Global Macro Research

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#China / #Growth / #Data indicators

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China's summertime blues

Policy has succeeded in loosening financial conditions modestly over the past three months. And, while headline data continued to disappoint in August, our China Activity Indicator points to a nascent stabilisation in sequential terms.

Key Takeaways

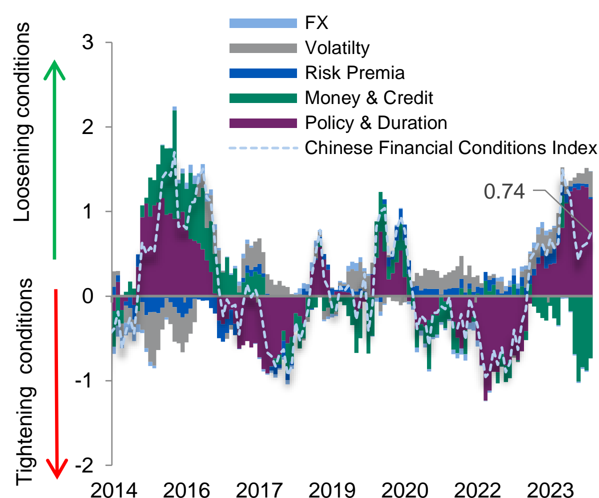
- The 2024 growth target of "around 5%" remains on a knife edge despite past policy easing gaining traction, and that activity could be stabilising in sequential terms.
- Our Chinese Financial Conditions Index (CFCI) has eased for the third consecutive month. The CFCI could be pushed higher by government debt issuance helping the credit impulse to turn and continued declines in long-dated yields, which are confounding the PBOC's attempts to stem the bond market rally.
- Speculation is rife that banks will lower interest rates on existing mortgages, providing a welcome boost to household disposable income. That said, with house prices continuing to fall at a fast pace, a negative wealth effect is likely to keep consumer confidence depressed.
- China's August data releases generally reinforced the lacklustre economic picture that emerged over the summer: many headline activity measures slowed and fell short of consensus expectations. Our China Activity Indicator has however firmed over the past two months.
- Questions remain as to whether China is sleepwalking into 'low-flation' or even 'Japanification'. Headline CPI inflation is positive, but tepid. We now judge that the continuation of an incremental and supply-side biased policy mix will limit annual CPI inflation to just 1% in 2025.
- The spectre of another trade war is a key factor keeping the policy floodgates shut for now. A forceful stimulus package that could counter much, but not all, of the damage should be unleashed if push comes to shove.

Policy gained further traction in August

The 2024 growth target of "around 5%" remains on a knife edge and, despite signs that past policy easing is gaining traction, further supportive measures will be needed to shore up growth and stop 'low-flation' from becoming engrained.

Our Chinese Financial Conditions Index (CFCI) has at least eased for the third consecutive month, moving into a marginally more accommodative stance (see Figure 1).

Figure 1: Policy settings remain modest relative to the scale of the challenges China faces



Source: Haver, Bloomberg, abrdn, September 2024

Money & Credit remains a drag on the CFCI largely due to weakness in money growth (especially M1).

A negative credit impulse is also not helping, but July may have marked the low point and it now appears to be turning back up.

Robust government debt issuance of RMB 1.6 trillion in August helped underpin credit expansion on the month. Issuance should remain strong for the remainder of the year, which could help push the CFCI modestly higher.

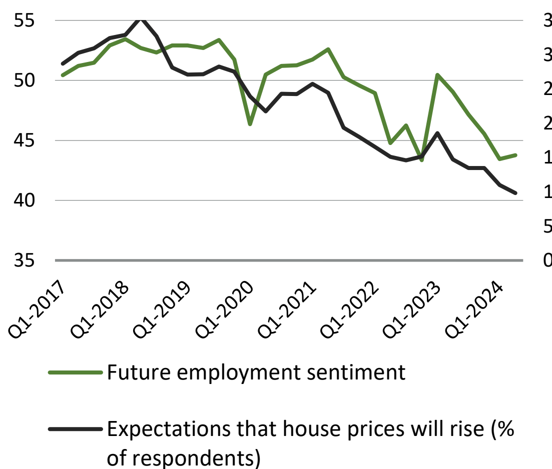
Incremental easing remains the preferred approach

Further easing measures are expected, but they are unlikely to be enough to turn around depressed household confidence or market sentiment.

Speculation is rife that banks will be pushed to lower interest rates on existing mortgages, potentially by as much as 80bps. Households may also gain the ability to refinance mortgages at lower rates by switching providers.

Such steps would provide a welcome boost to disposable income and may help sentiment to recover over time (see Figure 2).

Figure 2: Surveys continue to point to depressed consumer confidence and negative wealth effects



Source: Haver, abrdn, September 2024

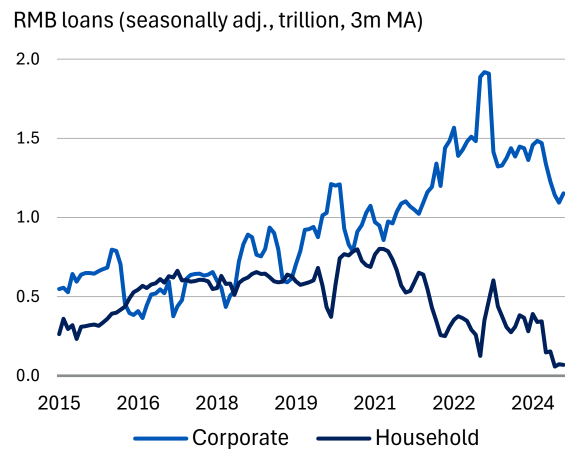
That said, questions remain about the willingness of the People's Bank of China (PBOC) to push through mortgage changes and lower rates more generally.

The PBOC has voiced concern about the squeeze on banks' net interest margins, while also announcing that banks will be stress tested to their exposure to a back-up in yields.

But this focus on financial stability risks addressing the symptoms rather than the root causes.

Indeed, demand to borrow funds by the private sector appears to have stepped down a gear since Q1: both corporate and household borrowing have declined by RMB 0.3 trillion (see Figure 3).

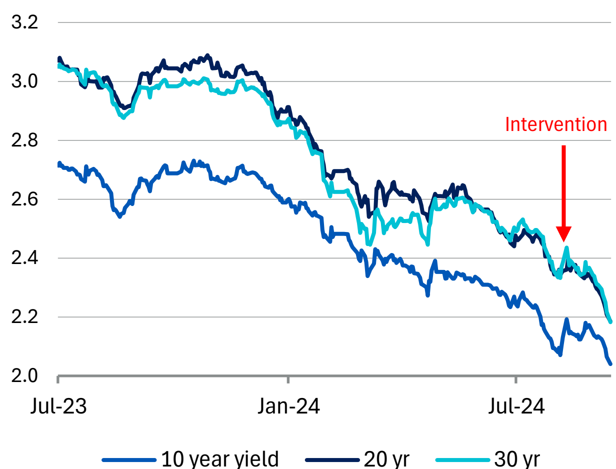
Figure 3: Private sector borrowing remains weak



Source: Haver, abrdn, September 2024

It is perhaps therefore unsurprising that weak demand for funds, high household savings and a tepid nominal environment continue to push long-dated yields down, despite the PBOC's efforts to intervene via a 'reverse operation twist' (see Figure 4).

Figure 4: The continued slide in long-dated yields is worrying the PBOC



Source: Haver, abrdn, September 2024

Activity remains underwhelming

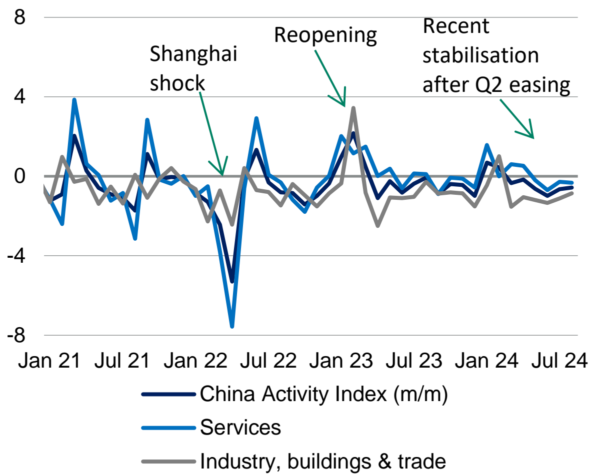
China's August data releases generally reinforced the lacklustre economic picture that emerged over the summer: many headline activity measures slowed and fell short of consensus expectations, while most housing metrics continue to slide.

Industrial production slowed to 4.5% year over year, down from 5.1% in July and below expectations of 4.7%. Retail sales expanded just 2.1% year over year (-0.6ppts), while the services output index eased to 4.6% (-0.2ppts).

Fixed asset investment was only 0.1ppt below consensus at 3.4%, but the miss is exacerbated by the fact that this is a year-to-date metric, which should be less volatile.

There is always a risk that year-over-year growth rates are slow to pick up changing economic momentum. Our month-over-month China Activity Indicator (CAI) has actually firmed slightly over the past two months, helped by an improving export sector (see Figure 5).

Figure 5: Over the past two months our China Activity Indicator has improved slightly



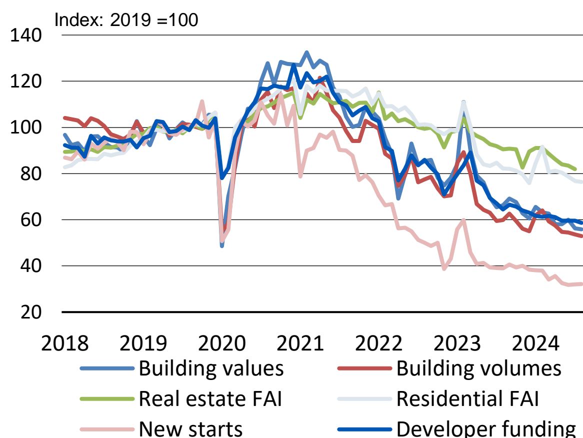
Source: Haver, Refinitiv, abrdn, September 2024

That said, it still appears that Q3 GDP growth will be soft, continuing to leave the authorities' "around 5%" growth target on a knife edge.

And, even if our CAI has shown some sequential improvement, it is questionable that momentum can recover more conclusively while the there is little sign of the housing market finding a firmer foundation.

Most key housing metrics continued to slide in August (see Figure 6). New starts haven't been this weak since 2005, while prices continue to fall at a fast pace.

Figure 6: Policy still needs to counter the direct and indirect effects from the real estate drag



Source: Haver, Refinitiv, abrdn, September 2024

Is China sleepwalking into 'Japanification'?

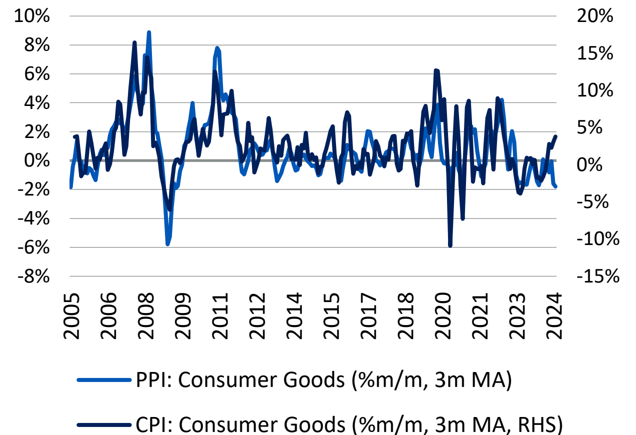
A painful real estate adjustment is just one potential parallel with Japan's slide into its 'lost decade'. At least superficially, China faces similar challenges across several other key dimensions including: its rapidly aging population; high national savings; an export-led growth model and trade tensions; becoming a major autos manufacturer; having a complex relationship between banks and corporates; policy that favours incremental easing; and, last but not least, policymakers who put other priorities above an inflation target.

China's still relatively low stage of development is a key bulwark against 'Japanification'. Even if price growth remains tepid, nominal GDP should remain high enough to guard against adverse debt dynamics and 'balance sheet' recession risk.

But, even if fears of 'Japanification' are overstated, questions remain as to whether China is sleepwalking into 'low-flation'.

Headline CPI inflation was positive for the seventh month in a row in August, but it is still advancing at a tepid pace of only 0.6%. Moreover, recent dynamics in producer prices imply that consumer goods inflation in the CPI basket is likely to be short-lived (see Figure 7).

Figure 7: A lack of pricing pressure should at least spur additional easing



Source: Haver, abrdn, September 2024

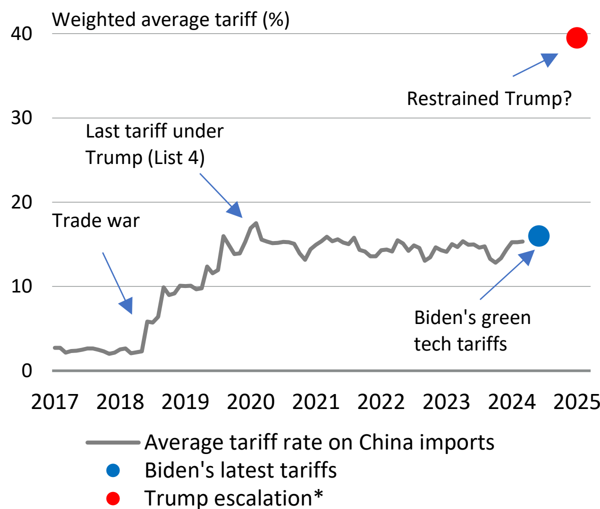
Overall, the incremental and supply-side biased policy mix, which favours investment in strategic industries over consumption, implies 'low-flation' will be hard to shake. As such, we now expect annual CPI growth of just 1% next year, below consensus expectations of 1.5%.

Policymakers appear to be keeping some powder dry in case Trump launches another trade war

Reticence to ease policy despite low inflation and lacklustre growth may not entirely be due to financial stability concerns or the prioritisation of strategic industries.

We judge that the spectre of another trade war under a potential second Donald Trump presidency is likely a key factor keeping the policy floodgates shut. If a trade war was to emerge – for example one that pushes up tariffs substantially (see Figure 8) – the authorities would be able to deploy a more targeted response once they know its exact format.

Figure 8: Tariffs could rise sharply under a Trump win



Source: US Census Bureau, USTR, WITS, abrdn, September 2024

It is difficult to calibrate the size of the economic shock that a second trade war could unleash, not least because of the uncertainty of its scale and key features.

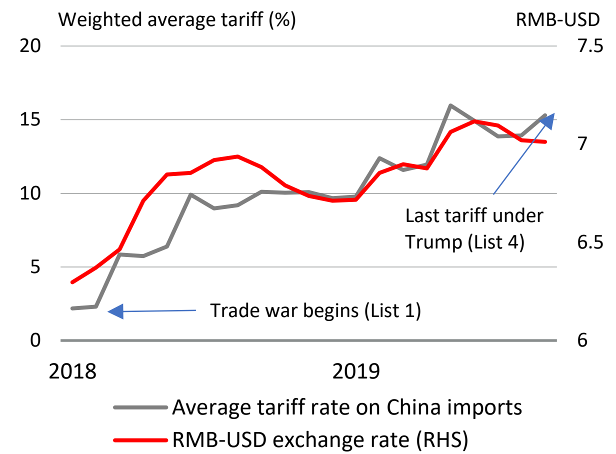
Chinese GDP growth did slow from an average of 6.9% year over year in 2016/2017 to 6.4% in 2018/2019 once the first trade war began, but it is difficult to be sure what role tariffs played.

'Shanty town' redevelopment was a major driver of growth in 2016/2017 and global trade also picked up notably following a period of particular weakness in 2015; hence, some moderation was likely.

In addition, the start of the authorities' 'de-risking' campaign was a key policy shift that began to weigh on trend growth over 2018/2019.

So, while the authorities allowed the RMB to release some of the pressure from tariffs (see Figure 9) and policy shifted to a more neutral setting (see Figure 1), cyclical and structural drivers outside of the first trade war may have actually been the largest contributors to China's 0.5ppt growth slowdown.

Figure 9: The exchange rate may once again be used to offset some of the impact of rising tariffs



Source: US Census Bureau, USTR, WITS, Haver, abrdn, September 2024

This doesn't mean the authorities will be complacent about a second trade war.

The potential for a second trade war to scale up tariffs to two or three times the current level could introduce a proportionately larger macro drag, especially if it coincided with measures to tighten 'rules of origin'.

The latter could limit the ability of firms to 're-direct' trade and could create a much longer-lasting hit to foreign direct investment and hence trend growth.

Moreover, given the recent experience of high inflation, US tariffs may induce the Federal Reserve to tighten policy once again, especially if combined with other inflationary aspects of Trump's policy agenda, potentially slowing growth in the US and further afield.

All of this may be enough to (finally) unlock a much more forceful stimulus package which could offset much, but not all, of the hit to near-term economic growth.

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