China | The economy gradually bounced back amid policy support and pandemic ease

Jinyue Dong

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Chinese authorities face the “Impossible Trinity” of policy setting in 2022 among “zero tolerance” Covid policy, synchronized monetary policy and the 5.5% growth target. That means, China 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 but 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 China wants “Zero Covid” and 5.5% growth target as announced in “two sessions”, they have to conduct very 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 trying to experiment (i), although the ultimate real-world scenario might be (ii). (see our recent Economic Watch: China | “Impossible Trinity” of 2022 Chinese Economy)

The economy seems to gradually recover in May as the lockdown measures in Shanghai came to an end and the authorities have pressed ahead a series of monetary and fiscal stimulus measures. (see our recent Economic Watch: New stimulus package not enough to ensure a 5.5% growth target) On balance, we believe the Omicron flare-ups and the authorities’ “zero-Covid” policy will continue to weigh on growth and 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 maintain our GDP forecasting of 2022 at 4.5% considering supply chain distortions and consumption slump, with the economic blow particularly severe in Q2 and th economy is antipated to bottom out in Q3.

Amid the lifted lockdown and a series of policy support, May economic activity indicators pointed to a bounce-back of the economic indicators as most indicators were above market expectations and the previous readings. On the supply side, the year-on-year growth of industrial production surged to 0.7% y/y from -2.9% y/y in the previous month, higher than the market consensus at -0.7% y/y, and its seasonal adjusted m/m growth also accelerated to 5.61 m/m from -5.8% m/m previously. The supply-side recovery came from the work resumption based on the “closed-loop” management of manufacturing and other sectors, as the lockdown in Shanghai has gradually approached to the end in the past month. By categories, the highest bounce-back is the electric vehicle production which jumped to 108.3% y/y from 42.2% y/y in the previous month(ytd y/y: 111.7%), supported by the authorities’ priority of green economy and new energy sector. Other sectors also recorded a recovery. For instance, the general authomobile manufacturing significantly shrank its dip from -43.5% y/y to -4.8% y/y in the previous month, power-generated electricity growth drop also shrank from -11.8% y/y to -3.3% y/y, computure equipment production from -16.8% y/y to -6.1% y/y etc. (Figure 1) Look ahead, we anticipate a further bounce-back of industrial production in the following month after Shanghai’s lockdown was lifted on June 1st.

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Tel. +2582 3111 / Fax +852-2587-9717
bbvaresearch@bbva.com www.bbvaresearch.com

On the demand side, retail sales also shrank its negative growth in May after it bore the heaviest economic blow amid a series of lockdown measures to curb Omicron contangion in the previous month. May retail sales recovered from -11.1% y/y in the previous month to -6.7% y/y (market consensus: -6% y/y). By component, restaurant sales remained lackluster which dipped to -21.1% y/y from -22.7% y/y previously, jewelry slumped to -15.5% y/y from -26.7% y/y previously, gaument dipped by -16.2% y/y from -22.8% y/y in the previous month and automobiles dropped by -16% y/y from -31.6% y/y. In the future, we expect Shanghai's lifted lockdown in June 1st will support retail sales recovery, but 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. (see our recent Economic Watch: China | Will the country abandon "zero tolerance" strategy on Covid-19?) (Figure 4)

In addition, fixed-asset investment (FAI) further moderated from the previous reading but above the market consensus, calling for a more expansionary fiscal easing to support infrastructure investment and the efficient allocation of the local government bond issuance quotas. In particular, FAI tumbled to 6.2% ytd y/y from 6.8% ytd y/y previously (market consensus: 6% ytd y/y), but its month-on-month growth accelerated to 0.72% m/m from -0.85 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. In detail, manufacturing FAI decelerated to 10.6% ytd y/y from 12.2% ytd y/d previously and the infrastructure FAI slowed to 6.1% ytd y/y from 6.5% ytd y/y previously; however, real estate FAI remained in the negative expansion to -4% ytd y/y from -2.7% ytd y/y previously. It indicated 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 both developers and home-buyers to secure a soft-landing of housing sector. That means, real estate sector needs more time to achieve a soft-landing this year. (See our recent China Economic Watch: China | Real estate sector needs a soft-landing) (Figure 2 and 3)

Except for the above May economic activity indicators, credit indicators also bounce back significantly from the previous readings and above the market consensus, suggesting a growth recovery is on the way. In particular, May's new yuan loans bounced back to RMB 1,890 billion from RMB 645.4 billion in the previous month (consensus: RMB 1,300 billion), and total social financing also ticked up to RMB 2,790 billion from RMB 910.2 billion previously (consensus: RMB 2,015 billion). On the other hand, by contrast with a sharp expansion of credit figures, outstanding loan growth only marginally picked up to 11% y/y from 10.9% y/y. That means, even though the authorities are pressing ahead easing monetary measures, banks are still reluctant to lend to enterprises and individuals with the weak sentiments during growth slowdown, leading to a weak monetary policy transmission to the real economy.

In sum, although the May economic activity figures displayed some gradual recovery amid expansionary monetary and fiscal measures as well as pandemic ease in China, the authorities' lockdown measures under "zero tolerance" strategy is set to continue to weigh on growth. Given that Chinese government 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 and capital flights, or, the authorities have to give up 5.5% growth target to accept a lower growth to circumvent aggressive easing and to avoid 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 shrank amid a trending-up inflation and sharp RMB depreciation recently. 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

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Tel. +2582 3111 / Fax +852-2587-9717
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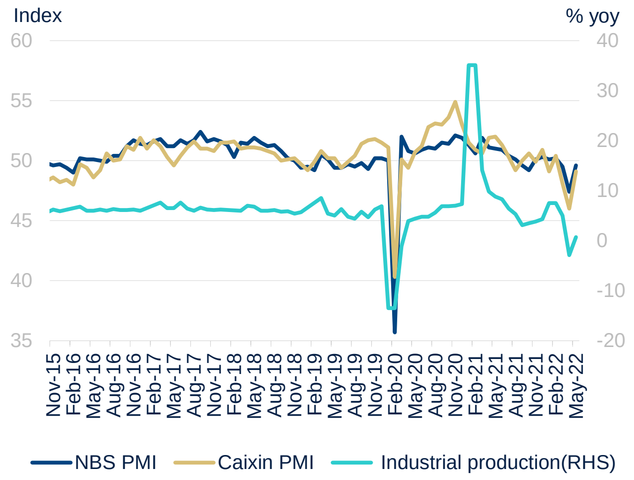
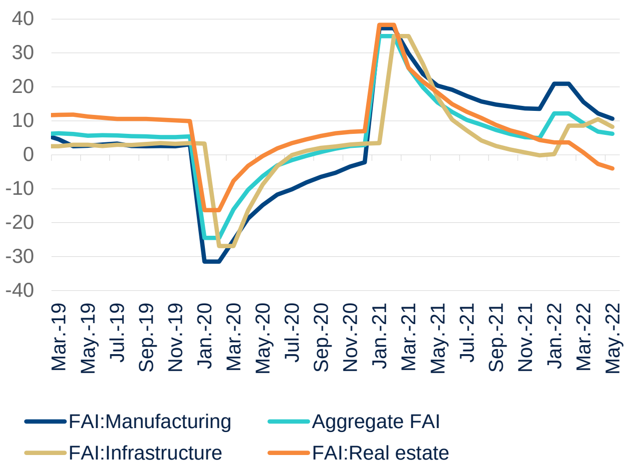
scenario, thus, the whole year GDP will reach 4.5% y/y for 2022. (Bloomberg market consensus: 4.5%, IMF: 4.4%) (see our Economic Watch: China | Shanghai lockdown: most likely scenarios and the impact on global value chain).

Figure 1. **INDUSTRIAL PRODUCTION AND PMIS PICKED UP GRADUALLY AMID PANDEMIC EASE**



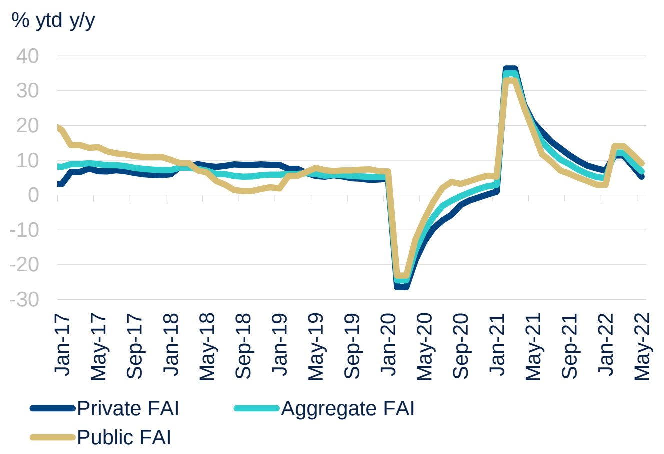
Source: CEIC and BBVA Research

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



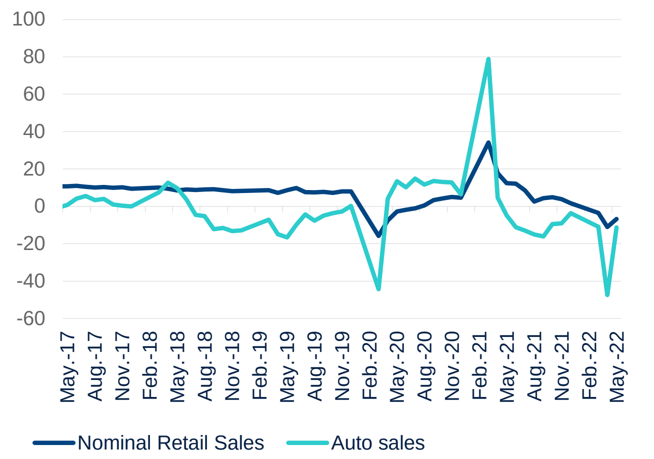
Source: CEIC and BBVA Research

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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