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China: Annual growth falling to its lowest rate since more than a decade with risks tilted to the downside

- A weaker global economic environment, a policy induced correction in the real estate market and a structural shift towards domestic demand led the Chinese economy to a gradual slowdown for six consecutive quarters.
- Following dismal economic data so far in the third quarter, China's second-half recovery looks to be on hold. The data underscore risks that the full-year growth rate may slide to its lowest in more than one decade.
- The government seems to accept the continued downward adjustment of growth expectations, since a more moderate performance of the Chinese economy is healthier and more sustainable. However, insufficient policy support could create significant downside risks to growth.
- We expect policy loosening to become more visible in the next few months, with the impact on the real economy to be felt only gradually. Therefore, growth is most likely to stabilize rather than recover in the second half.

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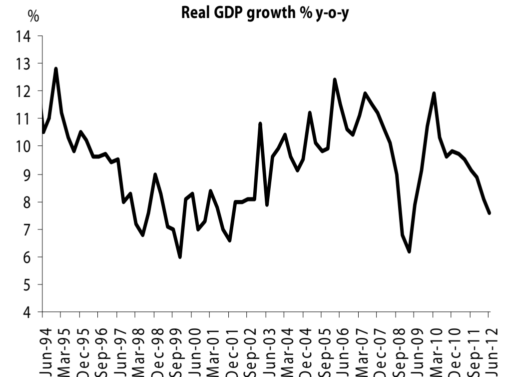
Overview

A weaker global economic environment, a policy induced correction in the real estate market and a structural shift towards domestic demand led the Chinese economy to a gradual slowdown for six consecutive quarters, with real GDP growth slowing to 7.6% in the second quarter of 2012 from 8.1% y-o-y in Q1 2012 and 8.9% in Q4 2011 (Figure 1). The global slowdown, mainly related to the euro crisis, made the deceleration more pronounced, slowing the economy more than expected and probably more than the authorities had intended. Following dismal economic data so far in the third quarter, China's second-half recovery looks to be on hold. Indeed, the data underscore risks that the full-year growth rate may slide to its lowest in more than one decade. Meanwhile, policymakers have held back on stimulus this year, particularly in the first half, in their attempt to rein in the property market boom and avoid a jump in bad debt. The government seems to accept the continued downward adjustment of growth expectations, since a more moderate performance of the Chinese economy is healthier and more sustainable. Further policy delay, however, could create additional downside risks to growth. We expect policy loosening to become more visible in the next few months, with the impact on the real economy to be felt only gradually. Therefore, growth is most likely to stabilize rather than recover in the second half.

Figure 1



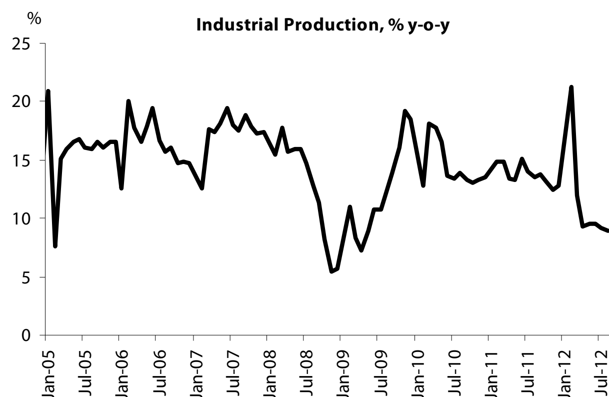
Source: Bloomberg

The slowdown continues so far in Q3 2012…

In contrast to the common expectation that China's economic growth should bottom in the second quarter, and despite some improvement in June, July and August activity indicators proved disappointing, showing that policy easing so far has not been strong enough to reverse the economy's weakening. Industrial production, the most reliable

monthly proxy for overall activity and highly correlated with GDP, decelerated further to 8.9% y-o-y in August, its lowest rate since 2009, from 9.2% y-o-y in July and an average of 9.5% in Q2 and 11.6% in Q1 (Figure 2). Weak exports and slower investment activity continue to be the main causes of slower industrial production growth.

Figure 2

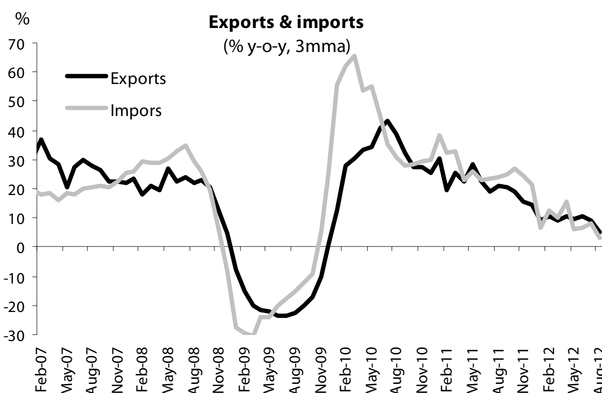


Source: Ecowin

With respect to China's trade, the deterioration of the external environment in conjunction with weak domestic demand is taking an increasingly significant toll on trade growth. Over the first half of the year nominal export and import growth came in at an average of 9.7% y-o-y and 8.3% y-o-y, down from 20.6% and 25.5% in 2011, respectively (Figure 3). In the meantime, in July, export growth decelerated sharply to 1% y-o-y from 11.3% y-o-y in June and stabilized slightly up at 2.7% y-o-y in August. While export demand weakened across all markets, the slowdown of demand from the EU constituted the major drag on exports (Figure 4). In particular, exports to the EU, which accounts for 17% of total Chinese exports, declined by about 20 percentage points in August compared to a year earlier. Although growth of exports to the US remains at a positive territory, the decelerating trend is similar to that of the EU over the past few months. Even shipments to ASEAN, which is the strongest contributor to overall export growth and had remained resilient so far, declined significantly over the summer (10.3% y-o-y in August compared to 13.3% y-o-y in July and 19.8% y-o-y in Q2). Softer global demand combined with subdued expectations for new export orders point to weak exports for the rest of the year.

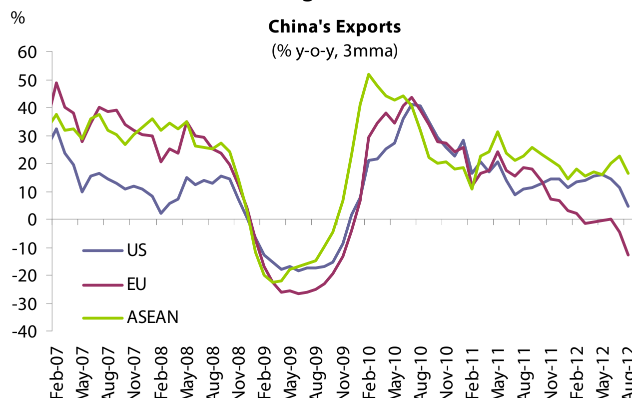
Import growth was dragged by industry destocking, tepid domestic demand and faltering exports, falling to -2.6% y-o-y in August from 4.7% y-o-y in July. The weakness in China's imports has mainly been driven by a broad-based slowdown in major commodity imports, which is attributed to both volume and price drops. Weak imports volume of major commodities reflects mainly the sustained weakness of investment demand, as well as continued slowing of stockbuilding on the back of weak industrial activity. In terms of volumes, crude oil imports turned negative, falling by 12.5% compared with 12.4% y-o-y growth in July. Imports of steel products continued to fall, declining by 11% y-o-y in August (July: -6.5% y-o-y), while iron ore import growth slowed to 5.7% y-o-y from 6.1% y-o-y in July (Figure 5).

Figure 3



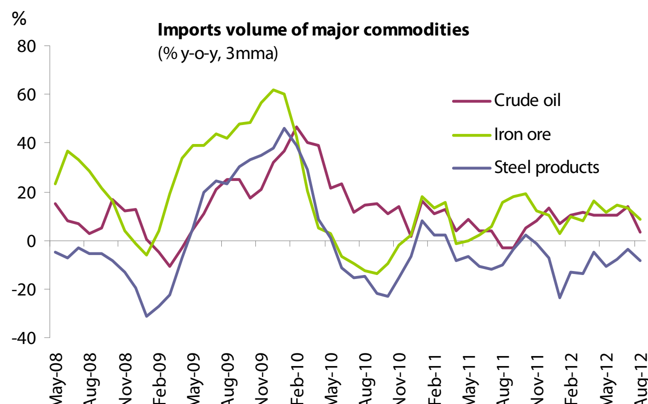
Source: Bloomberg

Figure 4



Source: Ecowin

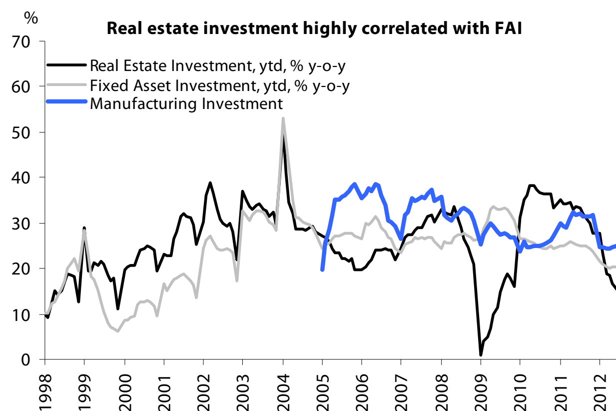
Figure 5



Source: Ecowin

With respect to investment, there are two main reasons behind the marked slowdown of investment growth: the moderation in manufacturing mainly due to the exports slowdown and the deceleration in real estate investment as a result of persistent tightening measures to ease property price increases. Funding constraints have also curbed investment growth. The slowdown of gross fixed capital formation was particularly felt in manufacturing and real estate (Figure 6). Fixed asset investment excluding rural households and not adjusted for inflation rose 20.2% in the first eight months of 2012. That was the weakest increase for the Jan-August period since 2001. Property development investment for the first eight months of the year was up 15.6% from a year earlier compared to 27.9% in 2011, while manucasturing investment increased 23.9% year-to-August, down from 31.8% y-o-y in 2011.

Figure 6



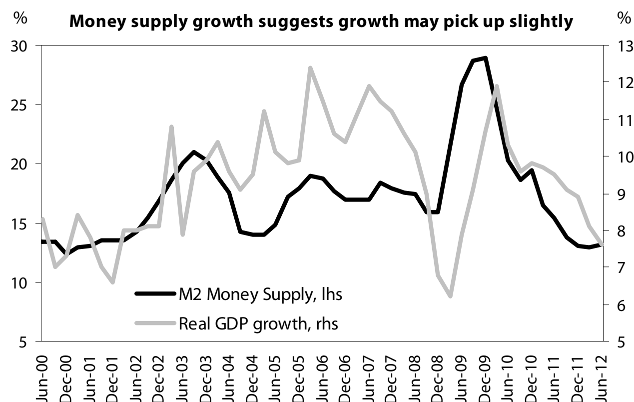
Source: Ecowin

Meanwhile, China's official manufacturing PMI index in August confirms that a second half recovery remains distant. The index slipped to 49.2, down 0.9 percentage points from July, the first time in the past nine months to see a reading below the 50 threshold that indicates expansion. It is worth noting that although the new export orders stabilized at the subdued level of 46.6, the new orders index declined further to 48.7 from 49. This may suggest that weak business confidence and a lack of additional effective policy support are weighing on domestic demand. Of the five components of headline PMI, raw material inventory and output declined the most.

…suggesting unchanged or weaker GDP growth in Q3 compared to the second quarter

Latest Chinese data releases confirm that Q3 GDP growth is most likely to remain unchanged or even slow down further compared to Q2, on the back of weakening external and domestic demand and inventory cuts. Indeed, based on the linear relationship between IP and GDP growth, we estimate real GDP growth to decline only modestly to 7.5% y-o-y in Q3 2012 from 7.6% y-o-y in Q2. In Q4 growth may pick up slightly as it is implied by money supply growth, a forward-looking indicator for growth, which appears to have bottomed. It climbed to 13.9% y-o-y in July from 13.6% y-o-y in June and 13.2% y-o-y in May (Figure 7).

Figure 7



Source: Bloomberg

Both fiscal and monetary policy action has been quite muted so far this year…

Weak activity growth in July and August brought the risks on the annual GDP growth forecast to the downside and fueled renewed fears of a possible hard landing of the economy. Moreover, it escalated the risk that the government will miss its full year growth target of 7.5%. In the meantime, both fiscal and monetary policy action has been quite muted so far this year, as the government is trying to rein in the property market boom and avoid a jump in bad debt. In fact, policymakers tolerate slower growth in order to rebalance the economy and transform the growth model. The central bank, in particular, has held off from monetary policy loosening since early-July when it cut benchmark interest rates for the second time in less than a month. Besides, the reserve requirement ratio has not been cut since May (the central bank lowered the reserve requirements three times since November 2011 by 50 basis points each time). Furthermore, on its attempt to strike a balance between unwinding the last fiscal stimulus and adjusting policies to support the slowing economy, the government has not implemented sufficient growth stimulating measures in order to change the growth trend around. In other words, it seems that policy easing so far has worked to avoid a deeper downturn of China's economy, but not effective enough to trigger a rebound.

…but the government is expected to roll out more measures to stabilize growth in the coming months, though any measure will be targeted and cautious

Looking forward, we believe that the government will do what is necessary to bolster growth for two reasons. First, as the leadership transmission comes near, the authorities should be decisive to act firmly and effectively to prevent a prolonged

slowdown in growth. Second, as we have already mentioned, the exports outlook for the rest of the year remains grim. This is particularly worrisome for policymakers as the export sector is labour-intensive. This implies that a continued slowdown in exports would result in a significant deterioration in job market conditions. As a result, policymakers are likely to be more determined to take measures to support growth and ensure social stability.

In fact, if needed, China has considerable room to ease monetary and fiscal policy to support growth. Unlike advanced economies, China has comfortable leeway to cut interest rates as they are still at a relative high level (for example the RRR for large banks stands at 20%) (Figure 8). Moreover, China's fiscal situation is relatively healthy. The budget for 2012 calls for the fiscal deficit to rise to 1.5% of GDP this year from 1.1% of GDP in 2011, which is still a low level. Overall government debt remains at comfortable levels, despite the increase in local government borrowing. National government debt (including local governments' debt) is about 45% of GDP, well below that of advanced economies, enhancing the government's capability to respond to a marked slowdown in growth. In addition, in a worst case scenario, some of the tightening measures targeting the calming down of the property market could be withdrawn. The problem is that both monetary and fiscal easing entails some drawbacks for the Chinese economy at this stage. Specifically, monetary easing will underpin a rebound in the property market, something that will not be greeted as good news by the government, given its commitment to contain house prices. Meanwhile, fiscal easing will have to rely mainly on investment and, particularly, infrastructure investment in order to have a significant impact on the economy. Apparently, this is not desirable at the moment, given China's attempt to rebalance the economy away from investment and towards consumption.

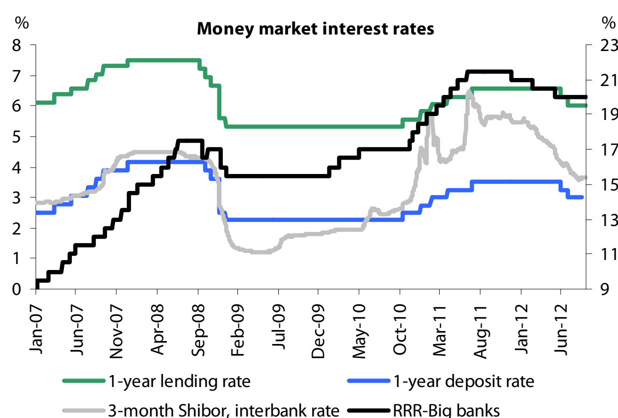
That said, we believe that any policy stimulus in the coming months will likely be moderate and targeted. The impact of such stimulus will most likely be felt only gradually. In particular, the government is tilted towards the following three areas:

1) *More monetary easing*. Weak growth should leave room for additional interest rate cuts. We expect the PBoC to proceed with two additional 25bp cuts to its leading benchmark rates in the rest of the year. In addition, we expect the reserve requirement ratio to be cut by 100-150bp before year end so as to keep liquidity in the banking system abundant. With respect to the slight increase in inflation in August (2.0% y-o-y from 1.8% y-o-y in July), we believe that it is not a constraint on monetary policy at this stage particularly as long as it remains substantially below the central bank's target of 4.0% (Figure 9). The acceleration of inflation was led by an increase in food inflation from 2.4% y-o-y in July to 3.4% y-o-y in August, mainly due to bad weather in large parts of China that drove vegetables prices higher. We believe that the moderating trend in CPI inflation is due to continue amid a slowing economy and the index is likely to remain below 3% in the following months. Our full year forecast for 2012 is 2.9% y-o-y, down from 5.4% in 2011.

2) *More investment projects*. The NDRC, China's top planning agency, recently approved more investment projects, such as urbal subway lines, totaling CNY 1 trillion. Furthermore the State Council has announced a subsidy program (totaling 36.3 billion yuan) to encourage consumption in home appliances.

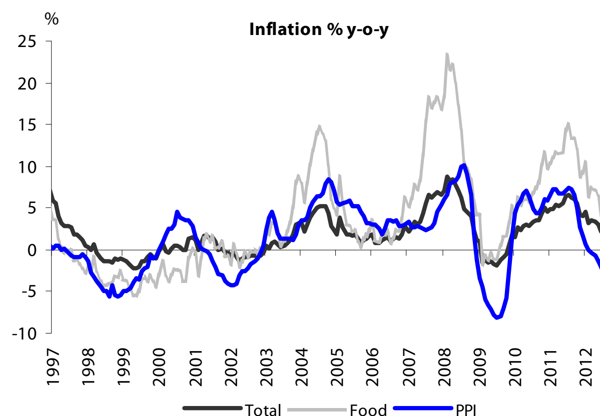
3) *Export tax rebate and consumption subsidies*. Policymakers are considering an increase of the export tax rebate by about 3 percentage points. They may also introduce measures to support consumer spending, including lower taxes, cheap credit and cash subsidies.

Figure 8



Source: Ecowin

Figure 9



Source: Bloomberg, Ecowin

Growth still in a soft landing territory but risks are biased to the downside

To sum up, China's economy has entered a period of subdued growth, with weak exports, credit and property prices. The three

decades of double digit growth is over and China's potential GDP growth is gradually slowing below 8.0%. The rest of 2012 will continue to be dominated by the persistent weakness in external demand and further property market adjustment, as the government recently reaffirmed its commitment to curbing speculative activity on real estate. This adherence to the restrictive measures will most likely keep growth lower than it would have otherwise been. We project growth to moderate to 7.7% in 2012 and 2013 from 9.3% in 2011. Risks are biased to the downside and particularly if the government fails to deliver further sufficient measures and, what's more, implement them consistently and effectively in the next few months. In any case, a sustained economic rebound is far from assured, given that risks still remain mainly in the export sector.

Main risks to our China outlook

A deteriorating situation in Europe

The situation in Europe presents a significant source of risk. A worsening of the euro area crisis means a much weaker GDP growth than our baseline scenario, reflecting mainly trade effects and a decline in capital inflows. Risk aversion could escalate further and financial conditions would become tighter. The persistent fragility of the global economy would dampen demand for Chinese exports, which still account for a significant percentage of GDP (about 25%). Given that China's exports to the EU make up about 20% of total Chinese exports, we estimate that a 1 percentage point decline of European Union's real GDP growth would reduce China's export growth to the EU by about 5% and, consequently, shave about 0.3 percentage points off China's GDP growth.

Insufficient domestic policy support and a non-smooth transmission to a more consumption-driven model and consequently a lower trend growth

While rebalancing the economy away from its dependence on exports and investment, China is facing the challenge to sustain growth through a soft landing. The prospects for a gradual slowdown are high, since there is enough room for policy to respond to downside risks. However, there are significant concerns that growth could slow too quickly, should policymakers prove too slow to address ongoing growth risks.

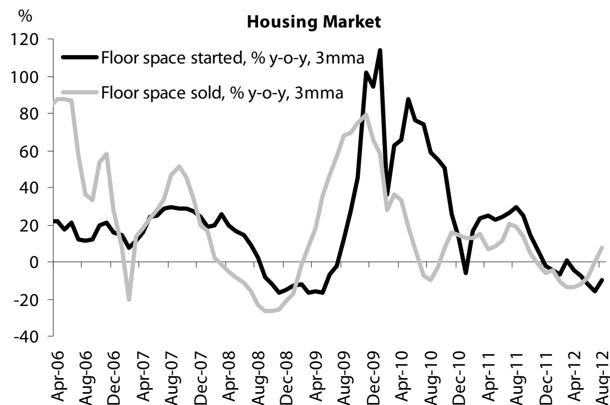
Risks related to political transition

There are some uncertainties surrounding the change in political leadership next March. The leadership change means that both outgoing and incoming policymakers may be conservative and try to deliver stable growth to ensure a stable leadership transition. Hence, policymakers may delay new spending plans. Furthermore, top leaders may have different opinions regarding the ideal growth stabilization rate.

The risk of a sharp correction in the real estate market has abated significantly

Over the first half of the year, one of the major risks to China's growth outlook was a sharp correction in the real estate market. However, in our Global Edition in June 2012, we had noted that this was not our baseline scenario. In fact, the government has managed an orderly correction in the property market, given that property policies have been relaxed at the margin. More specifically the government has been fine-tuning policies to support first-time home buyers and developers of affordable apartments. It has been also providing support to social housing construction. Recent data released point to a nascent recovery. New home prices in China rose in 25 out of 70 major cities from May to June. Additionally, they dropped in only 21 of the sampled cities, an improvement compared with May when prices fell in 43 cities. The overall m-o-m change was the most positive since July 2011. Moreover sales of new homes have been recovering since May, as a result of interest rate cuts. Thus, we believe that the risk of a sharp correction in the real estate market has been limited. This suggests that the negative contribution to growth from the property market may be less in the coming months. The crucial question, in our view, is how much the government will allow the property market to recover given that recently it has reiterated its stance that it does not intend to lift its property market curbs in order to revive growth in the economy. The consequence of lower growth is something that the government accepts in order to avoid a housing bubble and make housing affordable.

Figure 10



Source: Ecowin

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