PICTET 1805

Flash Note

China: Q2 GDP beats expectation again

GDP forecast revised up on solid H1 performance

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Chinese GDP for Q2 2017 grew by 6.9% y-o-y in real terms, the same pace of expansion as in Q1. The growth figure beats both the consensus forecast and our own estimate.

We have decided to revise our Chinese GDP forecast for 2017 to 6.8% from 6.5%, and the forecast for 2018 to 6.3% from 6.2%. These revisions reflect both the stronger-than-expected growth in Q2 and a better outlook for the near term as suggested by the latest data, in particular related to fixed asset investment.

Three factors have led to the positive surprise: a resilient property market, strong infrastructure investment and rising global demand.

The PBoC will likely maintain a neutral policy stance with a tightening bias for the rest of the year. If interest rates for general loans and mortgage loans rise as a result, it will likely have a negative impact on growth in H2 2017.

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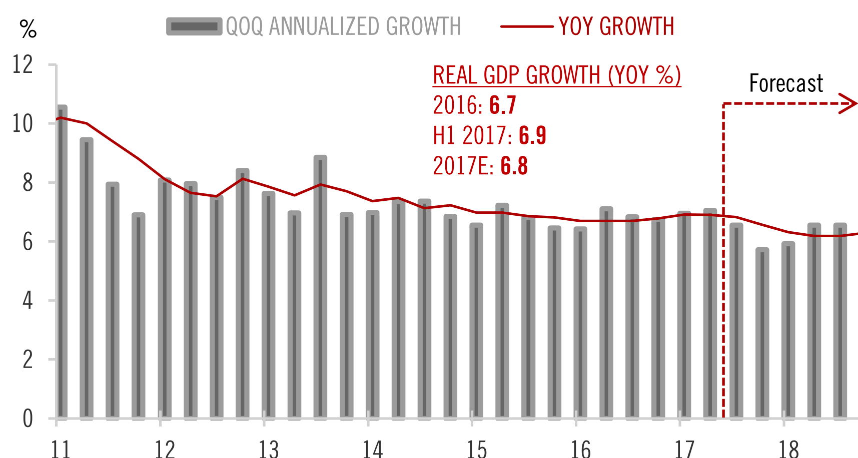
Chinese GDP for Q2 2017 came in at Rmb20.1 trillion (USD3.0 trillion), growing by 6.9% year-over-year (y-o-y) in real terms, the same pace of expansion as in Q1. The growth figure beats both the consensus forecast (6.8%) and our own estimate (6.7%). With the strong performance in Q2, the Chinese economy expanded at a solid pace of 6.9% y-o-y in the first half of 2017.

In light of the latest data release, we have decided to revise our Chinese GDP forecast for 2017 again, to 6.8% from 6.5%, and the forecast for 2018 to 6.3% from 6.2% (*Chart 1*). These revisions reflect both the stronger-than-expected growth in Q2 and a better outlook for the near term as suggested by the latest data, in particular related to fixed asset investment (FAI).

Chart 1: Chinese GDP growth including forecast



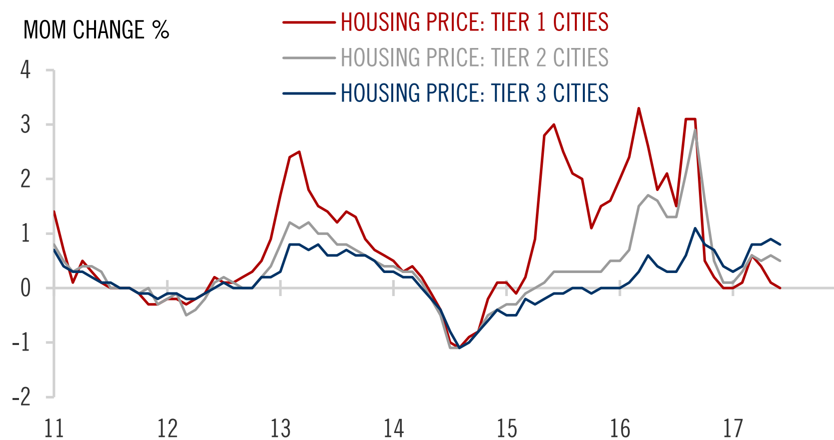
Source: Pictet WM - AA&MR, National Bureau of Statistics of China

Growth in Chinese GDP in H1 2017 has proven to be markedly higher than what we expected at the end of last year (6.4% y-o-y). In our view, three factors have led to the upside surprise.

First, the correction in property investment so far has been much shallower than we expected. After a strong rebound in 2016, growth in China's property investment, which accounts for 18% of total FAI, has remained at elevated levels. In Q2, property investment rose by 8.2% y-o-y, only moderately below the 9.1% growth in Q1 and 10% in Q4 2016.

The resilience in property investment was supported by strong housing sales, despite tightening policies to curb the property bubble. Property sales in Q2, in terms of gross floor area (GFA), amounted to 456 million square metres, up 14.1% y-o-y. While this is lower than the 19.5% growth in Q1, it is still at the higher end for the past three years. Sales are especially strong in some lower-tier cities, where purchasing restrictions are not in place. Booming property markets in lower-tier cities are also reflected in resilient housing prices, which continue to rise in the second- and third-tier cities (*Chart 2*).

Chart 2: MOM change in housing prices in Chinese major cities



Source: Pictet WM - AA&MR, National Bureau of Statistics of China

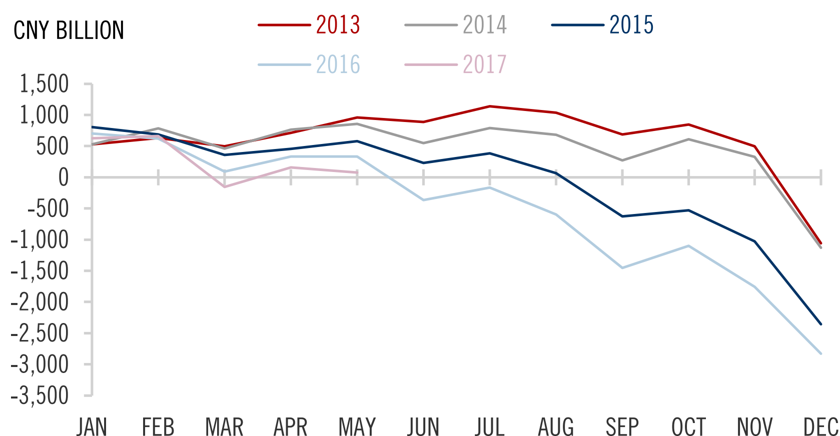
Strong housing sales have provided real estate developers with ample revenues to fund their construction activities. The latest data, for June, show that momentum in property investment will probably last longer than we expected. Growth of property sales rebounded to 16.1% y-o-y in the first half of 2017, compared to 14.3% in the first five months of the year. Growth in new housing starts also rebounded, to 10.6% y-o-y from 9.5%. In addition, land acquisition by developers rose by 8.8% y-o-y in June, compared to 5.3% in May. All these upbeat data points suggest that sentiment in the housing market is still fairly bullish, and the deceleration in property investment will likely come later than we expected, possibly in Q4 2017.

The second factor behind the positive surprise in Chinese growth so far has been front-loaded infrastructure investment in 2017. Infrastructure investment, which accounts for 27% of China's total FAI in H1 2017, rose by 16.0% y-o-y in Q2, declining slightly from the 18.1% growth in Q1. Taking the first half of 2017 as a whole, infrastructure investment grew by 16.8% y-o-y, significantly higher than the 12.7% y-o-y growth in H2 2016.

Strong growth in infrastructure investment is being supported by more aggressive fiscal spending by the Chinese government. In addition, fiscal spending has become much more front-loaded in recent years (*Chart 3*). For example, before 2014, the government's fiscal balance did not drop into deficit until December. In recent years, this has been coming earlier. This year, the government started to run a fiscal deficit as early as March, although it bounced back to a small surplus in the following month.

Active land acquisitions by real estate developers have also helped to fund infrastructure investment by the local governments, many of which rely quite significantly on land sales as a source of revenue.

Chart 3: Monthly distribution of the Chinese government's fiscal balance

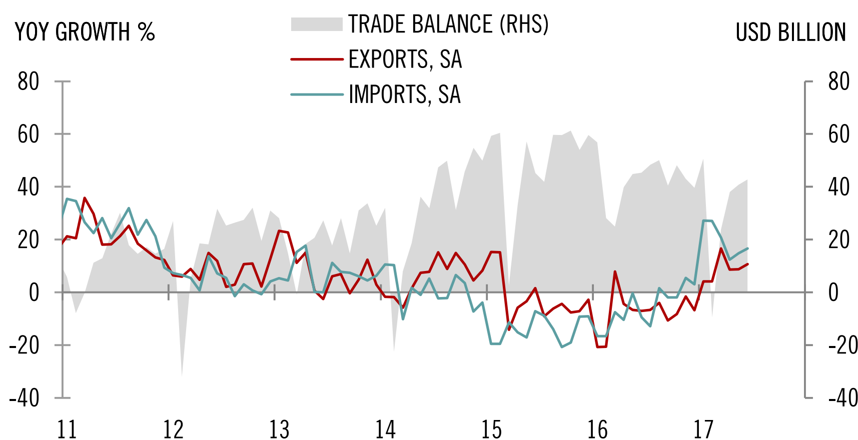


Source: Pictet WM - AA&MR, National Bureau of Statistics of China

The third factor in higher-than-expected GDP growth is strong global demand as a result of the economic recovery in the developed world. After being on a downward trend for roughly three years, growth in Chinese exports started to rebound in early 2016, along with the other major Asian exporters (*Chart 4*). Net exports contributed 0.3 percentage points to China's headline GDP growth in H1 2017, whereas this sector had previously been a drag to growth for six quarters in a row.

The latest purchasing managers' index (PMI) report shows that the new export orders sub-index continues to rise, reaching 52 in June–its highest reading for more than five years. With developed economies continuing to show healthy growth momentum, the positive boost from the export sector may last through the rest of the 2017.

Chart 4: China's exports, imports and trade balance



Source: Pictet WM - AA&MR, China Customs

With stronger-than-expected Q2 growth and solid momentum in FAI that may persist for longer, we are revising China's full-year GDP growth forecast for 2017 to 6.8% from 6.5% and the forecast for 2018 to 6.3% from 6.2%. Specifically, we expect y-o-y GDP growth for Q3 and Q4 of 2017 to be 6.8% and 6.6% respectively. Basically our new forecast assumes a slight slowdown in China's growth momentum in Q3 and a more notable decline in the growth rate towards the end of this year. Compared to our previous

scenario, the forecast deceleration in growth has been delayed to later this year.

However, there is still some uncertainty about the economy in the second half of this year. On the monetary policy front, we believe that the People's Bank of China (PBoC) will likely maintain a neutral policy stance with a tightening bias for the rest of the year. Since late 2016, the PBoC and the Chinese Banking Regulatory Commission (CBRC) have been pushing for a round of deleveraging in the financial system to counter rising financial risks. Inter-bank interest rates have risen significantly in the past few quarters and shadow banking activities have declined.

So far it seems the financial deleveraging has had little impact on the real economic activity. The average lending rates offered by banks rose in Q1 2017, for the first time in more than two years, but this was largely driven by bill financing, a kind of short-term credit mainly used by small and medium-sized enterprises (SMEs). However, if the regulators' tightening measures stay in place for much longer, interest rates for general loans and even mortgage loans may move higher as well, which will likely have a more meaningful impact on the real economy.

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