

International Commentary — July 20, 2021

China Economic Update: Growth Slowing, Not Slumping

Summary

China's Q2 GDP growth printed lower than we expected and, as a result, we are making another downward revision to our 2021 annual GDP forecast. Despite the downward revision, June activity indicators revealed China's economy is still resilient as retail sales and industrial production beat consensus expectations. Going forward, we are constructive on Chinese growth in the second half of this year, although some softening in data is expected. As far as monetary policy, we believe authorities will maintain their "semi-hawkish" stance and any further cuts to the Reserve Requirement Ratio to be operational in nature rather than a shift to an easier monetary policy stance.

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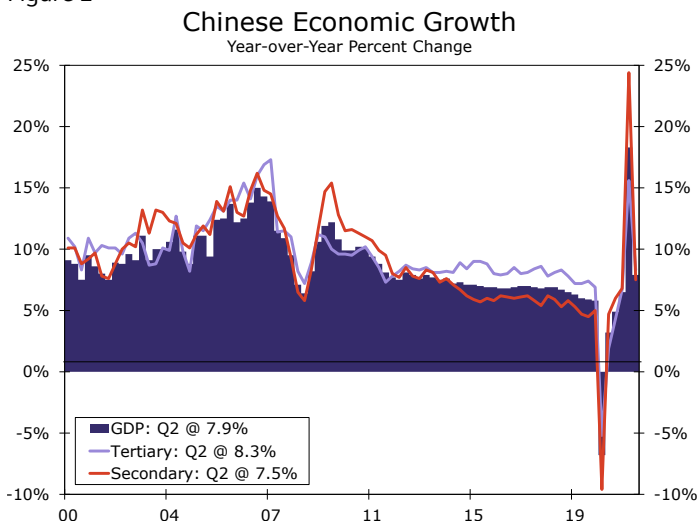
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China Growth Slows, but Still Resilient Economy

Last week, Q2-2021 GDP data were released, with numbers coming in slightly below our estimates, but in-line with consensus forecasts. In Q2, the Chinese economy grew 7.9% year-over-year, a noticeable slowdown compared to Q1 GDP growth of over 18% (Figure 1). Q1 GDP growth figures largely reflected base effects due to the pandemic; however, the deceleration in the Chinese economy is apparent. To that point, China's economy slowed more than we had forecast, as we expected the economy to grow over 8% on a year-over-year basis in the second quarter. A softer GDP print than we expected means we are adjusting our 2021 annual GDP forecast. Including Q2 data, along with minor adjustments to future growth, **we now forecast the Chinese economy to grow 8.5% this year**, a modest downward revision compared to our previous forecast of 8.7% annual growth.

Despite actual GDP coming in below what we expected our takeaway of the Chinese economy is that, while slowing, the economy is also demonstrating some signs of resiliency. In the lead-up to the GDP release, there was some concern among market participants that China's economy could be in worsening shape given the People's Bank of China (PBoC) unexpectedly cut the Reserve Requirement Ratio for most local banks. The surprise cut to the reserve ratio led markets to believe the Chinese economy could be experiencing a sharper deceleration than expected, and that China's central bank could be starting a monetary easing cycle in an effort to offset slower growth. The fact Q2 GDP came out in-line with consensus estimates could offer market participants some relief that China's economy is holding steady for the time being and the PBoC is not too worried about the overall health of the economy. If anything, the cut to the Reserve Requirement Ratio should be interpreted as a liquidity operation and technical adjustment, rather than the start of an easing cycle.

Figure 1



Source: Bloomberg LP and Wells Fargo Securities

Figure 2



Source: Bloomberg LP and Wells Fargo Securities

Alongside GDP data, activity indicators for the month of June were also released. In our view, the takeaway from activity indicators is similar to the takeaway from the GDP data. In June, industrial production and retail sales slowed as base effects dissipated; however, activity growth beat consensus expectations, which also demonstrates some resiliency. Ahead of retail sales data, concerns regarding the pace of consumption were building as the Chinese labor market has not fully recovered from the COVID shock. Retail sales rose 12.1% year-over-year against a consensus view of just 10.8%, and by 23% on a cumulative basis so far in 2021 (Figure 2), revealing strong consumer spending patterns. In addition, Chinese authorities would like to see consumer demand become a more prominent component of GDP growth and the economy become less reliant on its export sector. Strong retail sales in June could be an indication that China's economy is making progress in rebalancing itself toward a more consumption driven economy.

Second Half Optimism Intact

In-line Q2 GDP data and stronger-than-expected activity data gives us reason to be constructive on China's economy for the second half of the year. While we expect to see a continued softening

of GDP and activity data as base effects fully recede, we do not expect the Chinese economy to experience a significant slowdown or any type of "hard landing" coming out of the pandemic. Relatively speaking, growth of 8.5% not only reflects regional outperformance, but also outperformance across the emerging markets and developed market peers. As China's economy stabilizes and continues to demonstrate resiliency, we doubt the People's Bank of China resorts to a monetary easing stance and instead expect it to maintain its "semi-hawkish" view on policy. In that sense, we expect the credit impulse to be reduced going forward and for money market rates to be guided higher. While we do not explicitly expect any further reductions to the Reserve Requirement Ratio, further cuts would likely be viewed as technical in nature and more liquidity-type operations, rather than an easing of monetary policy.

There are, of course, downside risks to our GDP forecast; however, we note these downside risks are largely external in nature. The spread of the Delta COVID variant is becoming more concerning and could result in a sharp deceleration in global demand. While China appears to be making progress toward consumption playing a larger role in the economy, it is still an export driven country. A slowdown in global demand would likely have economic implications for China. In addition, tensions with the United States do not seem to be going away under the Biden administration. Trump-era tariffs remain in place, while the Biden administration continues to focus its foreign policy agenda on China and perceived unfair economic practices. Should tensions escalate and Biden's coordinated approach against China result in additional sanctions or adverse policies, China's economy could come under additional pressure.

In addition, as we noted in a [report earlier this year](#), the debt burden of China's non-financial corporate sector continues to be a risk to the economic outlook, and one of the more prominent non-external risks to China's economy. As of now, China's non-financial corporate sector debt is more of a vulnerability rather than an imminent trigger to start a full-blown financial crisis. However, with the Chinese government scaling back the amount of support it provides local corporations, elevated corporate defaults could pose financial risks to the economic outlook. A full-blown financial crisis could exacerbate China reducing the amount of available credit across the country. Less credit impulse typically has negative implications on economic growth, and we would expect similar dynamics to materialize in China as well if authorities take a more cautious approach to credit availability.

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