Economic Watch

China | Worse-than-expected growth deceleration exposed the vulnerability of its anti-virus strategy

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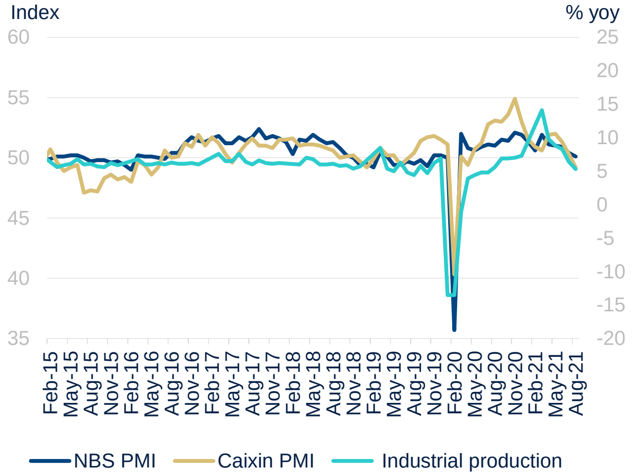
The August real economic indicators were released by the National Bureau of Statistics today, further confirming a continuing deceleration growth amid the recent regulation storms as well as the Delta variant virus flare-ups in mainland China. In particular, industrial production, retail sales and fixed asset investment all tumbled in terms of year on year growth. Presumably, the authorities were planning to take the time window of China's "first-in, first-out" of the pandemic to press ahead structural reforms towards a long-term "common prosperity". However, the ongoing worse-than-expected growth deceleration might force them to re-consider deploying pro-growth measures to balance the growth and reforms. Looking ahead, we believe that growth will continue to fall from the previous high readings in the rest of the year, particularly in industrial production, real estate investment and retail sales. Under this circumstance, a number of pro-growth measures are likely to be employed in the coming months, including more targeted loosening measures such as at least one more RRR cut of 50 bps, together with the speed-up of local government bond issuance. We maintain our 2021 GDP forecast at 8.2%, 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 slumped to 5.3% y/y from 6.4% y/y in the previous month (market consensus: 5.8% y/y), while the seasonal adjusted m/m growth turned out to be 0.31% m/m, in line with 0.3% m/m preciously. Several factors weigh on the industrial production: the carbon neutrality target directly led to shutdown of high-pollution sectors, the distortion of global value chain such as the bottleneck of chip's supply, the Delta variant virus flare-ups in China as well as domestic regulation storms that directly cracked down several sectors. By categories, the traditional auto sector dragged the industrial production, with the growth dipped to -19.1% y/y compared with its 13.5% ytd y/y growth; the steel production growth also tumbled to -13.2% y/y compared with 5.3% ytd y/y growth. By sharp contrast, electric vehicle remains the pillar of industrial production growth although it marginally decelerated to 151.9% y/y from 162.7% y/y in the previous month. Following that is the industrial robots and integrated circuits which registered 57.4% y/y and 39.4% y/y respectively, benefiting from the the carbon neutrality initiatives and industry policy transformation from prioritizing consumption to "profession, refinement, specialty, innovation" type of high-end manufacturing. (Figure 1)

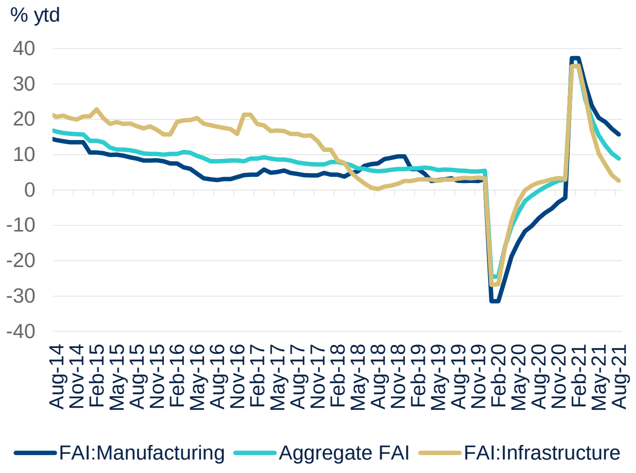
On the demand side, both FAI and retail sales growth tumbled. Fixed-asset investment (FAI) trended down to 8.9% ytd y/y from 10.3% ytd y/y previously (market consensus: 9% ytd y/y). By components, the previous pattern remains as manufacturing FAI surpassed the infrastructure FAI and real estate FAI to 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 decelerated to 15.7% ytd y/y (prior: 27.3% ytd y/y), higher than the infrastructure FAI at 2.9% ytd y/y (prior: 4.6% ytd y/y) and real estate at 10.9% ytd y/y (prior: 12.7% 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 continue to spearhead the FAI growth. (Figure 2 and 3)

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



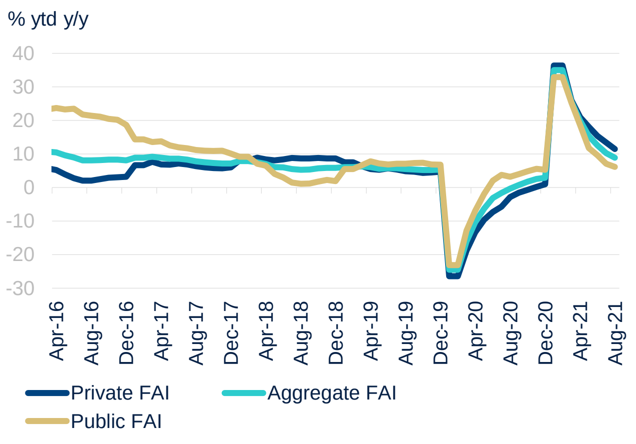
Source: CEIC and BBVA Research

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



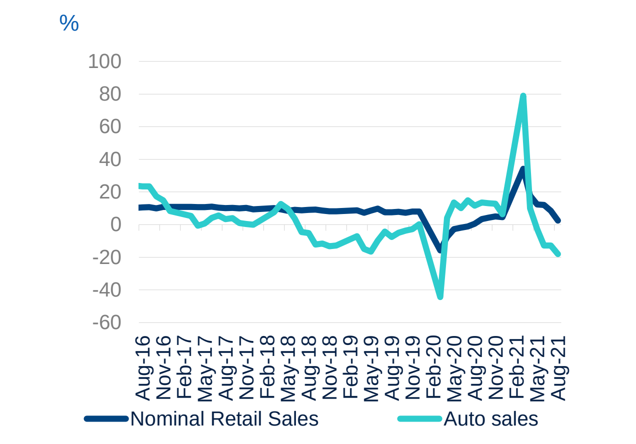
Source: CEIC and BBVA Research

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 tumbled most significantly to 2.5% from 8.5% y/y previously (market consensus: 7% y/y), while its month-on-month growth on the other hand picked up from -0.19 m/m to 0.17% m/m previously. The recent Delta variant flare-ups in China with the declining expected income amid pandemic as well as regulatory crackdown in several sectors all weigh on retail sales growth. By component, corresponding to the automobile production tumbling, the car sales dipped to -7.4% y/y from -1.8% previously. In addition, restaurant sales, also dropped to -4.5% from 20.2% y/y previously due to the authorities' social distancing measures to deal with the Delta variant flare-ups. (Figure 4)

Altogether, Chinese economy, after achieving a complete V-shape recovery from the pandemic in Q4 2020, has displayed a decelerating growth pattern throughout 2021. In the rest of the year, this deceleration 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 regulatory crackdown of various sectors. Thus, a lot of perseverance still needed to regain all the lost ground to go back to the pre-pandemic growth. Meanwhile, 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 while manufacturing investment remains a focal point due to the authorities' industry policy transformation to prioritize high-end manufacturing sector.

Notwithstanding the worse-than-expected headline figures and increasing market concerns, the short-term economic outlook is not that dim. 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 are 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 thus stimulate individuals' productivity. Second, China has lots of policy room to deal with the ongoing growth slowdown. China's monetary policy normalization after the pandemic has almost achieved, thus, more monetary easing measures such as targeted credit expansion and liquidity management tools like 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 authorities are aware of the growth deceleration and are striking a balance between maintaining growth and pressing ahead regulation tightening measures going forward.

However, the Chinese authorities need to review their currently approach to deal with the Covid-19 virus. As new Delta variant of the Covid-19 virus has proved to be highly infectious, the economic cost of implementing the existing "zero case" policy has become increasingly unaffordable. The situation will become even worse when the rest of the world eventually finds a way to coexist with the virus. By then China's roaring export sector may forcibly slow down as the global supply chain outside the country resumes. That being said, China's authorities must come up with a Plan B to better balance its citizens' health and the country's economy.

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