Economic indicators

China | Economic recovery moderated in Q2 amid fading reopening effect

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China's Q2 2023 GDP growth moderated to 6.3% y/y, lower than the market consensus at 7.3% and our BBVA forecast at 8.3%. To remove the base effect, we take average of 2023 Q2 and 2022 Q2 growth (0.4% y/y), the two-year Q2 average growth is only 3.35%, much lower than two-year Q1 average growth at 4.65% y/y. The quarter-on-quarter growth of Q2 also significantly slowed to 0.8% qoq from 2.2% qoq in Q1 2023, suggesting the previous strong recovery momentum came to a halt in Q2 amid the fading effect of reopening after three-year Covid-19 lockdown.

The main drag of the growth in Q2 came from retail sales, which slide significantly in Q2 after Q1 peak, indicating a sluggish market sentiments and consumer confidence amid households' "balance sheet recession" in the post-pandemic time. This could be further verified by China's June economic activities data which displays a very unbalanced structure, among which, industrial production bodes well, but fixed asset investment moderately decelerated and retail sales significantly dipped from the previous readings.

Except for significantly sliding consumption figures, the other two caveats are also noteworthy for Chinese economy:

First, June inflation data (CPI: 0.0% vs. prior: 0.2%; PPI: -5.4% vs. prior: -4.6%) indicate that China is technically entering into a deflation cycle. The deflationary environment in China needs our particular attention, because as long as deflation expectation is formed by households and enterprises, it is difficult to reverse.

Second, the transmission mechanism from current expansionary monetary and fiscal measures to private investment and consumption growth is not smooth. China's ongoing policy stimulus, including the most recent unexpected LPR cut and a series of targeted easing measures, goes directly to SOEs, infrastructure investment and to the replacement of maturing local government bond. But how to foster spillover effect from SOEs and infrastructure investment to private investment and household consumption should be the key of the economic recovery going forward.

Altogether, to solve the above-mentioned problems calls for more monetary and fiscal policy support at the central government level in the rest of the year to help alleviate "balance sheet recession" of households and enterprises and to rebuild market confidence. The weak Q2 GDP data added a significant downside risk to our previous 2023 GDP growth forecast (IMF: 5.2% and Bloomberg market consensus: 5.4%).

If we dive into the data in detail, June economic activity data outturns confirmed the economic slowdown with a very unbalanced structure. In particular, supply side recovery completely surpassed the demand side.

On the supply side, the year-on-year growth of industrial production accelerated to 4.4% y/y from 3.5% in the previous month, higher than the market consensus at 2.7% y/y, and its seasonal adjusted m/m growth achieved

0.68% m/m, higher than the previous month at 0.63% m/m. By categories, the highest growth sector is solar battery which registered 62.6% y/y, following that is power-generation equipment growing at 50.1% y/y and electronic vehicles which increased to 27.6% y/y, in line with the policy initiatives of nation's 2060 carbon neutrality target. The rebound of industrial production was mainly due to the lifting of "zero Covid" policy and lockdown measures, normalizing the industrial activities for manufacturing and other enterprises. (Figure 1)

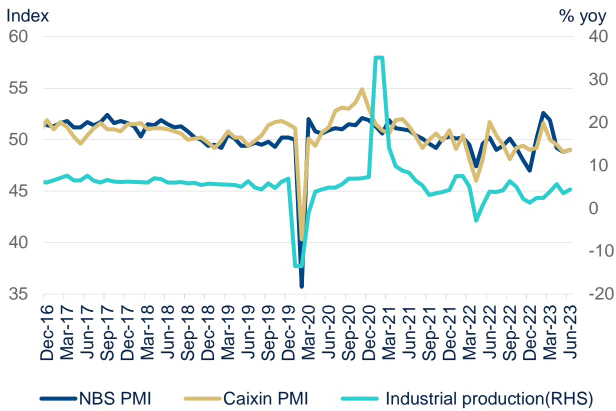
On the demand side, June retail sales significantly dipped to 3.1% y/y from 12.7% y/y in the previous month (market consensus: 3.2%) as the reopening effect faded as time goes. The month-on-month growth of retail sales also declined to 0.23% m/m compared with 0.39% m/m in the previous month. By component, the largest growth is restaurant sales which achieved 16.1% y/y, reflecting consumers' pent-up demand of outside dinning activities still remain the main pillar of retail sales; following that is tobacco sales (9.6% y/y) and jewelry sales (7.8% y/y). Altogether, we believe the retail sales sliding has been mainly dragged by sluggish market sentiments and consumer confidence amid household "balance sheet recession", lower income expectation and high young people unemployment rate in the post-Covid time. (Figure 4)

Also from the demand side, fixed-asset investment (FAI) further moderated to 3.8% ytd y/y from 4% ytd y/y in the previous month (market consensus: 3.5% ytd y/y). The main drag of FAI is the still sluggish housing investment (-7.9% ytd), expanding its decline from the previous reading. By components, infrastructure FAI which is supported by easing fiscal measures (expansionary local government bond issuance) reached 7.2% ytd y/y (see our recent Economic Watch: China | Will infrastructure investment become a key growth stabilizer?), which led the FAI growth and significantly surpassed the manufacturing FAI at 6% ytd y/y and real estate FAI at -7.9% ytd y/y. This further verified that Chinese economic recovery after lifting "zero Covid" is driven by public infrastructure investment. That means, fixed asset investment moderation is led not only by the sluggish housing investment, but also a slowdown of manufacturing investment amid external demand declining. (Figure 2 and 3)

Going forward, we believe the room for infrastructure and manufacturing investment recovery will be limited. In addition, the real estate sector needs more time to achieve a soft-landing. (See our recent China Economic Watch: China | Real estate sector needs a soft-landing) We anticipate the "16-point plan" by Chinese authorities will help to alter the market sentiments on real estate, and indeed we observed housing price and housing transactions in some tier-1 and tier-2 cities have already rebounded together with other housing indicators such as floor space started and completed etc. That means, the real estate sector is anticipated to start to bottom out in 2H 2023 or 2024.

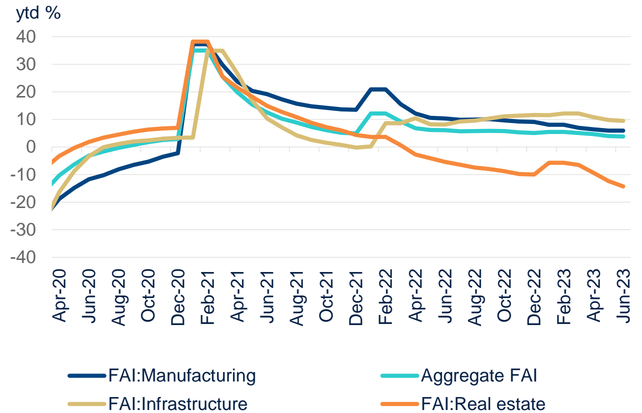
In sum, Chinese economic recovery momentum after lifting "zero Covid" policy seems to come to a halt in Q2 2023 as the reopening effect faded, which is mainly dragged by weak retail sales, continuing sluggish real estate market as well as decelerating external demand amid global economic slowdown. On top of that, Chinese economy is entering into a deflation cycle with zero growth of CPI and negative PPI for the past months. We should pay particular attention because as long as deflation expectation is formed among households and enterprises, it is difficult to alter. The key point to reverse the current situation, we believe, is to implement further monetary and fiscal stimulus at the central government level to help rebuild market sentiments and to reverse the "balance sheet recession" for households and enterprises.

Figure 1. **INDUSTRIAL PRODUCTION EXPANDED FROM THE PREVIOUS MONTH WHILE PMIS BELOW 50**



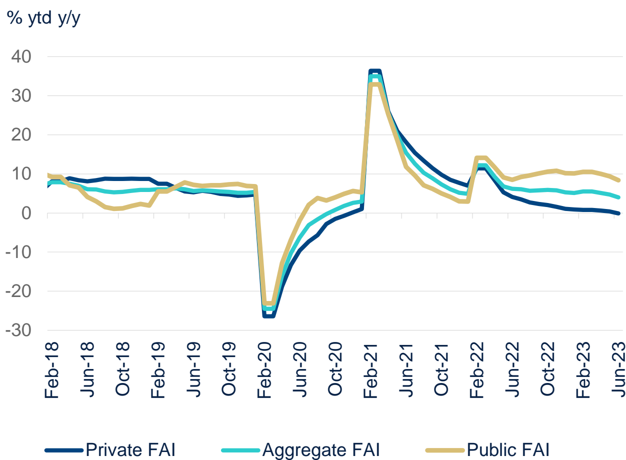
Source: CEIC and BBVA Research

Figure 2. **INFRASTRUCTURE INVESTMENT LED FIXED ASSET INVESTMENT GROWTH BUT REAL ESTATE REMAINS NEGATIVE**



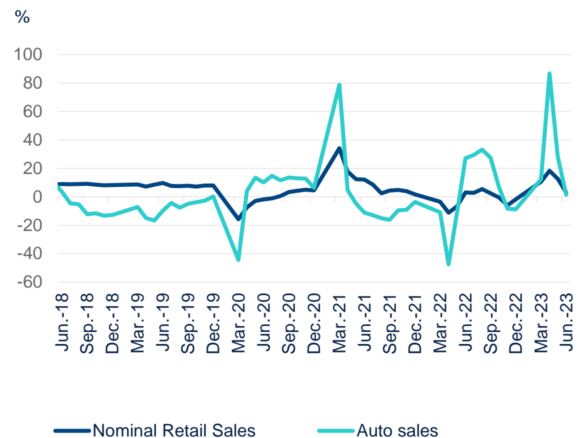
Source: CEIC and BBVA Research

Figure 3. **PUBLIC FAI LED THE FAI GROWTH WHILE PRIVATE INVESTMENT REMAINS WEAK**



Source: CEIC and BBVA Research

Figure 4. **RETAIL SALES DIPPED SIGNIFICANTLY IN JUNE**



Source: CEIC and BBVA Research

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