QNB Economics
economics@qnb.com
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How gloomy is China's economic outlook?

Chinese economic weakness has been a topic of major policy and investment discussions since at least 2015. More recently, China's aim to sustain both rapid growth and financial de-leveraging became ever more challenging. On top of domestic concerns associated with capital misallocation and high indebtedness, China is now facing several external headwinds, not least a slowing global economy and a fierce trade dispute with the US.

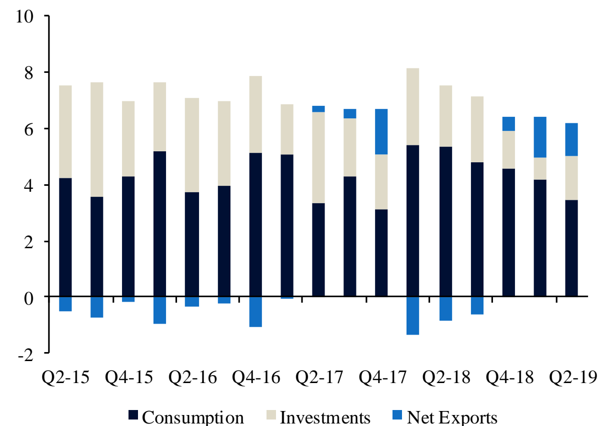
In fact, Chinese growth has continued to tick down. Last quarter, China's GDP growth figures presented the weakest reading (6.2% y/y) since the series started to be published in 1992. Moreover, key business surveys such as the manufacturing Purchasing Managers' Index (PMI) and new orders continue to hover below the contractionary threshold.

However, it is not all doom and gloom for China. A closer look at recent leading indicators suggest a more mixed picture, including significant signs of growth stabilization. Our analysis delves into the three factors that provide more solid ground for continuous economic expansion in China.

First, despite softer y/y figures, China's economy seems to be stabilizing. According to data from China's National Bureau of Statistics, demand is picking up on a seasonally adjusted quarter-on-quarter annualized basis, with 6.6% growth in Q2 2019 versus 5.7% in Q1 and 6.1% in Q4 2018. This is in line with recent positive surprises in industrial production and retail sales data. The composite PMI, which includes both manufacturing and services, is in expansionary territory as services business activity remains solid. Consumer confidence is near all time highs and the business climate index is running at the highest levels since 2012. Fixed asset investments are holding on well and equity markets are significantly above late last year lows.

Second, despite the intensification of the trade war and weakness in the electronics sector, there are early signs that external demand for Chinese goods is stabilizing. After several months in the doldrums, 3-month average exports of early-reporting East Asian economies (Japan, South Korea, Singapore, and Taiwan) are flattening. This includes their exports to China. Early-reporting East Asian economies are major exporters of intermediary industrial inputs to China's export sector and they are indirectly affected by US-China trade jitters. While China's exports to the US continuously declined since December last year and new tariffs were put in place, exports to the US may pick up as US importers run down their inventories of Chinese goods. China is now likely facing the reversal of the so-called front-loading effect in US-China trade, i.e., US based companies increasing imports from China last year to stock up before new tariffs come into effect. Moreover, recent studies from the US National Bureau of Economic Research highlighted that tariff hikes have so far fallen mostly on US businesses and households rather than Chinese exporters.

Real GDP growth in China
(Expenditure side, y/y contribution to growth)



Sources: Haver, China National Bureau of Statistics, QNB analysis

Third, the Chinese government has significant policy space to provide further support to the economy. On the fiscal side, the government has already launched a plethora of initiatives that can be expanded, including reductions of VAT rates and social security taxes as well as special tax deductions for households. The government has also increased the quota for special bond issuances to fund local government infrastructure investments. There is ample scope for scaling up stimulus when necessary. China's central government gross debt and general government gross debt account for 16.9% and 50.5% of GDP, respectively. Importantly, recent fiscal measures are focusing on reducing the heavy tax and

fee burden on the Chinese private sector, which implies more efficient resource allocation and a boost to more productive sectors.

On the monetary side, the People's Bank of China (PBoC) has more policy space to ease due to expected rate cuts in the US and looser global financial conditions in general. However, we do not expect the government to cut the official policy rate or the one-year benchmark lending rate. The PBoC is likely to follow the US Fed by cutting the more operational open market reverse repo rate, easing financial conditions in the interbank market. In addition, the PBoC is expected to use quantitative and administrative tools to expand the money supply and direct more loans to the private corporate sector rather than the bloated state-owned sector.

All in all, in the absence of a more severe escalation of trade and economic conflicts with the US, we do not see y/y GDP growth in China sliding below a floor of around 6.0% for a significant amount of time. Should external risks materialize, the government has enough fiscal and monetary space to provide a solid backstop.

QNB Economics Team:

James Mason
Senior Economist
+974-4453-4643

Luiz Pinto*
Economist
+974-4453-4642

Abdulrahman Al-Jehani
Research Analyst
+974-4453-4436

* Corresponding author

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