Economic Analysis

The recent stock market crash dims growth outlook despite the better-than-expected Q2 GDP outturn

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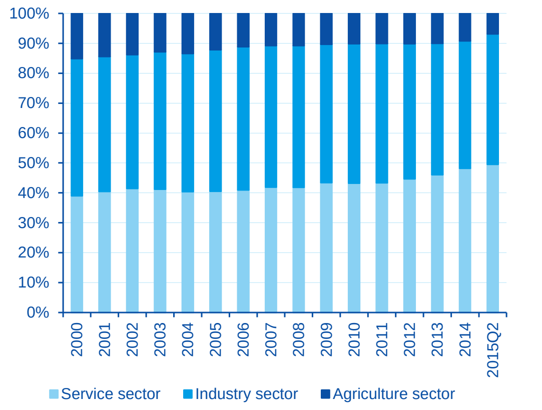
China's Q2 GDP growth came out at 7.0% y/y today, flat with the Q1 outturn while above market expectations (BBVA: 6.8% y/y versus Consensus: 6.8% y/y). In sequential terms, Q2 GDP expanded at a pace of 1.7% q/q sa, increasing from 1.3% q/q sa of Q1 2015. On top of this, the economic structure rebalancing is on the track (Figure 1). A number of economic activity indicators in June were also released, among which industrial production, urban fixed asset investment and retail sales all improved from the last quarter's readings and surprised the market from the upside. Putting together, both GDP outturn and activity indicators point to a stabilization of China's growth in the second quarter. Notwithstanding these recently improved fundamentals, we expect that the recent stock market crash will take a toll on the real economy and hamper the ongoing growth recovery in the second half of the year, which is to add difficulties for the authorities to meet their pre-set 7.0% growth target. Looking ahead, the authorities are likely to deploy more pro-growth measures to sustain domestic demand and prevent a hard-landing scenario.

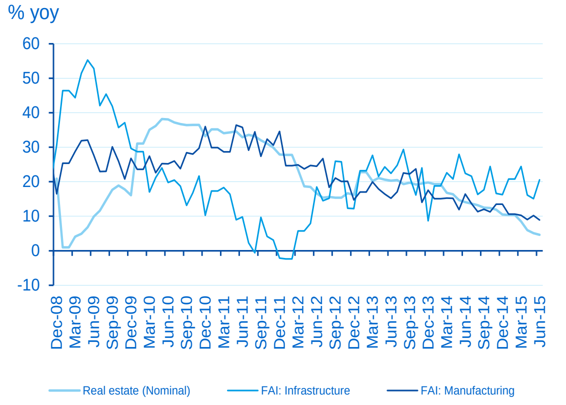
- **June economic indicators stabilized.** The growth of industrial production accelerated to 6.8% y/y in June, which is higher than the market expectation of 6.0% y/y and the last month's reading 6.1% y/y. Following a similar trend, urban fixed asset investment increased to 11.4% YTD y/y (Consensus: 11.2% YTD y/y), flat with the last month's reading. The investment in the real estate sector is still sluggish, as the enormous amount of property inventory keeps hindering new investment. (Figure 2) In the meantime, retail sales growth picked up to 10.6% y/y, compared to 10.1% y/y in the previous month, below the consensus of 10.2% y/y.
- **Stock market crash is to weigh on the full-year growth outlook.** Although the Q2 GDP outturn is still in line with the official 7.0% target, the adverse impact of the recent stock market crash on the real economy is expected to emerge in the second half of the year. In this respect, several contagious channels are at play: first, the suspension of IPOs (as part of the authorities' bailout policy set) will deteriorate financial conditions of firms queuing for being listed; second, the stock price plunge has evaporated an enormous amount of household wealth of individual investors, which tends to lower their consumption going forward; third, some firms have been using their shares as collaterals to borrow from financial institutions, thus, the stock market crash will limit their capacity to meet their fund needs as their lenders will apply higher haircuts for the stock collaterals.
- **Looking ahead, we anticipate more pro-growth measures to be deployed to stimulate growth.** On the front of monetary policy, we envisage that the PBoC will implement an additional interest rate cut of 25 bps in the third quarter, which is likely to be accompanied by a 50-bps universal reduction in the RRR. The PBoC will also increase the usage of targeted policy tools to ensure liquidity adequacy in the banking system in a bid to lower financing costs for firms, including selective RRR cuts, direct refinancing to banks, reverse repo, short or medium term lending facilities and other QE-like measures. On the fiscal front, as we anticipated, the authorities started to relax some tightening measures on local governments and to expand fiscal deficit, in order to avoid sharp fiscal consolidation at the level of local governments.

Figure 1
Q2 GDP outturns show economic rebalancing is on the track



Source: CEIC and BBVA Research

Figure 2
FAI maintains the last quarter's reading but real estate investment is still sluggish



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