

# China Watch

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## More signs of stabilisation

- Official GDP growth slows further to 6.4% yoy in Q4-2018
- Mixed data for December: PMIs point to slowdown industrial sector,
- ... while hard data show signs of stabilisation
- Collapse of trade growth feeds slowdown fears, but special factors at play
- We expect Chinese economy to stabilise further
- ... as Beijing steps up piecemeal fiscal and monetary support ...
- ... and the likelihood of a US-China trade deal has risen

### Official GDP growth slows further to 6.4% yoy in Q4-2018

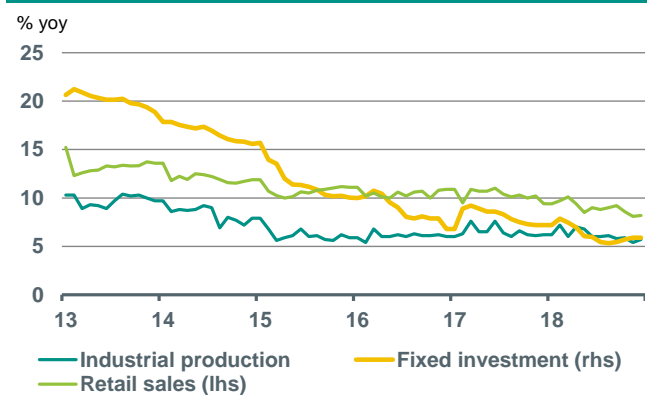
This morning, Chinese official GDP growth rate for the final quarter of 2018 came in at 6.4% yoy, in line with market expectations, including ours. While this was the slowest growth rate since the global financial crisis (Q1-2009: 6.2% yoy), that is not something to worry too much about in our view. China's economy is still on a gradual slowdown path, fitting with its transition towards a consumption-based growth model and Beijing's attempts to reduce financial risk. True, the industrial sector showed some serious signs of cooling in late 2018, reflected for instance in both manufacturing PMIs dropping below the neutral 50 mark. Still, recent hard data point to some stabilisation in the industrial sector, while the services sectors continue to show resilience. Annual growth dropped from 6.8% in 2017 to 6.6% in 2018, staying just above Beijing's growth target of 6.5%. In quarterly terms, growth dropped to 1.5% qoq, from 1.6% in Q3-2019.

### Economic growth still on gradual slowdown path



Source: Bloomberg

### Hard data for December point to stabilisation



Source: Thomson Reuters Datastream

### Mixed data for December: soft manufacturing PMIs, better hard data

The monthly activity data published for December show quite a mixed picture. The forward-looking PMIs published earlier this month shaped the picture of a sharper slowdown in China's industrial sector. The manufacturing PMIs for December from Caixin and NBS both fell below the neutral 50 mark. That was for the first time since early 2016, at the end of China's previous soft patch. Still, the monthly activity data published today show more signs of stabilisation and came in generally better than expected. Industrial production growth rose back to 5.7% yoy in December (November 5.4%, consensus expectation: 5.3%). Retail sales growth edged up marginally to 8.2% yoy (November and consensus expectation: 8.1%). Retail sales growth has been driven down last year by weak car sales. Over the past months, car sales have risen again, but they remain negative in annual growth terms (also reflecting special factors such as the fading out of favourable tax policies). Fixed investment growth has rebounded over the past few months supported by fiscal stimulus, but remained at 5.9% yoy in December. All in all, Bloomberg's monthly GDP estimate – which shows more cyclical variation than the official growth numbers – bounced back to a three-month high of 6.6% yoy in December (November: 6.4%).

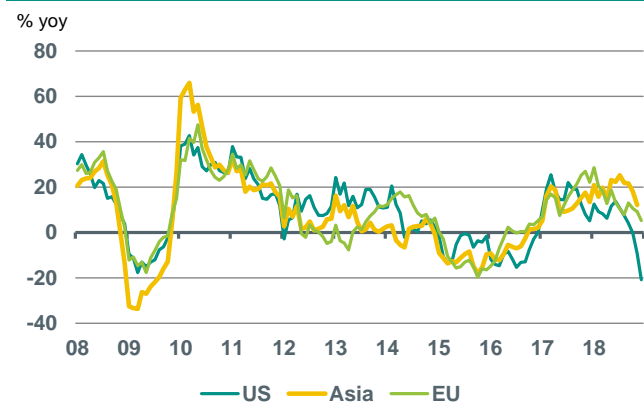
### Collapse of import/export growth adds to slowdown fears, but many special factors at play

Last week, much weaker than expected Chinese trade data added to markets fears of a global slowdown. Chinese annual import growth (measured in dollar values) stayed strong in January-October 2018 (20% yoy), weakened sharply in November and even became negative (-7.6% yoy) in December. This partly relates to the weakening in China's industrial sector, but we should warn for too much pessimism. It also reflects a couple of special factors. First, the escalating trade conflict with the US, related frontloading of trade flows and the fading thereof. More hawkish US trade policies started focusing on China since spring 2018 and both countries introduced 10-25% tariffs on USD 360bn of each other's bilateral imports/exports. Imports from the US were particularly weak in recent months (December: -36% yoy), with China's bilateral surplus with the US still rising. That suggests that so far, the US has shot itself in the foot. Second, it reflects base effects from strong imports in late 2017. Third, it relates to the sharp downward correction of commodity prices, as primary products (mainly commodities) make up around 30% of China's goods imports. Last but not least, it mirrors the slowdown of export growth, as processing imports make up more than 20% of goods imports.

#### Import and export growth turned negative in December



#### Imports from US have collapsed as trade conflict escalated



Growth of China's merchandise exports (in USD values) was strong at 12.5% yoy in January-October 2018, also weakened in November and became negative (-4.4% yoy) in December too. That was driven by weakening demand from main export partners (US, Hong Kong, Japan, EU), but lower export prices, strong base effects and payback of previous frontloading also added to the deterioration of export growth.

#### We expect the Chinese economy to stabilise further ...

The slowdown in the industrial sector seen in late 2018 has two main drivers (also see our [China Outlook 2019](#), [Stimulus offsets trade risks](#)). The initial trigger is Beijing's previous financial deleveraging campaign, including amongst others a crackdown of shadow banking and more stringent financing conditions for local governments. However, this has been aggravated by the the escalation of trade tensions with the US in the course of last year. The good news is that both of these two headwinds have started to ebb, as Beijing has started with rolling out offsetting easing measures and there have been more positive developments in US-China negotiations. Hence, looking ahead, we expect China's economy to stabilise further in the coming month. It may take a while before the full effects of easing policies and more positive trade negotiations will be felt in full. Moreover, Chinese activity data, particularly foreign trade data, may prove volatile in Q1-2019, reflecting the shift in timing of the Chinese New Year and distortions from previous trade frontloading practices

#### ... as the authorities continue with piecemeal support measures

In line with our expectations, the Chinese authorities have continued to step up fiscal and monetary support to counterbalance the drags from the financial deleveraging campaign and the trade conflict with the US. Policy makers are constrained by their goal to stabilise macro leverage and hence do not opt for aggressive easing policies. Instead, they continue with taking a range of piecemeal targeted fiscal and monetary support measures, with special attention to parties most hurt by the previous financial deleveraging campaign (in particular private firms/SMEs) and the trade conflict (exporters with large exposure to the US).

#### PBoC cuts bank RRRs further



Source: ABN AMRO Group Economics, EIU, Thomson Reuters Datastream

#### Overall credit growth up as policy easing sets in



Source: Thomson Reuters Datastream

#### ... both on the fiscal and monetary front

On the fiscal front, Beijing has raised bond issuance quota for local governments and has taken steps to enable frontloading of such issuance. Moreover, the authorities have continued with reducing all kinds of taxes to support consumption and investment. After cutting VAT, income

taxes and import taxes in the course of last year, earlier this month the State Council announced specific tax cuts for SMEs affecting about 95% of all corporate tax payers. On the monetary front, the PBoC announced in early January it would cut the reserve requirements ratio (RRR) for banks by another 100 bp (in two steps of 50 bp, per 15 and 25 January). That followed a cumulative 250 bp RRR cut throughout 2018. In the past weeks, the PBoC already introduced a new loan facility to support lending to the private sector, and eased certain criteria for banks to become eligible for previous RRR cuts as well. The PBoC also added extra liquidity to the system in mid January, through reserve repo operations. These measures should be seen in the context of supporting credit flows to the real economy, particularly to the private sector including SMEs, as well as safeguarding bank system liquidity in the run-up to the Chinese New Year break.

### **... and the likelihood of an US-China deal on trade and investment has risen**

As mentioned above, the escalation of the trade conflict with the US in the course of 2018 has become a serious headwind to the Chinese economy. However, while we expect US-China strategic competition (particularly on the tech front) to linger on for years, we have become a bit more optimistic. Following the 90-day truce reached between presidents Trump and Xi on 1 December, the US and China restarted 'mid-level' negotiations on trade and investment in Beijing in early 2019. Late January, China's vice premier Liu He will visit Washington to continue higher-level negotiations with Treasury Secretary Mnuchin and US Trade Representative Lighthizer.

As the fall-out to the US from the trade conflict has become more visible (in terms of growth, confidence and stock market performance), the likelihood that the US and China will succeed in working out some sort of a deal has risen in our view. China needs a deal to safeguard its growth target, while US president Trump will likely prefer entering a re-election year (in 2020) with an economy and a stock market that is as strong as possible. Our view is partly based on all kinds of recent public statements, both from US and China sides. What would such a deal involve then? China could easily step up agricultural, energy and car imports from the US (has already started to do so), while China has already temporarily reduced import tariffs for US cars back from 40% to 15%. China has also continued with liberalizing its FDI regime and opening up several sectors which are attractive to the US. Beijing has also tightened rules regarding the protection of intellectual property in reaction to US demands. Moreover, China has downplayed the importance of its *Made in China 2025* plan, although we do not expect Beijing to drop its state-led capitalist model and its strategy to support the development of national champions with a global outreach.

All told, we think the chance of a further stepping up of import tariffs has fallen. That takes away a key headwind for the Chinese economy. Even a (full or partial) cancellation of tariffs could result, as Mnuchin allegedly hinted at. That said, downside risks remain should the follow-up to the agreements prove unsatisfactory and tensions flare up again, for instance on the technology front.

### **In conclusion**

Growth momentum in China's industrial has cooled end-2018, driven by previous tightening policies and the US-China trade/tech conflict. However, as the authorities have shifted course and eased monetary and fiscal policies, we are starting to see signs of stabilisation. As we expect more of these easing measures to filter through and we see a rising likelihood of a US-China deal, we expect the Chinese economy to stabilise further in the course of this year. All in all, we expect the gradual slowdown in GDP growth to continue. That said, some data could prove quite volatile in Q1, given the shift in timing of the Lunar New Year and distortions from previous frontloading.

**Key forecasts for the economy of China**

	2016	2017	2018e	2019e	2020e
GDP (% yoy)	6.7	6.8	6.6	6.3	6.0
CPI inflation (% yoy)	2.1	1.5	2.1	2.5	2.5
Budget balance (% GDP)	-3.8	-3.8	-4.0	-4.5	-4.5
Government debt (% GDP)	16	17	19	21	24
Current account (% GDP)	1.8	1.4	0.5	0.0	0.0
Gross fixed investment (% GDP)	42.7	42.7	43.8	42.8	41.8
Gross national savings (% GDP)	45.9	45.8	44.3	43.2	42.1
USD/CNY (eop)	7.0	6.5	6.9	6.7	6.7
EUR/CNY (eop)	7.3	7.8	7.9	8.4	8.7

*Economic growth, budget balance, current account balance for 2019 and 2020 are rounded figures*

*Source: EIU, ABN AMRO Group Economics*

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