Economic Watch

China | Regulatory storms, Delta variant flare-ups and growth deceleration

Jinyue Dong

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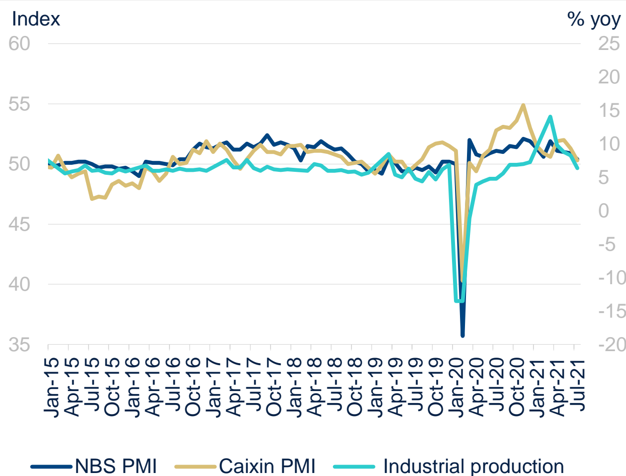
The July real economic indicators were released by the National Bureau of Statistics today, further confirming a continuing moderated growth momentum amid the recent regulation storms on private education, high-tech and real estate as well as the Delta variant virus flare-ups in mainland China. In particular, industrial production, retail sales and fixed asset investment all registered a decelerating year on year and month on month growth from the previous month's readings. Together with the previous released July PMIs and the weakening trade sector, economic growth moderation trend is certainly confirmed. Previously, the authorities were trying to take the time window of China's "first-in, first-out" of the pandemic to press ahead structural reforms and regulation tightening to pursue long-term equality and common prosperity, but the ongoing growth deceleration seems worse-than-expected. Looking ahead, we believe that the growth rate will continue to fall from the previous high readings to its long-term potential growth trend in the rest of the year. Under this circumstance, the moderated growth and financial market turmoil call for more easing measures in the coming months, so that we expect more targeted easing and liquidity management tools such as RRR cut will be implemented. We maintain our 2021 GDP forecasting at 8.2% y/y, which is way above the conservative official target of 6% announced in the "two sessions" this year, but lower than the market consensus of 8.5% and IMF's 8.4%.

On the supply side, the year on year growth of industrial production slowed to 6.4% y/y from 8.3% y/y in the previous month (market consensus: 7.8% y/y) while the seasonal adjusted m/m growth down to 0.3% m/m from 0.56% m/m in June. The distortion of global value chain such as the bottle neck of chip's supply due to the new Delta variant expansion globally weighs on the industrial production growth, while domestic regulation storms directly cracked down several sectors. By categories, the traditional auto sector dragged the industrial production, with the growth of production of cars and SUVs turning to -14.5% y/y and -12.9% y/y from their previous two-digit growth. By contrast, electric vehicle remains the pillar of industrial production growth although it decelerated to 162.7% y/y from 205% y/y in the previous month. Following that is the industrial robots and integrated circuits which registered 42.3% y/y and 27.5% y/y (prior: 69.8% y/y and 45.6% y/y) respectively, benefiting from the the carbon neutrality initiatives and elevated global demand. (Figure 1)

On the demand side, both FAI and retail sales growth slumped. Fixed-asset investment (FAI) trended down to 10.3% ytd y/y from 12.6% ytd y/y in June (market consensus: 11.3% ytd y/y). On sequential term, its seasonal adjusted m/m growth also decelerated to 0.18% m/m from 0.26% m/m in the previous month. By components, the previous pattern remains as manufacturing FAI surpassed the infrastructure FAI and real estate FAI to lead the investment growth, although all of them registered deceleration readings. The slowdown of infrastructure and real estate investment are dragged by the stagnancy of local government bond issuances amid fiscal policy normalization and recent regulation tightening on soaring housing market. In particular, manufacturing FAI reached 27.3% ytd y/y (prior: 19.2% ytd y/y), higher than the infrastructure FAI at 4.6% ytd y/y (prior: 7.8% ytd y/y) and real estate at 12.7% ytd y/y (prior: 15% ytd y/y) respectively. Looking ahead, as the local government bond issuance revs up in the rest

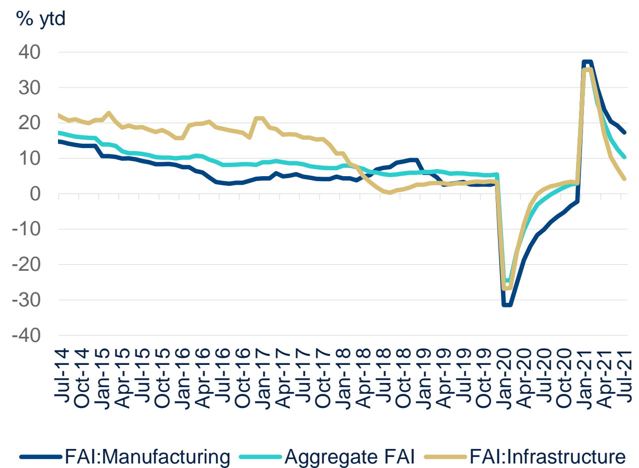
of the year, the infrastructure investment is anticipated to ramp up, while manufacturing FAI is poised to spearhead the FAI growth in 2021. (Figure 2 and 3)

Figure 1. **INDUSTRIAL PRODUCTION MODERATED ITS Y/Y GROWTH MOMENTUM**



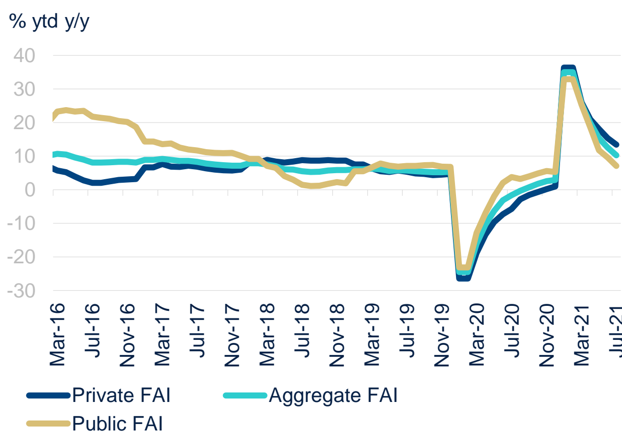
Source: CEIC and BBVA Research

Figure 2. **MANUFACTURING FAI SURPASSING INFRASTRUCTURE AND REAL ESTATE TO LEAD THE FAI GROWTH**



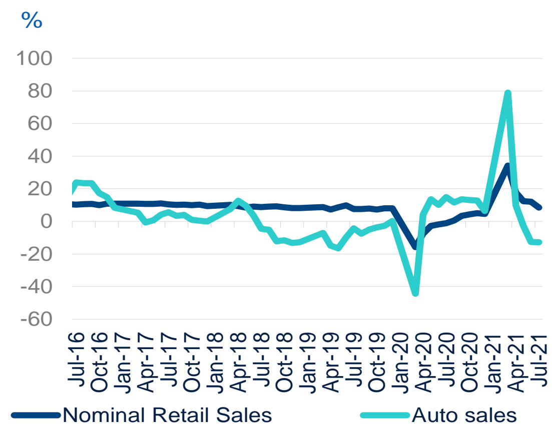
Source: CEIC and BBVA Research

Figure 3. **PRIVATE FAI SURPASSING PUBLIC FAI AMID FISCAL POLICY NORMALIZATION**



Source: CEIC and BBVA Research

Figure 4. **RETAIL SALES PARTICULARLY AUTO SALES DECELERATED IN Y/Y GROWTH**



Source: CEIC and BBVA Research

In addition, retail sales' year on year growth is also tumbling to 8.5% y/y from 12.1% y/y in June (market consensus: 11.5% y/y), while its month on month growth also decelerated to -0.13% m/m from 0.48% m/m previously. The recent Delta variant flare-ups in some provinces of China together with the authorities' social distancing measures and the declining expected income amid crackdown in several sectors all weigh on retail sales growth. By component, corresponding to the automobile production tumbling, the car sales also turned to negative at -1.8% y/y. By contrast, restaurant sales, food and beverage remained to be the main pillar of retail sales which registered at 20.7% and 20.8% y/y respectively. (Figure 4)

Altogether, Chinese economy, after achieving a complete V-shape recovery from the pandemic in Q4 2020, has displayed a moderated growth pattern throughout 2021. In the rest of the year, this moderation trend is set to continue amid the exports normalization from its previous stunningly high growth, the weaker-than-expected recovery of retail sales, the constrained real estate investment due to regulation tightening and decelerated industrial production. Thus, a lot of perseverance still needed to regain all the lost ground of 1H 2020. On the other hand, infrastructure investment might accelerate in the rest of the year due to the authorities' roll-out of unallocated local government bond quotas in 1H 2021.

Is the current situation too much worrisome and is there any systematic risk on the way? Simply speaking, the answer is no for both questions. First of all, it is obvious that the authorities are taking use of the precious time window of China's "first-in, first-out" of the pandemic to press ahead a series of structural reforms and regulation tightening in a bid to pursue long-term equality and common prosperity. We all know the private education, high-tech, gaming, pharmaceutical and real estate sectors that the regulation storms targeting are tightly related to households' well beings and social equality. Regulating these sectors, although devastating global market sentiments in the short term, will benefit long-term goals of common prosperity. Second, China has lots of policy room to deal with the ongoing growth slowdown. China's monetary policy normalization after the pandemic almost achieved, thus, more monetary easing measures such as targeted credit expansion and liquidity management tools such as RRR cut are indeed anticipated in the rest of the year to stimulate growth. In addition, local government bond issuance is also expected to accelerate in the rest of the year to boost infrastructure investment. All in all, the 2H 2021 policy will be neutral but accommodative, and there needs to be some balance between dealing with growth moderation and pushing forward regulation tightening measures going forward.

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BBVA Research: 43/F, Two International Finance Centre - 8 Finance Street. Central, Hong Kong.
Tel. + 2582 3111 / Fax. +852-2587-9717
bbvaresearch@bbva.com www.bbvaresearch.com