Economic Watch

China | What media sentiments tell us about China's financial vulnerabilities?

Jinyue Dong / Betty Huang /Jone Lorente / Le Xia
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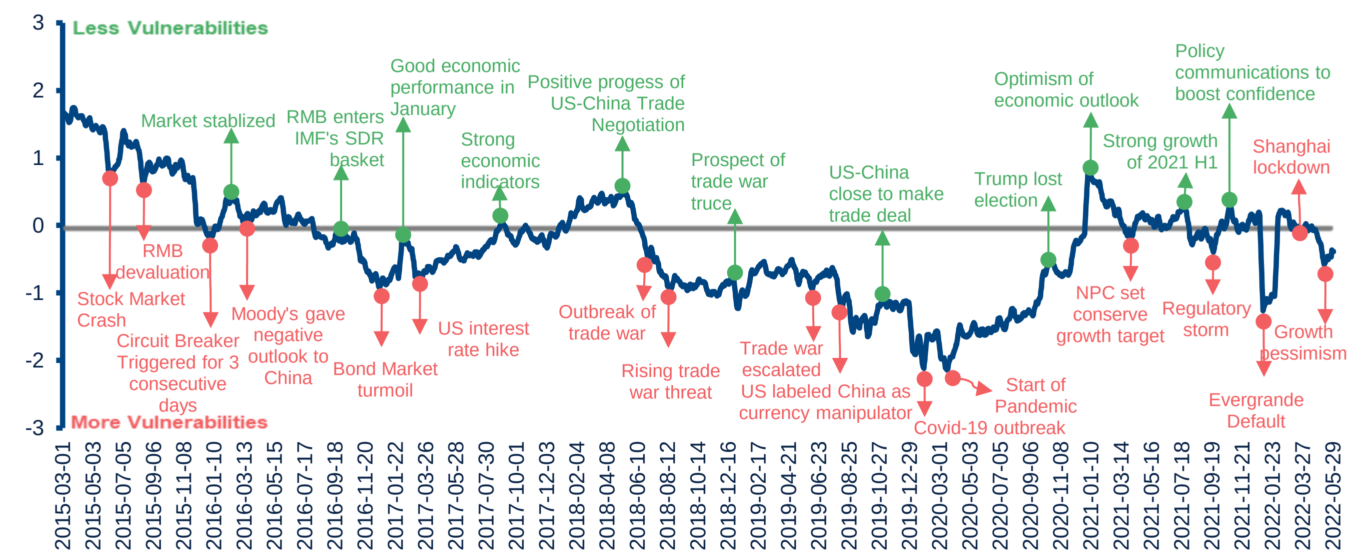
The first half of 2022 is fraught with negative shocks to the Chinese economy. The year started with a high-profile default of Evergrande Group, one of Chinese largest developers with assets more than 2 trillion RMB, which tipped the country's entire real estate sector into an unprecedented predicament. Right after Beijing successfully held the Winter Olympics in mid-February, the Russia-Ukraine war broke out, mounting foreign investors' concerns over the increasing geopolitical risks associated with China. Then the Omicron variant of Covid-19 virus unexpectedly swept in several large cities of the Mainland China, in particular Shanghai where the authorities imposed a two-month lockdown through April and May.

The above mentioned shocks to China this year not only brought strong headwinds to economic growth but also resulted in the deterioration of China's financial vulnerabilities. Even the authorities now admit that the 5.5% official growth target set for 2022 is hard to be achieved. Moreover, our Big-data based Chinese Vulnerability Sentiment Index (CVSI) to captures the evolution of China's financial vulnerability through the lens of media sentiment changes as well as market and real activity indicators. (Figure 1)

Figure 1. **CHINESE VULNERABILITY SENTIMENT INDEX** (CVSI) **COMBINING KEY INDICATORS WITH BIG DATA EVOLUTION OF THE "TONE" OF THE MAIN THEMES ON VULNERABILITY IN CHINA**



Source: GDELT,CEIC and BBVA Research

As shown in the figure, CVSI dropped sharply at the beginning of this year. Despite a lull of rebound, it currently hovers below the index historical average (which is represented by the level of 0). Indeed, our CVSI is composed by four different vulnerability dimensions:

1. The indebtedness vulnerability component, which captures indebtedness concerns of China's corporate sector;

2. The real estate vulnerability component, taking into account risks of the real estate sector;

3. The shadow banking vulnerability component, measuring shadow banking activities, including those linking to the formal banking sector;

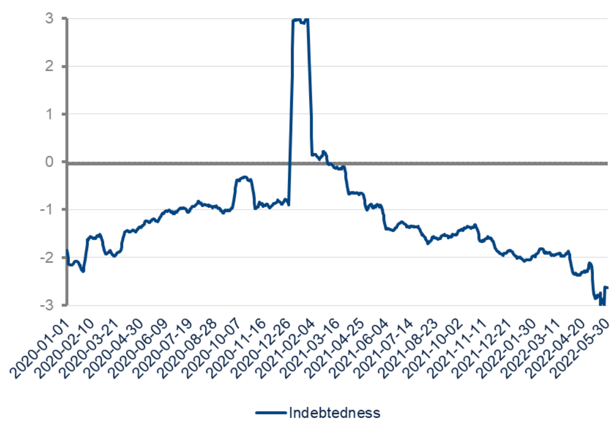
4. The exchange rate (FX) component, which accounts for concerns of exchange rate stability.

(For those who are interested in the methods of constructing the CVSI and its sub-index, they can refer to our CVSI working paper: [Tracking Chinese Vulnerability in Real Time Using Big Data])

Four sub-indexes of CVSI exhibit different patterns. The indebtedness sub-index was hovering around a low level at the beginning of the year and then dropped sharply in March. Although it stabilized a bit towards the end-May, its level was still below that of Q1 2020 when the Covid-19 broke out in Wuhan and spread to other regions in a short time. This sub-index shows that the corporate sector is under great financial pressure as the Omicron flare-ups and followed lockdown measures have led to large-scale production disruptions and logistic congestion. As a result, firms' debts started to pile up on their balance sheets. (Figure 2)

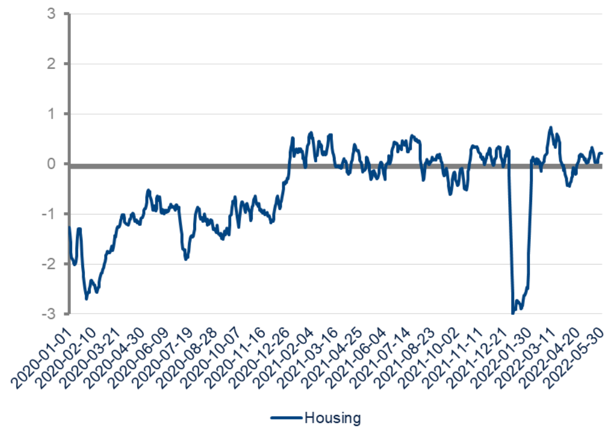
Comparatively, the sub-index of real estate showed certain stabilization recently. The default of Evergrand had a great knock-on impact on the entire sector at the beginning of the year, evidenced by a dip of the sub-index over the same period. However, the authorities quickly fine-tuned their housing policies and started to lend more support to the real estate sector. Although it still needs time to translate the policy support to improved activities indicators, the overall sentiment of the real estate sector rebounded swiftly. Now the sub-index is close to its historical average. (Figure 3)

Figure 2. **INDEBTEDNESS PROBLEM OF CORPORATE SECTOR BECOME ACUTE**



Source: GDELT, CEIC and BBVA Research

Figure 3. **REAL ESTATE SECTOR SHOW SIGNS OF STABLIZATION**



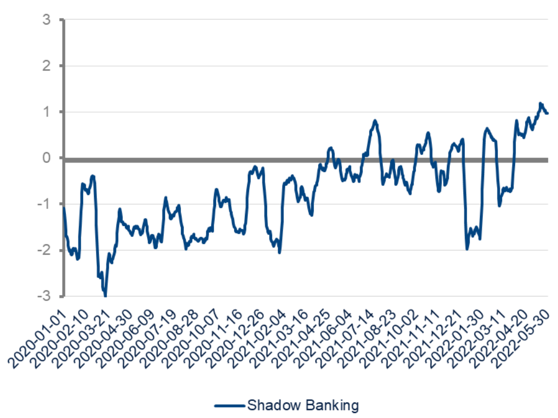
Source: GDELT, CEIC and BBVA Research

The sub-index of shadow banking activities has shown certain improvement since the start of the year. After three years of transition period, the new regulations of banks' wealth management products are fully implemented from this year. The new regulations are expected to curb banks' participation in shadow banking activities and reduce associated financial risks. It could boost the sentiment of the banking sector. However, it is noted that the reaction of banks' balance sheets to economic shocks is slower than that of the corporate sector since banks generally need a longer time to identify non-performing assets and write off losses. That being said, this sub-index could deteriorate in the near future given the worsened indebtedness problem in the corporate sector. (Figure 4)

The sub-index FX had a deep drop during March-April, in line with a round of fast depreciation in the RMB exchange rate. As explained in one of our notes (RMB outlook: getting worse before it gets better), this round of depreciation is synchronized with depreciation of other currencies amid the US Fed tightening measures. Moreover, Chinese authorities have adequate policy tools to avert excessive volatilities of the RMB exchange rate. Therefore, the RMB exchange rate is set to rebound towards the end-year when macro fundamentals in China improve.

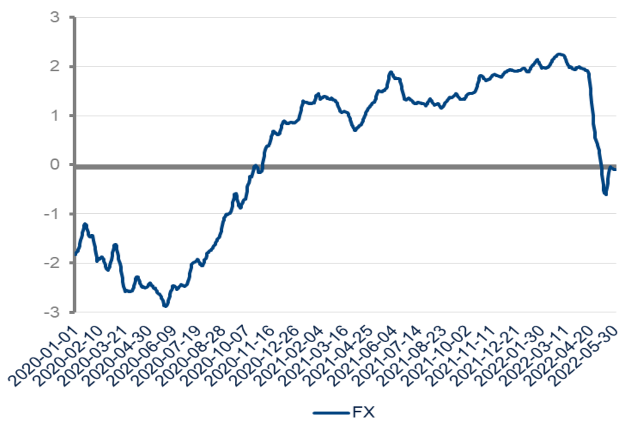
All in all, the CVSI and its sub-indexes show certain deterioration of Chinese financial vulnerabilities. In our opinion, the primary concern is still the financial stress faced by the corporate sector, which could dampen investors' confidence in China's growth prospective and financial stability. Regarding the housing market and exchange rate, the authorities still have adequate intervention tools to deal with them. That being said, China's authorities need to strike a nuanced balance between maintaining a decent growth pace and battling the Covid-19 flare-ups.

Figure 4. **SHADOW BANKING ACTIVITIES CURBED DUE TO BOTH REGULATIONS AND POLICY EASING**



Source: CEIC and BBVA Research

Figure 5. **EXCHANGE RATE IS EXPECTED TO REMAIN STABLE**



Source: BBVA Research and CEIC

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BBVA Research: 95/F, International Commerce Center, One Austin Road, Hong Kong
Tel. +2582 3111 / Fax +852-2587-9717
bbvaresearch@bbva.com www.bbvaresearch.com