

# China: Vulnerability sentiment stays upbeat in September

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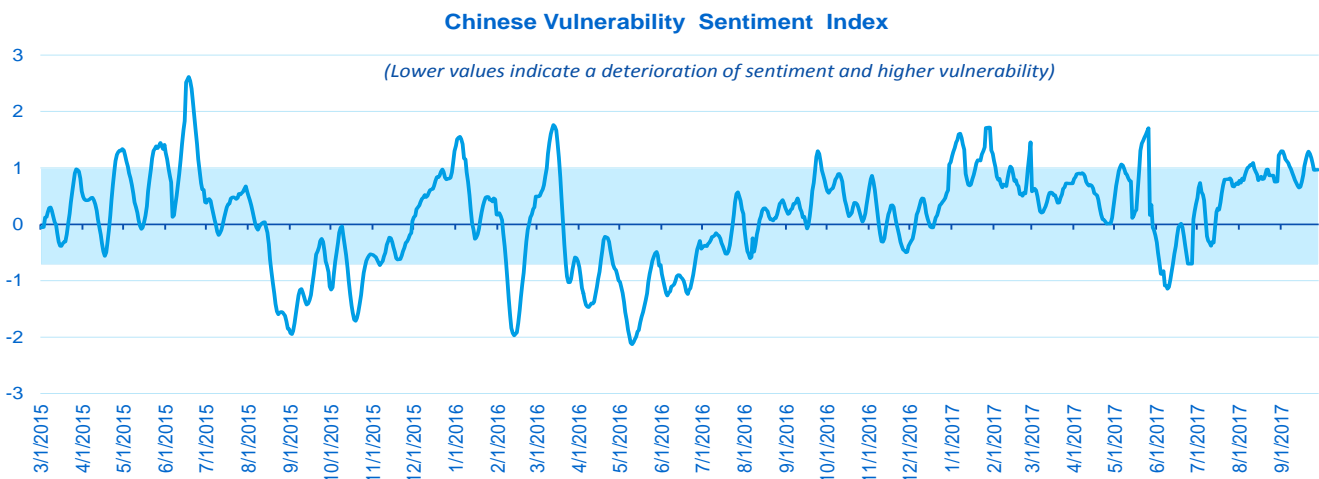
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Our China Vulnerability Sentiment Index (CVSI) for September held on to its recent gains with regulators focusing on maintaining macro-financial stability ahead of the crucial 19<sup>th</sup> Chinese Communist Party Congress (CCP), scheduled October 18<sup>th</sup>. An improvement in SOE component was partly offset by deterioration in Housing Bubble and Exchange Rate indices. Activity moderation extended in August, led by policy efforts to reduce overcapacity, curb leverage and reduce housing inventory. PBOC's prudent policy approach continues as it actively manages liquidity while shifting towards weaker Yuan fixing to cushion growth.

## September CVSI extends gains ahead of 19<sup>th</sup> Chinese Communist Party Congress

Our CVSI improved for the second straight month in September (Figure – 1), led by two key factors – 1) A constructive slowdown in Chinese activity momentum amid policy efforts to reduce overcapacity, curb leverage and reduce housing inventory and 2) A policy focus on ensuring macro-financial stability ahead of the crucial 19th Chinese Communist Party Congress in October, which marks a leadership reshuffle and announcement of a new set of important policy guidelines and certain targets of social and economic development for the next five years. Our SOE vulnerability Index (Figure – 2 and 7) softened. While China's corporate deliveraging cycle remains underway, its pace has been lackluster, and debt/GDP ratio continues to rise, although at a slower pace – a key reason cited by rating agency S&P in its downgrade of China's Sovereign rating last week to A+ from AA-. Meanwhile, Housing Bubble vulnerability Index deteriorated (Figure – 3) in September. Even as China's housing market gradually cools, chances of a notable and long lasting correction in house prices remain low given limited new supply and divergence across cities. Our Shadow Bank Vulnerability Index (Figure – 4), continues to post notable improvement, reflecting the ongoing rotation away from shadow banking to traditional bank financing as a part of policy efforts to repair financial fragilities in the system. Finally, the deterioration in Exchange Rate Vulnerability Index (Figure – 5) can be attributed to underlying risks to exchange rate stability arising from imminent Fed rate hikes, US fiscal policy uncertainty and geopolitical conflicts. These risks complicate reaction function of PBOC, which has recently shifted towards a weaker Yuan fixing aimed at cushioning the ongoing growth slowdown.

Figure 1. China Vulnerability Sentiment Index (CVSI)



Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC and Wind

### In sum...

A policy driven slowdown in China's economic growth should be viewed constructively, especially when consumption and services sectors continue to act as key stabilizers. However, the growth of aggregate debt financing by China is unlikely to come down very sharply unless reforms are expedited. The 19<sup>th</sup> CCP next month can provide some conviction in this regard.



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