Regional Analysis China

China's economy is still searching for a bottom

Expansión (Spain)

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Last week China's government announced its GDP figures in the second quarter as well as a batch of activities indicators in June such as industrial production, retail sales and fix-asset investment. These headline figures still look fine. In particular, the Q2 GDP growth moderated to 6.2% y/y from 6.4% y/y in Q1. Although the reading is the lowest quarterly one since 1992, the pace of growth slowdown appears to be mild, in particular taking into account the unexpected escalation of trade tensions with the US in May. On sequential terms, the growth rate even edged up to 1.6% q/q from 1.5% q/q in Q1.

In the meantime, the readings of June activity indicators even have some highlights. Industrial production surprisingly rebounded to 6.3% y/y in June from 5.0% y/y in May while the growth of retail sales accelerated to 9.8% in June from 8.6% in the previous month. The anemic fixed-investment also recovered somewhat in June.

The only bad news comes from inflation. Headline CPI inflation increased by 2.7% y/y in June due to the fast rising food price. However, it is mainly due to the fact that rampant African Swine Fever drove up pork prices. Other items contained in the consumer price index are still tame.

Despite the abovementioned good outturns in June, it is too early for investors to breathe a sigh of relief for now. Meticulous investors will find that these good headline figures are boosted by a couple of one-off factors. Firstly, the excellent retail sales in June were largely caused by a spike of auto sales, which grew by 17.2% y/y in June compared to the average growth rate of -2.0% during January-May. Indeed, China will implement a new standard for vehicle emission, effective from July 1st. Therefore, those automakers tried all means to reduce their inventory of cars in June which are not up to the new standard. We expect the auto sales to drop back to a sluggish level in the coming months after the implementation of the new standard for vehicle emission.

Secondly, to boost infrastructure investment the central government substantially increased the quota of special bond issuance to around RMB 2 trillion at the beginning of this year. It is reported that the quota has almost been used up in the first half of the year, functioning to stabilize the fixed asset investment. However, it also means that local governments need to find new fund sources to support their infrastructure investment in the second half of the year since the central government is unlikely to expand the quota within this year.

With the fading of the abovementioned one-off factors, China's economy might be subject to further downward pressure in the second half of the year. What complicates the case is the unsettled trade dispute with the US. Although a temporary truce was reached after the one-to-one meeting between President Trump and Xi at Osaka G20 meeting this June, the risk of dispute escalation itself is sufficient to dampen investors' confidence and hamper related economic activities.

In the face of stronger growth headwinds, China's authorities usually will deploy more stimulating measures to stabilize the economy. Nevertheless, we anticipate that their policy reactions will be measured this time. The ballooning debt level now has become a relevant concern for the authorities to unveil more pro-growth initiatives. According to the estimate of Bank of International Settlement, China's total debt level amounted to 254% of its GDP as of the end of 2018. The majority of China's debt belongs to the corporate sector. If the debt level continues to grow, it will pose very serious threats to the stability of China's financial sector. Therefore, the authorities need to strike a balance between sustaining a decent growth on the one hand and preventing fast debt accumulation on the other.

All in all, we would like to maintain our full-year growth projection of 6.0% for 2019. A smooth solution of trade dispute with the US could bring certain upside risk to our forecast but not much. More importantly, the authorities need to carefully use policy tools at disposal to avert a hard-landing as well as systemic financial risks.

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