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Written by Tian Yong Woon

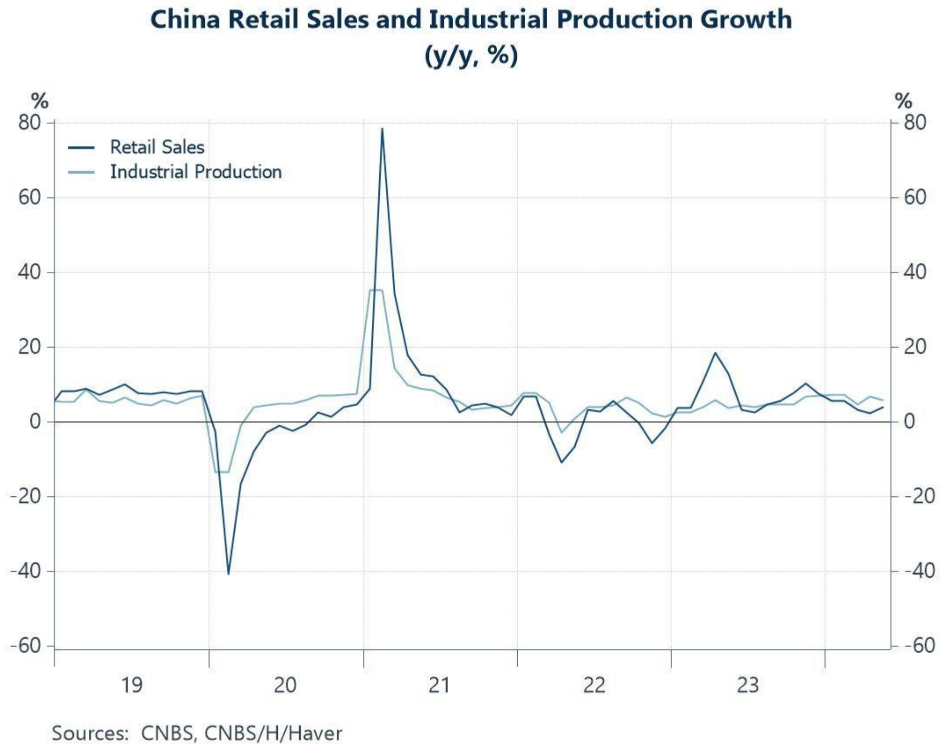
Chinese Contexts

In this week's newsletter, we delve into recent developments in China ahead of anticipated economic support measures from the Third Plenum meetings. The economic backdrop in China remains mixed, with cautious signals from forward-looking indicators. On monetary policy, we explore possible reasons behind unchanged policy rates this year, including the central bank’s views toward a depreciating yuan and banks' interest margins. We also look at potential reforms by the central bank, which would more closely align with practices seen in developed markets and enhance its liquidity management tools. Turning to the property sector, persistent challenges are evident despite recent government efforts to provide support. Sentiment remains subdued, reflecting sluggish sales and uncertain market conditions. We also assess the fiscal implications at the local government level, where declining revenues from land sales and high indebtedness pose significant pressures.

Growth

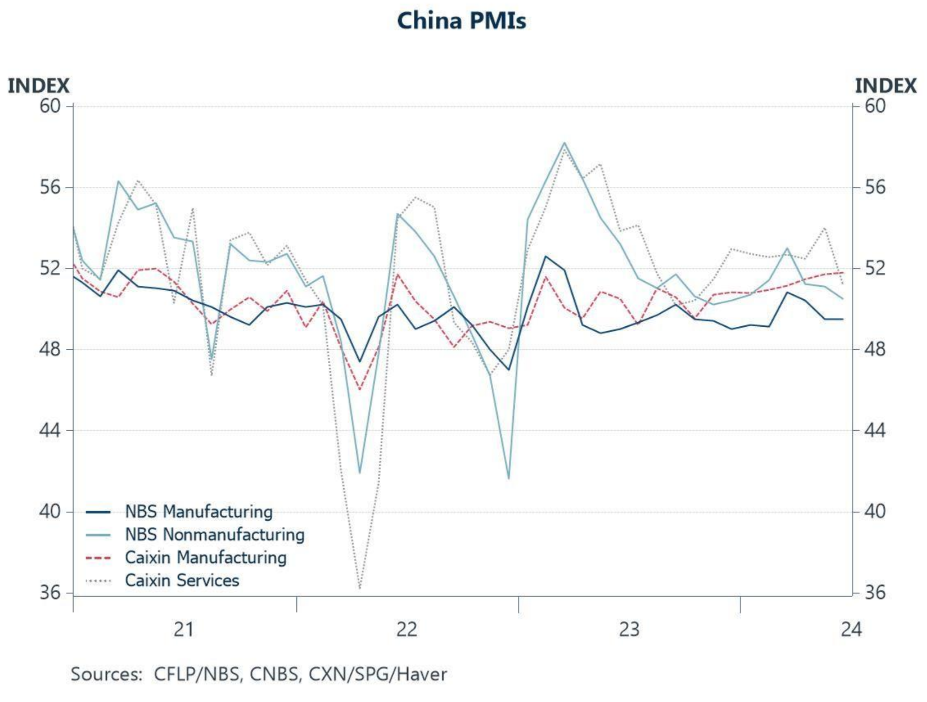
Latest data present a mixed picture about China’s economy. In May, retail sales outperformed expectations, growing by 3.7% y/y, yet industrial production disappointed with a slowdown to 5.6% growth, as depicted in Chart 1. The deceleration in industrial output was driven by a slowdown in the manufacturing sector, with mining providing only partial offsets. Furthermore, growth in fixed asset investment unexpectedly slowed to 4% y/y ytd, largely due to a further sharp decline in real estate investment. Recent data highlight the uneven growth across China's sectors, with persistent pockets of weakness despite the government's recent efforts to implement support measures.

Chart 1: China retail sales and industrial production growth



Looking forward, recent indicators such as China's official PMI readings paint a cautious picture. In June, the manufacturing gauge showed a persistent mild contraction, contrasting with a slower pace of expansion in the non-manufacturing sector (see Chart 2). Upon closer examination, while manufacturers' output showed growth, other key metrics such as new orders and employment continued to decline. In contrast, alternative indicators such as Caixin's PMI, employing a different methodology, indicate sustained expansion in the manufacturing sector. Among non-manufacturers, the official June PMI decline stemmed primarily from the construction industry, with the services sector barely maintaining its position within expansionary territory.

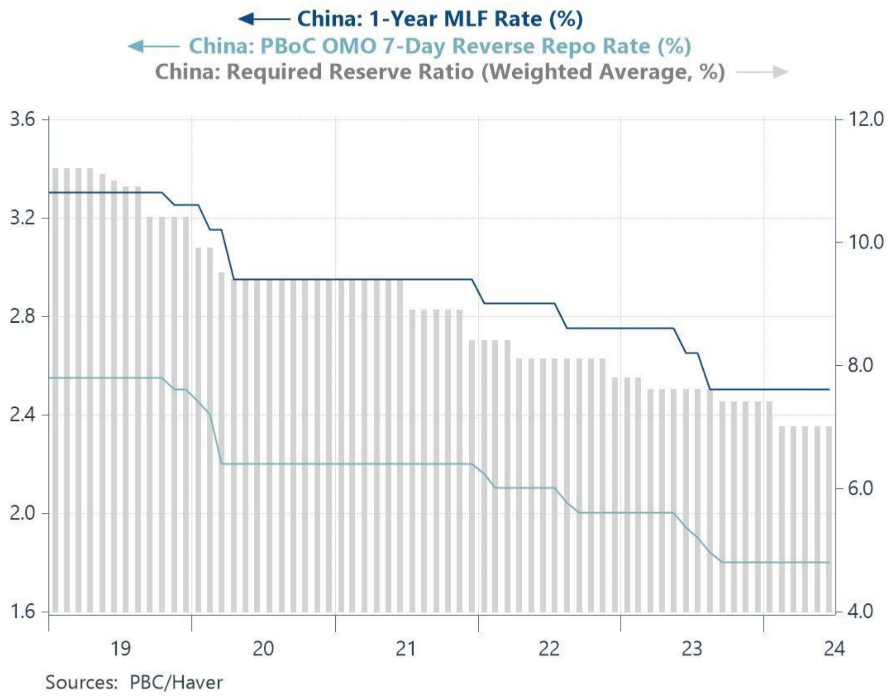
Chart 2: China's PMIs



Monetary policy

The People's Bank of China (PBoC) has left its key policy rates unchanged throughout this year (see Chart 3), possibly to prevent a further weakening of the yuan and to avoid further squeezing banks' interest margins. Instead, the PBoC has opted to support the Chinese economy through alternative measures, such as reducing the reserve requirement ratio (RRR) for banks by 50 basis points earlier in the year. Looking ahead, some analysts anticipate another RRR cut later in the year to bolster liquidity and facilitate a more favourable environment for bond purchases. More significantly, PBoC Governor Pan has hinted at forthcoming reforms in monetary policy. Specifically, there are indications that the PBoC may transition to a single short-term policy rate, aligning its practices more closely with other major central banks. Additionally, Pan suggested the possibility of the central bank engaging in government bond trading in the secondary market, which could offer another avenue to manage liquidity conditions alongside adjustments in the RRR.

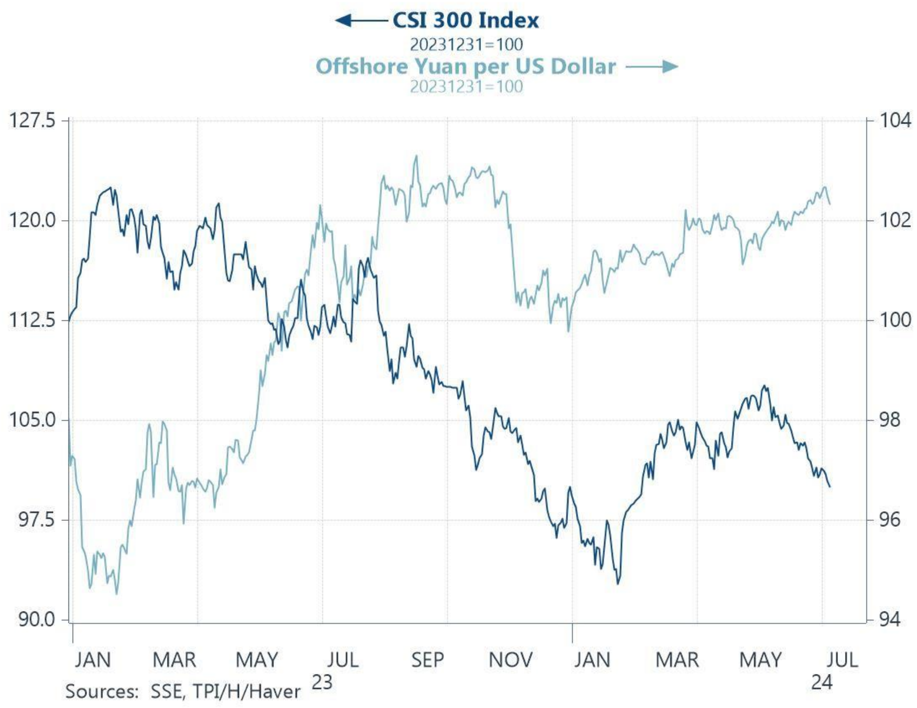
Chart 3: China's policy rates and reserve requirement ratio



Financial markets

Turning to financial markets, the yuan has experienced some depreciation this year. This is particularly evident in the offshore yuan, which has weakened by approximately 2.3% against the US dollar (see Chart 4). Factors contributing to this depreciation include the overall strength of the US dollar in global markets and Chinese exporters' cautious approach in converting foreign currency proceeds into yuan. Furthermore, outflows stemming from both direct investments and financial assets may have added to the yuan's weakening pressures as well. These outflows may reflect lingering uncertainty about the trajectory of China's economic recovery, which has thus far been uneven. Despite these trends, a weaker yuan can offer support to China's exports, which is generally beneficial. However, excessive currency volatility could lead to unintended consequences. Turning to asset prices, the Chinese equity market has displayed renewed weakness starting in late May, following a partial recovery from the extended downturn observed last year. Foreign portfolio investors, however, began divesting as early as April.

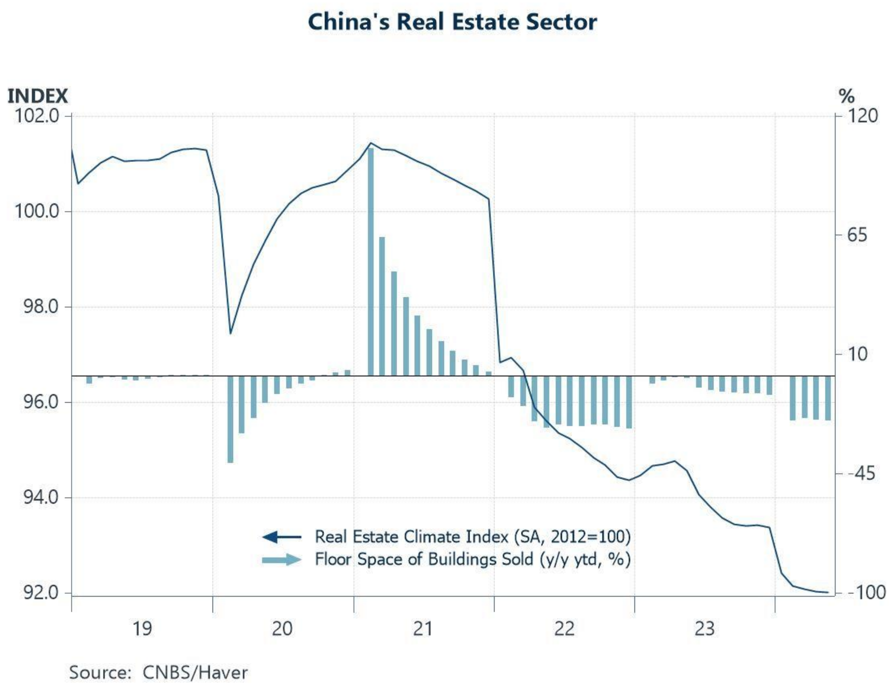
Chart 4: Chinese equities and offshore yuan



The property sector

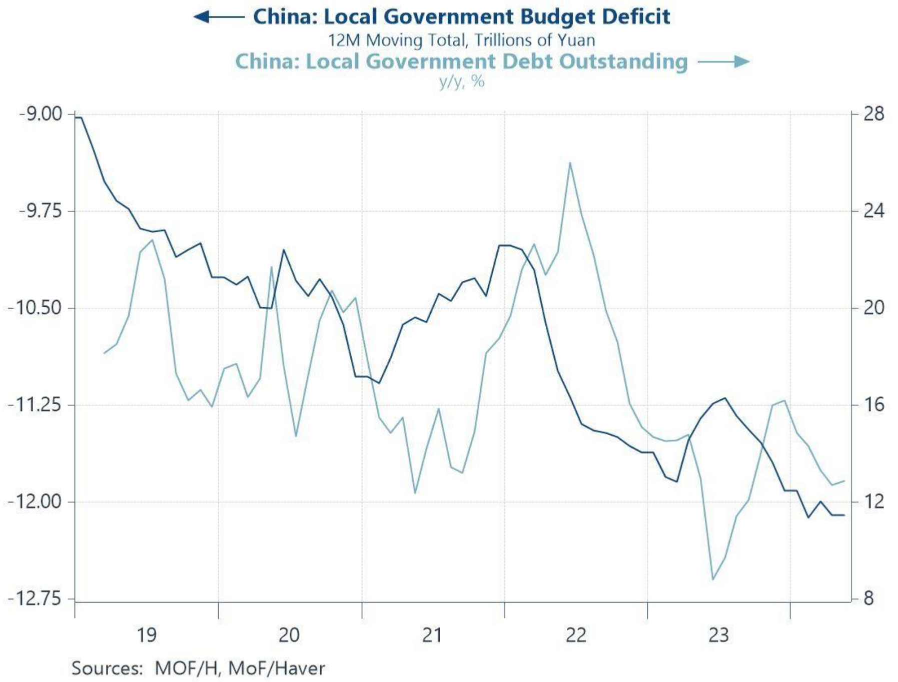
Moving on to developments in China's property market, it arguably remains premature to declare the bottom of the market's downturn. China's property sales slump continued unabated through May (refer to Chart 5), despite authorities' recent efforts. These initiatives included easing mortgage regulations and 300 billion yuan ($41.3 billion) of funding via the PBoC to help state-owned enterprises absorb surplus housing inventory. That being said, the scale of China's housing oversupply issue may be simply too immense, or the effectiveness of recently announced support measures may require additional time to manifest. Overall, sentiment within the sector remains bleak, and suggest a lengthy period before any substantial recovery can be anticipated.

Chart 5: China's real estate sector



In addition to the aforementioned support measures, China's government has implemented ongoing fiscal support to address weaknesses within its economy, particularly in the property sector. However, revenue from land sales, a key income source for local governments in China, is dwindling due to subdued demand in the property market. Consequently, constrained revenue streams, alongside the imperative to sustain economic support, are placing significant pressure on local governments to borrow for financing needs. This situation has led to persistent fiscal deficits and continued growth in outstanding debt (see Chart 6), which remains a cause for concern. Moreover, there remains the issue of off-balance sheet debt among local governments, notably through entities like Local Government Financing Vehicles (LGFVs).

Chart 6: China local government finances



About the author

Haver Analytics is pleased to bring Tian Yong Woon's commentaries on the state of the global economy to its clients.

Tian Yong joined Haver Analytics as an Economist in 2023. Previously, Tian Yong worked as an Economist with Deutsche Bank, covering Emerging Asian economies while also writing on thematic issues within the broader Asia region. Prior to his work with Deutsche Bank, he worked as an Economic Analyst with the International Monetary Fund, where he contributed to Article IV consultations with Singapore and Malaysia, and to the regular surveillance of financial stability issues in the Asia Pacific region. Tian Yong holds a Master of Science in Quantitative Finance from the Singapore Management University, and a Bachelor of Science in Banking and Finance from the University of London.

Data featured in this commentary:

Chart 1: China retail sales and industrial production growth
Series 1: yryr%(N924TRS@EMERGEPR)
N924TRS@EMERGEPR [China: Retail Sales (NSA, 100 Mil.Yuan)]
Series 2: yryr%(N924D@EMERGEPR)
N924D@EMERGEPR [China: Index of Industrial Value Added (NSA, 2005=100)]

Chart 2: China's PMIs
Series 1: S924VM@EMERGEPR
S924VM@EMERGEPR [China: PMI: Manufacturing (SA, 50+=Expansion)]
Series 2: S924VNG@EMERGEPR
S924VNG@EMERGEPR [China: PMI: Nonmanufacturing Business Activity (SA, 50+=Expansion)]
Series 3: S924M@MKTPMI
S924M@MKTPMI [China PMI: Manufacturing (SA, 50+=Expansion)]
Series 4: S924S@MKTPMI
S924S@MKTPMI [China PMI: Services Business Activity (SA, 50+=Expansion)]

Chart 3: China's policy rates and reserve requirement ratio
Series 1: N924FSY1@EMERGEPR
N924FSY1@EMERGEPR [China: Medium Term Lending Facility Rate: One Year (EOP, %pa)]
Series 2: N924RV1W@EMERGEPR
N924RV1W@EMERGEPR [China: PBoC OMO: 7 Days Reverse Repurchase: Reference Yield (AVG, %p.a.)]
Series 3: N924RRRE@EMERGEPR
N924RRRE@EMERGEPR [China: Required Reserve Ratio (EOP, %)]

Chart 4: Chinese equities and offshore yuan
Series 1: index(S924SH3@INTDAILY,20231231=100)
S924SH3@INTDAILY [China: China Security Index: Shanghai-Shenzhen-300 (Dec-31-04=1000)]
Series 2: index(XUSNHSB@INTDAILY,20231231=100)
XUSNHSB@INTDAILY [CNH Per USD Spot Del Exchange Rate at 7 AM ET (CNH/USD)]

Chart 5: China's real estate sector
Series 1: N924HIRC@EMERGEPR
N924HIRC@EMERGEPR [China: Real Estate Climate Index (SA, 2012=100)]
Series 2: Y924HGAT@EMERGEPR
Y924HGAT@EMERGEPR [China: Real Estate: Buildings Sold: Floor Space (YTD, Y/Y % Chg)]

Chart 6: China local government finances
Series 1: movt(na2z(N924FLB@EMERGEPR),12)
N924FLB@EMERGEPR [China: Local Government Budget Surplus/Deficit (NSA, 100 Mil.Yuan)]
Series 2: yryr%(N924FDL@EMERGEPR)
N924FDL@EMERGEPR [China: Local Government Debt Outstanding (EOP, NSA, 100 Mil.Yuan)]

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