Economic Analysis

Weaker August PMIs point to China's growth woes

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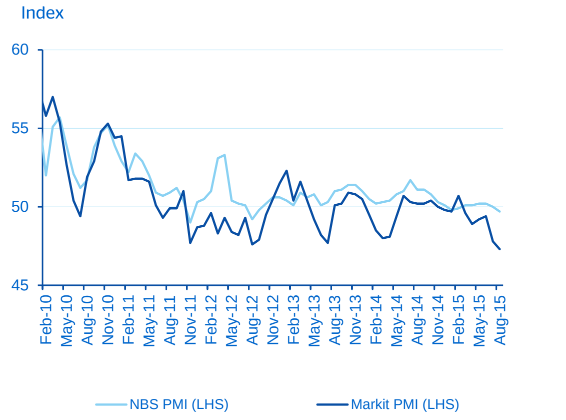
China's official PMI (released by NBS today) fell below the 50.0 watershed level to 49.7 in August, in line with the market expectation. (Consensus: 49.7 versus Prior: 50.0) The August reading of official PMI has registered its lowest level since 2012, indicating that the economy is mired in a contractionary territory. In the meantime, the final reading of Caixin China Manufacturing PMI dipped further to 47.3 in August (Consensus: 47.8) from 47.8 of the previous month. Indeed, the Caixin China Manufacturing PMI has been in the negative territory since March, which is due in part to the fact that its survey sample tilted toward SMEs and exporters. (Figure 1) Overall, manufacturing activities have not shown any recovery sign yet despite the authorities' stepped-up efforts of monetary easing. In our opinion, the lacklustre performance of growth stems from the weak external demand and the rising volatility of domestic financial markets. Unfortunately, both of the factors seem to persist for a while and therefore continue to weigh on China's growth. In view of this, we maintain our growth projections of 2015 and 2016 at 6.7% and 6.2% respectively.

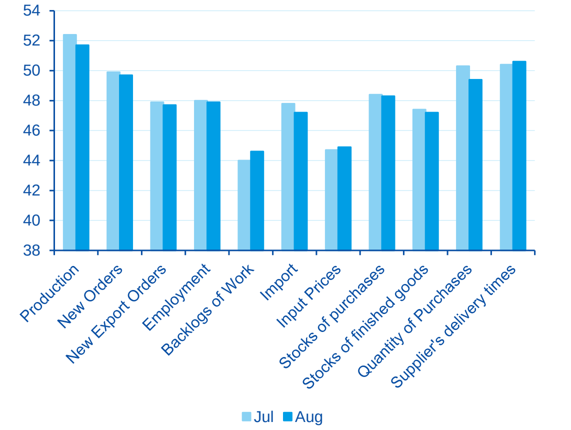
- **Broad-based decreases in NBS PMI sub-categories:** The index for New Orders decreased by 0.2 percentage points to 49.7, pointing to a deteriorated demand for manufacturing products. In the meantime, the Production Index decreased to 51.7 from the last month's reading of 52.4 but still remained in the expansionary region. Such a combination of declining demand indicators and expanding producing has made us even more uncomfortable since it could lead to the build-up of inventory and exert more downward pressure on manufacturing goods prices. Moreover, the Employment Index marginally decreased by 0.1 percentage points to 47.9, indicating the labour market condition for the manufacturing sector continues to deteriorate. Weakening Imports Index (August: 47.2 vs. July: 47.8) and exceptionally lower Stocks of Purchases Index (August: 49.4 vs. July: 50.3) also point to an anemic domestic demand (Figure 2).
- **On the policy front, we expect the authorities to deploy more growth-supportive measures in the rest of 2015.** On top of the interest rate and RRR cuts last week (see our previous China Flash), we envisage that the PBoC will enact more easing measures in the coming months. However, the prospective interest rate hike of the Fed and China's RMB devaluation have given rise to new uncertainties of financial markets and constrain the PBoC from loosening by interest rate cuts. The PBoC is likely to rely on the quantitative tools such as the RRR cuts and a number of unconventional monetary tools (namely selective RRR cuts, short-and-medium term liquidity facility, the Central Bank refinancing to commercial banks. etc) to spur domestic demand. On the fiscal front, the thrust should be to avoid sharp fiscal consolidation at the local government level. The authorities could further relax some tightening measures imposed on local government borrowing as well as expand the central government's fiscal deficit in the second half of the year. In addition to infrastructure investment, the authorities could consider more tax cuts for the corporate sector and increase public spending on social welfare.
- **No further devaluation is in sight for the rest of the year.** After the unanticipated devaluation of the RMB on August 11th, investors have significantly raised the concern over whether Chinese authorities are going to leverage the exchange rate tool as supplement to its stimulus policy set. We have a different thought on this point. The true intention of the PBoC is to reform the fixing rate mechanism and increase the flexibility of the RMB's exchange rate. However, it seems that the authorities have underestimated the market reactions before they made the move. In recognition of the elevated tension of global financial markets relating the move, China's authorities are likely to claw back and continue to maintain the exchange rate stability in the remainder of the year.

Figure 1
Both NBS PMI and Caixin China PMI are below the watershed of 50.0



Source: CEIC and BBVA Research

Figure 2
The decreasing of NBS PMI outturns are broad-based



Source: NBS and BBVA Research