Chinese economy: more intense slowdown in the second half of the year

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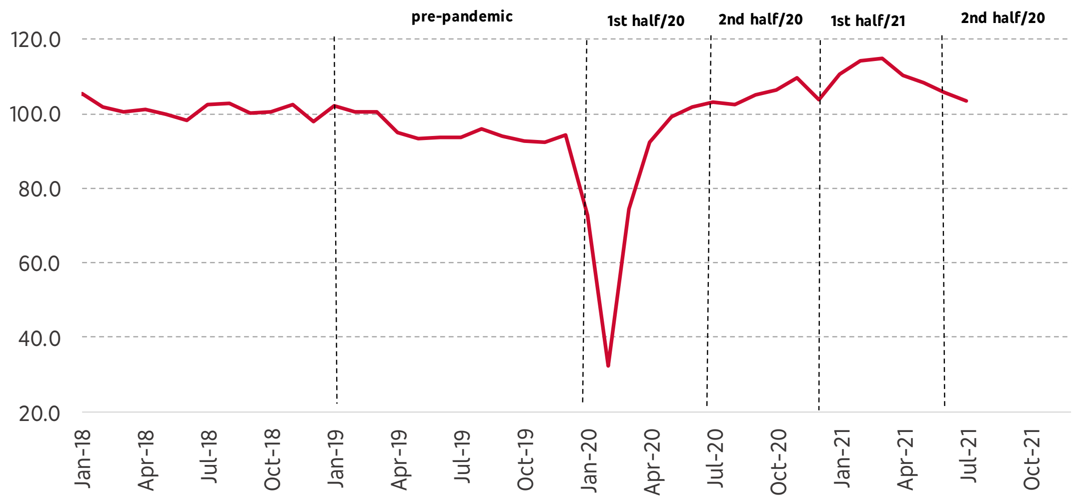
China's economic cycle in this second half of the year will be different from that observed in the first half, returning to patterns more similar to the pre-pandemic trends, but with additional challenges. The already expected economic slowdown should be a little more intense, as indicated by July data[1], which moderation trend should be repeated in August. Even so, economic policy conduct should be read as neutral, with support for some sectors and tightening in others. New shocks, such as the new wave of the pandemic and noise related to market regulation, have led to a recent adjustment in the majority of market expectations for growth in the remainder of this year. We adjusted our forecast for the 2021 GDP, which should expand 8.5%, compared to the previous estimate of a 9.0% expansion, noting that this quarter should be the one with the lowest growth.

A brief retrospective analysis of the last couple years allows us to highlight 5 important moments: (1) pre-pandemic: slowdown due to trade tensions and beginning of stimulus policies, including those focused on infrastructure; (2) first half of 2020: concentration of pandemic shock and economic shutdown; (3) second half of 2020: control of the pandemic, with economic recovery, favored to a great extent by exports and the expansion of credit offerings, which especially boosted the housing sector; (4) first half of 2021: supply still growing above demand, but with the normalization of economic policy; (5) second half of 2021: deceleration of the growth rate to below pre-pandemic levels due to negative shocks, underwhelming performance of consumption and reduced exports.

Chart 1: Leading indicator and economic cycles



Source: CEIC, Bradesco

[1] The economic slowdown in July was stronger than expected and widespread. The year-over-year expansion of 6.4% in industrial production fell short of expectations (7.8%). Retail sales, in turn, advanced 8.5% in the same metric, compared to the estimated increase of 11.5%. Fixed asset investments, also on a deceleration trend, reached 10.3% in the year up to July, below the expected 11.3%.

Part of the deceleration in the second half of 2021 was expected, largely reflecting the reversal of domestic and external drivers. Credit normalization explains the moderation of the economy as a whole. For the infrastructure sector – whose investments have accumulated growth of 4.6% in the year – the slow and selective approval of projects has limited the sector's improvement, even with the expected acceleration in the issuance of local government bonds. The housing segment, in turn, has faced significant government tightening – which aims to contain the sector's financial risks. Access to credit has been more restricted and several indicators such as land sales, property sales and new starts point to a loss of momentum in this relevant sector for the economy. Household consumption has been frustrating and this is mainly due to the caution of individuals, given that income and employment have already recovered. Last but not least, exports should follow the cooling trend already observed in July – responding to the lower global demand for goods, which has been gradually migrating to services – with an impact on the industry.

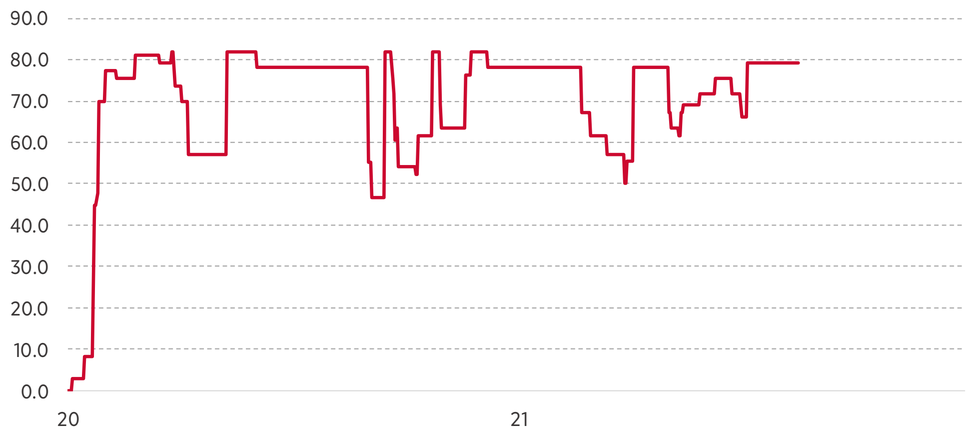
Chart 2: Credit impulse (as % of the GDP)

Source: Bloomberg

However, added to these vectors, we highlight two important shocks, which led us to lower our estimate for this quarter's result. The first of these concerns the new wave of Covid cases. In late July, new cases began to be recorded in the country, spreading rapidly from a regional point of view. Although daily cases are low (less than 150), the Chinese government follows a very strict control policy, seeking to eliminate cases altogether soon, even with vaccination reaching almost 65% of the population. As such, mobility restriction measures were resumed at levels compared to those recorded in the transition from 2020 to 2021, including port closures. This fourth wave[2] is likely to have negative impacts on the economy, as already suggested by the high frequency indicators. Estimating that it will take about two months to contain it, we must assume that the restrictive measures will be in place until mid-September, not only compromising economic activity, but also the confidence of families, who were already showing some degree of caution. The service sector and consumption in general are certainly the most likely to be affected. In addition, the country faced floods in several regions, many of them industrial, thus compromising production. Even assuming some rebound in the fourth quarter, the current quarter loss led us to reduce this year's growth rate by 0.5 p.p., taking into account the current closure level.

[2] Four major waves of the pandemic can be outlined in China. The first outbreak in Feb-April/2020, the outbreaks concentrated in the north of the country between December 2020 and January 2021, the first cases of the delta variant in Guandong in April this year and the most recent wave, which began on July 20 in Nanjing.

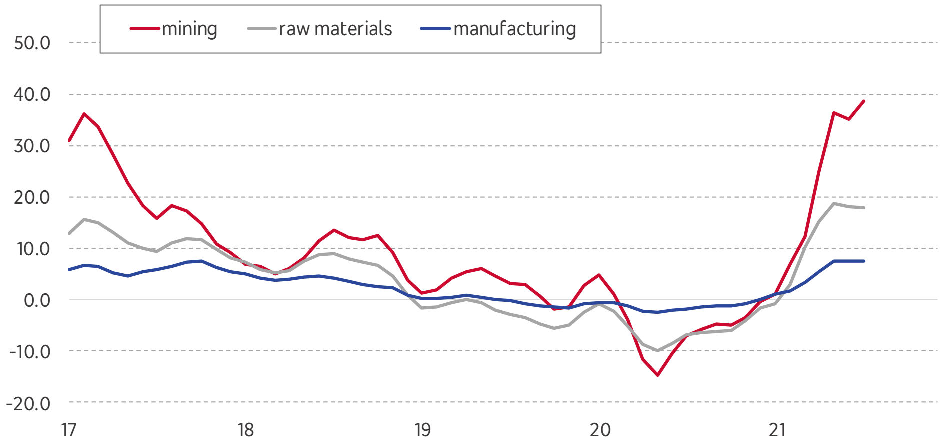
Chart 3: Mobility restrictions



Source: Oxford Stringency Index, CEIC

In the current phase, would it be natural to expect more stimuli, especially given the new shocks? From a macro point of view, the message from the Chinese authorities is one of economic policy neutrality, acknowledging that normalization has already occurred. In fact, following the momentum coming from credit, which is already negative today, and the rate of expansion of the total credit stock, we know that adjustments have been underway over the last few quarters. However, the signs in practice are not so clear or unidirectional. It is worth highlighting the cut in the bank reserve requirement, in early July, to increase the liquidity of the financial system (and address the maturity of several lines of credit from the central bank). At that time, attention was drawn to support small businesses, whose results had been affected by rising input prices. With the acceleration of producer inflation, the concern is that it will reduce the margin of most companies, which are unable to transfer the increase to final prices. Along those same lines, we note the effort to accelerate the issuance of local government bonds, which should boost the infrastructure segment (63% of the annual quota should be issued between August and December). On the other hand, while economic policy shows signs of easing, we highlight the control of several sectors, with emphasis on the housing sector, an important vector for China's economic dynamics. In addition, the closing of production capacity, as a way to control pollution, also works towards less growth.

Chart 4: Producer price index. Year-over-Year change



Source: CEIC

This economic policy reaction, in turn, must be considered within the political context, which we can separate into four agendas/reasons that also help understand the recent regulatory measures adopted in some sectors.

1. **Control of systemic risks,** whether financial, information/data or national security. This helps us understand the measures that have focused on companies in the technology sector, fintechs and the housing sector. This has already been an agenda for a few years now, but it was intensified once again when the pandemic was more under control;

2. **Geopolitical environment,** in the context in which tensions with the US (and other countries) are still present. Here, measures involving the participation of foreign capital as financers of Chinese companies are appropriate, including those listed on the U.S. stock exchange and recent IPOs in these markets. We must also take into account strategic sectors for the Chinese government, such as education;

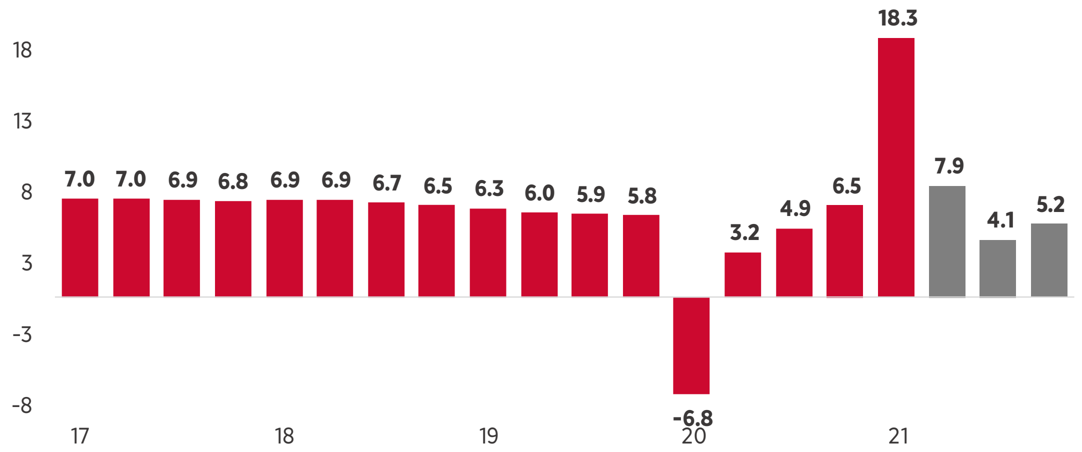
3. **Social aspects,** which involve the agenda of reducing inequality and improving labor rights. Actions recently taken for delivery app, education and gaming companies fall into this group;

4. **Five-year plan,** announced earlier this year, which listed priorities for the period 2021 to 2025: environment/sustainability, technology and dual circulation (which emphasizes domestic consumption). Actions focused on decarbonization, interventions in the technology sector and measures that strengthen domestic consumption should be intensified.

In addition, to clarify these adopted measures, the Party's Central Committee and the State Council released a document last week that indicates the country's regulatory framework for the next five years. We highlight the mention of "intensifying law enforcement in essential areas related to the population's vital interests, such as food and medicine, public health, natural resources, environment, safe production, occupational safety, urban management, transportation, financial services, education and training." The document also highlights the need for complementary legislation on the use of the Internet, big data, artificial intelligence, as well as environmental pollution and data use.

With growth closer to 5% from this year to next, China will face a year of important political transition. As already signaled, Xi Jinping is expected to remain in power, but the rest of the Party leadership should undergo major changes. This has broad implications for the economy, such as: regulatory and risk control measures should remain important agendas for consolidation and legitimacy, with support from other spheres of government. Furthermore, if the economy experiences a more intense deceleration, support measures should be intensified. For now, however, it appears that the magnitude of the economy's loss of momentum is compatible with other priorities, such as pandemic control and more medium-term strategies.

Chart 5: China's quarterly GDP. Year-over-Year change



Source: Bloomberg, Bradesco

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