China Flash

Weak PMI underscores challenge to restore growth momentum

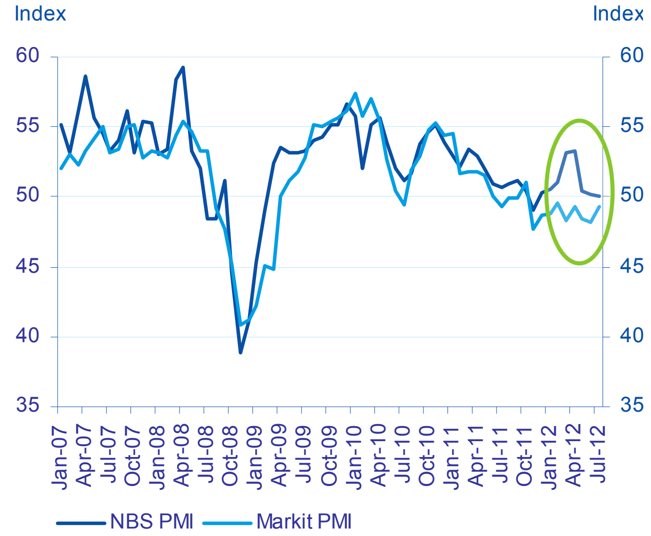
The official NBS Purchasing Managers Index (PMI) declined to a weaker-than expected 50.1% in July (BBVA: 50.7%; Consensus: 50.5%), from 50.2% in June (Chart 1). The decline is broad-based, suggesting both soft domestic and external demand (Chart 2). While the outturn casts some doubt on whether the recent deceleration in growth momentum is stabilizing in line with expectations, other indicators are more positive and provide some comfort that supportive policies are working to stabilize growth in H2. For example, in addition to the recent pickup in loan growth, the private-sector (Markit) PMI, also released today, turned upward in July to its highest level in five months on signs that small and medium-sized enterprises (SMEs) are benefitting from policy support. On balance, we continue to believe that growth momentum is stabilizing, but that further policy support will be needed to maintain growth at near 8% for the full year. On the monetary side, such support is likely to include another 150bp cuts in the RRR in the coming months, and up to two interest rate cuts. Fiscal support is also being stepped up at both the local and national level through increased infrastructure spending. Regional markets, which remain focused on possible actions by the ECB and US Fed, took the news in stride through mid-day, with the Shanghai composite rising on expectations of further domestic policy easing.

- **The decline in the official PMI for July is broad-based, reflecting weak external and domestic demand.** On the supply side, the production subcomponent (with a weight of 25%) eased to 51.8% from 52.0% in June. The employment subcomponent (with a weight of 20%) also declined, to 49.5% in July from 49.7%. On the demand side, the overall new order subcomponent (with a weight of 30%) moderated to 49.0% from 49.2% in the previous month, reflecting weaker market demand ahead. This weaker demand may be especially driven by subdued external market, as the new export order subcomponent declined to 46.6% from 47.5% in June, the lowest since December 2011. Encouragingly, inventories of finished goods have declined, which could support new orders in the months ahead.
- **A divergence in the direction of the official and Markit PMI likely reflects an upturn in the SME sector**. While the official PMI index has been consistently trending above the Markit index in recent months, the two indices have typically moved in the same direction. The fact that the two moved in opposite directions this month most likely reflects differences in coverage and firm size. According to the breakdown of the official PMI, the subcomponents increased by 0.2 and 0.9 percentage points, respectively, for mid-and small-sized enterprises. This is consistent with the outturn of the Markit PMI (rising to 49.3% in July from 48.2% in June), whose coverage includes a higher concentration of smaller firms.
- **The policy stance continues to be more growth supportive.** The authorities continue to make statements in support of a more proactive policy stance. Since June, the PBoC has cut interest rates twice, on top of 150bp cuts in the RRR since December. Fiscal measures are also being stepped up. In the past week, the State Council approved a plan to promote development of a number of centrally-located provinces, including a large package of infrastructure investment in Hunan province, on airport and subway lines.
- **A number of important economic indicators will be released in the coming days (August 9-15),** including inflation, industrial production, retail sales, inflation, trade, and credit aggregates. These indicators will be watched closely for further insights on growth momentum and the outlook.

Stephen Schwartz
Chief Economist for Asia
stephen.schwartz@bbva.com.hk
+852 2582 3218

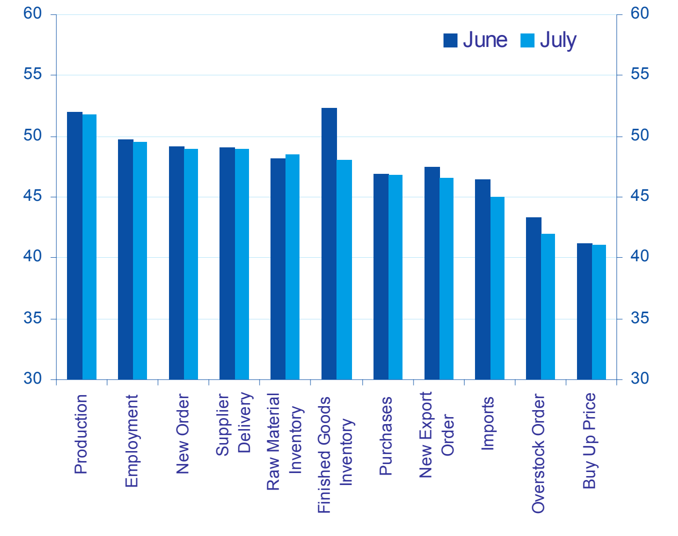
Zhigang Li
Senior Economist
Zhigangi.li@bbva.com.hk
+852 2582 3162

Chart 1
A divergence in PMI outturns



Source: CEIC and BBVA Research

Chart 2
The pickup in March official PMI was broad-based



Source: CEIC and BBVA Research

BBVA | RESEARCH | 43/F., Two IFC, 8 Finance Street, Central, Hong Kong | Tel.: +852 2582 3111 | www.bbvaresearch.com