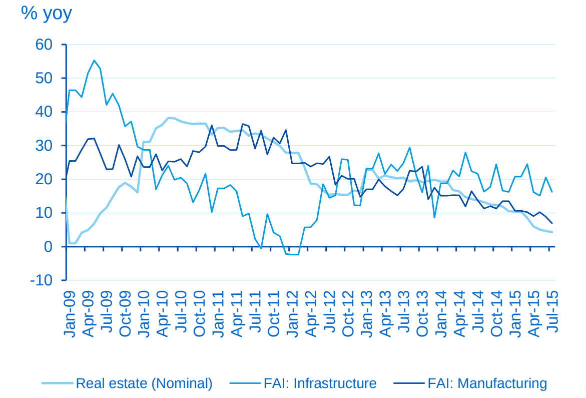
Source: CEIC and BBVA Research

Figure 2
…so did the FAI



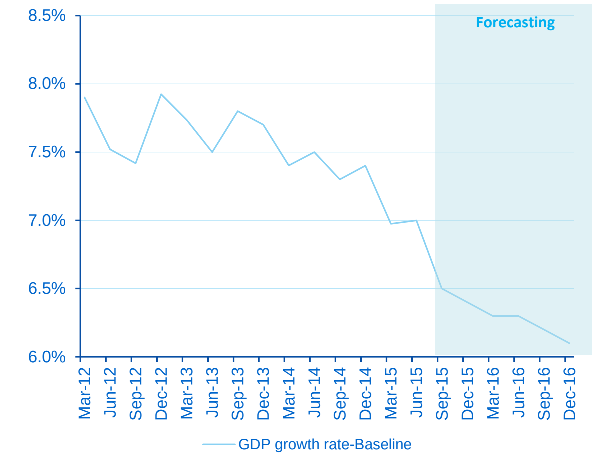
Source: CEIC and BBVA Research

Figure 3
Retail sales is almost in line with the expectation



Source: CEIC and BBVA Research

Figure 4
We lowered our 2015 growth forecasting to 6.7%, and 6.2% for 2016



Source: CEIC and BBVA Research

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