Economic Analysis

Behind the better-than-expected Q3 GDP：Rebalancing or Rebasing?

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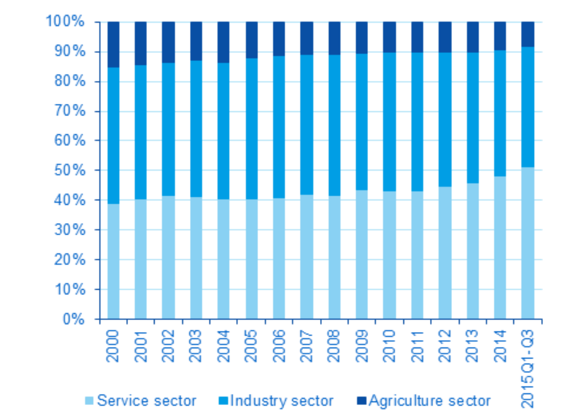
Today's announced Q3 GDP and a number of September activity indicators have depicted a rosy picture of economic rebalancing in China, despite a series of disruptions emerged in the third quarter including the stock market selloffs in June-July, the unexpected devaluation of the RMB in August, as well as the forceful shutdown of numerous small factories in Beijing's suburbs for the country's military parades in September. In particular, Q3 GDP expanded at 6.9% y/y (versus 7.0% in Q2), falling below 7.0% y/y for the first time since the first quarter of 2009 when the Global Financial Crisis (GFC) was at its height. Nevertheless, the year-on-year growth is way above our anticipations (BBVA: 6.5% y/y versus Consensus: 6.8% y/y). In sequential terms, growth pace modestly picked up to 1.8% q/q sa in the third quarter from 1.7% q/q sa previously. Moreover, the GDP components along with a number of September activity indicators are suggesting that China's economy is undergoing a rebalancing toward consumption and the service sector at a pace faster than we envisaged. (Figure 1) For example, the growth rate of industrial production in Q3 is around 0.3 ppt lower than that in Q2, indicating that the growth engine has increasingly tilted toward the service sector in Q3. By expenditure, final consumption accounted for 58.4% of GDP in the first three quarters of this year, significantly higher than the level of 51.4% registered in the previous year. (Figure 2)

Apart from economic rebalancing, we suspect that the Q3 GDP growth was, to a certain extent, boosted by some recent moves of the National Bureau of Statistics (NBS), including both a downward revision of 2014 in early September and the adoption of a new methodology for GDP statistics starting from the third quarter. All in all, the Q3 GDP outturn could introduce certain upward bias to our 6.7% full-year projection. Nevertheless, it is more important to realize that the headwinds to China's growth haven't abated yet. In view of this, the authorities need to continue their pro-growth measures to avoid a hard-landing.

- **September economic indicators are mixed.** The growth of industrial production declined to 5.7% y/y in September from 6.1% y/y in the previous month, below the market expectation of 6.0% y/y. (Figure 3) It indicates that the pressure on the manufacture sector is still on the rise due to the prevalent overcapacity problem. Following a similar trend, urban fixed asset investment decreased to 10.3% YTD y/y in September (Consensus: 10.9% YTD y/y; August: 10.8% YTD y/y). The sluggish investment is led by the real estate sector, where a large chunk of property inventory keeps hindering new investment. (Figure 4) By contrast, retail sales growth edged up to 10.9% y/y in September (consensus: 10.8% y/y) from 10.8% y/y in August. Relatedly, online retail sales are reported to increase by 36% on a year-on-year basis through September.
- **It still remains a question to what extent the Q3 GDP outturn was boosted by the NBS moves.** In early September, the NBS announced a downward revision of 2014 GDP growth rate from 7.4% to 7.3%. Indeed, the major revision of gross adding values happened in the service sector, which likely raised the service sector's contribution to the GDP this year. More importantly, the NBS, in today's press conference, said that the Q3 GDP is based on an improved calculating methodology as part of China's commitment to subscribe to the IMF's Special Data Dissemination Standard (SDDS), which sets up higher requirements for the Chinese authorities' released data compared to the current practice under the General Data Dissemination System (GDDS). The NBS pointed out that the quarterly GDP figures under the new methodology will be more accurate and suitable for comparison on sequential terms. However, they haven't provided the historical series of GDP under the new calculating method (even not the revised outturns of Q1 and Q2), which makes it difficult for us to assess its real impact on the Q3 GDP outturn.

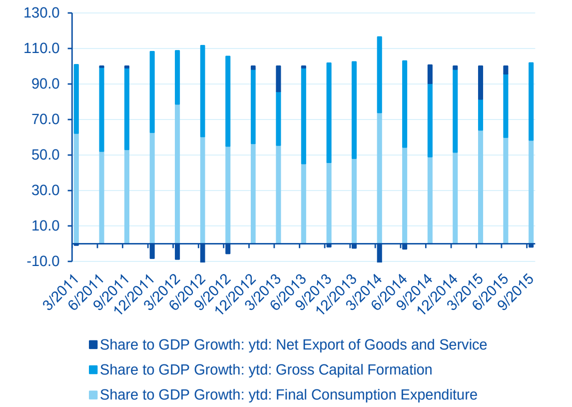
- **Looking ahead, we anticipate more easing measures to be deployed to stimulate growth.** Despite the better-than-expected GDP outturn in the third quarter, a number of September activity indicators point to a slowing growth momentum. That being said, the authorities need to deploy more easing measure to spur growth and avoid a hard-landing scenario. On the monetary policy front, the prospective FED's interest rate hike and China's RMB devaluation may constrain the PBoC from trimming interest rate. Therefore, the PBoC is more likely to rely on 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 stimulate domestic demand. Therefore, we project three additional RRR cuts with 50 bps each time and one more 25 bps interest rate cut in the rest of the year. On the fiscal front, the thrust should be to avoid sharp fiscal consolidation at the local government level. The authorities are expected to further relax some tightening measures imposed on local government borrowing as well as to expand the central government's fiscal deficit in the last quarter 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.

Figure 1
Q3 GDP outturns show economic rebalancing is on the track



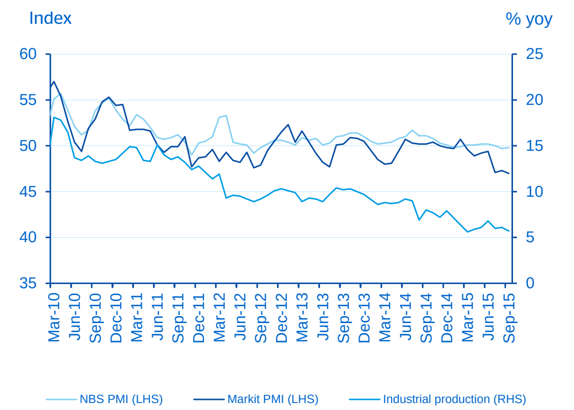
Source: CEIC and BBVA Research

Figure 2
Final consumption accounts for 58.4% of GDP in first three quarters of 2015, higher than in 2014



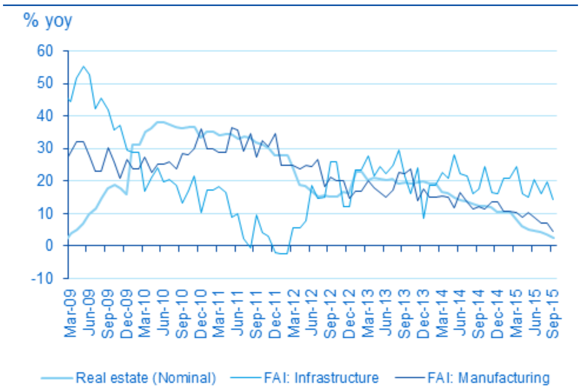
Source: CEIC and BBVA Research

Figure 3
Industry production surprised the market to the downside in September



Source: CEIC and BBVA Research

Figure 4
The sluggish investment is led by real estate, where high property inventory hinters investment



Source: CEIC and BBVA Research

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