Economic Watch

China | Lehman Moment or Volcker Moment? A comment on recent economic activities and policy

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Although at the beginning of this year, most China economists are talking about 2021 is probably a "respite" for Chinese economy given China's "first-in, first-out" of the pandemic while other countries are still grappling with the Covid-19 virus, what eventually surprised them to the downside is that the recent regulatory storms, real estate giants' default and energy crisis etc. all have brought the economy to a slowdown risk. Indeed, the Q3 GDP decelerated remarkably to 4.9% y/y from 7.9% in Q2 while the quarter on quarter growth also moderated to 0.2% q/q from 1.2% q/q previously. Although growth slowdown is unanimously verified, to what extent these growth headwinds will drag on growth is still divergent. One voice, mostly by some global investors, has been talking about China's "Lehman Moment" since the default of Evergrande, as they believe it will lead to systematic financial risks to Chinese financial system and the whole economy (which we excluded this scenario in our recent Economic Watch: China | Will the fall of Evergrande lead to a systematic breakdown?); some other voice is talking about "Volcker Moment" of China, borrowing the concept of the FED Chairman Volcker in 1980-1982 who dealt with stagflation by hiking interest rates which led to recession but eventually paved the way for the two decades prosperity, mimicking Chinese authorities are reluctant to ease monetary policy and regulations amid short-term growth slowdown to trade for long-term social equality; of course, there are also more positive voices, anticipating the economy's resilience as high-tech manufacturing and new energy sector could bring about opportunities to offset these growth headwinds.

To get a clear picture of China's economic outlook, the October activity indicators might answer this question better than dwelling on the economists' own preconceptions. The real economic indicators released by the National Bureau of Statistics today displayed a mixed picture of Chinese economic activities after a flurry of recent regulatory storms and policy initiatives targeting on "common prosperity" and carbon neutrality, as well as the important growth model transformation from consumption driven growth to high-tech manufacturing growth. (See our recent Economic Watch: China | Understanding China's new growth model) In particular, the retail sales and industrial production both bounced back from the previous readings while fixed asset investment continued its slowdown trend. That means, both supply side and domestic consumption indeed have some resilience, but the investment was dragged significantly by real estate sector slowdown with the contagion effect of Evergrande and other real estate giants' default.

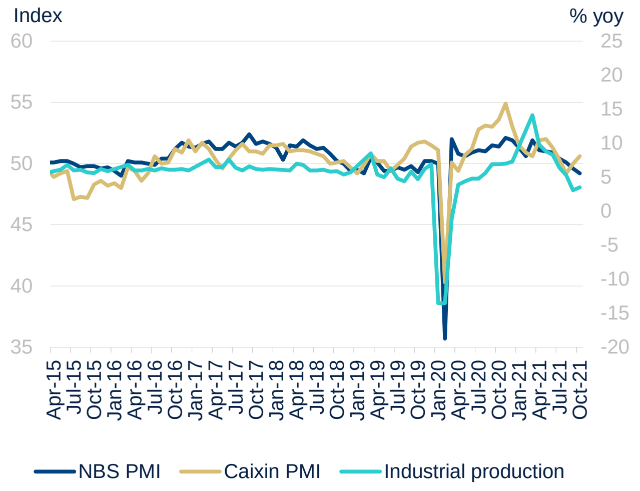
On balance, our view on Chinese economic outlook in the next year is that slowdown will continue as the authorities are willing to sacrifice short-term growth figures to trade for long-term social equality and carbon neutrality, but the economy will not turn to either Lehman or Volcker Moment. For the former situation, there is limited chance that the Evergrande default will lead to systematic risk (Economic Watch: China | Will the fall of Evergrande lead to a systematic breakdown?) while for the latter one, China is very far away from "stagflation" as the downward trending pork price and low CPI environment still provide large policy room for easing measures. On the policy side, monetary policy will be marginally eased in the next year but it does not mean a deluge of strong stimulus; while fiscal policy will be more proactive, mainly focusing on processing local government bond issuance. Altogether, we maintain our 2021 GDP forecast to 8.0% from 8.2% (Market consensus: 8.2%; IMF: 8%), which still way above the conservative official target of 6% announced in the “two sessions” this year.

Regarding October activities, on the supply side, the year on year growth of industrial production bounced back to to 3.5% y/y from 3.1% y/y in the previous month (market consensus: 3% y/y), and the seasonal adjusted m/m growth also picked up to 0.39% m/m from 0.05% m/m previously. By categories, electric vehicle production leads the rebound, which remains the main pillar of industrial production growth at 127.9% y/y. Following that is the integrated circuits and industrial robots which registered 22.2% y/y and 10.6% y/y respectively, benefiting from the industry policy transformation from prioritizing consumption to the “profession, refinement, specialty, innovation” type of high-end manufacturing. By contrast, the steel production and other commodity production kept declining, reflecting electricity crunch and the carbon emission led capacity reduction. In particular, the crude steel production growth tumbled to -23.3% y/y from -21.2% y/y in the previous month and the cast iron also dipped to -19.4% y/y. (Figure 1)

On the demand side, fixed-asset investment (FAI) continued trending down to 6.1% ytd y/y from 7.3% ytd y/y previously (market consensus: 6.2% ytd y/y), mainly dragged by real estate investment, as the contagion effect of Evergrande’s default looms large. By components, the previous pattern remains as manufacturing FAI surpassed the infrastructure FAI and real estate FAI to lead the investment growth, although all of them registered deceleration readings. In particular, manufacturing FAI decelerated to 14.2% ytd y/y from 14.8% ytd y/y previously, higher than the infrastructure FAI at 1% ytd y/y (prior: 1.5% ytd y/y) and real estate at 7.2% ytd y/y (prior: 8.8% ytd y/y) respectively. Looking ahead, as the local government bond issuance is anticipated to rev up in the rest of the year to support growth, the infrastructure investment is set to bounce back, but the sluggish real estate investment will continue due to the extremely weak market sentiments. (Figure 2 and 3)

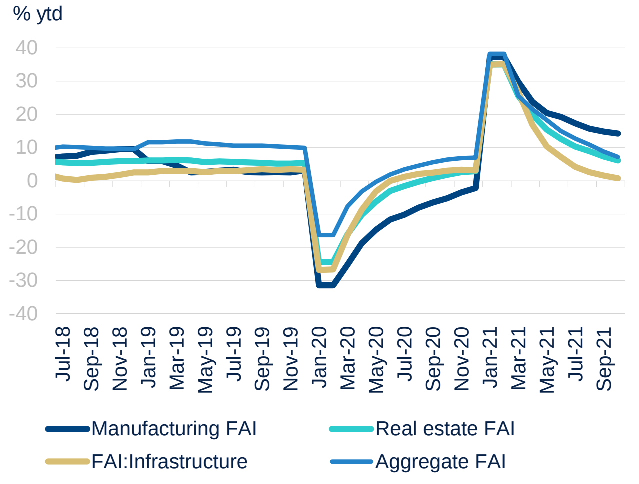
By contrast, retail sales’ year-on-year growth bounced back to 4.9% from 4.4% y/y previously (market consensus: 3.3% y/y), with its month-on-month growth also rising from 0.43 m/m to 0.3% m/m. However, it still needs perseverance to catch up with the pre-pandemic growth. The pick-up of retail sales shows the consumption strengthened as households in China gradually adapt the coexistence with Covid-19 pandemic as the new normal of the society. By component, communication equipment showed a significant increase, which ticked up to 34.8% y/y. In addition, cigarettes and wines sales growth also rebounded to 14.3% y/y. (Figure 4)

Figure 1. **INDUSTRIAL PRODUCTION BOUNCED BACK IN OCTOBER**



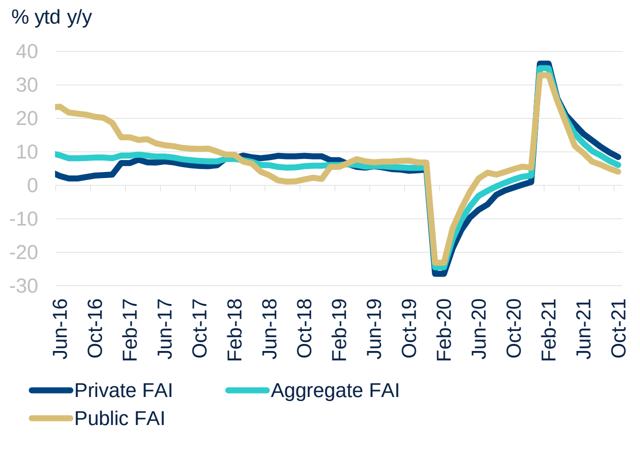
Source: CEIC and BBVA Research

Figure 2. **AGGREGATE FAI REMAINED DECELERATION, WHILE REAL ESTATE INVESTMENT DRAGGED BY RECENT EVERGRANDE DEFAULT AND HOUSING REGULATIONS**



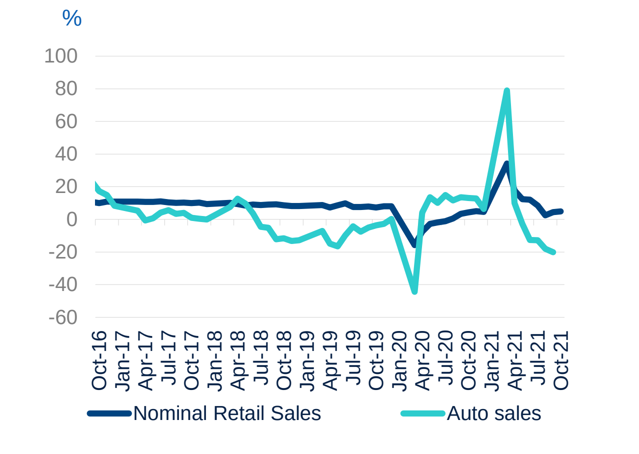
Source: CEIC and BBVA Research

Figure 3. **PRIVATE FAI SURPASSING PUBLIC FAI AMID THE PREVIOUS FISCAL POLICY NORMALIZATION**



Source: CEIC and BBVA Research

Figure 4.**RETAIL SALES ALSO REBOUNDED IN OCTOBER**



Source: CEIC and BBVA Research

After dwelling on the October economic activities, going back our question at the beginning, the answer of China's economic outlook becomes clearer. China is neither experiencing Lehman Moment nor Volcker Moment. In particular, there is no systematic risk from Evergrande default, let alone the recent regulatory storms and carbon neutrality target, which will eventually benefit the economy in the long term. The recent October activity indicators suggest the economy, particularly industrial production and consumption has some resilience in front of all of recent growth headwinds, while the new policy priority of new energy sector and high-tech advancement will provide more opportunities to offset these headwinds as well.

However, we indeed agree that the recent weaker-than-expected economic growth reflected the authorities' intention to concern more about the long-term structural issues instead of the short-term growth figures, thus to press ahead various structural reforms to pursue “common prosperity” and social equality taking the “first-in, first-out” time window. Unfortunately, the authorities’ original good willingness coincidentally met with the recent power crunch, production curbs under the carbon neutrality pledge, real estate giant’s default, bottle-neck of global supply chain and soaring energy prices, etc., leading to a faster-than-expected growth deceleration. In addition, growth slowdown also exposed the vulnerability of China’s anti-virus strategy as authorities’ “zero tolerance” to the pandemic has become increasingly unaffordable.

The recent slowdown of China’s economy will prompt the authorities to deploy more pro-growth policy initiatives in the rest of the year and 2022. Due to the comparatively closed capital account and independent monetary policy, as well as the contained inflation environment which is contrast with that of the advanced economies, China will have quite a diverging monetary policy stance with the advanced economies. By contrast with the US QE tapering and potential interest rate hikes among other economies, we anticipate the authorities will have more loosening monetary measures, such as to implement 1-2 more RRR cuts (50-100 bps cumulatively) and 10-bps cut in LPR in the coming months together with other targeted easing measures, although no deluge of strong monetary stimulus is expected. From the fiscal policy perspective, local government bond issuance is also anticipated to accelerate to boost infrastructure investment. Beyond that, the recent regulatory forbearance particularly on real estate sector might add further impetus for economic growth given the large share and strong spillover effect of housing sector to the economy. All in all, the authorities are well aware of the growth deceleration and will strike a balance between stimulating growth and pressing ahead structural reforms going forward.

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