CHINA ECONOMICS WEEKLY

Waiting for stimulus, heatwave highlights climate risks

Support measures could take time to draw up

Hopes for more policy easing intensified last week after the surprise cut to the PBOC's reverse repo rate and the release of weak activity data for May. Late last Friday, the State Council said that it was considering various policies to boost demand.

So far, the follow-up has been underwhelming. There was a small cut to the Loan Prime Rate (LPR) this week, matching the 10bp decline in the PBOC's other policy rates. But the central bank passed over the chance to push down the 5Y LPR, the benchmark for mortgage rates, by a larger margin.

What's needed most is additional fiscal support but there has been little movement on that front. The only announcement this week was a four-year extension of tax breaks for electric vehicle (EV) purchases that had been due to expire at the end of 2023. This represents RMB520bn (0.4% of GDP) in savings over the duration of the extension. But it only alters the status quo from next year, so won't provide immediate economic support.

Policymakers may simply need more time to draw up the specifics of a fiscal package. They have just begun an audit of local government debt and may be awaiting its findings before deciding on the best course of action. While the timing is uncertain, we still expect some additional fiscal stimulus this year. Officials may opt to experiment with greater support for consumers than they have in the past. But the preference for investment-led stimulus is deeply rooted in China and so the bulk of any support is still likely to take the form of infrastructure spending.

As for how the money will be allocated, green tech and climate resilience are key focus areas. On Monday, the State Council released guidance aimed at building out an extensive EV charging network by 2030. Meanwhile, spending on water conservancy and flood prevention has been among the fastest growing forms of infrastructure investment so far this year. Further projects are planned, including the construction of a national water network.

Still not prepared for extended hot and dry spell

North China registered the hottest June day on record yesterday. Temperatures in Beijing, Tianjin and Hebei province exceeded 40°C. South China also experienced severe heat in late May. The earlier-than-usual arrival of high summer temperatures has placed additional pressure on the energy grid due to increased use of air-conditioning. To make matters worse, rainfall has been low. A third less hydro power was generated in May than last year. In response, some regions have asked firms to reduce their electricity use.

This is reminiscent of last summer's power shortages, which were triggered by a heatwave and severe drought. Since then, China has tried to strengthen the buffer provided by coal-fired generation – power plants have amassed a record 187 million tonnes in coal inventories. But power demand has risen too so these swollen stockpiles don't offer much more protection than they did a year ago.

Extreme weather is also a problem for farmers. Another drought would hurt crop yields while livestock are vulnerable to high temperatures. Last year's heatwave gives some sense of the risks to China's food supply and the potential impact on prices. After adjusting for seasonality, the food component of CPI rose 3.8% between last June and October, adding 0.8%-pts to headline inflation.

Even if a similar outcome is avoided this year, climate change means such events are likely to happen with increasing frequency in future. In addition to water shortages and extreme heat, rising sea levels pose a major challenge given that low-lying coastal regions are home to 40% of China's people and 60% of its industry. Our research suggests that, among the world's major economies, China is particularly vulnerable to global warming.

The week ahead

The PMIs are likely to show the rebound continued to falter in June. Services probably lost momentum while manufacturing continued to struggle.

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Data Previews

Manufacturing PMIs (Jun.)

Fri. 30th Jun. / Mon. 3rd Jul.

Forecasts	Time (China)	Previous	Consensus	Capital Economics
"Official" PMI (30th Jun.)	09.30	48.8	49.0	49.0
Caixin/S&P Global PMI (3rd Jul.)	09.45	50.9	49.8	50.0

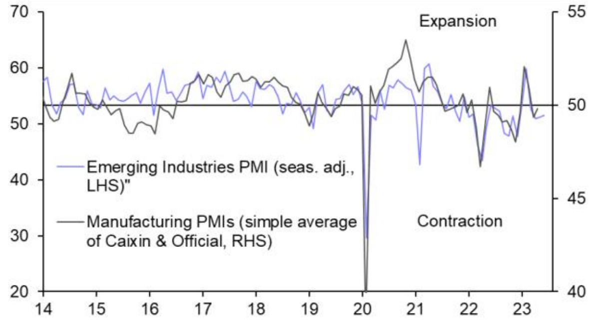
Factory activity continued to struggle

The official manufacturing PMIs fell further while the Caixin survey rebounded above 50 in May. Given differences in the composition of the firms surveyed, the decline in the official index suggests that larger firms and those located inland are facing the greatest headwinds. The average remains consistent with some modest downward pressure in factory activity.

The May activity data generally underperformed expectations. And early signs suggest the economy has continued to lose momentum in recent weeks – steel output declined and cement inventories are at their highest levels since 2016. Policy tightening outside of China probably continued to weigh on foreign demand. Domestic consumer goods demand is holding up better but probably hasn't made much headway either.

Consistent with this, the official Emerging Industries PMI – which covers high-tech parts of manufacturing – picked up slightly but remained under 50 in June. (See Chart 1.)

Chart 1: Manufacturing & Emerging Industry PMIs



Sources: CEIC, S&P Global, Capital Economics

Non-manufacturing PMIs (Jun.)

Fri. 30th Jun. / Wed. 5th Jul.

Forecasts	Time (China)	Previous	Consensus	Capital Economics
"Official" PMI (30th Jun.)	09.30	54.5	-	52.0
Caixin/S&P Global PMI (5th Jul.)	09.45	57.1	-	54.0

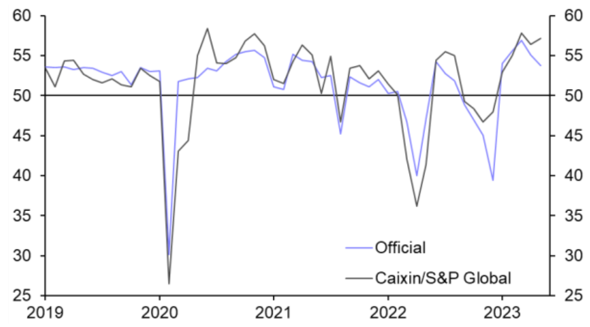
Services recovery losing momentum

The Caixin PMI unexpectedly picked up in May while the official index dropped back again. (See Chart 2.) The average of the two edged down but remained consistent with a rapid expansion in services activity.

We think the services recovery lost some momentum in June. Much of the return to normality has already happened. Most high frequency data show a much smaller improvement this month compared to May. This suggests that while the recovery is still progressing, it is occurring at a more modest pace.

Construction activity, which is part of the official non-manufacturing PMI, dropped back in May. It probably declined again in June. The prop to infrastructure spending from the front-loading of fiscal support will have continued to fade. And an unwinding of the recovery in home sales will have weighed further on developers' appetite to launch new projects.

Chart 2: Services PMIs



Sources: CEIC, S&P Global, Capital Economics

Economic Diary & Forecasts

Upcoming Events and Data Releases

Date	Country	Release/Indicator/Event	Time (China)	Previous*	Median*	CE Forecasts*
June						
Tue 27th	**HK**	Trade Balance (May, HKD)	(16.30)	-36.6b	-	-43.5b
	HK	Exports (May, HKD)	(16.30)	(-13.0%)	-	(-12.5%)
	HK	Imports (May, HKD)	(16.30)	(-11.9%)	-	(-10.0%)
Wed 28th	**Chn**	Profits of Large Industrial Firms (May)	(09.30)	(-20.6%)	-	-
Fri 30th	**Chn**	"Official" Manufacturing PMI (Jun.)	(09.30)	48.8	49.0	49.0
	Chn	"Official" Non-Manufacturing PMI (Jun.)	(09.30)	54.5	-	52.0
	Chn	Current Account Balance (Q1, Fin., USD)	-	+82.0b	-	-

Selected future data releases and events:

July

Date	Country	Release/Indicator/Event
Sat 1st	**HK**	Hong Kong Special Administrative Region Establishment Day (National Holiday)
Mon 3rd	**Chn**	Caixin Manufacturing PMI (Jun.)
	Chn	Retail Sales (May)
Wed 5th	**Chn**	Caixin Services PMI (Jun.)
Fri 7th	**Chn**	Foreign Exchange Reserves (Jun., USD)

Main Economic & Market Forecasts

%q/q annualised (%y/y), unless stated	Latest	Q2 2023	Q3 2023	Q4 2023	Q1 2024	2022	2023f	2024f	2025f
Official GDP	+2.2(+4.5)*	(8.1)	(5.3)	(5.9)	(4.6)	(3.0)	(6.0)	(4.6)	(4.2)
GDP (CE CAP-derived estimates)	+7.0(+4.2)*	(11.6)	(7.9)	(11.1)	(4.7)	(-2.5)	(8.5)	(4.0)	(3.5)
Consumer Prices	(+0.2)**	(0.4)	(0.3)	(1.0)	(2.4)	(2.0)	(0.5)	(2.0)	(1.0)
Producer Prices	(-4.6)**	(-4.1)	(-2.6)	(-1.8)	(-1.0)	(4.2)	(-2.5)	(-0.5)	(-0.9)
Broad Credit (AFRE)	(+9.5)**	(9.9)	(10.0)	(10.8)	(9.5)	(9.6)	(10.8)	(8.9)	(8.3)
Exports (US$)	(-7.5)**	(-10.0)	(-17.0)	(-6.5)	(-11.0)	(7.0)	(-8.5)	(-3.5)	(2.5)
Imports (US$)	(-4.5)**	(-6.0)	(-11.0)	(-3.5)	(15.5)	(1)	(-7)	(7.5)	(1.5)
RMB/$†	7.18	7.15	7.05	6.90	6.80	6.95	6.90	6.50	6.40
7-day PBOC reverse repo† %	1.90	1.90	1.80	1.80	1.80	2.00	1.80	1.80	1.80
1-year Loan Prime Rate† (LPR) %	3.55	3.55	3.45	3.45	3.45	3.65	3.45	3.45	3.45
1-year MLF Rate† %	2.65	2.65	2.55	2.55	2.55	2.75	2.55	2.55	2.55
10-year Government Bond Yield† %	2.71	2.80	2.90	2.90	2.85	2.85	2.90	2.70	2.60
RRR (major banks)† %	10.75	10.50	10.25	10.25	10.25	11.00	10.25	10.25	10.25
CSI 300 Index†	3,864	3,880	3,915	3,950	4,085	3,872	3,950	4,500	5,100
Hong Kong GDP	(+2.7)*	(4.0)	(9.0)	(11.0)	(7.5)	(-3.5)	(6.5)	(7.5)	(6.5)
Hang Seng Index†	18,814	18,900	19,250	19,750	23,500	19,781	19,750	23,500	27,000

Sources: Bloomberg, Refinitiv, CEIC, Capital Economics *Q1; **May; † End of period