

China Watch

Group Economics
Emerging Markets Research

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Oops, he did it again

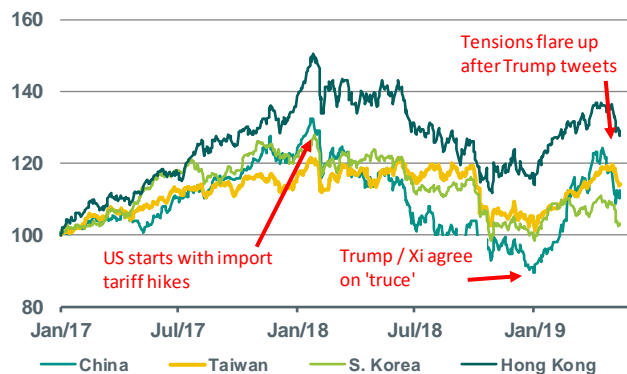
- **US-China tensions re-escalate**
- **... affecting stock markets and the yuan**
- **Complete breakdown of talks not likely, but uncertainty remains high**
- **Permanent broadening of tariffs would again create strong headwind**
- **Even before higher tariffs are in place, April data disappoint**
- **We expect authorities to step up stimulus further ...**
- **Still, all in all, risks are shifting to the downside again**

US-China tensions re-escalate

After months of negotiations following an extended truce since the Trump-Xi meeting last December, US-China tensions unexpectedly re-escalated last week. On 10 May, the US hiked the tariff rate over USD 200bn of imports from China (implemented in September 2018) from 10% to 25%. On 13 May, China retaliated by raising the tariff rate on USD 60bn of imports from the US to 5-25%. Also last Monday, the US published an additional USD 300 bn list of goods, implying that basically all US imports from China would be taxed (by 25%). The timing of the announced measures leaves some wiggle room. The US tariff hike on USD 200bn will not affect goods that have already left Chinese harbours. China's higher tariffs on USD 60bn will be implemented per 1 June. And the US threat of expanding tariffs to the remaining USD 300bn is set for late June, after a possible Trump-Xi meeting at the margins of a G20 summit in Tokyo.

China/Asian stock markets have tanked on re-escalation

Indices, 1 Jan 2017 = 100



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

... while Chinese yuan is approaching 6.90 again

CNY per USD



Source: Thomson Reuters Datastream

Despite these timing nuances, financial markets reacted sharply on the change in settings, as markets were positioned for a short-term US-China trade deal without further tariff hikes (and possibly even some cancellation). Hence, this was a big negative surprise impacting risk sentiment, with for instance Chinese and other Asian equity markets tanking again and the CNY dropping by over 2% versus USD since 3 May, reaching the lowest levels since December 2018.

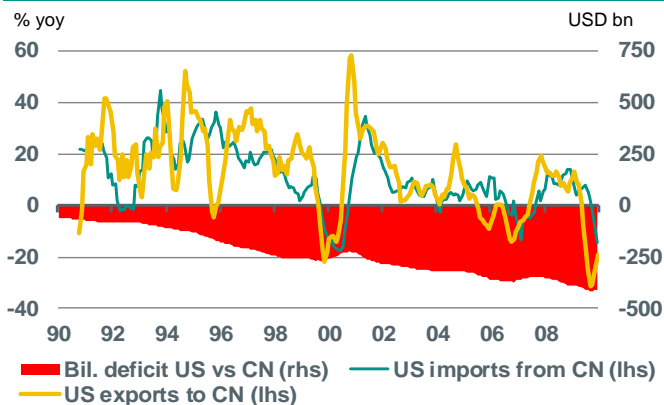
Why did this happen?

The reasons why negotiations failed and the US decided to hike tariff rates further are not clear-cut. Not surprisingly, both parties put the blame on each other. The US states that China backtracked on commitments made in the draft document of around 150 pages (e.g. regarding the agreement to make changes in Chinese law). Meanwhile, China is blaming the US that it would not consider reducing existing tariffs in return for concessions. Chinese sources also stated that the US is not respecting China's dignity by sticking to an 'imbalanced agreement'. In any case, it seems that trust between the two sides has eroded over the past weeks, with 'hardline voices' having gained more weight. In addition, with the US and China's economies doing better than expected in Q1, the political calculus regarding the pros and cons of a deal look to have changed in Washington and Beijing, at least for the short term. Last but not least, the renewed tensions reflect that the starting point of 'market capitalist' US and 'state capitalist' China is very different.

What to expect going forward?

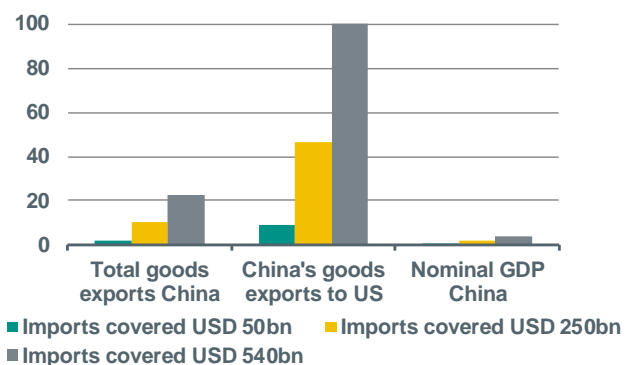
Trying to predict how the negotiations between the US and China will proceed is difficult. We have regularly expressed our thought that any short-term deal will not mean that tensions between the two giants will fully fade, certainly not on the technology front (as the 5G/Huawei casus shows). Strategic competition between a status-quo power (US) and a rapidly emerging power (China) is a natural phenomenon and will linger on. That said, we are still of the view that there are certain checks and balances that should prevent escalation from going too far. Strong negative effects on US stock markets or the US economy (which we expect to slow in 2019-20) are not welcome to president Trump, who wants to be re-elected next year. And for China, it certainly does not want a prolonged economic war with its largest export partner. All in all, we think a full breakdown of negotiations is still not very likely. Talks may resume in the run-up to a potential Trump-Xi meeting late June (a US delegation is said to travel to China again, although no time schedule has been mentioned yet). That said, at this stage we cannot have a strong conviction on this: at the moment the only certainty we have is that uncertainty is here to stay for a while.

Bilateral surplus China vs US has stopped rising



With stakes being raised, drag on Chinese growth increases

Value of Chinese goods covered by US import tariffs - in % of ...



Potential impact of higher tariffs on Chinese economy

Last year, the escalation of the trade conflict was a key headwind for the Chinese economy and equity markets, adding to a tightening of financial conditions (on top of the effects of Beijing's previous financial deleveraging campaign). With the tensions easing since the Trump-Xi truce agreed in December 2018, this headwind started to fade. However, now that tensions are flaring up again and tariffs are raised further, downside risks to the Chinese economy are rising again.

The drag on GDP growth from the US import tariffs implemented last year so far (25% on USD 50bn and 10% on USD 200bn) is roughly estimated at 0.25-0.5 ppt. With the tariff rate on USD 200bn hiked from 10% to 25%, this drag would rise to roughly 0.5-0.8 ppt. And a further extension of the 25% import tariff to all other US imports from China would mean that this drag would rise to 1.0-1.5 ppt. We should add that these are very rough estimates, for several reasons. First, these are 'ceteris paribus' numbers, as they do not take into account a potential easing of macro economic policies. Second, last year we have seen that indirect (hard to estimate) effects on confidence, financial markets and financial conditions are probably as important as direct effects on trade flows. Third, these numbers assume the tariffs installed to remain in place for at least a year, but that is far from sure yet.

April data disappoint, even before higher tariffs are in place

In our previous China Watch, [Spring time, so here are the green shoots](#), we pointed at various signs of an improving momentum in the Chinese economy, on the back of policy easing and fading of trade tensions. The macro data for April, however, show a less rosy picture. Some payback was to be expected, as for instance industrial production's spike in March (8.5% yoy ytd) was driven by seasonal effects. Still, growth of industrial production and retail sales fell back to multiyear lows. Industrial production came in at 5.4% yoy (consensus: 6.5%), while retail sales growth dropped to 7.2% yoy (March: 8.7%, consensus: 8.6%). Fixed investment growth slowed to 6.1% yoy ytd (March: 6.3%, consensus: 6.4%), as the policy driven acceleration of state-led investment was more than offset by weaker private investment.

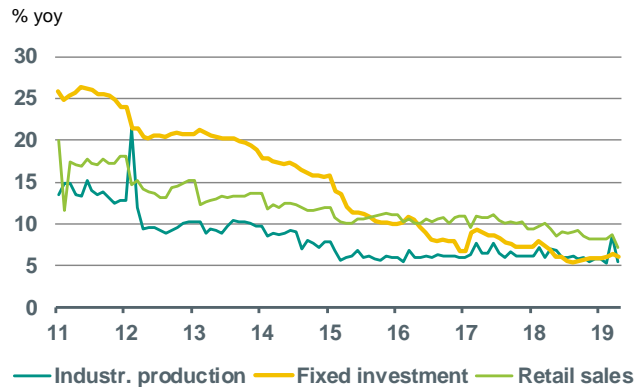
Earlier this month, the PMIs for April were a touch weaker than a month ago, but on balance show an improving pattern over the past months. Import growth for April was back in positive territory, although export growth fell back to negative territory highlighting risks from the external front. Lending data for April came in weaker than expected, but still the pace of lending growth has accelerated by almost a full %-point since May 2018. Producer price inflation has stopped falling, while consumer price inflation edged up again to 2.5% in April partly driven by higher food prices reflecting a swine flu outbreak.

... although Cheung Kong indices point to improving financing conditions

With the volatility in China's quarterly official growth figures being suspiciously low, we look at a wide range of indicators to capture changes in underlying economic momentum. Those include comprehensive indicators such as the various PMIs and Bloomberg's monthly GDP estimate. Another set of indicators that is worth looking at in this respect are the business confidence indicators published by the Cheung Kong Graduate School of Business (CKGSB). Since September 2011, the CKGSB publishes a business confidence index based on a survey amongst senior executives (typically alumni) of more than 300 Chinese firms. The methodology of these indicators is comparable to those of the PMIs. The index contains a general business sentiment index, but also specific subindices. This set of indicators confirms the picture of a clear

improvement in business confidence and financing conditions since late 2018. The overall business confidence index has risen sharply over the past few months, from a historic low of 41.4 in October 2018 to a two-year high of 62.8 in April. The corporate finance sub-index even jumped to a record high of 58.2 in April, reflecting the policy shift to targeted easing with a specific focus on private firms.

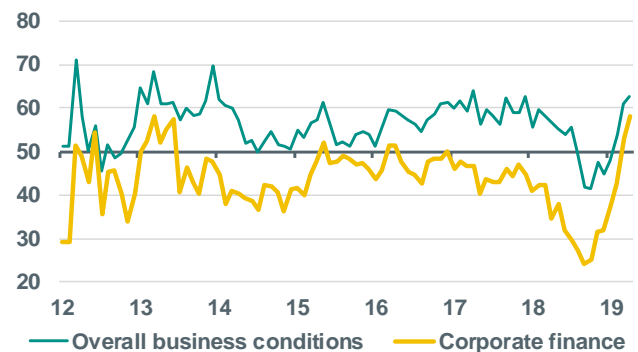
April activity data clearly disappoint



Source: Thomson Reuters Datastream

Cheung Kong index points to improving financing conditions

Cheung Kong business indices, 50 = neutral mark



Source: Thomson Reuters Datastream

We expect authorities to step up stimulus further

We have explained in previous reports that since mid 2018 Beijing switched its policy stance from financial deleveraging/targeted tightening to targeted easing. On the monetary front, the authorities have taken several measures to safeguard liquidity in the banking system and stimulate lending, particularly to private firms and SMEs (for instance by further cuts of banks' reserve requirements and by using/expanding existing lending facilities and open market operations, or moral suasion). 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). All in all, Beijing has opted for what we call a *piecemeal approach* of monetary and fiscal easing, not for *big bazooka* forms of stimulus (that was not needed and would run counter to longer-term goals such as stabilising leverage). That said, Beijing still has sufficient room for further policy easing in our view, and we expect the authorities to use that room. The PBoC could opt for further RRR cuts or, if needed, even lower the benchmark policy rate (that has been kept on hold on 4.35% since 2015), while allowing overall debt levels to pick up again somewhat. In addition, a renewed weakening of the yuan would also help to offset the impact of tariffs.

Still, all in all, risks are shifting to the downside again

So, if we add everything up, where do we stand? Looking at the incoming macro data over the past months, some weeks ago we were inclined to say that risks to our base scenario had shifted to the upside. However, now that the US-China tensions have re-escalated and the latest macro data are weaker than expected, we think that risks to our base scenario are shifting to the downside again. Still, we leave our 2019-20 growth forecasts unchanged at 6.3% and 6.0% for now, as we assume a further easing of macro economic policies that should offset further drags from the trade conflict (at least partly). That said, longer term, a permanent breakdown in US-China relations would lead to an erosion of China-US centered supply chains posing additional challenges to future growth.

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	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	6.6	6.6
EUR/CNY (eop)	7.3	7.8	7.8	7.7	8.3

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

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