

China: risks to the economy piling up

With the RRR cut, a partial rollover of the MLF and weaker economic data, we believe that the risks to economic growth are mounting. We discuss these risks and the possible policy actions that may follow



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The roll over of the medium term lending facility together with a RRR cut means a lot

The recently announced RRR cut of 0.5 percentage points will be effective today. The medium-term lending facility (MLF) was also rolled over by CNY100bn, though less than the matured size of CNY400bn. That said, it is difficult to get the "real" roll-over size because a year ago, there was a targeted MLF that had a maturity of 3 years, and the PBoC did not state how much of that CNY400bn MLF belonged to that targeted MLF.

Anyway, there is a rollover of MLF on top of the RRR. This is a big signal that the economy needs liquidity.

Economic data is not too bad though the automobile industry is still in bad shape

Given the RRR cut and the MLF rollover, we would like to know which part or parts of the economy need so much cash? We believe that banks need more liquidity as bad loans could be rising as confirmed [by the banking regulator](#).

Looking at the GDP growth figure of 7.9%YoY in 2Q21 compared to 18.3% in 1Q21, we don't see the overall economy as being particularly weak in 2Q21. The slower year-on-year growth rate is attributable mainly to the higher base in 2Q20 compared to that in 1Q20.

Looking at the other activity data, we see decent growth in retail sales (12.1%YoY) in June compared to 12.4%YoY in May when there was a long holiday which would have helped consumer spending and staycations. Demand was soft on cars, with sales growing only 4.5%YoY. Otherwise, retail sales kept their trend of moderate growth.

Industrial production was not too bad either, at 8.3%YoY in June compared to 8.8%YoY a month ago. The worst performing sector was automobile manufacturing which is in contraction, and the best performing sector was integrated-circuit production benefiting from the strong demand for chips.

Investment was the pain point

Weaker momentum was, however, clearly evident in fixed-asset investment, which registered growth of 12.6%YoY YTD compared to 15.4%YoY YTD. Automobile production investment was -2.3%YoY YTD.

It is worth noting that investment in equipment purchases shrank 0.8%YoY YTD in June even as infrastructure investment supported by the government was still growing over 30%YoY YTD.

Slow investment momentum in equipment purchases could be due to semiconductor chip shortages and/or a lack of confidence in future economic growth. We believe both are possible explanations.

Risks from international politics

US Treasury Secretary, Janet Yellen, has said that there won't be talks between the US and China at a high level. Before this decision, 25 Chinese companies were added to the entity list by the US, all of these in the technology sector. Japan has also said that it will line up with the US to confront the rise of China in the technology area.

This all points to the technology war that China is having to face, and this will affect how China can source necessary electronic components to manufacture their own technology products.

Risks from within

Even with the pressure stemming from the technology war, China is reforming fintechs and

data privacy, as well as deleveraging the real estate sector. Both will put downward pressure on growth in the short term but will reduce risks to the economy and the financial system in the future.

Now the RRR cut with the rollover of MLF look more reasonable

Considering together all of the data released today, recent developments in international politics and ongoing domestic reforms, the RRR cut and rollover of MLF look more reasonable.

We believe that there will be another RRR cut in the next quarter if these risk factors do not abate.

Revising GDP forecast

After considering all of this, we are revising our 2021 GDP forecast to 9.4% from 8.7%, mainly due to our weaker forecast in 2Q than the reported figure, and a slight upward adjustment for 3Q21 to reflect the boost from the RRR cut.

We continue to expect no change in policy interest rates for 2021, including the loan prime rate (LPR) and 7D policy rate.

We are keeping our USDCNY forecast at 6.45 for the end of 2021.

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