China | “Impossible Trinity” of 2022 Chinese economy

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Chinese authorities face the “Impossible Trinity” of policy setting in 2022 among “zero tolerance” Covid policy, synchronized monetary policy and 5.5% growth target. The concept of “Impossible Trinity” actually comes from one of the most classic theory in international economics (which means it is impossible for a country to have all three policy choices at the same time: a fixed foreign exchange rate, free capital movement and an independent monetary policy). By borrowing this concept, what we want to emphasize is Chinese authorities cannot achieve “zero Covid”, a synchronized monetary policy with the US FED to maintain financial stability and 5.5% growth target at the same time in 2022; in other words, they could only prioritize two of them and scarify the other one. Given that at the current stage the authorities are still pledged to maintain “zero Covid” policy, there are only two possible policy mix going forward: (i) if they want “Zero Covid” and 5.5% growth target as announced in “two sessions”, they have to conduct aggressive easing monetary measures, which absolutely unsynchronized with the US FED, leading to capital flight and sharp RMB depreciation; or (ii) if they want “Zero Covid” and a synchronized monetary policy with the US FED to circumvent financial instability, they have to accept a lower growth rate instead of 5.5% target. Based on our understanding of the recent policy moves, the authorities are probably trying to experiment the former choice although the ultimate real-world scenario might be the latter case.

A series of policy easing measures have already been promulgated recently: (i) monetary easing: RRR cut on April 15th releasing RMB 1.2 trillion long-term liquidity; (ii) fiscal easing local government bond issuance acceleration in Q1 to boost infrastructure investment, and (iii) regulatory forbearance of real estate: the recent decrease of lending rate for home buyers to stimulate real estate investment, etc. However, the economic data of April seems to largely lag behind these aggressive easing monetary and fiscal measures. And what are worried more by the market is the recent trending-up CPI and the sharp RMB depreciation have actually shrink China’s policy room for aggressive easing monetary and fiscal measures. (See our recent Economic Watch: China | China’s low inflation environment bears some changes) On balance, we believe the Omicron flare-ups and Shanghai’s lockdown will make the authorities’ 2022 growth target of 5.5% announced in the recent “Two Sessions” very challenging to be achieved (see our recent Economic Watch: China | 2022 “Two sessions” prioritizes stabilizing growth). Thus, 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.

In particular, April economic activity indicators continued to confirm economic deteriorating trend as all of them fell below market expectations and the previous readings. On the supply side, the year-on-year growth of industrial production dipped to -2.9% y/y from 5% y/y in the previous month, lower than the market consensus at 0.4% y/y, and its seasonal adjusted m/m growth also decelerated to -7.08 m/m from 0.39% m/m previously. The supply-side slowdown came from the disruptions of the supply chain and the production, 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 -43.5% y/y from -4.9% y/y in the previous month, while other significant drop also include power-generated electricity (-11.8% y/y), computure equipment (-

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16.8% y/y) and metal cutting machine (-19% y/y). The only silver lining is that electric vehicle remains the pillar of industrial production growth with its growth at 42.2% y/y (ytd y/y: 112.7%), 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 6.8% ytd y/y from 9.3% ytd y/y previously (market consensus: 7% ytd y/y), with its month on month growth also decelerated to -0.82 m/m. By components, manufacturing FAI surpassed the infrastructure FAI and real estate FAI to lead the investment growth, while infrastructure FAI also achieved significant improvement due to the recent expansionary fiscal measures such as speed-up of local government bond issuance. In detail, manufacturing FAI decelerated to 12.2% ytd y/d from15.6% ytd y/y previously and the infrastructure FAI slowed to 6.5% ytd y/y from 8.5% ytd y/y in March; however, real estate FAI dipped to negative expansion to -2.7% ytd y/y from 0.7% ytd y/y previously, indicating that once the housing price decline expectation is formed, it is difficult to change people's expectation although the authorities have already eased financing conditions for developers and home-buyers 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)

More severely, retail sales bears the heaviest blow amid a series of lockdown measures to curb Omicron contangion which tumbled sharply to -11.1% y/y from -3.5% y/y previously (market consensus: -6.1% y/y). By component, restaurant sales dipped to -22.7% y/y from -16.4% y/y previously, jewelry slumped to -26.7% y/y from -17.9% y/y, gaument by -22.8% y/y from -12.7% y/y and automobiles by-31.6% y/y from -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 if the lockdown measures are not eased. (see our recent Economic Watch: China | Will the country abandon "zero tolerance" strategy on Covid-19?) (Figure 4)

Except for the above April economic activity indicators, credit indicators also suggest a significant slowdown. In particular, due to the very weak demand during the pandemic flare-ups and lockdown measures, new yuan loans dipped to RMB 645.4 billion from RMB 3,130 billion in the previous month (consensus: RMB 1,515 billion), and total social financing also slumped to RMB 910.2 billion from RMB 4,650 billion previously (consensus: RMB 2,150 billion), among which, loan growth moderated from 11.4% y/y to 10.9% y/y. That means, even though the authorities are conducting easing monetary measures, the credit demand from enterprises and individuals remained weak during lockdown period, leading to a weak monetary policy transmission to real economy.

In sum, the tumbling April economic activity figures reflected the authorities' lockdown measures under "zero tolerance" strategy significantly weighed on growth. Given that Chinese authorities will continue to stick on "zero Covid" policy in the rest of the year based on their announcement in the recent important high-level conferences, there will be "impossible trinity" for China's policy setting in 2022: either China needs to give up synchronized monetary policy with the US FED to continue aggressive easing in order to achive 5.5% growth target which might lead to financial instability, or, the authorities have to give up 5.5% growth target to accept a lower growth in a bid not to conduct aggressive easing measures to circumvent capital flights and sharp currency depreciation. Under the current situation, we predict the real case would be the latter one, as the policy room of aggressive easing has been shrank significantly amid a trending-up inflation and sharp RMB depreciation. 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, and the whole year GDP will reach 4.5% y/y for 2022. (see our Economic Watch: China | Shanghai lockdown: most likely scenarios and the impact on global value chain).

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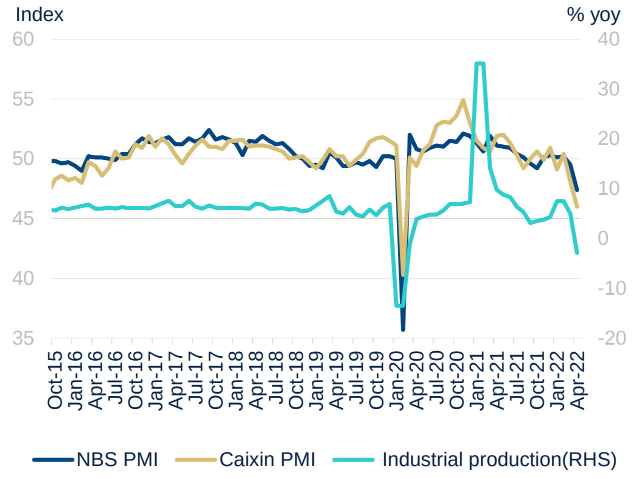
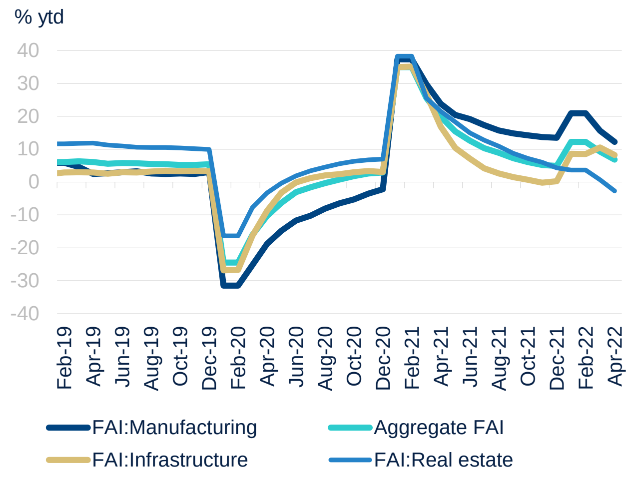
Figure 1. **INDUSTRIAL PRODUCTION AND PMIS DROPPED DUE TO THE LOCKDOWN MEASURES**



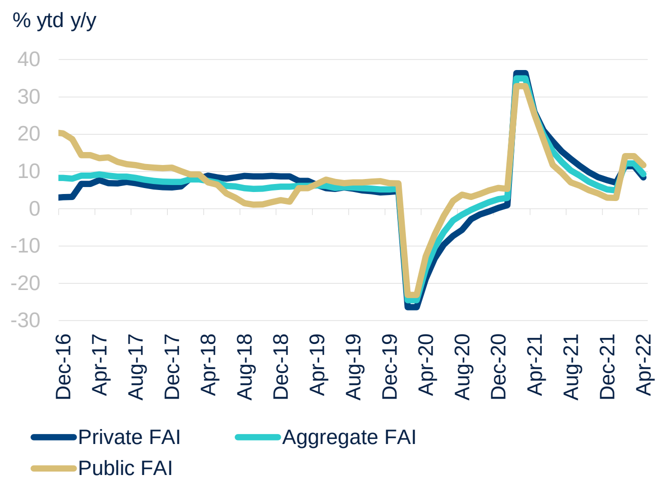
Source: CEIC and BBVA Research

Figure 2. **INFRASTRUCTURE INVESTMENT PICKED UP DUE TO THE EASING FISCAL MEASURES BUT REAL ESTATE REMAINS LACKLUSTER**



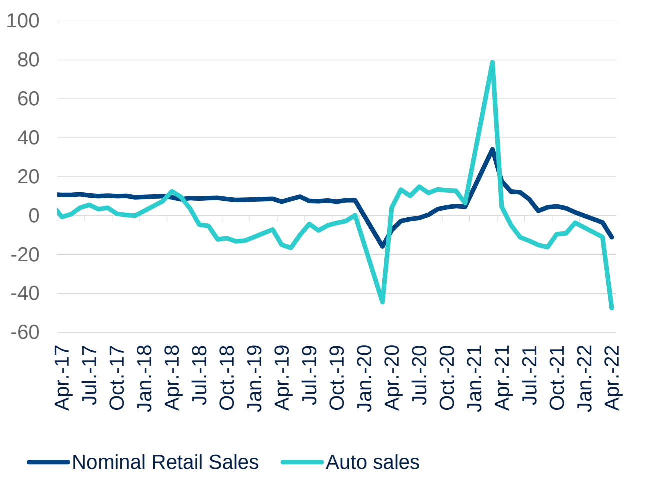
Source: CEIC and BBVA Research

Figure 3 PUBLIC FAI LED THE FAI GROWTH DUE TO EXPANSIONARY FISCAL MEASURES



Source: CEIC and BBVA Research

Figure 4 RETAIL SALES DIPPED TO NEGATIVE SIGNIFICANTLY AMID LOCKDOWN



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