

2. Music still goes on

Notwithstanding the authorities' stepped-up efforts to cool down the property market and curb shadow banking activities, the Chinese economy continued its good performance in the second quarter with a GDP outturn of 6.9% YoY, flat with the Q1 outturn and higher than the market consensus of 6.8% YoY. On a sequential term, growth has significantly picked up to 1.7% QoQ from 1.3% QoQ in Q1, suggesting that the ongoing recovery is robust and tenable. Thus, we raise our 2017 growth forecast to tally with the official target of 6.5% from 6.3%, reflecting the good outturns in the first half of the year and the resilience of the world's second largest economy .

Compared with Q1, growth in Q2 was mainly buoyed by investment and net exports. In particular, investment's contribution to growth is much larger than in Q1 and net exports' contribution to growth turned positive as from Q1 2017. (Figure 2.1) The upbeat growth momentum could derive from several factors: First, it is occurring in the context of a global trade recovery. As such, the improved external environment and long trend of RMB depreciation that started in 2015 have given an additional impetus to China's growth. Second, the PBoC fine-tuned the pace of the ongoing financial deleveraging, maintaining comparatively easing credit conditions in the second quarter through unconventional monetary tools (see our China Economic Watch: [Financial deleveraging: two steps forward; one step back](#)). Third, the rebalancing of the economy, especially the thriving service industry and high-tech-oriented sectors, together with the progress of urbanization, provided a new growth engine for the economy.

However, the economy is still subject to a number of uncertainties. For instance, the current stronger-than-expected growth momentum could embolden the authorities to push forward their deleveraging campaigns in both the financial sector and industries with overcapacity. On July 16th, China's authorities concluded their two-day National Financial Work Conference. As the main message of the conference, the authorities announced the establishment of a Financial Stability Development Committee under the State Council, which focuses on coordinating Central Bank and other three regulators (now in charge of banking, the securities market and insurance) to form a unified regulatory umbrella. Meanwhile, the conference confirmed the leading role of the PBoC in implementing macroprudential policy and maintaining financial stability. That being said, the authorities will continue its prudent stance of monetary policy with a tightening bias and deploy more measures to crack down on rampant shadow banking activities and debt overhang.

The deleveraging measures will consequentially drag on growth over the medium and long term. First, M2 in June already decreased to a historical low for the past twenty years, which will influence corporate financing, especially borrowing by SMEs. Second, a lot of bond issuance has been delayed due to the tighter regulation, affecting the bond issuers' financial conditions. Third, as the authorities have been deleveraging the financial sector, the interbank rate has risen and become more volatile, influencing the liquidity conditions of banks and corporations. All these might weigh on growth over the next couple of years.

The recovery is broad-based

2017 Q2 GDP reached 6.9% YoY, flat with Q1 outturn and higher than the market consensus of 6.8% YoY. The QoQ growth rate also accelerated to 1.7%, higher than the previous reading of 1.3% QoQ. Our BBVA MICA model forecast is 7.0% YoY, basically in line with the current strong growth momentum. (Figures 2.1 and 2.2)

Figure 2.1 Growth momentum is stronger than expected

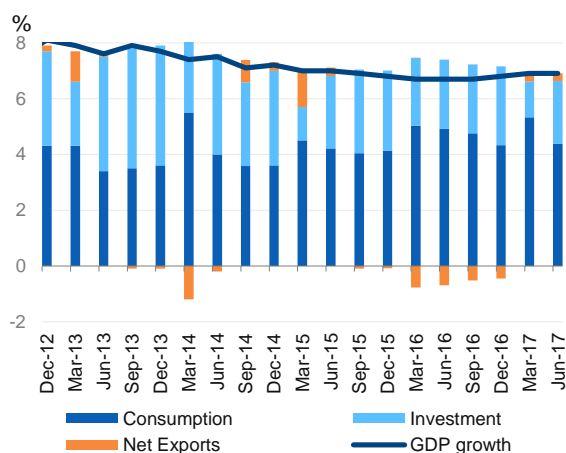
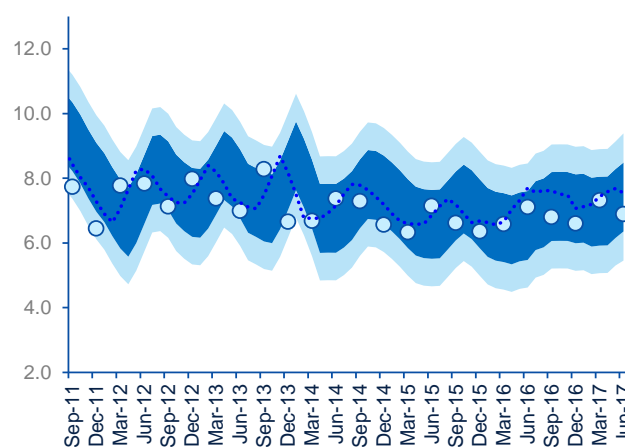


Figure 2.2 BBVA MICA model for GDP forecasting



China's official NBS manufacturing PMI picked up significantly to 51.7 in June from 51.2 in May, well above market expectations (Consensus: 51). Following the same trend, the Caixin China Manufacturing PMI, which includes a survey sample tilting toward SMEs and exporters, increased to 50.4 in June from 49.6 in the previous month (Consensus: 49.8). (Figure 2.3) The soaring NBS and Caixin PMI outturns were mainly driven by surging external demand and comparatively easing credit conditions in June, again reflecting the stronger-than-expected growth momentum.

Separately, growth in industrial production in June jumped to 7.6% YoY from 6.5% YoY in the previous month (consensus: 6.5% YoY) (Figure 2.3), underpinned by the improvement in the manufacturing sector and robust external demand. The continuing recovery has reinforced firms' confidence and prompted them to accelerate their stocks and production. Moreover, firms' profitability has also picked up, in particular for the upstream industries. (Figure 2.4)

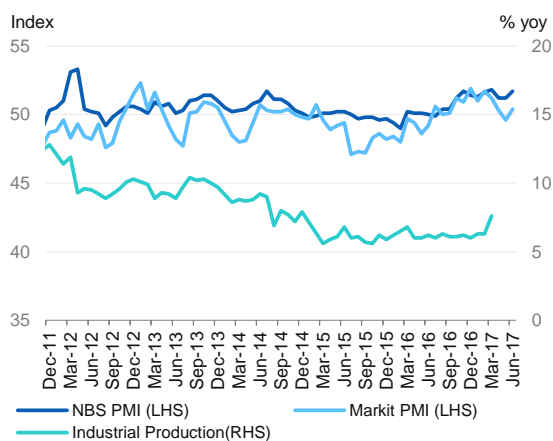
The demand side picked up in June as well. In particular, retail sales growth accelerated to 11% YoY from 10.7% YoY in May (consensus: 10.6% YoY). (Figure 2.5) By category, auto sales in June posted better-than-expected growth of 5.2% YoY (compared with 0.7% YoY in May) despite the expiration of the tax exemption for passenger car purchases in Q1 of this year.

Growth in urban fixed asset investment is in line with the previous reading of 8.6% YTD YoY (consensus: 8.5% YTD YoY). Moreover, private investment, which we have been concerned about, picked up to 7.2% YTD YoY in June from

6.8% YTD YoY previously. By category, infrastructure FAI growth accelerated to 17.3% YTD YoY in June from 13.1% YTD YoY in May, suggesting the continuing fiscal spending to stimulate growth. FAI in the manufacturing sector continued to improve in June, with the outturn of 6.7% compared with 5.6% in May, suggesting the robust external and domestic demand. In addition, real estate FAI YoY dipped to 4.3% YoY in June from 4.6% YoY previously, mainly due to the authorities' tightening measures on the property market. (Figure 2.6)

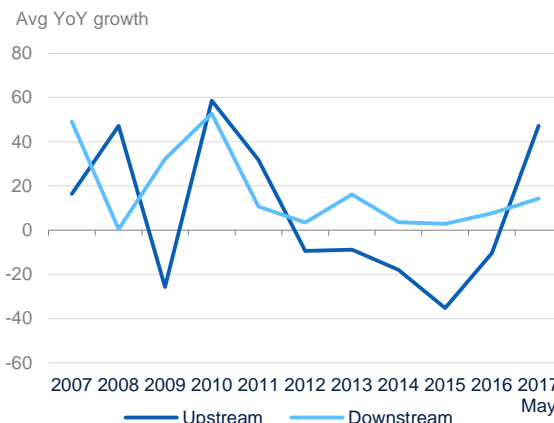
All in all, the latest indicators of economic activity show signs of significant improvement on both the supply and the demand side. Thus, the impetus of the current recovery seems stronger and more persistent than expected.

Figure 2.3 PMIs and IP picked up, indicating strong growth momentum



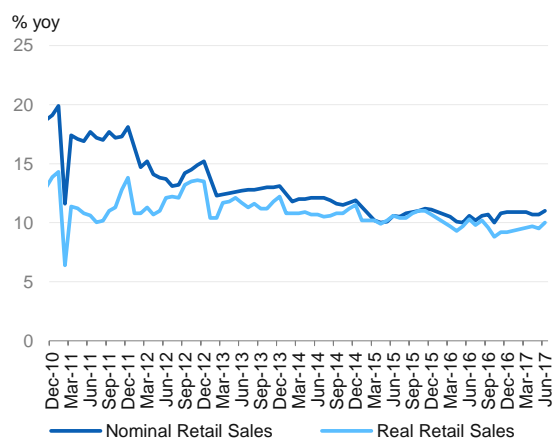
Source: BBVA Research and CEIC

Figure 2.4 Profit in the upstream sector rebounded significantly



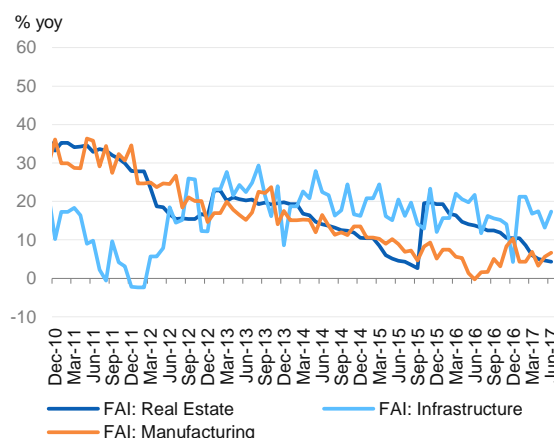
Source: BBVA Research and CEIC

Figure 2.5 Retail sales have been steady



Source: BBVA Research and CEIC

Figure 2.6 Manufacturing and infrastructure FAI picked up in June while real estate FAI decreased



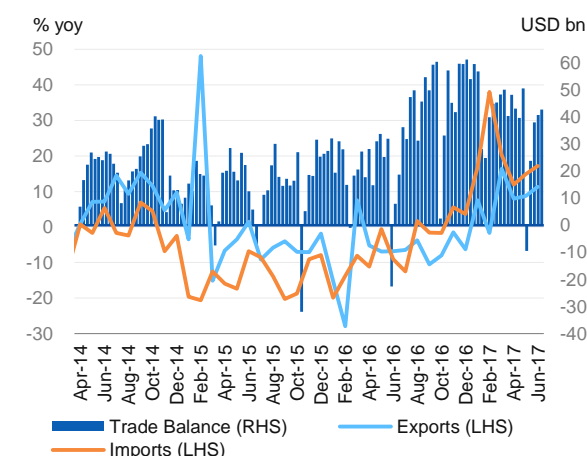
Source: BBVA Research and CEIC

Both exports and imports are stronger than expected

China's stronger-than-expected trade data in June are in line with the global trade recovery and robust demand both from home and abroad. In USD terms, imports registered a year-on-year growth of 17.2% (vs consensus: 14.5% YoY; May: 14.8% YoY) thanks to strong growth momentum domestically. (Figures 2.7 and 2.8) More importantly, export growth in June accelerated to 11.3% YoY (consensus: 8.9% YoY; May: 8.7% YoY). As a result, the balance of trade expanded in June to USD 42.8 billion, compared with USD 40.79 billion in the previous month.

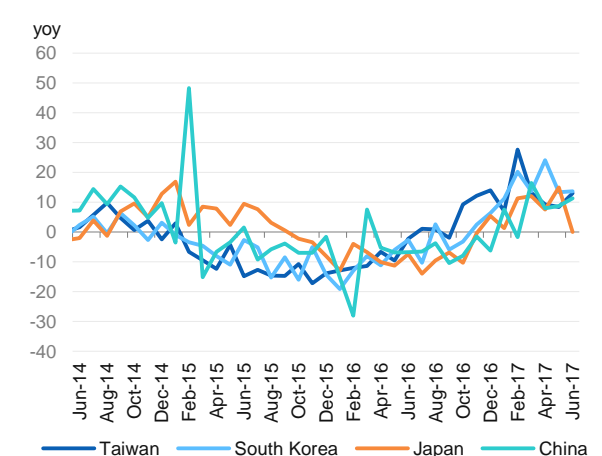
Good news also came from the country's largest trading partner, as tensions with the US appear to be easing after 100-day trade talks which signalled some progress toward addressing the deficit run by the U.S. However, from the imports perspective, we are sceptical that the current pace of imports can be sustained for much longer given the increasing headwinds to China's economy from policy tightening and a cooling housing market. In addition, the stronger RMB exchange rate recently might also drag on exports in the short term.

Figure 2.7 Both exports and imports registered stronger-than-expected growth in June



Source: BBVA Research and CEIC

Figure 2.8 China's exports are finally in step with those of other major exporters



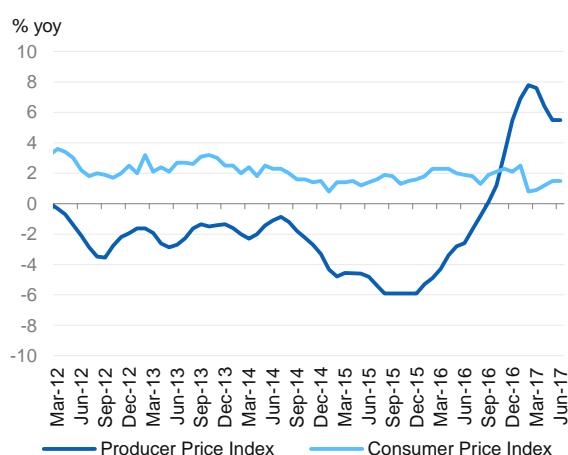
Source: BBVA Research and CEIC

Gradual converging of CPI and PPI

CPI and PPI started to converge in the second quarter. Headline CPI inflation remained subdued and its June reading remained the same as that of the previous month at 1.5% YoY. (Figure 2.9) The subdued CPI was mainly due to the deflated food prices, while non-food prices steadily edged up. It remains to see whether sluggish food prices are transitory or not. From this respect, we suspect that the ongoing prudent monetary policy with some tightening bias has exerted a certain downward pressure on food prices. From a positive perspective, inflation risk seems to have been subdued this year, leaving room for the unconventional monetary policy to play its role, such as injecting money through MLF and SLF to maintain liquidity conditions for financial institutions (Figure 2.10).

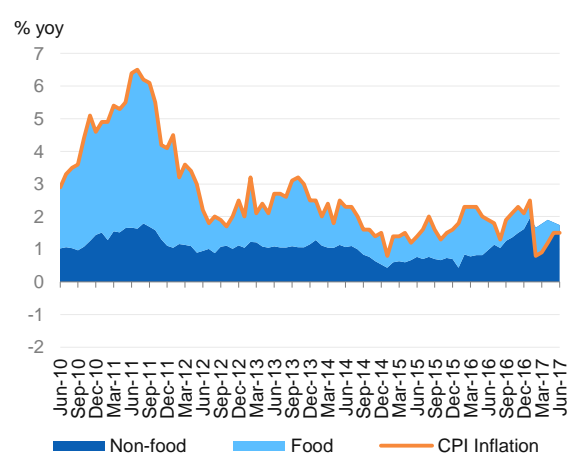
On the other hand, PPI started to decrease from its peak at 7.8% YoY in February. The June outturn of PPI remained the same as that of the previous month, both at 5.5% YoY. The decreasing PPI was mainly due to the downward trend of global commodity prices after hitting a peak in February. In addition, the slowdown of PPI is also in line with the contained manner of the de-leveraging in the real sector. Looking ahead, CPI and PPI could show further convergence during the rest of the year.

Figure 2.9 The gradual converging of CPI and PPI



Source: BBVA Research and CEIC

Figure 2.10 The subdued CPI is mainly due to sluggish food prices



Source: BBVA Research and CEIC

Significant divergence of growth in M2 and total social financing indicates financial deleveraging is taking effect

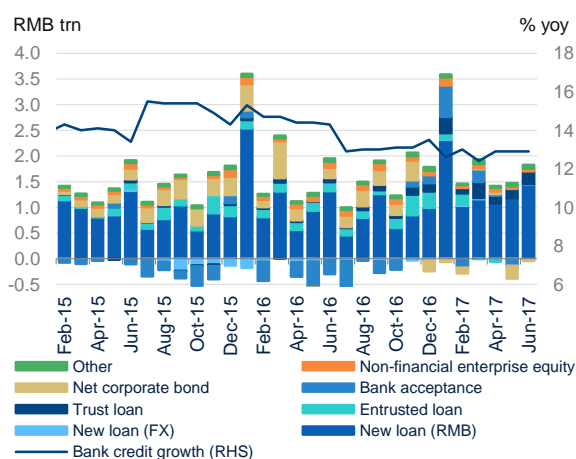
The authorities adjusted their monetary policy stance at the end of 2016 from accommodative to prudent, intrinsically with some tightening bias to curb shadow banking activities and other financial vulnerabilities. In practice, the PBoC even guided market interest rates to a higher level through the newly established corridor system. The effects of the monetary policy tightening continued in June, as M2 growth dipped to the historical low to 9.4% YoY, compared with the previous month's reading at 9.6% YoY (consensus: 9.5% YoY), which is the lowest reading during the past 20 years. (Figure 2.12)

By contrast, both new yuan loans and total social financing were much higher than the market expectation, significantly diverging from the M2 growth slowdown. In particular, total social financing increased to RMB 1,780 billion (prior: RMB 1,062.5 billion; consensus: RMB 1,500 billion). In addition, new yuan loans also significantly picked up to RMB 1,540 billion in June, compared with RMB 1,110.6 billion in the previous month (consensus: RMB 1,300 billion). (Figure 2.11) As M2 mainly includes new yuan loans, interbank business, forex sales by banks and commercial banks' security investment etc, given the strong outturn of new yuan loans, the significant divergence between M2 growth and total social financing indicated that the financial deleveraging has been taking effect so that interbank business has shrunk to a large extent. On the other hand, the improved growth momentum has increased firms' demand for

funds in the second quarter, pushing up the growth of both new yuan loans and total social financing. This suggested that while financial deleveraging is pressing ahead, the transition from tightening monetary policy to the real economy has not emerged yet. And more importantly, as the regulations are strengthened, more and more off-balance-sheet lending has been moved back onto the formal balance sheet.

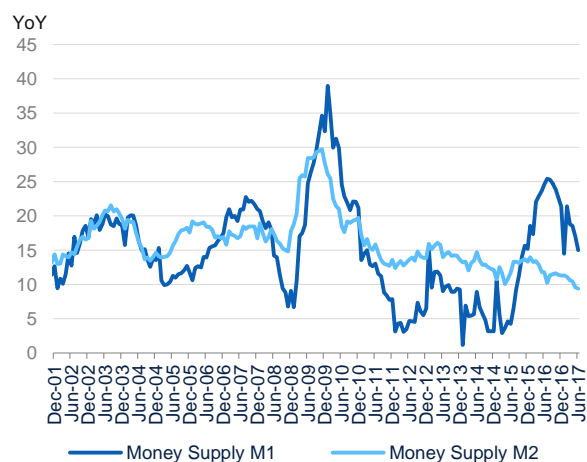
All in all, we believe that the ongoing macro-prudential measures and financial deleveraging may continue to drag on M2 growth during the rest of this year. Moreover, the stronger-than-expected new yuan loans and total social financing might decrease as well with some time lags as we believe the current boost of bank loans is temporary, which is mainly due to the issuing of previously accumulative loan contracts and moving the off-balance-sheet lending onto the balance sheet. Altogether, the effect of financial deleveraging on economic growth might finally emerge in the future.

Figure 2.11 Significant divergence between M2 and total social financing in June



Source: BBVA Research and CEIC

Figure 2.12 M2 decreased to the historical low



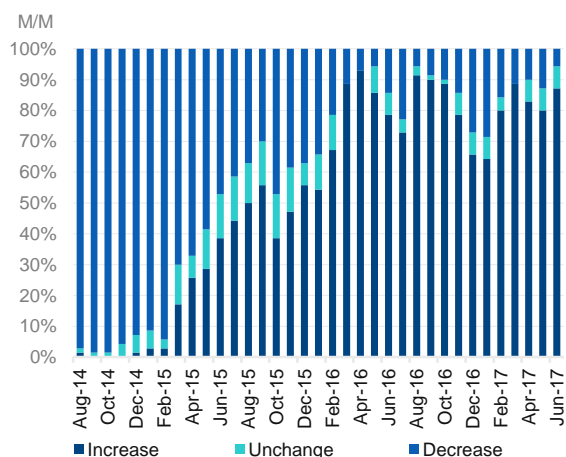
Source: BBVA Research and CEIC

Housing price decelerated in big cities due to tightening measures

The tightening measures on the property market have effectively moderated price increases and frozen the trading volume in Tier 1 cities (Figure 2.14). However, investors' enthusiasm for residential property has not cooled the way the authorities intended. Instead, the house buying spree has shifted to non-tier-1 cities and boosted local housing prices, which actually pushed up the overall housing prices over the country. It also has prompted more local governments to deploy tightening measures aimed at cooling down their local housing markets in the past two or three months. (Figure 2.13)

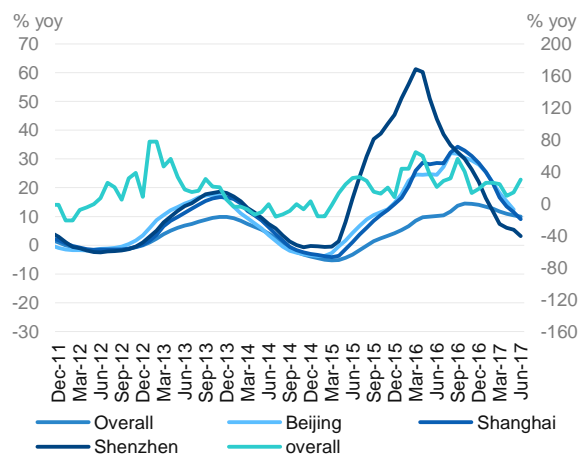
The ongoing tightening measures in tier 1 cities and the existing large stocks in small cities also dragged on real estate investment. In particular, real estate FAI YoY dipped to 4.3% YoY in June from 4.6% YoY previously. As the real estate sector and its related sectors constitute a large proportion of the economy, we believe that the current round of housing market tightening will encumber growth in the medium term.

Figure 2.13 Housing price decreasing only happened in big cities while price in small cities still picked up



Source: BBVA Research

Figure 2.14 Housing prices in Tier-1 cities decelerated due to the authorities' tightening measures



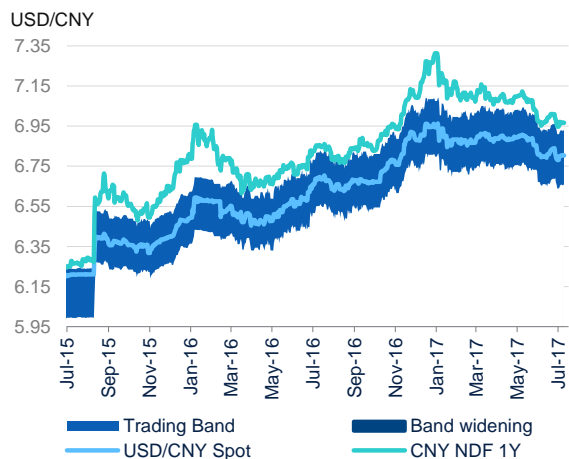
Source: BBVA Research

RMB exchange rate picked up and foreign reserves increased

The RMB exchange rate has picked up somewhat recently, mainly due to the weaker momentum of the USD and the authorities' tighter capital control measures. Moreover, the recent fine-tuned RMB exchange rate policy also contributed by introducing some counter-cyclical factors to the middle-price pricing mechanism. Accumulatively, the CNY to USD exchange rate appreciated by 1.3% from the beginning of the second quarter until now (Figure 2.15). At the same time, similar to the first quarter, foreign reserves recovered part of their lost ground in June, reaching USD 3056.8 billion, compared with USD 3053.6 billion in May. (Figure 2.16) The pick-up of foreign reserves is mainly due to favourable valuation effects and slower capital outflows. We estimate that capital outflows continued at around USD 54.5 billion in June, much slower than USD 85.1 billion in the previous month.

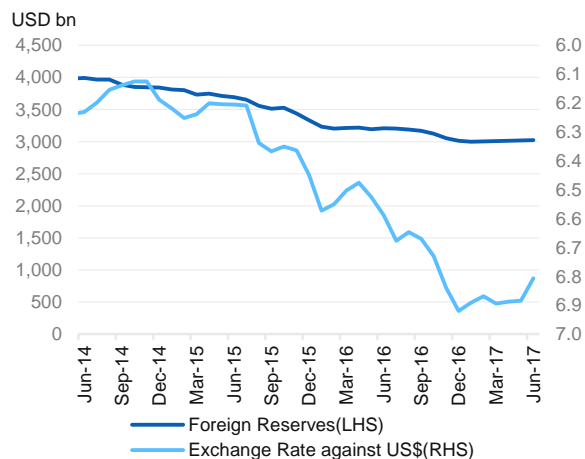
The recent foreign reserve pick-up reflected the effect of the authorities' policies of "promoting inflow and tightening outflow". In particular, the domestic portfolio-diversification-led capital outflow has still continued, although it has moderated given the authorities' stricter capital control. On the other hand, if we break down the capital inflow items, we find that the retrieval of financial institutions' overseas deposits and foreign deposits in China improved significantly. Moreover, three recently-implemented policy initiatives also encouraged capital inflow: the Bond Connect programme, the MSCI inclusion of China's stock market and the announcement of ECB to include RMB in its reserve assets. All in all, under the recent circumstances, we predict that the increase in foreign reserves and moderating of capital outflow could continue in the following months.

Figure 2.15 CNY appreciated recently, due to the weakening of USD and tight capital control



Source: BBVA Research and CEIC

Figure 2.16 Foreign reserves stopped their downward trend in June



Source: BBVA Research and CEIC

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