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China | Growth is recovering from its Q2 trough

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China's 2022 economic outlook has been largely changed from its previous policy-finetuning-led softlanding story to an "Impossible Trinity" risk mode by the second round Omicron outbreak and Shanghai's lockdown in March and April. (See our recent Economic Watch: "Impossible Trinity" of 2022 Chinese economy) To sufficiently reflect Shanghai lockdown and other stringent restrictive pandemic measures imposed in Q2, Q2 GDP figure dipped to 0.4% y/y, the lowest since the recovery from the first pandemic wave, which is also significantly lower than the market consensus at 1% y/y.

However, due to the authorities' expansionary monetary and fiscal stimulus this year, the economy started to gradually recover in May and June as the lockdown measures in Shanghai came to an end. (see our recent Economic Watch: New stimulus package not enough to ensure a 5.5% growth target) In particular, all of the economic indicators, namely retail sales, industrial production and fixed asset investment, significantly bounced back in June or maintained at an expansionary level. In particular, retail sales bounced back even higher than that of the pre-lockdown period. The recent fast recovery retrospects the aftermath of the fisrt Covid-19 outbreak in China back to early 2020, and we believe the growth recovery path will be quite similar as of the period after Wuhan lockdown in 2020. On balance, we believe 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 2022 "Two Sessions" very challenging to achieve. Thus, we maintain our GDP forecasting of 2022 at 4.5% while highlighting the downside risk (IMF: 4.4% y/y), and anticipate a fast recovery in Q3 and Q4 to be higher than 5%.

On the supply side, the year-on-year growth of industrial production surged to 3.9% y/y from 0.7% y/y in the previous month, although marginally lower than the market consensus at 4.1% y/y; while its seasonal adjusted m/m growth moderated to 0.84% m/m from 4.22% m/m previously due to a quick bounce-back in May. The supply-side recovery came from the work resumption based on the "closed-loop" management of manufacturing and other type of enterprises, after the lockdown in Shanghai has lifted on June 1st. By categories, the fastest recovery is the electric vehicle production which jumped to 120.8% y/y from 108.3% y/y in the previous month (ytd y/y: 111.2%), supported by the authorities' priority of green economy and new energy sector. Other sectors also recorded a continuing recovery. For instance, the general authomobile manufacturing significantly revved up from -4.8% y/y in the previous month to 26.8% y/y, power-generated electricity growth also turned to positive growth from -3.3% y/y to 1.5% y/y, and computure equipment production from -6.1% y/y to -1.3% etc. (Figure 1) Very similar to the recovery in the aftermath of the first pandemic wave since May 2020, the supply-side industrial production led the growth recovery from the pandemic lockdown measures .

On the demand side, retail sales also surprised the market to the upside, which elevated significantly from previous -6.7% y/y to 3.1% y/y in June after it bore the heaviest economic blow amid a series of lockdown measures to curb Omicron contangion from March to May, which also beats the market consensus at 0% y/y. By component, restaurant sales revved up to -4% y/y from -21.1% y/y previously, significantly shrank its negative growth; jewelry soared to 8.1% y/y from -15.5% y/y previously, gaument turned to positive growth at 1.8% y/y from -22.8% y/y in the previous month and automobiles sales ramped up to 13.9% y/y from -31.6% y/y in the previous month.

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Actually, retail sales has already surpassed its pre-lockdown growth at 1.7% y/y in December 2021, and we expect it will continue to recovery in the following month amid policy support such as the distribution of consumption vouchers to individuals etc. However, we maintain our view that Chinese government's persistence of "zero tolerance" strategy on pandemic by contrast of other countries' "co-existence" policy will constrain China's consumption to go back to pre-pandemic growth. (see our recent Economic Watch: China | Will the country abandon "zero tolerance" strategy on Covid-19?) (Figure 4)

In addition, also from the demand side, fixed-asset investment (FAI) maintained its expansionary growth at 6.1% ytd y/y (prior: 6.2% ytd, y/y) which is above the market consensus of 6% ytd y/y, and its month-on-month growth also picked up to 0.95% m/m from 0.83% m/m. It calls for a more expansionary fiscal easing to support infrastructure investment and the efficient allocation of the local government bond issuance quotas. By components, manufacturing FAI reached 10.7% ytd y/y, which surpassed the infrastructure FAI at 7.1% ytd y/y and real estate FAI at -5.4% ytd y/y to lead the investment growth, while infrastructure FAI also achieved significant improvement due to the recent expansionary fiscal measures. (see our recent Economic Watch: China | Will infrastructure investment become a key growth stabilizer in 2022?) However, real estate FAI continued its negative growth to -5.4% ytd y/y from -4% ytd y/y previously. It indicated that once the housing price decline expectation is formed, it is very difficult to change people's expectation of housing price 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 in the second half of this year. (See our recent China Economic Watch: China | Real estate sector needs a soft-landing) (Figure 2 and 3)

Except for the above June economic activity indicators, credit indicators also trended high significantly from the previous readings and above the market consensus, suggesting a growth recovery is on the way together with credit demand acceleration. In particular, June's new yuan loans bounced back to RMB 2,810 billion from RMB 1,890 billion in the previous month (consensus: RMB 2,400 billion), and total social financing also ticked up to RMB 5,170 billion from RMB 2,790 billion previously (consensus: RMB 4200 billion). Moreoever, outstanding loan growth picked up to 11.2% y/y from 11% y/y and M2 growth revved up to 11.4% y/y from 11.1% y/y. That means, growth recovery highly depends on the monetary transmission mechanism, and it needs to overcome the weak transmission, which means even though the authorities are pressing ahead easing monetary measures, banks are reluctant to lend to enterprises and individuals with the weak sentiments during growth slowdown.

In sum, June economic activity figures displayed a growth recovery path which is quite similar to that of the aftermath of Wuhan lockdown back to early 2020, amid expansionary monetary and fiscal measures as well as the gradual lift of restrictive "zero Covid" lockdown measures. The pace of economic recovery from lockdown depends on several factors: (i) whether further large-scale lockdown will be imposed again in large cities; (ii) how large is the policy room, as the recent trending-up inflation and RMB sharp depreciation shrink the room for easing measures; (iii) how effective of the easing measures, i.e. the monetary transmission mechanism; and (iv) how to rebuild market confidence, i.e. real estate.

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

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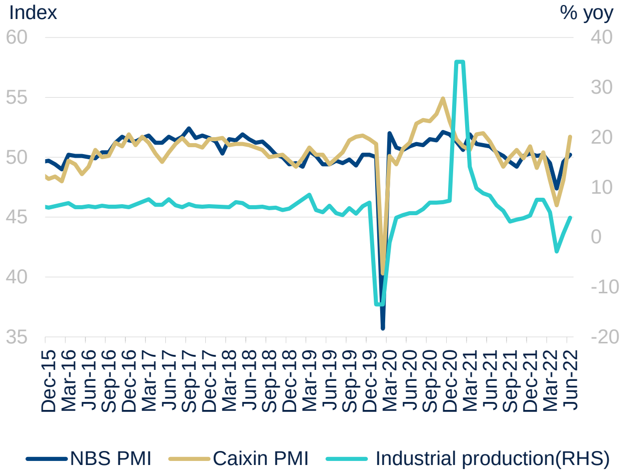
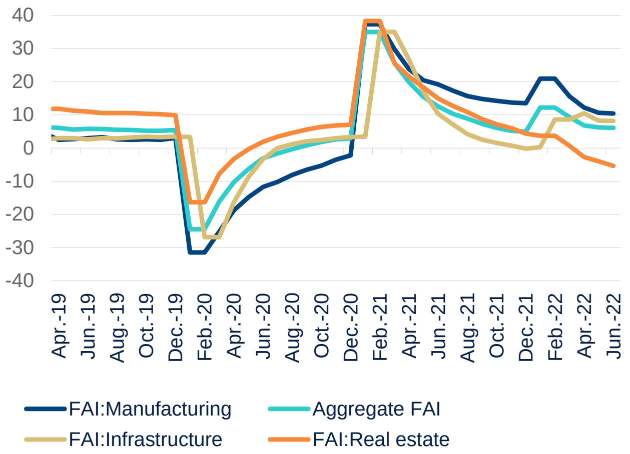
RMB depreciation recently. Look ahead, we predict Q3 and Q4 GDP will significantly bounce back to above 5% y/y, making the whole year GDP will reach 4.5% y/y for 2022 with some downside risks. (Bloomberg market consensus: 4.1%, IMF: 4.4%).

Figure 1. **INDUSTRIAL PRODUCTION AND PMIS RECOVERED AFTER SHANGHAI LOCKDOWN LIFTED**



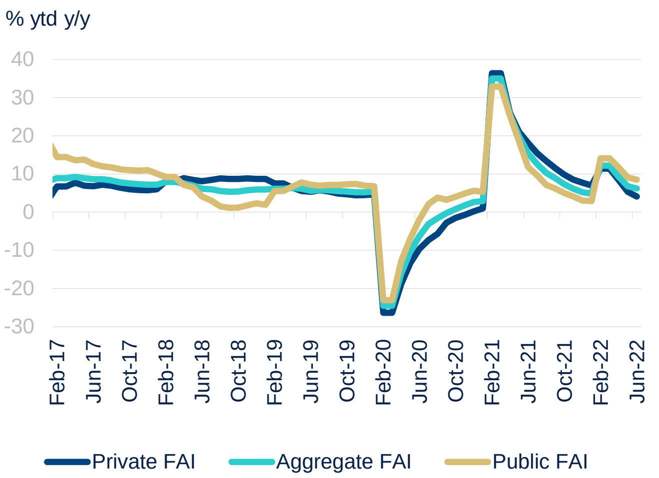
Source: CEIC and BBVA Research

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



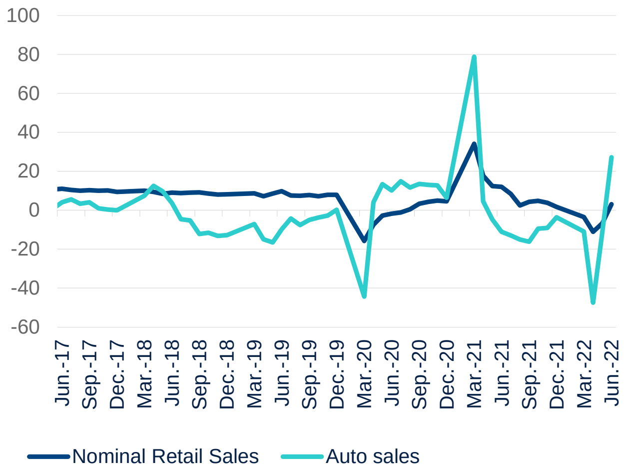
Source: CEIC and BBVA Research

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



Source: CEIC and BBVA Research

Figure 4 RETAIL SALES BOUNCED BACK SIGNIFICANTLY AFTER LOCKDOWN MEASURES LIFTED



Source: CEIC and BBVA Research

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