China Watch

Group Economics
Emerging Markets Research

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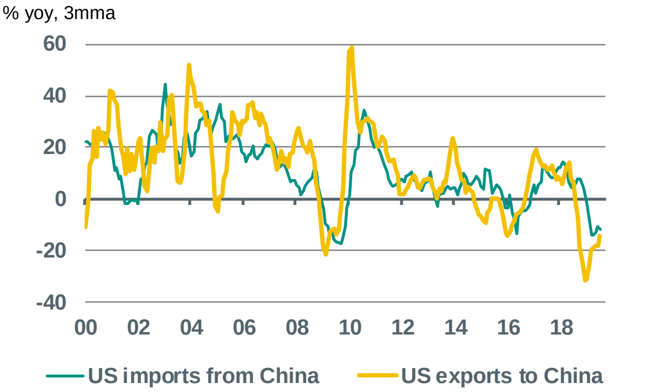
More support likely, as weakness deepens

- **China and US made some goodwill gestures, with new talks on the horizon …,**
- **… after an escalation of tensions over the summer**
- **Sort of (interim) deal would not mean strategic competition is over**
- **'Cold war' 2.0: US and China much more integrated than US-USSR back then**
- **August data show that economic momentum has weakened further …**
- **… building the case for additional (piecemeal) stimulus**

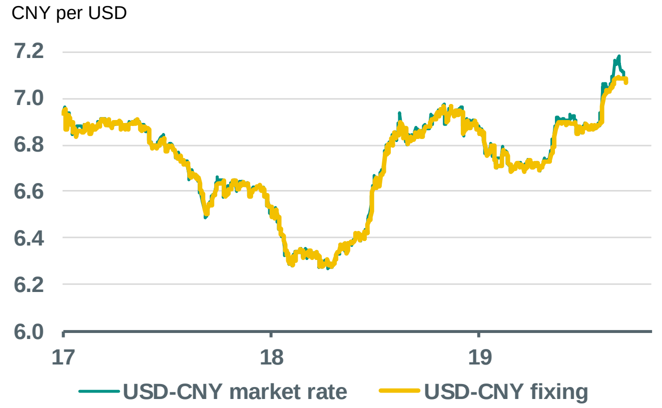
US and China recently made some gestures of goodwill, with restart of talks looming …
While the trend has been an escalation of tensions, more recently or so we see both sides making some gestures of goodwill. China started by pledging not to retaliate the latest US actions, but seeking to lower tariffs instead. The PBoC has set the USDCNY fixing stronger recently and the CNY has gained back around 1.5% versus USD since 3 September. Last week, China temporarily exempted some US goods from 25% tariffs installed last year and announced it would consider whether to permit renewed imports of American agricultural products, including soybeans and pork. President Trump reacted last Wednesday by postponing the imposition of a 5% higher tariff rate (to 30%) on USD 250 bn of imports from China by two weeks to 15 October, beyond the celebrations of the 70th birthday of the Chinese Communist Party on 1 October and providing some space of negotiators, with a resumption of 'mid-level' talks foreseen in early October.

Trade conflict drives collapse of US-China bilateral trade



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Yuan weaker after summer escalation, with recent correction



Source: Bloomberg

… after an escalation of tensions over the summer
Despite the recent goodwill gestures, these are only twists in a conflict that has escalated sharply throughout 2018 and particularly since last May. As the second truce agreed between presidents Trump and Xi in late June proved very short-lived, US-China tensions escalated over the summer.

Group Economics: 'Enabling smart decisions'

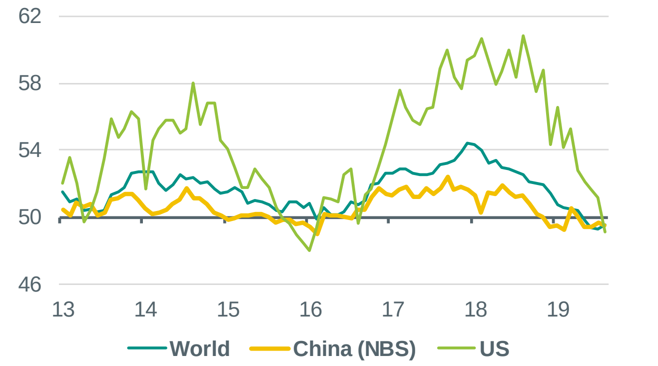
Over the past months, the US implemented fresh tariffs over close to USD 300bn of imports from China to be implemented in two stages (per 1 September and 15 December), raised tariff rates after China's retaliation and called China officially a currency manipulator. What is more, president Trump tweeted that US companies should leave China and linked the restart of negotiations with China's handling of the Hong Kong protests. China also presented fresh tariffs on imports from the US, including the reinstallment of a 25% tariff on US cars, curtailed agricultural imports from the US, and allowed the yuan to slide below the level of 7 per US dollar for the first time since 2008.

Damage done; some sort of deal, if any, would not mean strategic competition is over

As we explained before, the damage of this conflict already made itself felt in a sharp deterioration of global business confidence and a global slowdown in manufacturing, trade and GDP growth. It has also been a major drag for the Chinese economy over the past year or so and there is ongoing evidence that it is adding downward momentum to the US economy as well. Key question remains whether this growing evidence that the Chinese and US economies are slowing will change the political calculus, both in Washington and Beijing, regarding the pro's and cons of arranging some kind of (interim, not comprehensive) deal at relatively short notice. Even in case of such a deal, we think that strategic tensions, particularly on the technology front, between the US and China will linger on for years.

Impact trade conflict broadly felt, now also clearly in US

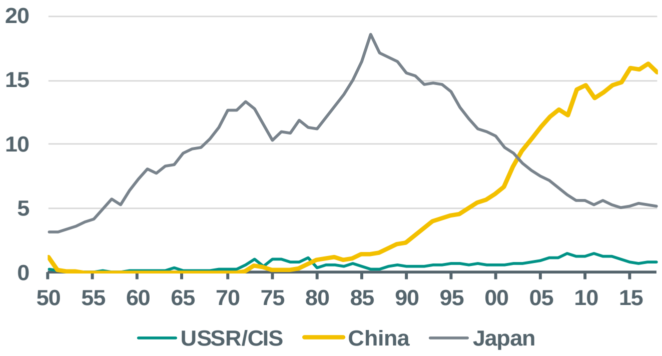
Manufacturing PMIs, index, 50 = neutral mark



Source: Thomson Reuters Datastream,

Cold war 2.0? China more integrated with US than ex-USSR

Share in total US trade (imports + exports), %



Source: ABN AMRO Group Economics, Thomson Reuters Datastream

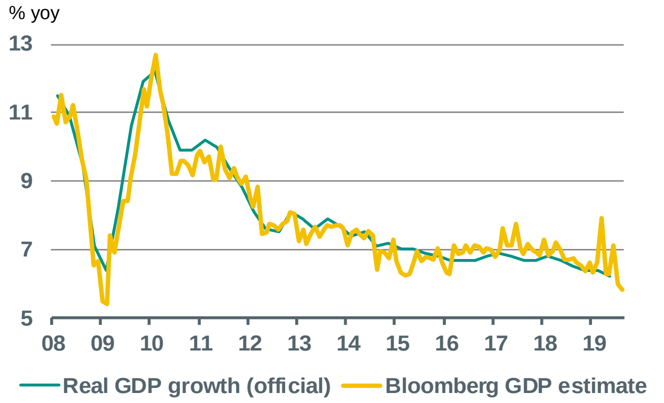
'Cold War' 2.0: US much more integrated with China than with former Soviet Union

In some ways references are made to a new 'Cold War' (US Economic Advisor Kudlow referred to that recently), as there is strategic competition between market capitalist/democratic US and state capitalist/non-democratic China. Still, a big difference between the former Cold War between the US and the USSR and the new one is that the US and the USSR were never much integrated. The share of the Soviet Union and afterwards the CIS in US trade (imports plus exports) has never been higher than 2% or so. With China, that is completely different. As many US firms have chosen China as production hub, China's share in US imports/exports peaked at around 15%. In that sense, a comparison with Japan's tech rise in the 1980s (with a US trade share peaking at 20%) looks more relevant, although Japan's economic model was more in line with the US and Japan was never a candidate to surpass the US as leading economic power. All this also explains why the escalation of US-China tensions and a decoupling of both economies has such a large impact on the global economy and on (the acceleration of) a shift in supply chains.

August data point to ongoing weakness, …

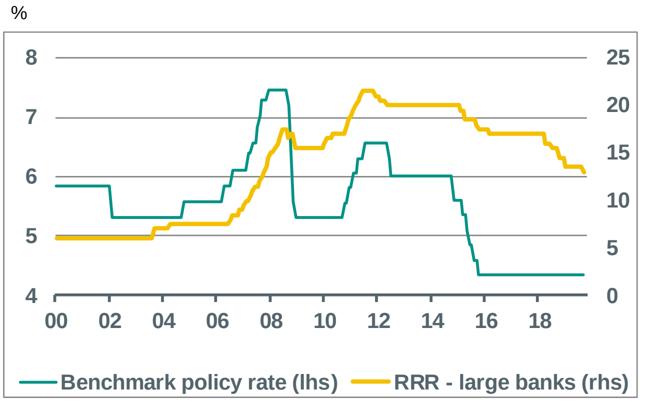
The weak July data were partly a payback from the surprisingly strong June data. Hence, market consensus expected some improvement in August. The month indeed started promising. Whereas the 'official' PMIs pointed to stabilisation, Caixin's PMIs showed an improvement with the composite index rising back to a four-month high of 51.6. That partly reflects the fact that China's stimulus measures are targeted at private firms, which are better represented in Caixin's survey. However, most macro data published in the course of August were less encouraging. Foreign trade growth remained weak, with exports in dollar terms falling back to contraction mode (-1.0% yoy) and imports at -5.6% yoy (July: -5.3%, consensus: -6.4%). While this weakness is primarily the result from the trade-conflict related collapse of US-China, weaker external and domestic demand also plays a role. The activity data published today were also disappointing. Industrial production growth dropped to 4.4% yoy (July: 4.8%, consensus: 5.2%), the lowest pace in 17 and a half years. Retail sales slowed to a four-month low of 7.5% yoy (July: 7.6%, consensus: 7.9%) and fixed investment to a one-year low of 5.5% yoy ytd (July and consensus: 5.7%). All in all, Bloomberg's monthly GDP estimate fell to a post-global financial crisis low of 5.8% yoy.

Monthly GDP estimate drops to post-global crisis low



Source: Bloomberg

More targeted easing on the way



Source: Thomson Reuters Datastream

… building the case for additional (piecemeal) stimulus

In recent weeks we have seen more evidence of Beijing adding piecemeal stimulus to offset the rising drag from the trade/tech conflict with the US. Last month, the PBoC announced a shift in their monetary toolbox, in an attempt to improve the monetary transmission mechanism and create room for lower borrowing rates. In early September, a State Council Meeting also highlighted that further support was on the cards, particularly referring to RRR cuts and to frontloading of local government debt issuance to finance specific types of infrastructure projects. On 6 September, the PBoC announced it would lower bank's reserve requirements ratios (RRRs) by another 50 bps, in line with our expectation. The central bank has now cut RRRs by a total of 150 bp this year and by 400 bps since March 2018. The PBoC also presented a 100 bp additional RRR cut for certain city commercial banks, that are lending a lot to SMEs. Lending data for August indeed showed an improvement and generally came in better than expected (with M1 growth as an exception, remaining low at 3.4% yoy). All in all, we expect the PBoC to continue with RRR and interest rate cuts and the fiscal authorities to create further room for local governments to step-up infrastructure spending.

Key forecasts for the economy of China

	2016	2017	2018	2019e	2020e
GDP (% yoy)	6.7	6.8	6.6	6.2	5.8
CPI inflation (% yoy)	2.1	1.5	1.9	2.5	2.5
Budget balance (% GDP)	-3.8	-3.8	-4.2	-4.5	-4.5
Government debt (% GDP)	16	17	15	19	22
Current account (% GDP)	1.8	1.6	0.4	0.0	0.0
Gross fixed investment (% GDP)	42.7	42.9	43.1	42.4	41.8
Gross national savings (% GDP)	45.9	46.3	45.2	44.5	43.4
USD/CNY (eop)	7.0	6.5	6.9	7.2	7.5
EUR/CNY (eop)	7.3	7.8	7.8	8.1	8.6

Economic growth, budget balance, current account balance for 2019 and 2020 are rounded figures
Source: EIU, ABN AMRO Group Economics