MERICS ECONOMIC INDICATORS

Quarterly analysis of economic trends in China

Q2/2018:
Credit tightening and trade conflict threaten growth

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MERICS Q2 analysis

Chinese regulators face tough decisions

The onset of a slowdown of economic activity in the second quarter, which was reflected by GDP growth falling to 6.7%, coincides with the beginning of the trade war with the United States. After nearly a year of regulatory policy tightening, China's deleveraging campaign as well as stricter environmental protection have started to affect the real economy. The consequences of an escalating trade war with the United States are not yet reflected in the current economic slowdown, but could accelerate it. As internal and external factors threaten to slow GDP growth more than the government might feel comfortable with, it puts China's policy makers between a rock and a hard place.

It has become clear that tightening conditions are accompanied by economic pain. A shift in mood within the economy is already reflected in MERICS's leading indicator, the MCCI, which remained below 100, indicating negative sentiment. Slower growth of key macroeconomic data has affected market sentiment, pushing down China's stock markets, which have fallen 16% since the beginning of the year. The unfolding trade war could cause sentiment to deteriorate further. Following steady economic growth since 2016, the changing economic environment is a reminder that stable growth cannot be taken for granted.

The direct effects of the United States' tariffs on economic growth are likely to be subdued as China's export dependency has fallen considerably over the past years. However, the conflict's indirect effects on the economy will likely lead to a less stable economic environment and pull down headline growth. Most notably the depreciation pressure of the CNY against the USD is increasing and the prospect of a return of capital flight looms. The external disruption will expose vulnerabilities within the Chinese economy just as China is attempting to address trouble spots.

But there are limits to how far the Chinese government can allow GDP growth to fall if it wants to deliver on its economic development goals. Over the next three years a minimum annual GDP growth of 6.4 percent is necessary for China to be able to double GDP and income by 2020 from 2010 levels. Growth can only fall by 0.4 percentage points before dropping below this critical base line of 6.4 percent. Although this seems unlikely for 2018, defending the minimum GDP growth in 2019 might force Chinese leaders to dial back on controls of credit growth and environmental protection.

China's commitment to more restrictive policies will be tested as the trade conflict puts more pressure on the economy. At this stage a full-scale reversal of the deleveraging campaign seems unlikely as regulators remain vigilant in the face of financial risks. But as GDP growth is increasingly under threat, further policy fine-tuning can be expected. In this unpredictable policy environment, a return to a more expansive fiscal and monetary policy paired with stricter capital controls looks likely to be the Chinese leadership's preferred defensive strategy.

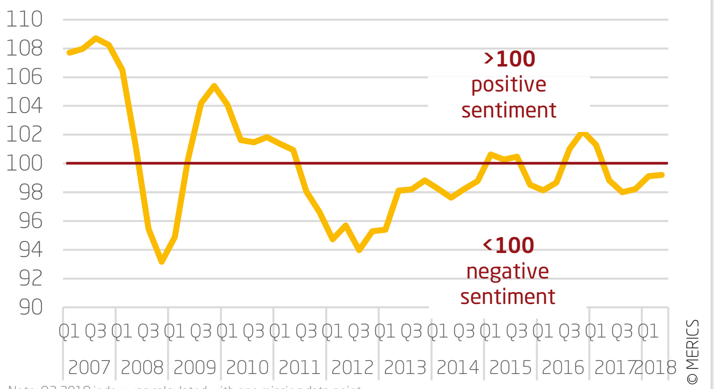
The MERICS China Confidence Index (MCCI)

The MERICS China Confidence Index measures households' and businesses' confidence in future income and revenues.

The index is weighted between household and business indicators. It includes the following indicators: stock market turnover, future income confidence, international air travel, new manufacturing orders, new business in the service sector, urban households' house purchase plans, venture capital investments, private fixed asset investments and households' consumption share of disposable income. All components have been tested for trends and seasonality.

The MCCI was first developed in Q1 2017.

MCCI indicates negative sentiment
MERICS China Confidex Index



Note: Q2 2018 index was calculated with one missing data point.

Focus topic: Free Trade Ports

New Free Trade Ports unlikely to advance China's economic opening

By Aymeric Mariette

China's authorities have launched a new experiment to spur economic reform and opening. In April, the State Council announced a plan to establish so-called Free Trade Ports (FTPs) in Hainan by 2025. Local authorities in Shenzhen also released a document stating that an FTP should be implemented by 2020. The aim is to create an environment that is responsive to market needs, provides spaces for experimentation and that ultimately aim to strengthen the countries international competitiveness. But there is reason to be skeptical about the success of those plans.

For many years, the Chinese government has used specially designated zones for testing economic reforms in local experiments. The policies that proved successful would then be replicated nationwide. The best-known examples of this approach are the Special Economic Zones (SEZ) launched in the 1980s. Back then, SEZs like Shenzhen or Xiamen served as catalysts for liberalizing China's planned economy and played a central role for China's opening-up to the world.

Although China's President Xi Jinping has re-centralized policymaking, testing reform measures remains an important tool for Chinese economic policies. At the end of 2013 the administration launched a series of "Pilot Free Trade Zones (PFTZ)" to honor the CCP's commitment made at the 3rd Plenum of the 18th Central Committee, to let "market forces play a decisive role" in the Chinese economy. Shanghai was the initial PFTZ and by 2018 there were a total of 11.

New attempts with similar goals
Types of experimental zones designed to open the Chinese economy to the world

Type of experimental zone	First implementation	Goal	Reforms needed
Special Economic Zones (SEZs)	Shenzhen, 1980	Open Chinese economy to the world	Transform China's planned economy into a more liberalized model
Pilot Free Trade Zones (PFTZs)	Shanghai, 2013	Reach high trade and investment standards	Let market forces play a decisive role in the Chinese economy
Free Trade Ports with Chinese characteristics (FTPs)	Shenzhen, 2020 (planned)	Reach Hong Kong and Singapore trade and investment standards	Free flow of capital and trade; rule of law system

Pilot Free Trade Zones: Broken promises of free capital flows and legal certainty

In this new round of reform, two experimental zones have raised high expectations among foreign investors as their goals to implement market-oriented standards are particularly ambitious: The Shanghai PFTZ aims at transforming the city into a world financial center. The Qianhai PFTZ in Shenzhen is intended to become a hub for modern service industry and for closer cooperation with Hong Kong. Like the SEZs before them, the PFTZs offer more liberal trade and investment conditions for foreign companies in a still fairly closed Chinese economy. In Shanghai a relaxation of China's tightly controlled cross-border financial flows was on the table, as was the implementation of Hong Kong's highly acclaimed legal system based on the Common Law in Qianhai.

However, so far this new round of experimentation has not met foreign investors' expectations. In a survey conducted by the European Chamber of Commerce (EUCC) in June 2016, 83% of respondents stated they did not benefit from the reduced negative list system in the Shanghai Pilot Free Trade Zone, which lists sectors off limits for foreign investors. Capital controls were not fully loosened either. The experimentation with a free trade account, which enables companies registered inside the zone to freely move funds between the zone and overseas, was put on hold when central authorities cracked down on capital outflows in late December 2016. Neither was the attempt of Qianhai PFTZs to replicate Hong Kong's business-friendly environment successful: The experiments designed to build an efficient rule-of-law system inspired by Common Law has not shown any result yet. As a result, foreign companies' reception of the new zones remains muted: According to the latest available survey of the EUCC only 17% of respondents had established a presence in a PFTZ by 2017.

Free Trade Ports: one experimental zone inside another

President Xi's call to establish Free Trade Ports "with Chinese characteristics" during the 19th CCP Congress was therefore met with skepticism in the international business community. The ports are to be created within existing PFTZs, effectively creating a new experimental zone within another. They are supposed to meet even higher international standards for trade and investment and are expected to compete with the successful free trade ports in Hong Kong and Singapore.

As of now, it seems unlikely that a Chinese FTP will be able to match the success of Hong Kong and Singapore. Both ports benefit from a smart combination of two types of regulations: First, they grant global shipping companies favorable tax and business regimes. Second, and that is maybe even more important considering the highly globalized character of the maritime business, they offer well-integrated financial and legal services, providing an efficient, open and free ecosystem for their customers' trade.

The lack of reform progress in the PFTZs makes it seem unlikely that Free Trade Ports established under their tutelage will manage to provide efficient financial and legal services. A recent review by the central government of the policy experiments within the zones was not encouraging, with a few successful reforms in these two realms (see table).

Dwindling reform zeal
Number of successful reforms in the financial and legal sector

Date of biannual government reviews	Financial sector liberalization reforms	Legal sector liberalization reforms	Rate of successful reforms per review
Dec 14	8	0	38%
Nov 16	0	0	0%
May 18	0	2	7%
Total	8	2	15%

One challenge to policy implementation is the lack of incentives to conduct bold reform. Compared to the 1980s local officials enjoy less policymaking autonomy. Moreover, the harsh corruption campaign during Xi's first term has intimidated local officials fearful of being targeted for deviating from the Party line. The top-down approach has proven incompatible with the decentralized decision-making process that worked successfully in the initial FTZs.

China's political system stands in the way of genuine economic freedom

The central government has realized that it has to loosen its grip in order to inspire genuine attempts economic reform on the ground. During the 19th Party Congress in the fall of 2017, the CCP leadership encouraged local officials to conduct bolder experimentation. This was also made explicit in the new guidelines to further reform inside selected Pilot Free Trade Zones published in May 2018, which called for further liberalization of the service sector. On June 30th 2018 Chinese authorities announced the introduction of a new negative list for all PFTZ, bringing the number of prohibited sectors for foreign investment down to 45 compared to previously 95.

The renewed efforts of Chinese authorities to deepen reforms are undeniable, but the question whether a truly efficient, open and free market can be built within China's authoritarian system remains open. Institutionalizing corporate governance based on the rule of law remains one of the key difficulties as it conflicts with the CCP's position above the law. Potential discrimination and policy ambiguity result in insecurity among foreign companies. For example, recent practice has shown that investment restrictions continue to exist even in industrial sectors not on the negative list. For example, in 2015, new restrictions appeared under the National Security Review experimentation launched in selected PFTZs in 2015. In the same way, authorities backtracked on liberalizing capital account controls in late 2016 when the government tried to rein in capital flight.

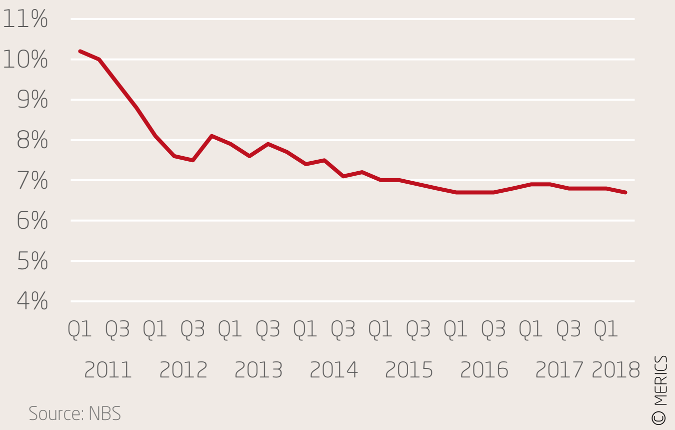
The establishment of Free Trade Ports may well inspire bolder experimentations in the Pilot Free Trade Zones. The PFTZs are and will remain important for policy experimentation. However, fusing China's specific economic and political approach with international trade and investment standards remains an impossible proposition. It is highly unlikely, that free trade ports "with Chinese characteristics" will one day compete with Hong Kong or Singapore.

Economy

China's economy faces headwinds despite stable Q2 growth

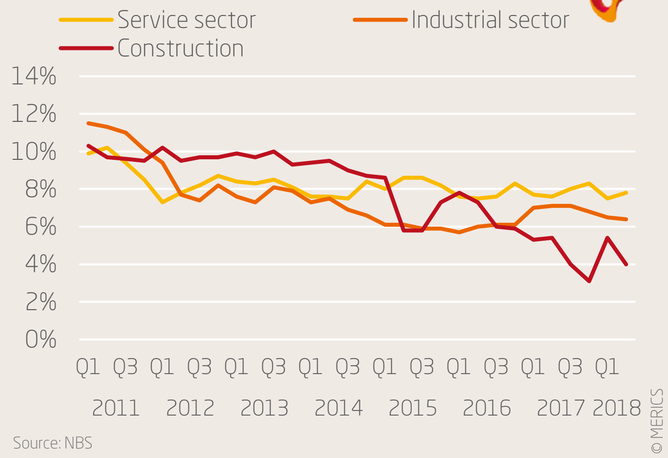
- Tighter government policies begin to impact the economy
- Impact of trade war still to come

Long lasting steady GDP growth under threat
GDP growth (real, yoy)



Source: NBS

Service sector lifts growth
GDP growth by sector (real, yoy)



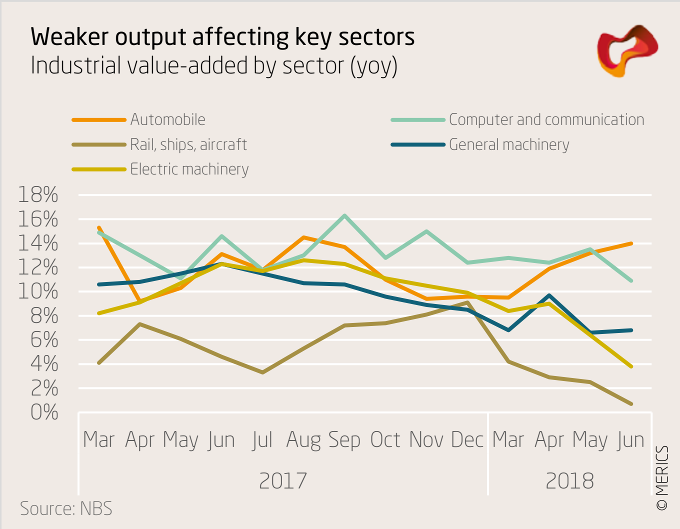
Source: NBS

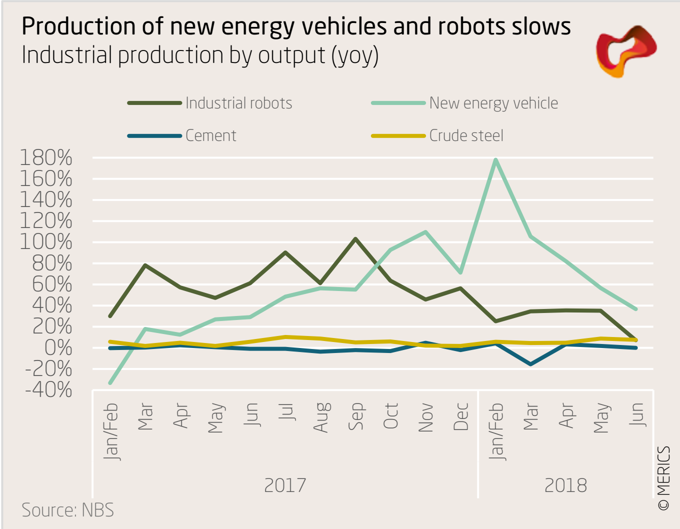
- The Chinese economy continued its steady growth pattern, expanding by 6.7% in the second quarter and 6.8% in the first six months. For the past 12 quarters GDP has expanded on a remarkably stable course within a band of 6.7% and 6.9%.
- This leaves growth within a very comfortable range for a gradual and controlled deceleration to lower growth levels. For 2018 GDP growth is on track to reach the government's GDP target of 6.5% to 7%, even in the face of a likely slowdown in the second half of the year.
- As in previous quarters the service sector outpaced other areas of the economy. It expanded at 7.8% compared to the first quarter, while manufacturing and construction were weaker, expanding by 6.4% and 4.0% respectively. Service sector growth was carried by transport and logistics (8.1%), IT services (31.7%) and business services (9.4%). All other categories, including real estate and financial services, grew below the average for services in the second quarter.
- In 2017 GDP was lifted by exports, but this has since been reversed. Net exports pulled down growth by 0.67 percentage points. Consumption increased its share in GDP growth composition, accounting for 78% in the second quarter, while gross fixed-capital formation remained relatively stable at 31.4%.
- The ongoing efforts to rein in credit growth have started to affect the real economy though slowing investment activity. Tighter implementation of environmental protection is affecting the manufacturing sector, although the direct effects are difficult to measure.
- In the months ahead, the growing impact of these policies can be expected to coincide with negative side effects of the trade conflict with the United States – from weakening exports, to currency depreciation and an increased risk of capital outflow.
- For the second half of the year, the slowdown is likely to be more pronounced. The comparable high GDP growth in the first half gives the government some flexibility in form of acceptable slower economic expansion. However, the stability-minded policy makers will want to avoid an uncontrolled and rapid deceleration.
- With the growth target for 2018 secured, the real challenge is to ensure stable growth for 2019. Further stimulus through investment as well as efforts to stabilize the CNY with the aim to guide a gradual and controlled deceleration to lower growth levels are likely.

Business

Industrial production growth shows first signs of softening

- Stricter domestic policies and trade war darken outlook
- Government announces new round of tax cuts and support for emerging industries





- Backed by strong growth in industrial production in the first five months led to stable manufacturing activity output expanded by 6.7% in the first half of the year, output expanded by 6.7% year-on-year. Following elevated growth in April (7 %) and May (6.8 %), production began to soften in June with growth falling to 6 %. The slower growth in June can partially be explained by high growth during the reference period of the previous year.
- However, slower growth was noticeable across several industries in June. Production of computer and communication equipment, general and electric machinery as well as rail, ships and aircraft recorded slower growth over Q2, with growth falling further in June. The production of new energy vehicles as well as industrial robots dropped to the lowest level on record, while output of cement and coal remained flat. A noticeable exception was accelerated growth in the automobile industry (14%).
- The Purchasing Mangers' Index (PMI) compiled by the National Bureau of Statistics (NBS), a key measure of business sentiment, remained above 50, indicating expansion. However, the outlook in PMI's export sub-category for export orders dropped below 50 in June.
- The signs of weakening in industrial production in June may hint at more downward pressure to come. Slower investment activity; tighter credit conditions, especially for small and medium-sized enterprises (SMEs); as well as stricter enforcement of environmental standards and the impact of the trade war are likely to dampen industrial output.
- In order to dampen the negative impact of domestic policies and extern threats, the government has announced a number of support measures over the course of the quarter. Measures include tax breaks of 60 billion CNY for innovative small businesses as well as a new 300 billion CNY state fund targeting newly emerging industries including biotechnology, new materials and new-energy vehicles.

International trade and investment

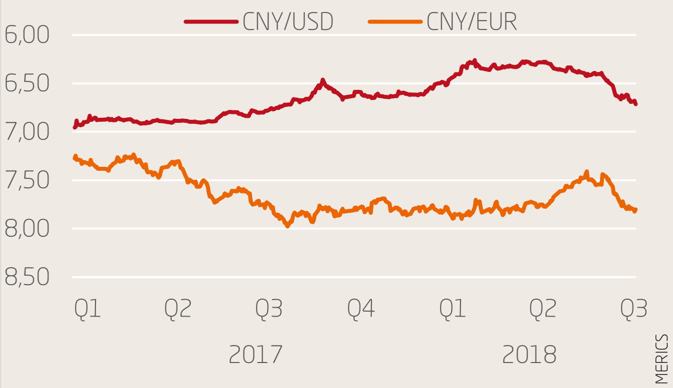
China's export will feel impact of escalating tensions with United States

- Export and import growth remain solid in second quarter
- Steep fall in CNY exchange rate major policy concern

Impact on trade strong for now
Growth in imports and exports (yoy, in USD)

Source: CEIC / GAC

CNY depreciated sharply
Exhange rate of CNY to USD and EUR (inversed scale)



Source: CEIC

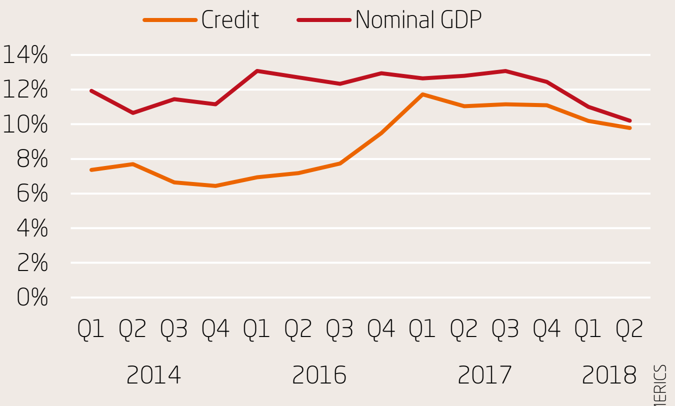
- The trade conflict between the United States and China has not yet affected trade flows which are growing at a faster pace than overall economic growth. Measured in USD, exports and imports grew by 12.3 and 20.5 % respectively in the second quarter. An unusual overall Chinese trade deficit in March has been reversed into a surplus. The initial round of tariffs imposed by the United States will not be felt until the next quarter.
- Stating that talks with China had yielded no significant concessions, the United States implemented tariffs on 34 billion USD worth of imports (a relatively small proportion of total imports) on July 6 with a focus on Chinese high-tech goods. China retaliated by imposing tariffs on an identical value of US goods. In response the United States threatened to further target 200 billion USD worth of Chinese exports.
- Since China imports much less from the United States than it exports it will quickly run out of products which it can subject to tariffs. Therefore, it is likely that China will begin adjusting its response, for example by targeting individual US companies.
- China's dependency on trade has fallen from a peak in 2010, but exports still amount to 20 % of Chinese GDP. The United States is still China's largest single export market, corresponding to roughly one fifth of all Chinese exports. In June alone China exported 42 billion USD worth of goods to the United States. This means that China will have to find other export markets if the trade conflict further escalates. But the size of the US market is so large that this will be a difficult task.
- China announced several adjustments over the second quarter to prove its commitment to open markets. The administration reduced the number of sectors barred for foreigners from 63 to 41. It lowered tariffs on some goods, particularly automobiles; and it relaxed foreign ownership caps in the automobile and financial sectors.
- Foreign direct investment into China increased by 4.1 % to 68.3 billion USD in Q2. This number included high-profile investments in high tech manufacturing from BASF and Tesla. The German car giant BMW also announced taking a majority stake in a joint venture with Brilliance.
- The CNY recorded the sharpest drop in its history in June. The exchange rate to the USD peaked around 6.3 in April and has now depreciated close to around 6.7. The fall is likely due to more than one reason, fears of the trade war played a part. A continued depreciation could cause severe problems: Firstly, China imports many key commodities, particularly oil. The prices of such commodities will increase if the currency depreciates. Secondly, if investors believe the currency will fall further they might begin selling off CNY-denominated assets to insulate themselves against losses, leading to capital flight.

Financial markets

Liquidity injections and capital controls aim to calm markets

- Credit growth continues to slow, but remains above nominal GDP growth
- Stock markets tumble in second quarter

Credit growth only slowly coming down
Total credit* and nominal GDP growth (yoy)



Source: CEIC / PBOC / * measured as aggregate financing

Stock indicies on downward trend
Shanghai and Shenzhen stock exchange

Source: CEIC

- Overall credit growth continued to slow in Q2, expanding at an average of 10.2 %, the lowest in recorded history. This will make it easier to maintain oversight over potential risks in the financial system.
- But credit is still growing at a faster pace than nominal GDP (9.8 %), meaning that China is still taking on new debt at a faster pace than it is able to repay old debt. Credit and economic growth are highly correlated; they typically fall in sync. Therefore, true deleveraging would require much lower growth levels.
- Because of efforts to rein in shadow banking, categories of financial products such as Bankers' Acceptance Bills and Entrusted Loans contracted by 6.7% and 4.5 % respectively. Trust loans, another such type of debt, grew at 10 %, the lowest since 2016. However, regular bank lending grew by 12.7 %.
- The People's Bank of China (PBOC), has cautiously loosened monetary policy. The central bank supplied liquidity to the market through net injections, through open market operations and reductions of the reserve requirements of banks that lend to SMEs. Furthermore, it only partially matched the United States' Federal Reserve's controlling rate increases. China's central bank has signaled that it would allow more targeted loosening of monetary policy if necessary.
- A year-long fall in stock market indices indicate that Chinese equities have entered bear-market territory. The Shanghai and Shenzhen stock market indices have both fallen by more than 16 percent since the beginning of the year, partially triggered by fears of the beginning trade war with the United States.
- The USD/CNY exchange rate fell from 6.3 to 6.7 in June, reflecting falling returns in equity and capital markets. In response, Chinese authorities have introduced new measures to control capital outflow. One example is the suspension of a relatively new policy that enabled Chinese investors to buy Hong Kong-listed Chinese tech firms, such as Xiaomi, though the Hong Kong Stock Connect scheme.
- Continued careful loosening of monetary policy to support economic growth and provide liquidity is likely to continue. As was the case in 2015, direct government intervention to deter sharp falls in equities as well as the currency can also be expected. But unless Chinese investors' access to foreign markets is further curbed or domestic returns increase, this is unlikely to be enough. Raising rates could destabilize the system, so further tightening of capital controls is likely.

Investment

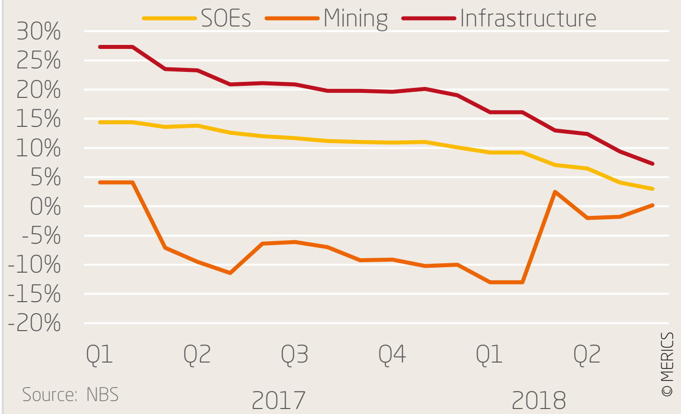
Fixed asset investment falls to historical low

- Tighter credit conditions slow investment by state-owned enterprises
- Private investment holds up growth so far

Fixed asset investment growth at record low
Growth of fixed asset investment (yoy)

Source: NBS

Delevaraging hits investments by local governments
Growth of fixed asset investment by type (yoy)



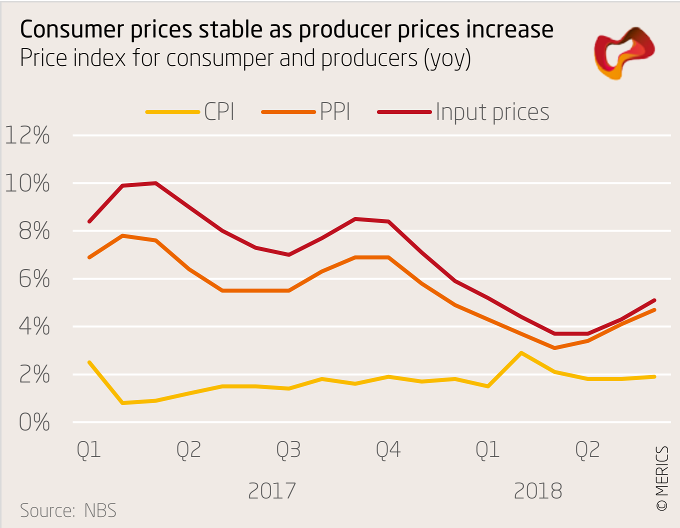
Source: NBS

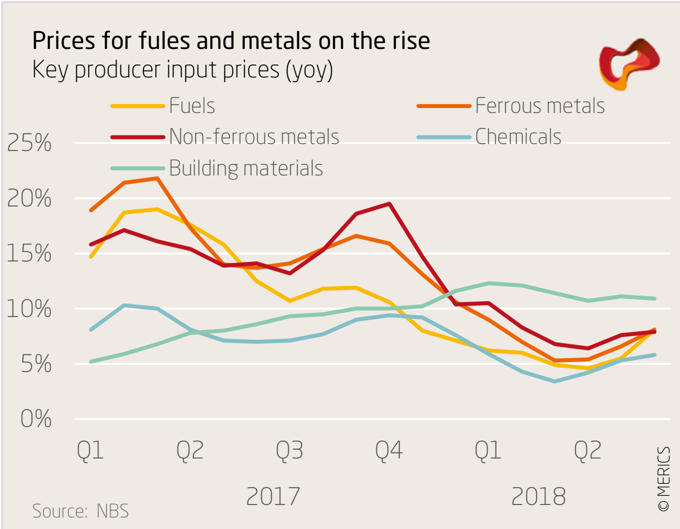
- Fixed-asset investment growth fell to 6% over the second quarter, the lowest since data has been available. Investment growth has trended down over the past years, but tightening credit is beginning to affect the real economy.
- The decline in investment activity by state-owned enterprises (SOE) was most pronounced, with growth falling to 3% in the first half of the year. SOE and investments by local governments have been particularly affected by the government's deleveraging campaign.
- Tighter financing conditions for local governments have resulted in a drop in infrastructure investments, where growth declined from 15% in 2017 to 9.7% in the second quarter. Efforts to cut overcapacities in mining operations, which are often government-owned, have kept growth negative since 2015, with Q2 investment contracting by 1.2%.
- Private fixed-asset investment remained stable with an expansion by 8.3%, despite tightening credit conditions. Investment in highway and railway transports stood out as particularly high, growing at 23.9% and 53.3% respectively.
- Real estate investment grew by 10%, following large increases in land purchases in 2017. These purchases have since subsided, indicating that real estate investment could fall in H2.
- Investment in the primary, secondary and tertiary sectors grew at 15.2%, 2.9% and 7.9% respectively. Investment activity in the tertiary sector, which includes infrastructure and services, accounted for 60% of investments, while the share of manufacturing investment continued to fall, accounting for 36.8% in Q2.
- Should GDP growth come under increased downward pressure, a return to increased investments by state-owned enterprises and local governments seems likely in an attempt to generate short-term growth support. This would require a relaxation of credit conditions and risks undermining the government's deleveraging campaign.

Price levels

Consumer price levels remain flat

- Currency devaluation and tariffs likely to push up price levels for imports in second half 2018
- High housing prices still pose a problem



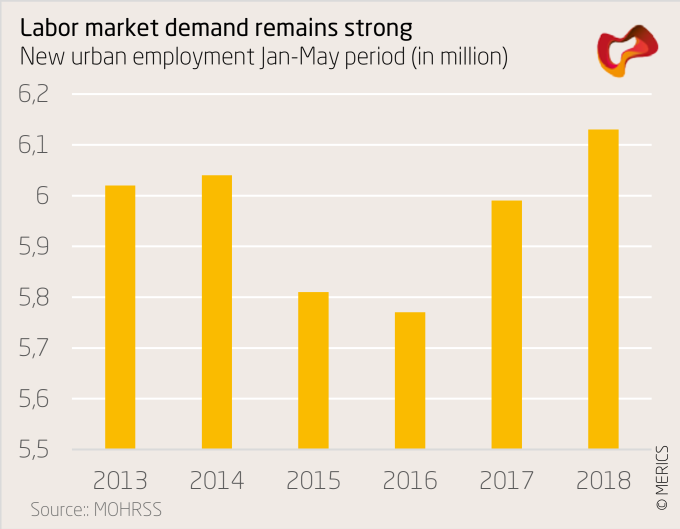


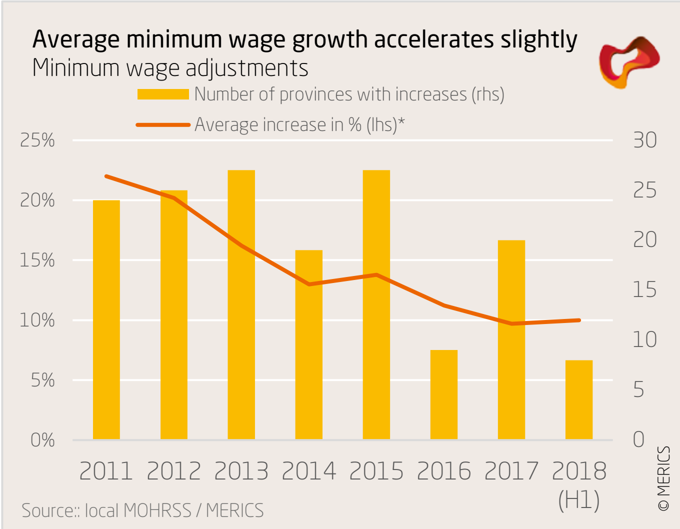
- Consumer price inflation (CPI) was largely unaffected despite the People's Bank of China injecting large sums in to the monetary system this year. Following a mild uptick in the previous quarter, price levels returned below the 2 % mark. CPI and core inflation which does not include volatile food and fuel prices both grew at 1.9 % in the second quarter.
- The price of various consumer goods such as clothing (1.1 %), household items (1.6 %) as well as transport and communication services (1.2 %) grew below overall CPI in the first six months. Medical services (5.5 %), fuel (9.4 %) and rents (2.4 %), on the other hand, increased at a higher pace.
- Due to higher global oil prices the cost for vehicle fuel increased by 9.4 % in the first half of the year, with spiking up by 17.8% year-on-year in June. If the Chinese currency keeps depreciating, prices for fuel as well as other imported commodities may increase further in the second half of the year.
- Producer price growth picked up after declining in the first quarter, growing at roughly 4 %. This will increase industrial profits, helping leveraged companies to pay off debt. Factory gate prices for oil and natural gas, mining goods and raw materials increased the most, growing at 24 %, 8.6 % and 7.3 % respectively. The two most important reasons for the increase in prices are the government's continued reduction of overcapacities in these sectors as well as global increases in crude oil prices.
- Input price growth remained steady from Q1, growing at 4.4 %. But indicating tighter supply and demand conditions, key input categories including building materials, timber and paper products, fuels and metals all grew above this rate. The low growth of the overall input basket was due to the very low price growth for products such as textiles, agricultural products and semi-finished products.
- The trade war with the United States is set to affect prices in the second half of the year. China's tariffs on US agricultural products will likely lead to higher prices for livestock feed, which will result in rising prices for pork.
- US tariffs on Chinese industrial goods may have the opposite effect. If Chinese exports to the United States' fall, Chinese production prices might fall as the country absorbs excess production internally.
- The current low inflation environment could lead the PBOC to unleash stimulus, if the overall economy slows due to the trade war. However, inflation figures do not include asset prices. Despite the government's attempts to cool the housing market, prices for 70 cities increased by 5.8 % in June and remain 22.3% above 2015 levels. A large-scale stimulus risks complicating the government's efforts to control real estate prices.

Labor market

Record number of new urban jobs created

- Employment stable as record number of university graduates about to enter labor market
- Government promises support and income taxt reform in anticipation of slower growth and trade war





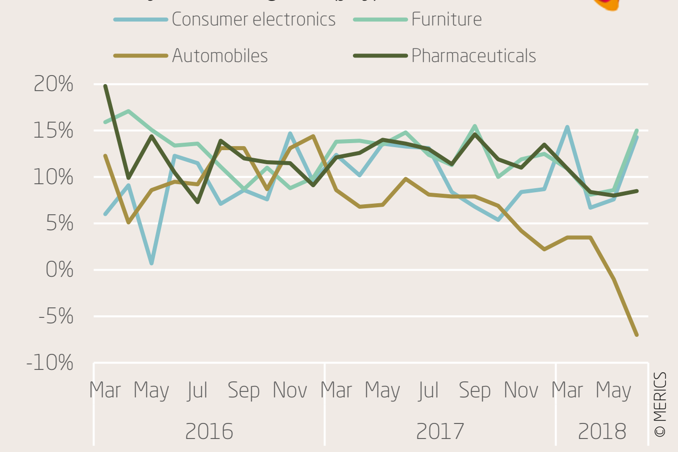
- Employment figures remained resilient despite a slowdown in economic growth over the second quarter. According to data released by the Ministry of Human Resources and Social Security (MOHRSS), a total of 6.13 million new urban jobs were created in the first five months (latest available data). The figure represents the highest addition of jobs since data has first been released in 2013.
- Following a sharp uptick over the previous quarters, the latest data available for Q1 2018 indicates that the ratio between job vacancies and applicants is at 1.23, the highest level on record. The National Bureau of Statistics' Purchasing Managers' Index indicates that demand for labor in manufacturing has begun to pick up, while the figures for service companies fell to the lowest level in two years.
- The solid labor market conditions come as a record number of university graduates will graduate over the summer. In 2018, a total of 8.2 million graduates are expected to enter the workforce.
- Prospects of the trade war with the United States escalating and overall slower growth will challenge the labor market in the coming quarters. Export-oriented regions in Guangdong and the Yangtze River Delta and migrant workers in labor-intensive consumer goods manufacturing are particularly exposed to a drop in export demand or to an accelerated relocation of some export-oriented manufacturing to Southeast Asia.
- Amid increased uncertainty the government has taken steps to ensure stable employment. New measures announced by the State Council on July 5 promise better vocational training and encourage entrepreneurship for university graduates, former military personnel as well as laid-off workers. They go beyond previous similar measures in calling for more flexible labor market conditions, making it easier for start-up companies to hire and fire.
- The second quarter was marked by several unusual strikes. Truck drivers took to the streets in several cities to protest competition from online platforms providing logistic services as well as rising fuel costs. Independently, van drivers as well as crane operators also went on strike across different regions to call for higher wages.
- Slowing wage growth has been a source of grievance, in particular for low-skilled workers. In the first six months, eight provinces announced increases in minimum wage. Compared to 2017, the average minimum wage increased slightly from 9.5 percent to 10 percent. Half of the provinces had not increased minimum wages since 2015.
- In another effort to boost income, the government has proposed an amendment of the individual income tax. The draft includes higher income tax thresholds as well as additional deductibles.

Retail

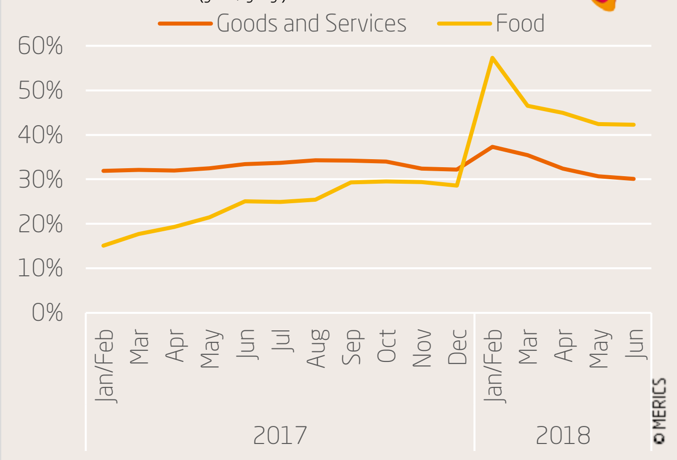
Stable consumer spending is crucial growth pillar

- Slump in retail sales in May not an indicator of shift in consumer sentiment
- Escalating trade war may accelerate demand for domestic brands

Slump in car sales the expection
Retail sales by consumer goods (yoy)



E-commerce maintains dynamic growth
Online retail sales (ytd, yoy)



- Retail sales expanded by 9.4% in the first half of the year. The fall below the 10% mark is in line with a gradual shift towards a lower growth level. Fears of a sharp slowdown following weaker growth in May (8.5%) did not materialize as sales rebounded in June (9%).
- The general resilience in consumption activity is reflected in the consumer confidence index released by the National Bureau of Statistics (NBS). Following a peak reading of 123.9 in October 2017, the index has plateaued at a high level as of June (122.9). A reading above 100 indicates optimism.
- Following a mild slowdown in May, consumer demand of most goods has recovered in June. The slowdown in May was mostly caused by falling demand for cars as a result of tightening credit for consumer loans. Sales of automobiles weakened to 2.7% in the first six months, with a contraction in both May (-1%) and June (-7%).
- Online sales continue to expand their share of overall retail, now accounting for 17%, up from 16.1% in Q1. E-commerce sales of both services (30.9%) and goods (29.8%) expanded at similar levels year-on-year in the first six months. Consumers' increasing preference for online orders led to online food sales growing by 42.3 %.
- Efforts have been made to further expand the development of e-commerce in rural areas as part of the government's poverty alleviation policy. The efforts can expect to receive a further boost after Alibaba's announcement in April to invest 4.5 billion CNY in an online service platform for rural areas.
- The expansion of cross-border e-commerce continues. According to the Ministry of Commerce, cross-border retail exports grew by 41% to 33.7 billion CNY, while imports grew 120% to 56.6 billion CNY. The State Council announced 22 additional pilot zones for promoting online sales for international trade on July 13, up from previously 13.
- Further depreciation of the CNY could dampen purchasing power by increasing costs for imports. In part however, this impact could be offset by consumers switching from foreign to domestic brands. Chinese consumers could also start to shun US brands amid the trade war.