Growth in China dives as policy and supply challenges mount

The Chinese economy grew slower in the third quarter, mainly because of policy challenges and high base effects from last year. We expect these two factors will continue to be in play for the fourth quarter, which means the slow growth of the Chinese economy will continue.

This is an updated version of our earlier note

People walk through Beijing's business district

The economy faces policy challenges

The Chinese economy grew slower at 4.9% year-on-year in the third quarter of this year compared with 7.9% in 2Q21. This is mainly down to policy challenges from deleveraging the real estate sector, increasing compliance on the tech sector, and a clampdown on tuition centres and the entertainment sector. There was also some policy confusion on the supply of coal to generate electricity, which paused manufacturing activities, but that is now solved, and coal-generated electricity should be normalised.

Let's go through the activity data and we will see how policy hit the economy.

Industrial production was affected by Covid, chip shortages and policies

Industrial production grew only by 3.1% YoY in September from 5.3% in the previous month. Manufacturing was hit hard by supply chain disruption due to Covid as some port operations continued to be hit and chip shortages were will very much in evidence. Nearer September, real estate development activities were slow because of deleveraging reforms which make it more difficult for developers to get funding to continue their projects. Construction materials recorded a contraction. Growth rates of cement were -13% YoY, pig iron was down 16.1% YoY and crude steel was -21.2% YoY. This all points to contracting property construction activities in the month.

I am not particularly worried about the high PPI because the September data was mainly down to higher coal prices. The policy has changed as China has to import coal for electricity generation as well, so the high PPI should be more like a one-off event.

Supply chain disruptions are expected to last

But some lower-tier city governments have jumped in to create better sentiment for the residential market by imposing a home price floor, which hopefully will end the wait-and-see buying sentiment and shore up transaction volumes so that developers can get cash back to repay debts. Even though real estate construction activities continue there are still other challenges.

Supply chain disruptions are expected to last as freight rates are still high and chip shortages are still a critical issue for industries like equipment, automobiles and telecommunication devices.

Retail sales weakened from more joblessness

Retail sales were a bit stronger at 4.4% YoY in September compared with 2.5% YoY growth in August. One thing I note is that there was a 20.1% YoY growth in jewellery and gold spending. This could come from investment demand for gold when investors are not interested in buying property, so this doesn't look to be consumption-led.

Even with that support, the overall retail sales growth rate was still low because of central government policies that have resulted in the shutting down of things like tuition centres and that's had a knock-on effect on spending power. And, of course, there are still concerns about Covid.

I usually use spending on clothing as a benchmark for the average consumer

---

I usually use spending on clothing as a benchmark for the average consumer. As spending on clothing and accessories contracted 4.8% YoY, it just reinforces the view that retail sales were indeed weak.

Looking ahead, the Covid factor will remain the same as China exercises a very strict virus policy across the country. The jobless factor is less clear. The government seems to be finding ways to absorb unemployment by diverting resources to other sectors. But these government-led reallocations could be temporary for labour as people may not find their new "allocated" job attractive for their careers.

Infrastructure is still the hope

We expect that infrastructure investment from the public sector could support growth, which is turning out to be partly true as at least investments in transportation construction were up 26.7% year-on-year. Another strong infrastructure investment was telecommunications, which grew 24.4% YoY.

5G network infrastructure work to give coverage to the whole of mainland China will speed up and that will broaden telecommunication services for harder to reach places and will lead to major improvements in things such as mining safety.

> *We cannot rely too much on private sector investments for growth*

We cannot rely too much on private sector investments for growth as there have been so many policy changes, and those are creating uncertainties for business prospects. As an example, investment in automobile production contracted 6.5% YoY.

It was a bit of a surprise to see investments in renewable energies not being so strong. Overall investment in energy was only up 1.6% YoY. But we expect that this will change to a much stronger growth as the recent limited use of coal to generate electricity reflects the importance of renewable energy for China.

Forecasts and monetary policy

We are revising our China GDP growth forecast down to 4.3% YoY for the fourth quarter of this year from 4.5% YoY, after the release of this latest data, although our full-year GDP forecast stays at 8.9%. This is based on the expectation that there will be a 0.5 percentage point broad-based RRR (required reserve ratio) cut in 4Q21 to support growth by ensuring enough liquidity to avoid any spikes in interest rates. If there is no easing in monetary policy in the quarter, we should expect GDP growth to drop even further.

There is a small chance of a brighter spot for the economy should international borders reopen more comprehensively if the government considers Covid is under control. But I have to emphasise that the chance of this policy action is small.