Creating Opportunities

China | Shanghai lockdown effect has not been fully reflected in Q1 figures

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China’s economic outlook of this year has been largely changed from its previous policy-led softlanding story by the recent flare-ups of Omicron in some mainland cities and particularly Shanghai’s lockdown. However, this adverse spillover effect has not yet been fully reflected in Q1 GDP figures which came out at 4.8% y/y exceeding the market consensus at 4.4% y/y (BBVA forecast: 4% y/y; BBVA MICA forecast: 4.2% y/y), as the lockdown of Shanghai just started in March while Januray-February activity figures bore some early fruits (see more details in our recent China Economic Outlook: Second Quarter 2022).

Indeed, the Omicron flare-up in Shanghai has deteriorated very fast with the number of daily infected cases more than 20 thousands. As Chinese authorities are still sticking to “zero tolerance” strategy on the pandemic, the lockdown of Shanghai which is China’s financial center, manufacturing and transportation hub unavoidably leads to adverse spillover to the whole economy and supply chain distortions at home and abroad. March economic activity indicators have confirmed this deteriorating trend. In face of growth slowdown, Chinese authorities are pressing ahead their expansionary monetary and fiscal policy in a bid to stimulate the growth, chief among them is the recent RRR cut releasing RMB 1.2 trillion long-term liquidity. On balance, we believe the Omicron flare-ups and Shanghai’s lockdown will make the authorities’ 2022 growth target of 5.5% which was announced in the recent “Two Sessions” very challenging to be achieved (see our recent Economic Watch: China | 2022 “Two sessions” prioritizes stabilizing growth). Altogether, we lowered our GDP forecasting of 2022 from previous 5.2% to 4.5% considering supply chain distortions and consumption slump, with the economic blow particularly severe in Q2.

March economic activity indicators have confirmed this deteriorating trend. On the supply side, the year-on-year growth of industrial production dipped to 5% y/y from to 7.5% y/y in the previous month, higher than the market consensus at 4.5% y/y, and its seasonal adjusted m/m growth also decelerated to 0.39% m/m from 0.51% m/m previously. The supply-side slowdown came from the disruptions of the supply chain both domestically and abroad, as the lockdown in Shanghai triggered large-scale shutdown of manufacturing factories and transportations. By categories, the largest industrial production drop is general authomobile manufacturing, which declined by -4.9% y/y, while other significant drop also include power-generated electricity (-5.7% y/y), iron production (-6.2% y/y) and steel production (-5.7% y/y). The only silver lining is that electric vehicle remains the pillar of industrial production growth with its growth at 121.4% y/y (prior: 150.5%), supported by the authorities’ priority of green economy and new energy sector. (Figure 1)

On the demand side, both fixed-asset investment (FAI) and retail sales slumped from the previous readings while the economic blow to retail sales amid Omicron flare-ups is particularly severe. In particular, FAI tumbled to 9.3% ytd y/y from 12.2% ytd y/y previously (market consensus: 8.5% ytd y/y), with its month on month growth also decelerated from 0.71% m/m to 0.61% m/m. By components, manufacturing FAI surpassed the infrastructure FAI and real estate FAI to lead the investment growth thanks to the strong exports, while infrastructure FAI also achieved significant improvement due to the recent expansionary fiscal measures such as speed-up of local

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government bond issuance. In detail, manufacturing FAI decelerated to 15.6% ytd y/y from 20.9% ytd y/y previously and the infrastructure FAI picked up from 8.1% ytd y/y to 8.5% ytd y/y; by contrast, real estate FAI remained lackluster and slowed from 3.7% ytd y/y to 0.7% ytd y/y. That means, for the housing market, once the housing price decline expectation is formed, it is difficult to change people's expectation thus it is still difficult to stimulate housing investment, although the authorities have already started to ease financing conditions to secure a soft-landing of housing sector. (See our recent China Economic Watch: China | Real estate sector needs a soft-landing) (Figure 2 and 3)

In addition, retail sales bears the heaviest blow amid a series of lockdown measures to curb Omicron contangion which tumbled sharply to -3.5% y/y from 6.7% y/y previously (market consensus: -1.6% y/y). By component, restaurant sales dipped to -16.4% y/y, jewelry slumped to -17.9% y/y, gaument by -12.7% y/y and automobiles by -7.5% y/y. In the future, we maintain our view that Chinese government's persistence of "zero tolerance" strategy on pandemic by contrast of other countries' "co-existence" will continue to weigh on China's consumption recovery. (see our recent Economic Watch: China | Will the country abandon "zero tolerance" strategy on Covid-19?) (Figure 4)

In sum, although the Q1 GDP and related activity indicators have not fully reflected Shanghai's lockdown and Omicron flare-ups in mainland China, it has already displayed some deteriorating evidence particularly in consumption. Look ahead, we predict Q2 GDP will even dip to 3.3% y/y and will gradually recovery since Q3 based on the course of the pandemic in our baseline scenario (see our Economic Watch: China | Shanghai lockdown: most likely scenarios and the impact on global value chain). Indeed, a series of high-frequency indicators covering production, consumption and price confirmed this trend that the economy will tumble further in Q2. (Figure 5-10)

On the other hand, China's comparatively closed capital account and low inflation environment provide sufficient policy room for conducting easing monetary and fiscal measures. By sharp contrast with the US FED QE tapering, interest rate hikes and central bank balance sheet reduction, following recent three RRR cuts and LPR cuts, 1-2 more LPR and RRR cuts are anticipated, together with targeted credit expansion tools, such as MLF, SLF, re-discount and re-lending tools to stimulate growth. On the fiscal front, local government bond issuance (total scale RMB 3.65 trillion) will speed up in 1H to support infrastructure investment together with tax cuts and fee reduction at the scale of RMB 2.5 trillion this year. Beyond that, the recent regulatory forbearance particularly on real estate sector might add further impetus for growth which will offset the lockdown effect in Shanghai.

All in all, to what extent these policy stimulus buffer could offset the adverse effect of Shanghai's lockdown sharply depends on the evolvement of the pandemic, the lenghth of lockdown period and the authorities' willingness to ease some of the strict "zero tolerance" measures going forward.

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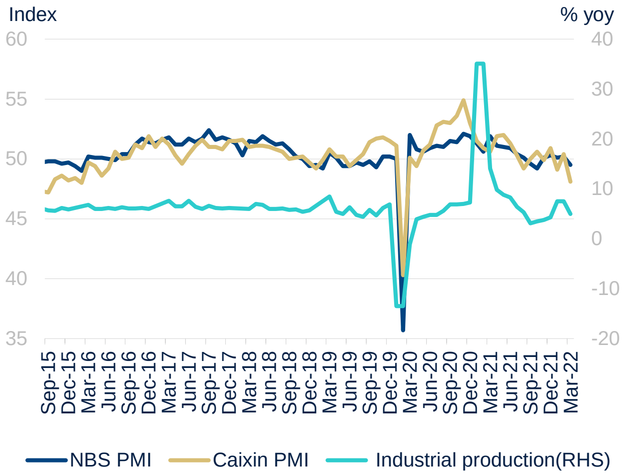
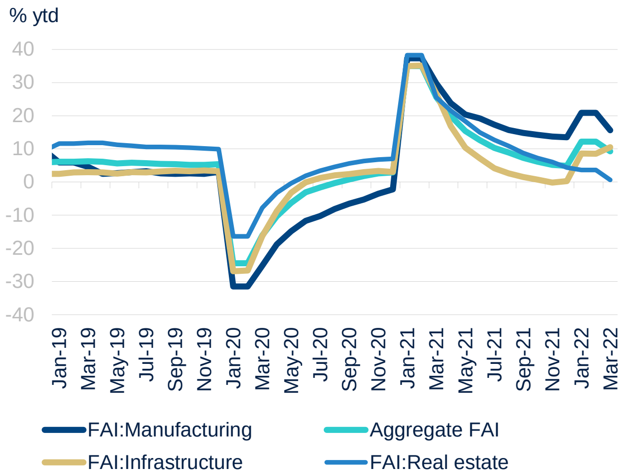
Figure 1. **INDUSTRIAL PRODUCTION AND PMIS DROPPED DUE TO THE OMICRON OUTBREAK**



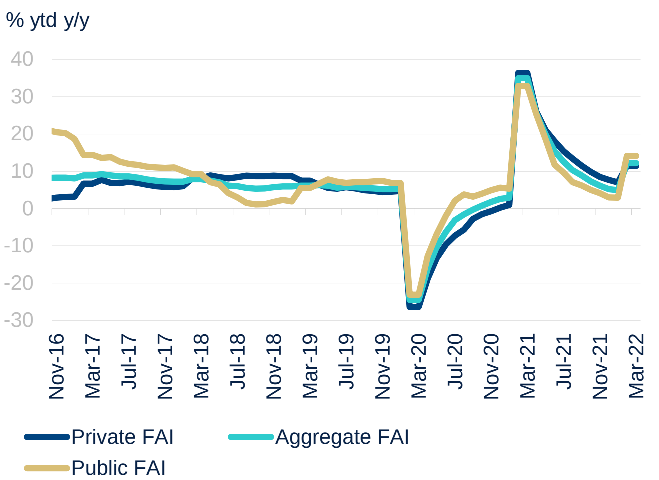
Source: CEIC and BBVA Research

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



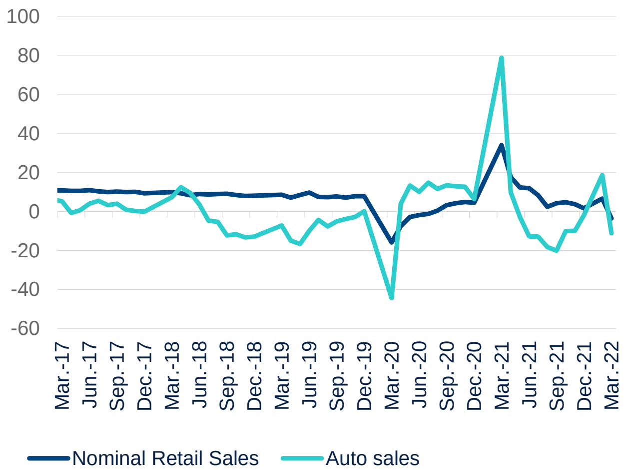
Source: CEIC and BBVA Research

Figure 3 PUBLIC FAI PICKED UP DUE TO THE EXPANSIONARY FISCAL MEASURES



Source: CEIC and BBVA Research

Figure 4 RETAIL SALES DIPPED TO NEGATIVE



Source: CEIC and BBVA Research

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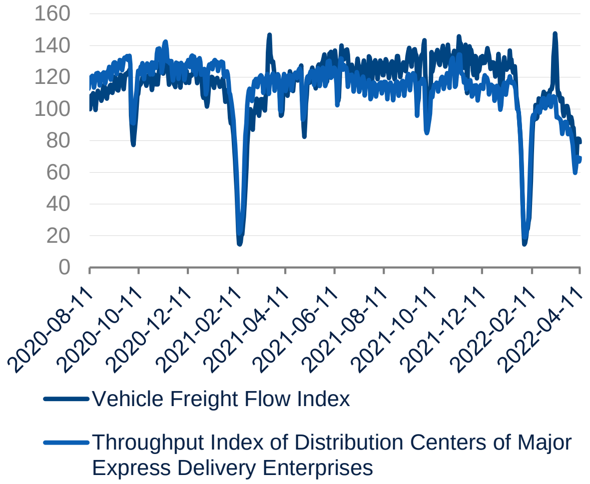
Figure 5. **VEHICLE FREIGHT FLOW INDEX AND THROUGHPUT INDEX**

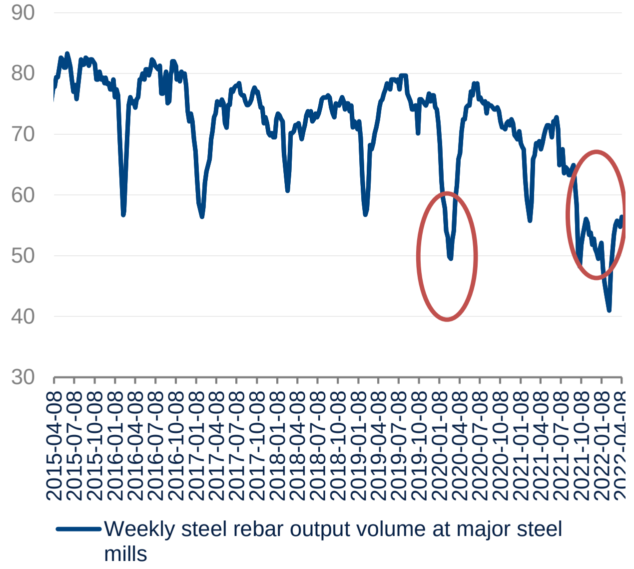


Source: CEIC and BBVA Research

Figure 6.**FLIHGT DISRUPTIONS**

Source: CEIC and BBVA Research

Figure 7STEEL PRODUCTION HIGH FREQUENCY INDEX



Source: CEIC and BBVA Research

Figure 8 STEEL REBAR HIGH FREQUENCY INDEX

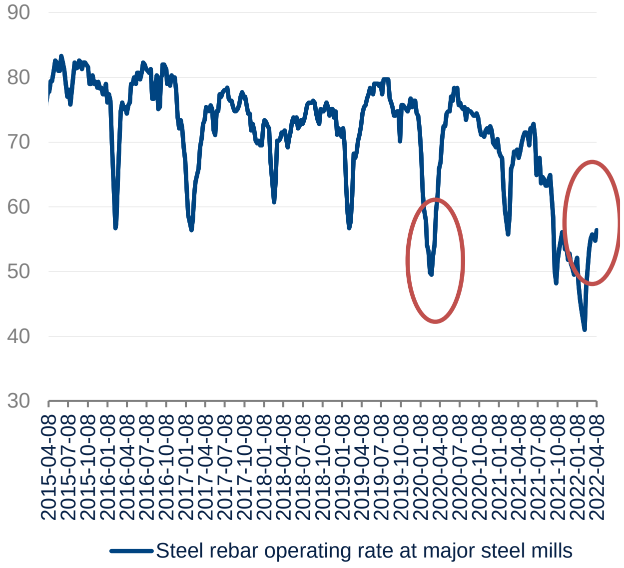


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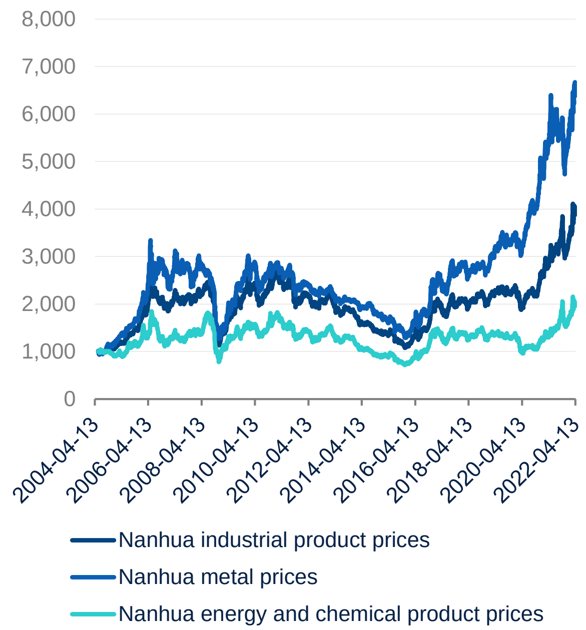
Figure 9. **ASPHALT OPERATING INDEX**

Source: CEIC and BBVA Research

Figure 10. **THE SUPPLY CHAIN DISRUPTION LEADS INDUSTRIAL TO PRICE SURGE**



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