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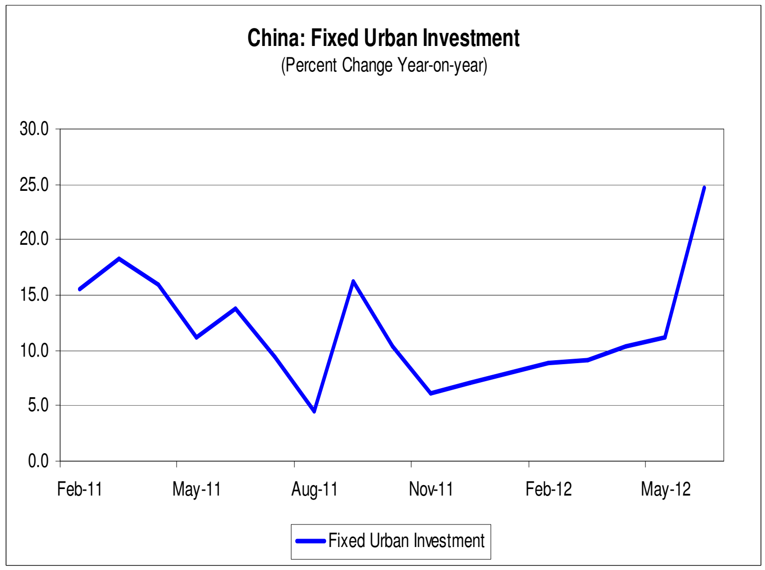
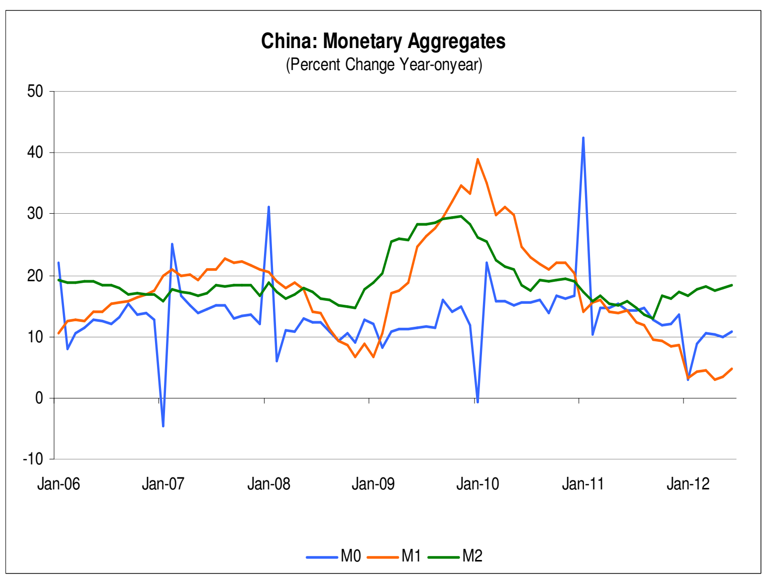
China: A Turning Point?

The data just released, including real GDP, plus a number of high frequency indicators, confirm that the economy decelerated, on average, during the second quarter but—more importantly—that a shift towards an expansionary macroeconomic policy is underway and *possibly* already yielding some results.



In effect, annual real GDP growth slowed down to 7.6% year-on-year, as expected, but consumption and domestic investment seem to have entered an up-trend towards the end of the April-to-June period. Adjusting the official retail sales series for inflation, for example, show a gradual, although modest, acceleration since March, leaving the index for June 11.5% up on last year.

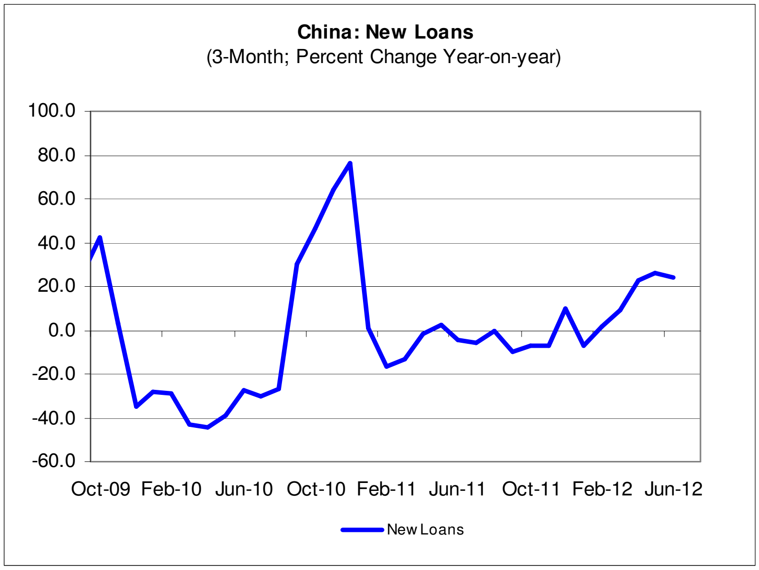
The apparent change in fixed investment's trajectory is more significant. Year-to-date (as the data is published) urban fixed capital formation grew 20.4% in June, just marginally higher than in April and May.



However, the underlying monthly series shows a more clear, if still modest, upward trend: investment growth dropped to 19% year-on-year in April, rose to 19.9% year-on-year in May, and to 21.2% year-on-year in June.

Similarly calculated figures show that the improvement is due entirely to a spike in public sector investment, which was only around 10% year-on-year during the first five months of 2012, and 10.7% year-on-year in May. The corresponding June figure: 24.7% year-on-year. In contrast, private investment decelerated further, to 20.2% year-on-year. A caveat: these numbers are DE estimates derived from the official series, which is sometimes sharply revised.

More data will be needed to verify that the economy has bottomed, particularly because the private sector still looks soft. Monetary aggregates provide some support for the optimistic view, and some encouragement regarding the near-term outlook, as they appear to be improving. This is consistent with the healthy expansion of lending reported earlier in the week.



But even if policy helps move the economy closer to stable growth as the third quarter unfolds, risks remain relatively high and further easing is all but certain.

The biggest unknown, of course, relates to the European crisis, which is already having an impact on Chinese exports and could eventually generate a potent financial shock. But there is also a question of how much stimulus China's policymakers are willing and able to apply, and for how long.

Contrary to what happened in 2008-09, and perhaps because of the costs of that experience, the government's reluctance to ease policy has been very clear. At least for the very near-term the key obstacle is unlikely to be inflation: prices are actually falling, and year-on-year inflation was just over 2% in June. But there is a reasonable concern regarding the health of the banking system as the short-term push to restore growth could lead to a lowering of lending standards.