Economic Analysis

China | Weak growth momentum has prompted the authorities to cut banks' reserve ratio

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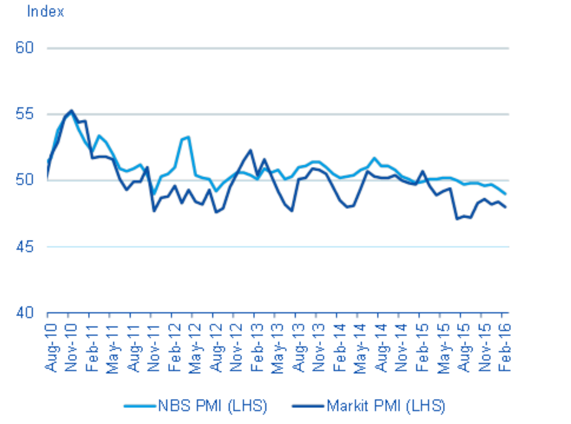
China's official manufacturing PMI (released by NBS today) fell to 49 in February, down from 49.4 in January and below the market expectation (Consensus: 49.2). Following the same trend, the Caixin China Manufacturing PMI (the previous HSBC Markit PMI which includes a survey sample tilting toward SMEs and exporters) dipped further to 48 in February from 48.4 in the previous month. More importantly, both of the manufacturing PMI outturns have been below the 50 watershed level since last August (Figure 1), pointing to persistent woes in the country's manufacturing sector stemming from the deteriorating overcapacity problem, sluggish external demand as well as escalated policy uncertainty surrounding over the transition of exchange rate regime and the extent of policy stimulus.

In the face of strong growth headwinds, the authorities have beefed up their efforts to spur domestic demand. On top of paying lip service in the recently wrapped-up G-20 meeting of central banks and Finance Ministers, the People's Bank of China cut the reserve requirement ratio (RRR) by 50 bps yesterday, the first time since last October. The move is expected to inject liquidity of RMB 700-800 billion into the banking sector, enabling large lenders to pump funds to the real economy. Looking ahead, we expect the authorities to maintain their easing stance of monetary and fiscal policies. In view of strong headwinds to growth, we maintain our growth projection of 6.2% for 2016, lower than the official floor target of 6.5%.

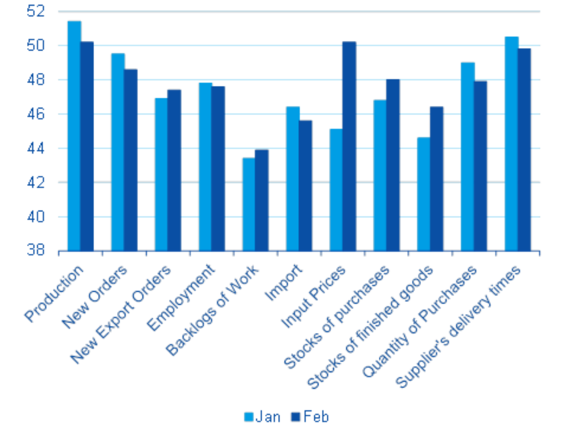
- **Broad-based decreases in NBS PMI sub-categories:** The index for New Orders decreased by 0.9 percentage points to 48.6 while the Production Index decreased to 50.2 from the last month's reading of 51.4. (Figure 2) Moreover, the Employment Index edged down by 0.2 percentage points to 47.6, exerting additional pressure on the labour market. The only good news is that the New Export Orders Index rebounded marginally to 47.4 from 46.9 in the previous month. However, given the strong seasonality of trade data around the Chinese New Year, such a small pickup cannot change the dim growth outlook.
- **More monetary easing measures are in the pipeline.** We envisage that the PBoC will enact more easing measures through the year, including three additional RRR cuts of cumulative 150 bps and two cuts in the benchmark lending rates of cumulative 50 bps. These measures are likely to be frontloaded. As we explained in *our recent report* about China's new monetary policy framework, interest rate cuts now appear to be symbolic moves after the completion of interest rate liberalization last year. The authorities will increasingly use some newly introduced measures along with Open Market Operation (OMO) as regular policy tools, including the Standing Lending Facility and Medium Lending Facility etc. All in all, the authorities will continue to use available tools to guide market interest rates to the south.
- **However, financial risks could rise over the easing measures.** Side effects of monetary easing could become acute than before, due to both investors' fragile confidence and drawbacks in the monetary policy transmission mechanism under a low-growth environment. Indeed, some of previously implemented monetary easing measures have boosted bank lending and ballooned housing prices in a number of large cities (Figure 3 and 4) but do little help to pick up the growth momentum of real economic activities. As a consequence, housing bubble risks stand out again, echoing last year's boom-bust of China's equity market. That being said, the authorities need to balance the needs of boosting growth with policy stimulus on the one hand and contain financial risks on the other hand.

Figure 1
Both NBS PMI and Caixin China PMI are below the market consensus and the prior readings



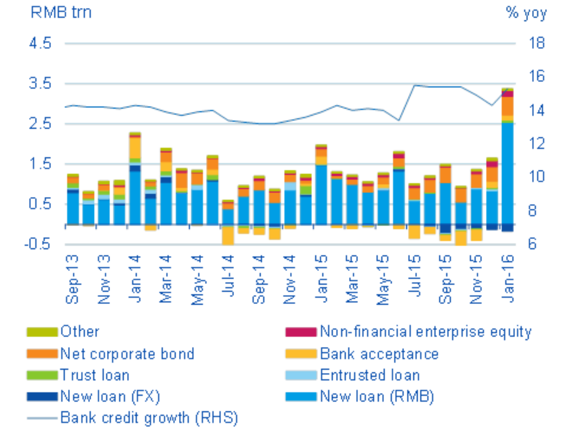
Source: CEIC and BBVA Research

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



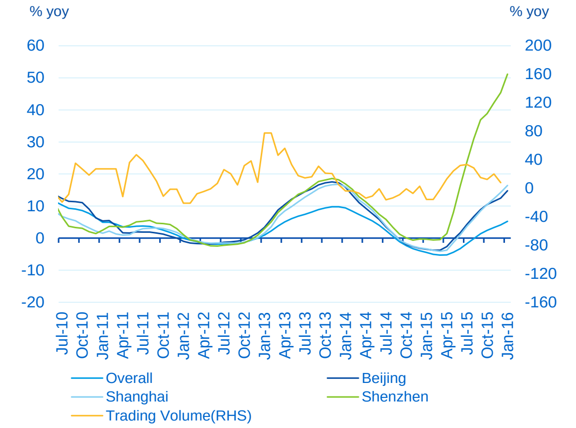
Source: NBS and BBVA Research

Figure 3
January credit figures were significantly higher than the consensus and the prior readings



Source: CEIC and BBVA Research

Figure 4
Housing prices have picked up significantly in tier-1 cities



Source: NBS and BBVA Research

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