ABN·AMRO

China Watch

Group Economics
Emerging Markets Research

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Growth forecasts down a bit on trade/tech conflict

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- **Our base case regarding the trade conflict has become more conservative**
- **As a result, our 2019-20 growth forecasts for China have been lowered a bit**
- **… although we expect more policy easing to soften the blow**
- **Macro data for May mixed bag, but on balance not encouraging**
- **Trade conflict key driver of weaker exports and imports growth**
- **Our USD-CNY forecasts have been revised a bit**

As the US seems to have toughened its stance versus China …,
Over the past weeks, following months of talks after the Trump-Xi truce agreed late 2018, we have seen an re-escalation of trade, tech and other tensions between the US and China (also see our previous China Watch, *Oops, he did it again*). It seems that, at least for now, president Trump has become less concerned about market reactions to his trade policies than previously thought and that the US administration has become more steadfast. By the way, our view has always been that strategic tensions between the US and China – particularly on the technology front – would linger on for years, even in the case of some sort of short-term deal that would mitigate the risk of a further import tariff spiral. It remains to be seen whether Trump and Xi will meet again at the margins of the G20 meeting in Japan and if so, whether they will be able to agree on some thawing of tensions as they did in late 2018.

Chinese stock markets down on re-escalation tensions

Source: Bloomberg

Yuan weakness still limited compared to 2nd half 2018

Source: Bloomberg

… our base scenario regarding the trade conflict has become a bit more conservative
Based on recent developments, ABN AMRO Group Economics has become a bit more conservative and shifted its base case (previously, we already assigned a high probability to a

more negative scenario). We now assume that escalation of the trade conflict between the US and China and possibly others will continue, implying that uncertainty will remain high. Still, we cannot have a 'high conviction view' on this, as the Trump presidency is characterized by U-turns. Still, as a result of all of this, our global growth forecasts have been lowered, as direct effects of higher import tariffs will be aggravated by indirect effects on business confidence and financial conditions. Meanwhile, our base scenario assumes central banks to react by a stepping up of monetary policy easing, that should set the scene for an improvement in economic growth in the second half of next year (see here for more details on recent changes in our global forecasts).

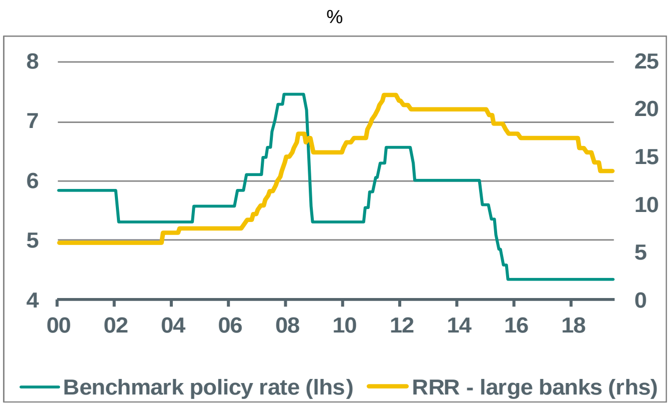
As a result, our China growth forecasts for 2019-20 have been lowered somewhat

Regarding China, the escalation foreseen in our new base scenario assumes the US to expand the 25% tariff to all imports from China. That would imply a more than doubling of the import base subject to tariffs, from USD 250bn to over USD 500bn. In our previous China Watch, we assessed the potential drag to GDP growth in this case to be in the order of 1.0-1.5 ppt. We added that this assessment should be taken as a rough estimate, partly because it does not take into account policy adjustments. And indeed, we expect the Chinese authorities to step up monetary and fiscal stimulus to offset this larger drag (see below). Therefore, on balance, we have only modestly cut our China growth forecasts for 2019-20, to 6.2% (from 6.3%) and 5.8% (from 6.0%), respectively. That said, downside risks to industry and trade remain prevalent given the trade conflict. We would like to add that risks to our forecasts have now become a bit more balanced (in case of positive twists in US-China relations we may revise these growth forecasts upwards again).

Stepping up of monetary and fiscal stimulus expected

In the course of 2018, Beijing switched the macro-economic policy stance from financial deleveraging/targeted tightening to targeted easing. Policy makers did so, because they found out that the headwind caused by the escalation of the trade/tech conflict – on top of the effects of previous targeted tightening – was dragging growth down too much. On the monetary front, the authorities have taken steps to safeguard liquidity in the banking system and stimulate lending, particularly to private firms and SMEs. On the fiscal front, the government opted for a broad range of tax cuts and a doubling of bond issuance quota for local governments (hit by previous financial deleveraging). Still, the authorities have taken a piecemeal easing approach, and have refrained from *big bazooka* types of stimulus. Overdoing stimulus would not have been in line with the longer-term goal of stabilising leverage and was also not needed to stabilise the economy.

We expect cuts of RRRs and one-year lending rate



Source: Thomson Reuters Datastream

Overall credit growth still on an upward trend

Source: Bloomberg

Targeted easing to continue …

We assume Chinese policy makers will continue with their targeted fiscal and monetary easing, with a special focus on private companies and sectors most hit by US import tariffs. Overall credit growth has accelerated somewhat this year compared to previous years, while M1 growth is also picking up. Over the past weeks, the PBoC injected additional liquidity in the banking system, but that was mainly to stabilise money markets after government interventions at a smaller regional bank (Baoshang Bank based in Inner Mongolia) in late May drove up interbank rates. On the fiscal front, Beijing eased restrictions this week regarding the proceeds of issued local government special-purpose bonds, to stimulate infrastructure investment.

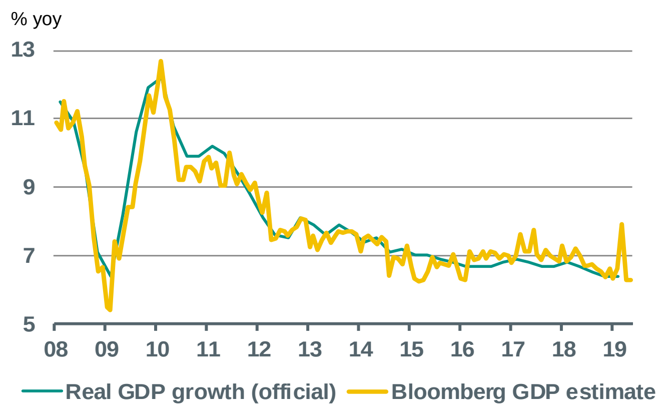
… but we now also anticipate two cuts in the 1-year lending rate and sharper RRR cuts

Still, assuming the US to step up import tariffs further, Beijing may have to do more to offset the larger drag. Recently, PBoC Governor Yi Gang stated that China still has plenty of room to ease. The authorities are pragmatic and willing to shift policy priorities if circumstances change. They will likely put macro-economic stabilisation higher on their priority list again, and shifting down (financial) deleveraging. We think they will still not choose for aggressive easing, but will add more general elements in their easing approach. The PBoC has left its benchmark policy rate on hold since 2015, as it felt lowering it would not fit in their deleveraging approach. We now expect the PBoC to cut the 1-year lending rate by 25 bp this year and another 25 bp in 2020, taking it to 3.85%. Sharper reductions in banks' reserve requirement ratios for large banks are also likely: we now expect an additional 150 bp cut this year (was: 100 bp) and a further 100 bp cut next year.

Macro data for May mixed bag, but on balance not encouraging

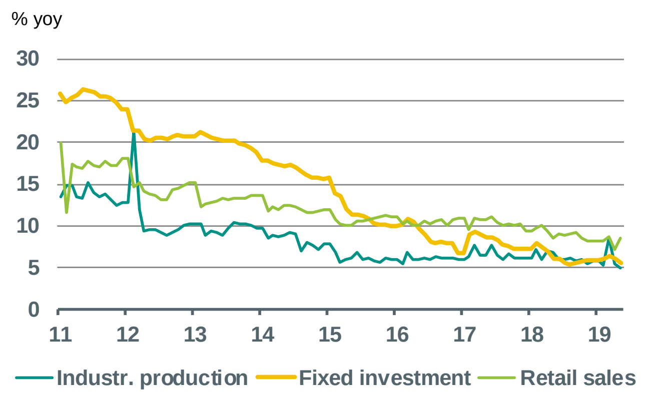
The macro data for May were, on balance, not encouraging. The official PMIs published were stable compared to April, but Caixin's PMIs were clearly weaker. Export growth was a bit better than expected, but import growth disappointed (see below). Retail sales did much better than expected, climbing back to 8.6% yoy (consensus: 8.1%) from a dip of 7.2% in April. However, fixed investment growth fell to an eight month low of 5.6% yoy (consensus/April: 6.1%), with both private and public investment slowing. Meanwhile, industrial production growth also slowed to 5.0% yoy, the weakest number since 1991 (consensus/April: 5.4%). New lending picked up compared to April but less than expected. Inflation also picked up a bit (to 2.7% yoy, from 2.5% in April) driven by a swine flu related spike in food prices. Producer prices moderated a bit, falling back to 0.6% yoy (April: 0.9%). Bloomberg's monthly GDP estimate for May came in at 6.3% yoy, similar to April's number.

Bloomberg's monthly GDP estimate stable in May



Source: Bloomberg

Retail sales pick up, investment/industrial production slow



Source: Thomson Reuters Datastream

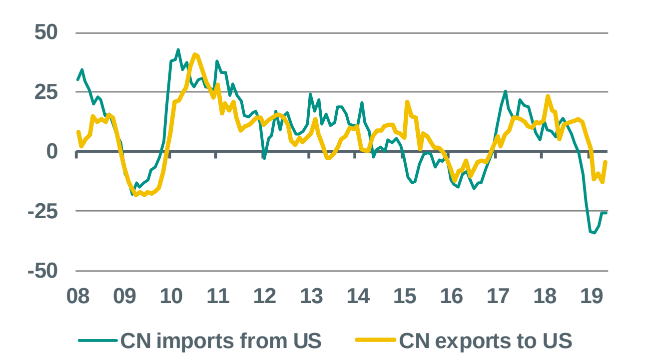
Trade conflict important driver of weaker exports and imports growth

Chinese exports and imports have weakened significantly since end-2018. In our view, that is to a large extent driven by the escalation of US-China tensions and related payback from frontloading of trade flows (illustrated by a collapse of bilateral US-China trade). Looking through the usual volatility at the start of the year (due to annual changes in timing of the Chinese New Year), total Chinese exports in dollars grew by only 0.4% yoy in January-May 2019, compared to almost 13% in the same period of 2018. That fits with the overall weakening of global growth and trade, with the effects of the trade conflict likely starting to hit China-centered global supply chains. Meanwhile, imports in dollars contracted by 3.7% yoy in January-May 2019, compared with a growth of over 21% in the same period of 2018. While it is tempting to attribute the slowdown of imports to a weakening of domestic demand, the trade conflict and its impact on exports is probably even more important as a large part of imports is closely related to exports. Price effects also play a role, given that China imports a lot of commodities and commodity prices have been hit by trade tensions and global growth fears as well. Looking forward, a further escalation of US-China trade/tech tensions poses even more downside risks to China's export and import growth.

Export and import growth hit by trade conflict …

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

… with US-China bilateral trade collapsing



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Our USD-CNY forecasts have been revised a bit

Last year, a 10% depreciation of the yuan versus USD helped to mitigate the impact of US tariffs, but since the recent re-escalation the Chinese authorities have acted to keep yuan weakness contained. Note that the US Treasury has again not declared China a 'currency manipulator' in their recent bi-annual report on foreign trade partners' exchange rate policies. We are still of the view that Beijing will refrain from using a weaker yuan as a weapon in the trade conflict, partly because a sharp CNY depreciation could trigger a surge in capital outflows (as it did back in 2015-16). Still, the risk is increasing that they will allow some more yuan weakness should the US indeed step up tariffs on Chinese imports further. We have revised our USD-CNY forecasts for end 2019 and end 2020 a bit, to 6.90 and 6.70 respectively (both from 6.60).

Key forecasts for the economy of China

	2016	2017	2018e	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	-4.0	-4.5	-4.5
Government debt (% GDP)	16	17	19	22	25
Current account (% GDP)	1.8	1.4	0.3	0.0	0.0
Gross fixed investment (% GDP)	42.7	42.9	43.9	43.1	42.1
Gross national savings (% GDP)	45.9	46.0	44.6	43.5	42.4
USD/CNY (eop)	7.0	6.5	6.9	6.9	6.7
EUR/CNY (eop)	7.3	7.8	7.8	7.7	8.0

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