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Creating Opportunities

Economic indicators

China | Will Chinese economy enter into "Japanization"?

Jinyue Dong
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After the announcement of disappointing Q2 GDP result which moderated to 6.3% y/y (2022 and 2023 two-year Q2 average growth only 3.35%), July economic activities including industrial production, fixed asset investment and retail sales continue sliding. Together with dipping export and import growth and the ongoing deflation environment, it suggests China's previous strong recovery momentum came to a halt amid the fading effect of reopening from three-year Covid-19 lockdown, calling for more policy stimulus at the central government level to revert the economic malaise.

China's ongoing economic slowdown is broad-based, from both supply and demand side. In particular, all economic activity indicators from both supply and demand side slide from the previous readings and market consensus in July. The economy was mainly dragged by sluggish retail sales and real estate market crash, indicating weak market sentiments and consumer confidence amid households and enterprises' "balance sheet recession" in the post-pandemic time. Except for significantly sliding economic activity figures, the other three caveats are also noteworthy for Chinese economy:

First, July inflation data (CPI: -0.3% vs. prior: 0.0%; PPI: -4.4% vs. prior: -5.4%) 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, weak external demand amid global economic slowdown also drags economic growth in China. Export growth, which used to be the main pillar of Chinese economy during the pandemic time, slid to -14.5% y/y in July from -12.4% previously while imports also dipped to -12.4% in July from -6.8% y/y in the previous month due to weak domestic demand.

Third, the transmission mechanism from current expansionary monetary and fiscal measures to private investment and consumption growth is weak. China's ongoing policy stimulus, including the most recent unexpected LPR cut, today's MLF 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 and to revert the current malaise 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. To respond to the economic slowdown, today, the PBoC indeed announced the MLF cut from 2.65% to 2.5%. Given that the LPR is the MLF plus some adding points, this suggests a foreseeable LPR cut which will be announced on August 20.

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Tel. + 2582 3111 / Fax. +852-2587-9717
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If we dive into the data in detail, July economic activity data outturns confirmed the broad-based economic slowdown. On the supply side, the year-on-year growth of industrial production decelerated to 3.7% y/y from 4.4% y/y in the previous month, lower than the market consensus at 4.4% y/y, and its seasonal adjusted m/m growth also dipped to 0.01% m/m from 0.68% m/m in the previous month. By categories, the largest drop sector of industrial production growth is computer equipment which dipped to -22.3% y/y, following that is hydroelectric power generation which slowed to -17.5% y/y and industrial robots by -13.3% y/y and car production by -12.2% y/y. The only silver lining is solar battery production which registered 65.1% growth, higher than the previous reading at 62.6% y/y, following that is electronic vehicles which increased to 24.9% y/y (prior: 27.6% y/y), in line with the policy initiatives of nation's 2060 carbon neutrality target. However, the thriving new energy sector cannot offset the significant slowdown of industrial production of traditional sectors. (Figure 1)

On the demand side, July retail sales further dipped to 2.5% from 3.1% y/y in the previous month (market consensus: 4.5%) as the reopening effect faded amid weak consumer sentiments. The month-on-month growth of retail sales also declined to the negative territory at -0.06% m/m from 0.24% m/m in the previous month. By component, the largest decline is cultural products and office supplies which dipped to -13.1% y/y, following that is construction and decoration related products sales that slid to -11.2% y/y and jewleries by -10% y/y. 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 have 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 3.4% ytd y/y from 3.8% ytd y/y in the previous month (market consensus: 3.8% ytd y/y). The main drag of FAI remained the sluggish housing investment (-8.5% ytd y/y; vs. prior: -7.9% ytd y/y), further expanding its decline from the previous reading. By components, infrastructure FAI which is supported by easing fiscal measures (expansionary local government bond issuance) reached 6.8% ytd y/y (prior: 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 5.7% ytd y/y and real estate FAI at -8.5% 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 weak external demand due to global economic slowdown. (Figure 2 and 3)

Going forward, 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) The recent default case of Country Garden Holding, the largest China's real estate developer, following the Evergrande Group crisis back to 2021, indicate the intrinsic vulnerability and unsustainability of China's real estate business model with very high leverage. It also indicates that the previously promulgated "16-point plan" by Chinese authorities failed to alter the market sentiments on real estate. Look forward, we anticipate a larger-scale bailout moves to be announced to circumvent the adverse spillover effect of the Country Garden Holding's default and sliding stock price.

In sum, Chinese economic recovery momentum after lifting "zero Covid" policy seems to come to a halt from Q2 2023 as the reopening effect faded, which is mainly dragged by weak retail sales, real estate market crash as well as decelerating external demand. On top of that, Chinese economy is entering into a deflation cycle with negative 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. In addition, households and

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Tel. + 2582 3111 / Fax. +852-2587-9717
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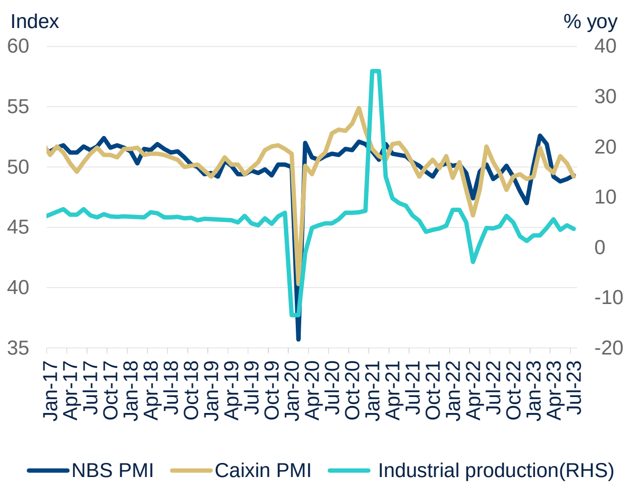
enterprises' "balance sheet recession" in post-Covid time also need enough attention. The key point to reverse the current situation, we believe, is to implement further larger-scale monetary and fiscal stimulus at the central government level to help rebuild market sentiments.

However, we do not believe Chinese economy will enter into "Japanization" with constant "balance sheet recession" and deflationary environment.

First, China still has large policy room to implement easing monetary measures. For instance, China's deflationary environment provides room for further interest rate cuts and RRR cuts etc. Second, Chinese government debt at the central government level is still small compared with other main economies, providing room for fiscal stimulus. Third, China has some key technology advancement with self-sufficient and self-developed technologies; in some main areas, such as EV, 5G, AI, "new infrastructure" and green energy sector, China's achievements may foster new economic growth points to offset the traditional industrial de-capacity etc. Finally, there is also the policy room for consumption stimulus, as China did not follow the advanced economies to directly subsidize households during the pandemic time.

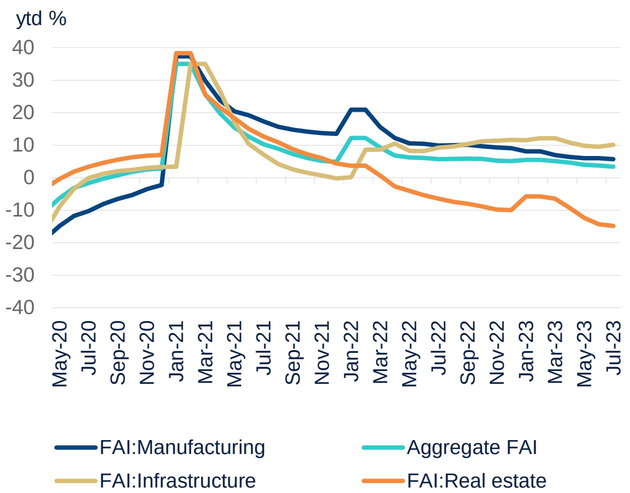
Based on the above, we believe Chinese economy could bottom out in the rest of this year, but how to balance growth stimulus and financial stability is always a constant challenging job for Chinese authorities going forward.

Figure 1. **INDUSTRIAL PRODUCTION SLOWS IN JULY**



Source: CEIC and BBVA Research

Figure 2. **REAL ESTATE INVESTMENT REMAINED THE MAIN DRAG ON FAI**



Source: CEIC and BBVA Research

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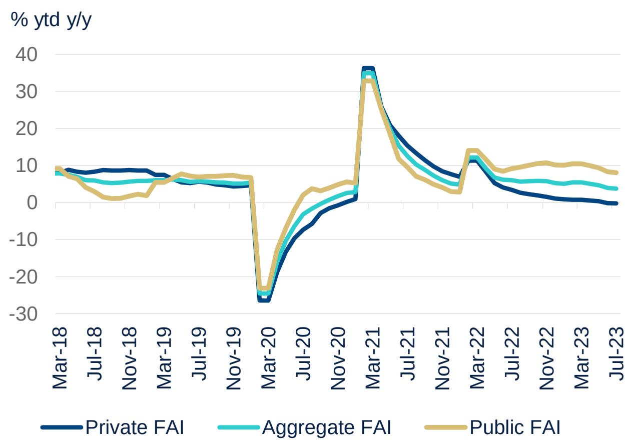
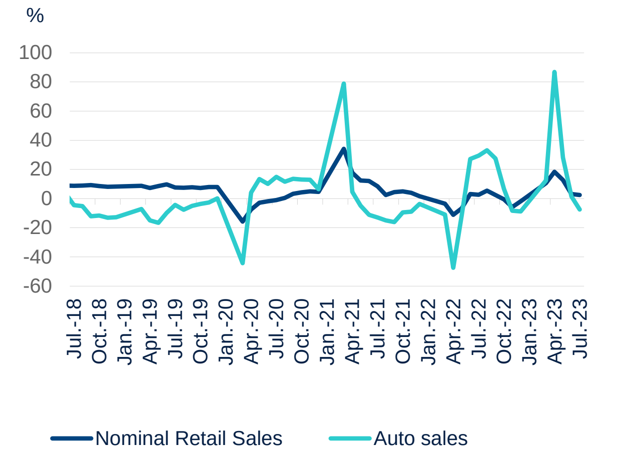
Figure 3. **PUBLIC FAI LED THE FAI GROWTH DUE TO EXPANSIONARY FISCAL MEASURES**



Source: CEIC and BBVA Research

Figure 4. **RETAIL SALES CONTINUED TO SLOW DOWN**



Source: CEIC and BBVA Research

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