

China Watch

Group Economics
Emerging Markets Research

xx February 2019

Arjen van Dijkhuizen
Senior Economist

Tel: +31 20 628 8052

arjen.van.dijkhuizen@nl.abnamro.com

Will the Pig arrive in time this year?

- China's slowdown has accelerated somewhat in the 2nd half of last year,
- ... with financial deleveraging and US trade conflict as key headwinds
- But with Beijing adding piecemeal monetary and fiscal support,
- ... we have seen some green shoots as first indicators of stabilisation
- January trade data come in better than expected (but mind special effects)
- Extension of truce within sight as US-China trade talks resume in Beijing

Will the Pig arrive in time to safeguard wealth and fortune?

On 5 February 2019, China's Lunar Year of the Pig started. In Chinese culture, pigs are being associated with wealth and fortune. Also, the Pig is the twelfth and last of all zodiac animals, allegedly due to the fact that it was the last one to arrive at the Jade Emperor's party because he overslept. This Year of the Pig will be an interesting and challenging one. Since mid 2018, the Chinese economy has shown more signs of slowing, driven by two headwinds. The first headwind relates to Beijing's previous financial deleveraging campaign, including a crackdown on shadow banking and more stringent financing conditions for local governments. The other headwind stems from the escalation of the trade conflict with the US in the course of 2018, which has hit business confidence, export prospects and stock markets. In reaction, Chinese policymakers have put macroeconomic stabilisation at the top of their priority list and have changed their policy mix from targeted tightening/financial deleveraging to targeted easing. Key question of course is whether these measures will prove sufficient to stabilise the economy.

China's piecemeal easing approach

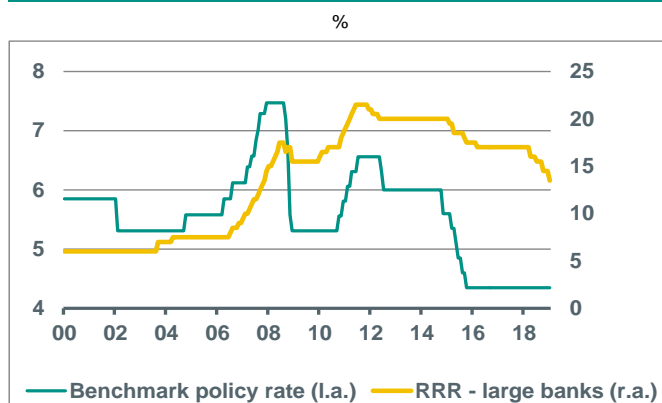
The Chinese authorities are well-known for re-prioritising policy goals if circumstances ask for that. Since mid 2018 they have put macro economic stabilisation on top of their priority list, while shifting (financial) deleveraging down. As late US president Kennedy once phrased it: 'The time to repair the roof is when the sun is shining!'. Another characteristic of China's policy shift is its gradual approach. Chinese policy makers are still constrained by longer-term goals, such as stabilising macro leverage and tweaking China's growth model, to safeguard long-term growth and prevent future rating downgrades. Moreover, with official growth remaining 'within target', they currently do not have an incentive to re-accelerate the economy, but rather are aiming at stabilising growth. This explains why do not opt for aggressive easing and 'big bazooka' stimulus (as financial markets sometimes seem to long for), but rather take a piecemeal approach.

Monetary easing with a special focus on supporting lending to private firms/SMEs

In this macro-economic stabilisation approach, supporting the private sector including SMEs has become a key target. The reason for that is that private firms/SMEs have been relatively hard hit

by the financial deleveraging campaign, as they traditionally rely more on shadow banking and related entities than SOEs. On the monetary front, the authorities have taken a wide range of measures since mid 2018 to safeguard liquidity in the banking system and stimulate lending, particularly to private firms and SMEs. They have added liquidity by using/expanding existing lending facilities and open market operations, introduced a new Targeted Medium-lending facility, lowered banks' reserve requirements ratios by another 200 bps in October-January (following 150 bp cuts in April-July) and by easing eligibility criteria to profit from these RRR cuts. In January 2019, the PBoC introduced a swap mechanism, enabling primary dealers to trade perpetual bonds for PBoC bills. That measure was aimed at supporting bank capital and bank lending. To support private funding, the central bank also established a guarantee fund for banks' SME lending and introduced new credit enhancement instruments (e.g. CDS). The PBoC also used moral suasion to encourage banks to boost lending to the private sector.

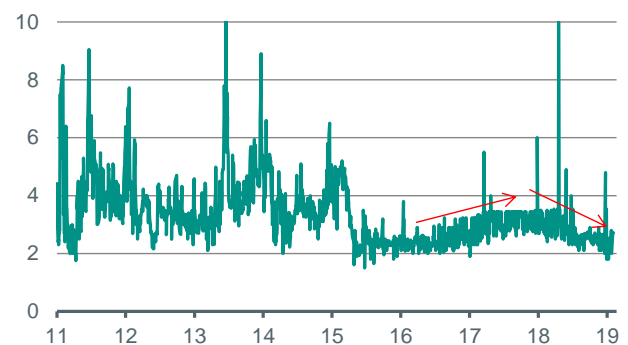
Monetary easing in perspective



Source: Thomson Reuters Datastream

From targeted tightening to targeted easing

China Interbank repo rate, 7 days, %



Source: Thomson Reuters Datastream

Monetary easing in perspective

From a big picture perspective, the recent monetary easing steps are of a smaller scale than the measures taken during the global financial crisis and the episode of China wobbles in 2015-16. The PBOC has left its benchmark policy rate on hold this time, compared to a reduction by 216 bps in 2008-09 and 165 bps in 2014-16. The 350 bp reduction in RRRs for large banks in 2018-19 so far is similar to the 300 bp cuts in 2015-16, but we should add that these measures are partly needed to sterilise the liquidity drain stemming from smaller inflows through the capital account. Hence, these RRR cuts are needed to safeguard liquidity in the banking system and therefore cannot be purely seen as a stimulus measure. That said, the PBoC's shift has caused a general easing of monetary and lending conditions. The 7-day interbank repo rate has fallen again since mid-2018 after a rise in 2016-17 (although the fall in interbank rates in 2015 was sharper). Last but not least, the PBoC also allowed a relatively sharp CNY depreciation versus USD last year (around 10% in April-October). That partly offset the impact of US import tariffs, although the depreciation was triggered by market forces. Meanwhile, CNY has stabilised in the autumn of 2018 and has regained a bit since the US-China truce agreed by Trump and Xi on 1 December.

Fiscal easing targets local government infrastructure spending ...

During the financial deleveraging campaign, the tightening of regulation regarding the financing of local governments has been an important factor driving the growth of state-led investment down, following a sharp pick-up in 2015. In the summer of 2018, the central authorities ordered local

government to use the room available under existing quota for raising the issuance of special purpose bonds to finance local projects. Subsequently, in late 2018, Beijing announced to raise the 2019 quota for local government bond issuance, while also taking action to assure frontloading of such issuance. Meanwhile, the banking supervisor removed a 20% cap enabling banks to hold more local government debt in their lending books, while the Ministry of Finance has lifted restrictions regarding the maturity of local government bonds. All these measures have already resulted in a stepping-up of local government bond issuance.

... and focuses on tax reduction and other measures to support domestic demand

To support consumption and investment, Beijing has also implemented several tax cuts in the areas of personal income tax, corporate tax (with a special focus again on private firms/SMEs), social security fees, import tariffs and VAT (in the form of higher export tax rebates). Recently, the National Development and Reform Commission announced measures to support consumption, in particular car sales. Car sales account for over 30% of total retail sales and accounted for almost 70% of the slowdown in retail sales growth last year. The central government is also stepping up infrastructure spending, including in the railway network and in aviation infrastructure.

Overall lending starts to show a pick-up



Source: Bloomberg

Public investment rebounds a bit, more to come



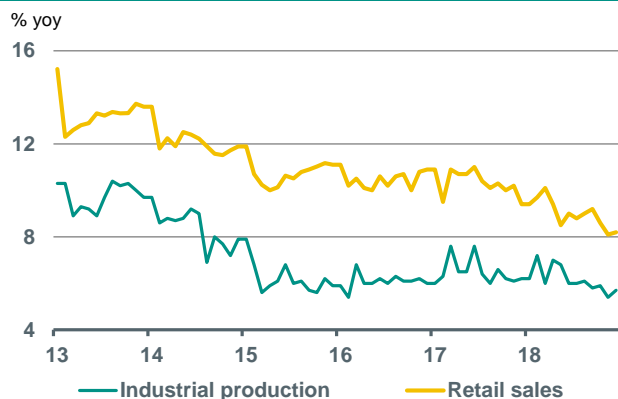
Source: Thomson Reuters Datastream

With headwinds starting to fade, we see some green shoots

While China's manufacturing PMIs have fallen below 50 and the latest foreign trade data are ugly, we already can see some signs of stabilisation as these easing measures are gradually filtering through. Growth of overall lending has started to pick up. It is also expected that bond issuance of local governments (not included in the 'aggregated financing' data) will pick up further in the course of this year. These moves have already contributed to some rebound in state-led investment, with a further pick-up expected in the course of this year.

Growth of industrial production also picked-up a bit in December, partly helped by Beijing softening its anti-pollution campaign somewhat. Retail sales growth has been driven down by weak car sales growth, although stabilising in December. Car sales – which show a strong seasonal pattern – have risen again over the past months, but annual growth is still negative (also reflecting special factors such as the fading out of favourable tax policies). With specific policies targeted at boosting car sales, we expect some rebound going forward.

Industrial production and retail sales



Source: Thomson Reuters Datastream

Bloomberg GDP tracker edged up a bit in December



Source: Bloomberg

Trade data for January come in better than expected (but mind special effects)

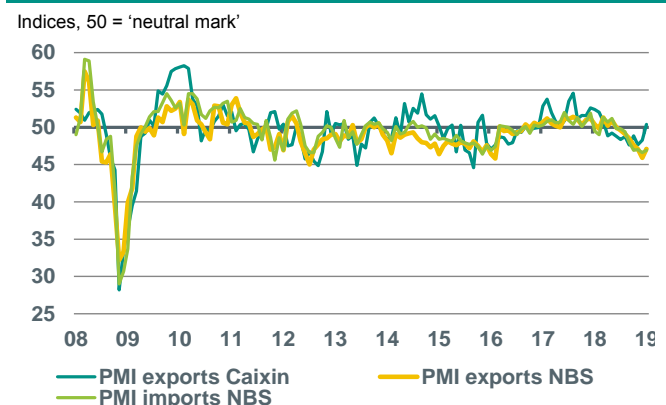
After remaining solid during January-October 2018 despite the trade conflict, Chinese foreign trade data started weakening since last November. Very weak December data added to fears of a global slowdown. In our previous [China Watch](#) we warned that one should not attribute this drop in imports fully to the slowing of domestic demand. Various special factors are at play: the slowing of exports (as a big chunk of Chinese imports is export-related), the effect of import tariffs implemented last year, payback from trade conflict related frontloading, the drop in commodity prices and base effects from strong trade numbers end 2017. Indeed, the foreign trade numbers for January published today came in much better than expected. Import growth remained negative (-1.5% yoy), but much less than expected (-10.2%) and in comparison to December (-7.6%). On a mom basis, imports rose by 8.7% in January. In terms of destination, imports from the US were the negative outlier (-41% yoy), obviously a consequence of the trade conflict. Import growth from the EU (+8.5% yoy) and Germany (+5.8% yoy) was solid.

Trade data for January better than expected



Source: Thomson Reuters Datastream

PMI export/import indices rebounded a bit



Source: Thomson Reuters Datastream

Meanwhile, export growth was in positive territory again (+9.1%, versus consensus -3.3% and December -4.4%), taking away some of the fears of a sharp slowdown in external demand. That said, Chinese monthly trade data are notoriously volatile, particularly at the start of year reflecting the year-to-year changes in the timing of China's New Year holiday break. That means that one should be careful in drawing to sharp conclusions from monthly trade figures. That said, Chinese

export and import PMIs for January also showed a turnaround, possibly also reflecting hopes of a positive outcome of resumed US-China trade negotiations.

US-China talks may lead to extension of truce

Compared to late 2018, we have become a bit more optimistic about the possibility that the US and China will reach some kind of short-term deal. On 1 March, the truce agreed between presidents Trump and Xi will expire, with the risk that the US indeed raises import tariffs on USD 200bn of imports from China from 10% to 25%. With US-China talks resuming in Beijing this week (after previous talks earlier this year), we think it is more likely that there will be an extension to this deadline than a comprehensive agreement being wrapped up beforehand. High-level communication from both the US and China side also point in this direction, even though a bilateral Trump-Xi summit would not be held before 1 March. US President Trump told reporters this week that negotiations between the US and China are going well, and indicated that he was open to extend the deadline should progress be satisfactory. Longer term, strategic competition between the US and China will likely linger on (particularly on the technology front, also illustrated by the Huawei case). Some sort of monitoring and enforcement framework facilitating future talks could be helpful in this respect.

To conclude

China's economy has slowed, but we do not expect a collapse as headwinds are ebbing. The Chinese authorities have shifted from targeted tightening/financial deleveraging to piecemeal monetary and fiscal easing. The likelihood that we will see a further rise of US import tariffs soon has fallen. Recent activity data show several green shoots as first signs of stabilisation. Chinese trade data for January came in much better than expected. Regarding official GDP growth, we expect a marginal slowdown in Q1-2019, with growth stabilising from Q2 onwards.

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

This document has been prepared by ABN AMRO. It is solely intended to provide financial and general information on economics. The information in this document is strictly proprietary and is being supplied to you solely for your information. It may not (in whole or in part) be reproduced, distributed or passed to a third party or used for any other purposes than stated above. This document is informative in nature and does not constitute an offer of securities to the public, nor a solicitation to make such an offer.

No reliance may be placed for any purposes whatsoever on the information, opinions, forecasts and assumptions contained in the document or on its completeness, accuracy or fairness. No representation or warranty, express or implied, is given by or on behalf of ABN AMRO, or any of its directors, officers, agents, affiliates, group companies, or employees as to the accuracy or completeness of the information contained in this document and no liability is accepted for any loss, arising, directly or indirectly, from any use of such information. The views and opinions expressed herein may be subject to change at any given time and ABN AMRO is under no obligation to update the information contained in this document after the date thereof.

Before investing in any product of ABN AMRO Bank N.V., you should obtain information on various financial and other risks and any possible restrictions that you and your investments activities may encounter under applicable laws and regulations. If, after reading this document, you consider investing in a product, you are advised to discuss such an investment with your relationship manager or personal advisor and check whether the relevant product—considering the risks involved—is appropriate within your investment activities. The value of your investments may fluctuate. Past performance is no guarantee for future returns. ABN AMRO reserves the right to make amendments to this material.

© Copyright 2019 ABN AMRO Bank N.V. and affiliated companies ("ABN AMRO").