Economic indicators

China | Has the worst already passed?

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There are some positive signals in August economic activity indicators announced today, together with other indicators such as inflation, exports and credit etc., suggesting the economy might passed the worst amid a series of recent policy support, although there will still be a long haul for Chinese economy to go back on a right track.

After the announcement of disappointing Q2 2023 GDP result which moderated to 6.3% y/y (2022 and 2023 two-year Q2 average growth only 3.35%), and after all of July economic activity indicators missed the market consensus and previous readings amid the fading effect of reopening from three years' lockdown, the market has raised two hot debates of Chinese economy recently: (i) In the long term, whether Chinese economy will enter into "Japanization" and "balance sheet recession"? (ii) In the short term, whether Chinese economy will go into "hard-landing" or could the soft-landing achievable?

The August economic activities outturns seem to answer the second question in a rapid manner that the economy is still resilient amid the authorities' policy support to achieve soft-landing against the backdrop of a very challenging domestic and international environment: housing market crash, weak household and enterprises sentiments, deflationary environment, dipping external demand and ever-escalating China-US tensions.

The recent monetary and fiscal support of Chinese authorities, although still weaker-than-expected in order to avoid flooding massive stimulus with the financial stability concerns, to a certain extent, helped to rebuild the sentiments of household and enterprises and paved the way for a more sustainable recovery going forward. Chief among the recent stimulus is the 10 bps one-year LPR cut on August 21 and yesterday's 25 bps unexpected RRR cut, as well as the recently announced easing housing market measures-lowering existed mortgage's interest rate, lowering down-payment rate etc.

In particular, the bottomed-out signals in August seem to be broad-based, from both supply and demand side. Except for still weak fixed-asset investment which was slightly missed previous readings primarily dragged by housing market crash, all of the other indicators such as industrial production, retail sales, exports and imports, inflation as well as credit indicators recorded a significant improvement in August. In more details:

First, August inflation data (CPI: 0.1% vs. prior: -0.3%; PPI: -3% vs. prior: -4.4%) indicate that China is kind of drifting away the deflation cycle, although the inflation expectation is still negative. 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, both exports and imports shrank their negative growth in August. In particular, export growth shrank its decline to -8.8% from -14.5% y/y in July while imports also improved to -7.3% from -12.4% in July.

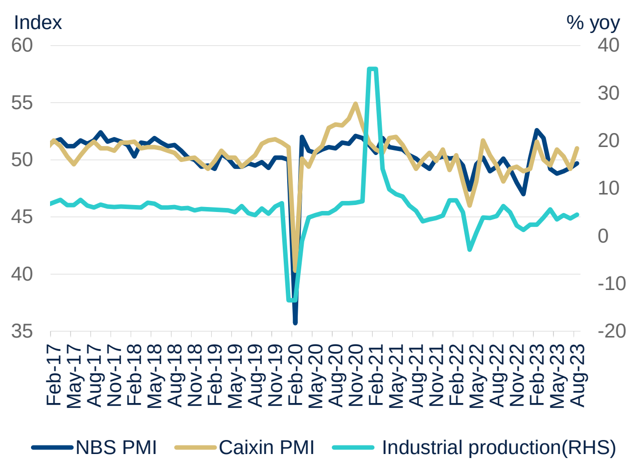
Third, credit data also significantly improved due to a series of monetary easing and easing measures in the housing market mentioned above. In particular, total social financing which is an aggregate gauge of China's credit environment significantly jumped to RMB 3,120 billion from RMB 528 billion, while new RMB loans also accelerated to RMB 1,360 billion from RMB 345.9 billion, indicating the ease of credit conditions and the willingness to re-leverage among households and enterprises.

If we dive into the economic activity data in detail, August outturns indeed have sent out some bottomed-out signals. On the supply side, the year-on-year growth of industrial production accelerated to 4.5% from 3.7% y/y in the previous month, higher than the market consensus at 3.9% y/y, and its seasonal adjusted m/m growth also accelerated to 0.5% m/m from 0.01% m/m in the previous month.

By categories, the pillar of China's industrial production remained in the green economy transformation sectors, such as solar lithium battery which recorded 77.8% y/y growth, the highest among all the industrial sectors; following that is EV cars which achieved 13.8% y/y in August, as well as hydraulic power generation (18.5% y/y) and solar power generation (13.9%), in line with the policy initiatives of nation's 2060 carbon neutrality target. Other traditional industries also achieved growth recovery, for instance, electricity generation equipment (32.4% y/y), ethylene production (16.8%), chemical fiber (17.3%) and steel production (11.4%) as China's trade sector is experiencing forced imports substitution industrialization among rising conflicts with the US and global value chain relocation. (see our recent China Economic Watch: China | Structural change of the international trade: forced imports substitution industrialization for more details) (Figure 1)

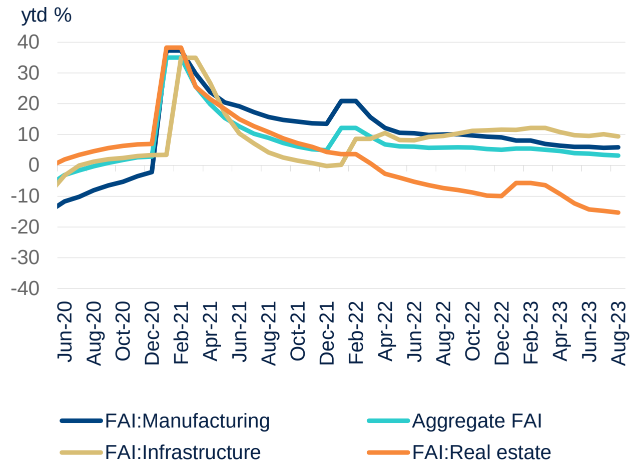
On the demand side, August retail sales rebounded to 4.6% y/y from 2.5% in the previous month (market consensus: 3%). The month-on-month growth of retail sales also bounced back to 0.31% m/m from -0.02% m/m in the previous month. By component, the largest growth is restaurant sales which achieved 12.4% y/y in August, reflecting consumers' pent-up demand of outside dinning activities from the three-year lockdown still remains the main pillar of retail sales. Following that is cosmetics (9.7% y/y), communication equipment (8.5%) and jewelry sales (7.2% y/y). However, automobile sales remain sluggish at 1.1% y/y, so does other durable goods categories. Going forward, the retail sales recovery, including not only restaurant service but also durable goods consumption, depends on the recovery pace of market sentiments, income expectation and young people unemployment rate. (Figure 4)

Figure 1. **INDUSTRIAL PRODUCTION EXPANDED FROM THE PREVIOUS MONTH WHILE PMIS ALSO IMPROVED IN AUGUST**



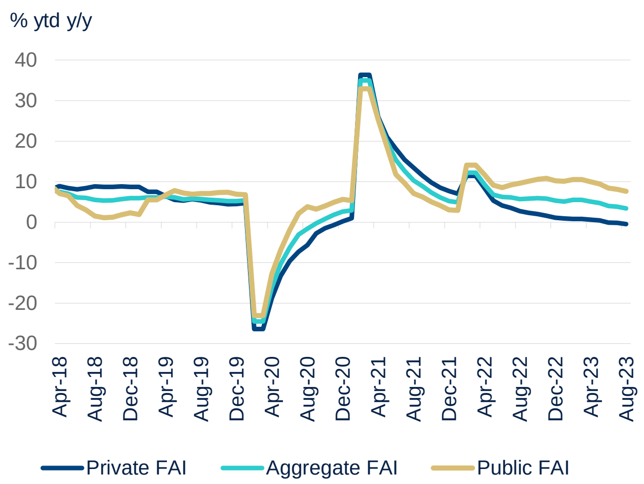
Source: CEIC and BBVA Research

Figure 2. **FIXED ASSET INVESTMENT WAS SIGNIFICANTLY DRAGGED BY HOUSING INVESTMENT**



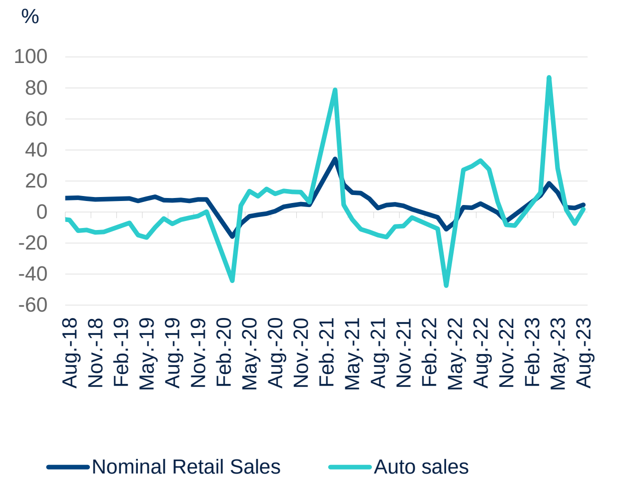
Source: CEIC and BBVA Research

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



Source: CEIC and BBVA Research

Figure 4. **RETAIL SALES AND AUTO SALES ALSO BOUNCED BACK IN AUGUST**



Source: CEIC and BBVA Research

Also from the demand side, fixed-asset investment (FAI) further moderated to 3.2% ytd y/y from 3.4% ytd y/y in the previous month (market consensus: 3.3% ytd y/y). The main drag of FAI remained as the sluggish housing investment (-8.8% ytd y/y; vs. prior: -8.5% ytd y/y) which further expanded its decline from the previous reading.

By components, infrastructure FAI which is supported by easing fiscal measures (expansionary local government bond issuance) reached 6.4% ytd y/y (prior: 6.8% 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 5.9% ytd y/y and real estate FAI at -8.8% ytd y/y. This further verified that Chinese economic recovery after lifting “zero Covid” is driven by public infrastructure investment. However, the multiplier effect from public FAI to private FAI is still very weak, dragged by weak sentiments of private enterprises after experiencing 2021 regulatory reforms and housing market crash. In addition, weak external demand amid US and Europe growth slowdown in 2023 also weighs on manufacturing investment. (Figure 2 and 3)

Going forward, the real estate sector needs more time to achieve a soft-landing. (See our previous China Economic Watch: China | Real estate sector needs a soft-landing) However, we have to realize that the current round of real estate crash is driven by supply side but not the demand side. 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 developers’ business model with very high leverage. But this is a typical supply issue while housing demand in China, particularly in tier-1 and tier-2 cities remain strong.

To reverse the malaise of housing market, the authorities have recently promulgated a series of easing measures, such as lowering the existed mortgage rate, the down-payment rate etc. Look forward, we anticipate more supportive moves to be announced to circumvent the adverse spillover effect of the Country Garden Holding’s default to other upstream and downstream sectors which will help to underpin market sentiments.

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, dragged by weak household and enterprises’ sentiments, real estate market crash as well as decelerating external demand. However, the most recent August economic data sent out some bottomed-out signals and seem to suggest that the worst time has passed.

However, we cannot ignore that the Chinese economy still faces a series of challenges going forward, particularly focusing on housing market, deflationary environment and weak market sentiments. 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 reverse market sentiments.

Based on the above, we believe Chinese economy could gradually bottom out in the rest of this year amid a series of recent monetary and fiscal stimulus, but how to balance growth stimulus and financial stability, particularly the local government debt overhang and RMB depreciation, is always a constant challenging job for Chinese authorities going forward.

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