

# China Outlook 2020

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## Growth to stabilise in Year of the Rat

- ▶ Slowdown deepened in 2019 due to trade conflict, previous deleveraging and slump car sector
- ▶ 'Phase One' deal US-China reduces uncertainty, but does not eliminate it
- ▶ 2020: bottoming out industry will help economy to stabilise
- ▶ Impact swine flu on consumer price inflation expected to fade this year
- ▶ Monetary and fiscal easing will remain 'piecemeal'
- ▶ China's debt levels keep rising, but at a lower pace
- ▶ Risks remain: US-China tensions, transition risks, Hong Kong/Taiwan, debt burden

On 25 January 2020, the Year of the Rat will start. The rat is the first animal of the Chinese Zodiac and is associated with wealth and surplus. That is a bit symbolic for our macro outlook: after a challenging 2019, we expect China's economic growth to stabilise in 2020 helped by the Phase One deal between the US and China and ongoing piecemeal stimulus. 'Stabilisation' will also be the buzzword for the Chinese authorities this year. According to the annual Central Economic Work Conference held last December, Beijing will put slightly more emphasis on safeguarding growth, while deleveraging will become a bit less urgent. In the press communique the aim to 'structurally reduce leverage' was replaced by 'keeping macro-leverage basically stable'.

### Growth slowdown has deepened in 2019



### Private investment has slowed again



## Looking back to 2019: China's slowdown deepens due to US-China trade/tech conflict, ...

2019 was a challenging year for China. After a period of relative stability in 2016-17, official real GDP growth has slowed materially since mid-2018, falling to 6.0% yoy in Q3-19 (the lowest pace since 1990). Not surprisingly, this slowdown occurred during a period of escalating US-China tensions. In 2018 the US imposed tariffs on USD 250 bn of imports from

China. The situation temporarily improved after Trump and Xi reached a truce in December 2018. However in May 2019, the conflict re-escalated with the US raising existing tariffs on USD 200bn of imports from China and announcing new tariffs on USD 300bn (to be implemented in phases, per 1 September and 15 December). Notwithstanding the de-escalation that took place in the fourth quarter of 2019, the trade-tech war (with its many twists and turns) on balance had a negative impact on Chinese business confidence and domestic spending (both on investment and consumption) in the course of last year.

### ... previous financial deleveraging and drags from the car sector

The trade conflict is not the only factor that has driven down Chinese growth. Lagging effects from Beijing's previous financial deleveraging campaign also played a role, as particularly the private sector but also local governments had to deal with more difficult funding conditions. That was for instance illustrated by a rise in corporate defaults. The number of real estate companies filing for bankruptcy, for instance, has risen last year, partly due to a tightening of credit regulations. All of this is also reflected in a slowdown of private investment in the course of last year.

Another key drag on China's growth rate came from the car sector. In January-November 2019, around 10.5% less cars were produced and sold than in the comparable period of 2018. In the first months of 2019, car sales growth was even close to -20% yoy. Growth of car production and sales is traditionally volatile, given the importance of special policies. Last year, car production and sales have been hit by the fading of previous tax breaks, by environmental issues and also by a more cautious attitude of the Chinese consumer.

#### Difficult funding conditions after financial deleveraging

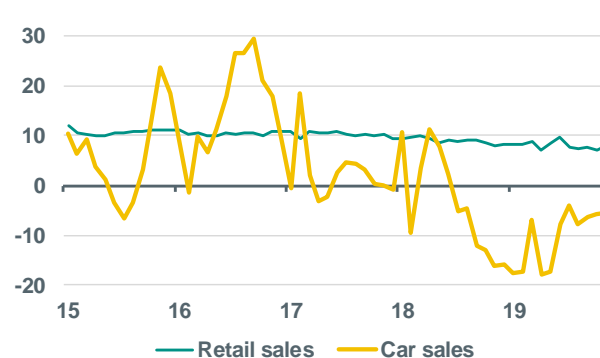
Cheung Kong, Lending Attitude Banks, index, 50 = neutral mark



Source: Bloomberg

#### Car sector has been a clear weak spot

% yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

### 'Phase One' deal reduces uncertainty, but does not eliminate it

We expect the 'Phase One deal' agreed between the US and China mid December, to be formally signed mid January, to be supportive for the Chinese economy, as it puts the tariff tit-for-tat to an end, at least for now, and even leads to some rollback in tariffs. The 25% tariff on USD 250 bn of imports will remain in place, but the 15% tariff on USD 120bn implemented last September has been halved and new 15% tariffs on the remaining US imports (due on 15 December) were cancelled. The direct effect of these tariff reductions will likely be small, but the truce will help to reduce uncertainty, limit downside risks and restore confidence. In fact, the improvement in PMIs seen over the past months can be partly attributed to rising hopes of a trade deal.

That said, the deal does not take away all uncertainty. First of all, although the contours of the deal have been sketched, the details of the agreement yet have to be published and the formal signing still has to be done. Second, according to the US, China has agreed to step up imports of goods and services from the US by USD 200bn in two years compared

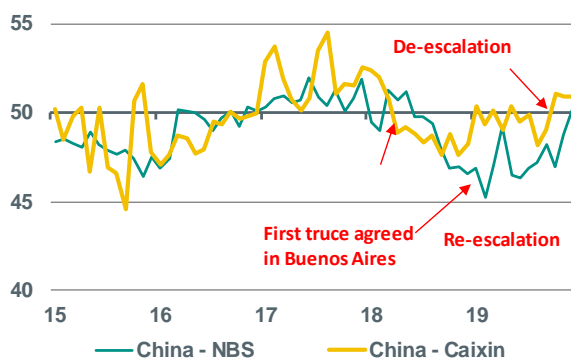
to 2017 levels. From current levels, that would seem quite ambitious; China has not yet confirmed these numbers. Third, given that US-China tensions have risen in all aspects of the relationship (not only trade, but also intellectual property, governance, technology transfer, currency management, security/cyber and human rights), they will likely linger and may flare up when the political calculus in Washington or Beijing changes again. Fourth, the US may also resort to other instruments than tariffs (such as more restrictions on strategic exports or FDI) to halt China's rise as a technology giant. All in all, it remains to be seen whether this Phase One deal will hold, let alone whether both countries would agree on a more fundamental Phase Two agreement.

## 2020: Bottoming out industry will help economy to stabilise

In addition to the end of the tariff tit-for-that, there are indications that Beijing's shift to a piecemeal fiscal and monetary easing approach is filtering through. With past headwinds fading, there is increasing evidence that the weakness in China's industry is starting to bottom out (although the picture is still mixed, with many hard data yet weak). Annual growth of car production turned positive again in November, for the first time since June 2018. Caixin's manufacturing PMI – with a relative strong coverage of the private sector – has been improving since July, probably reflecting that Beijing's piecemeal easing is targeted at private firms. Since November 2019, the official manufacturing PMI rose back to above the neutral 50 mark again (for the first time since April 2019), likely helped by an improving sentiment on US-China talks. The 'official' PMI export subindex has jumped by four full points between June and December 2019. There are also indications that the global IT cycle is bottoming out, which will also be helpful in supporting external demand for Chinese goods. All in all, assuming no further stepping up in US-China tariffs, we expect a bottoming out in industry this year. That will help the Chinese economy stabilise: we expect official GDP growth to slide only marginally to 5.8% in 2020, from 6.0% yoy seen in Q3-2019.

### Export prospects improve with Phase One Deal in sight

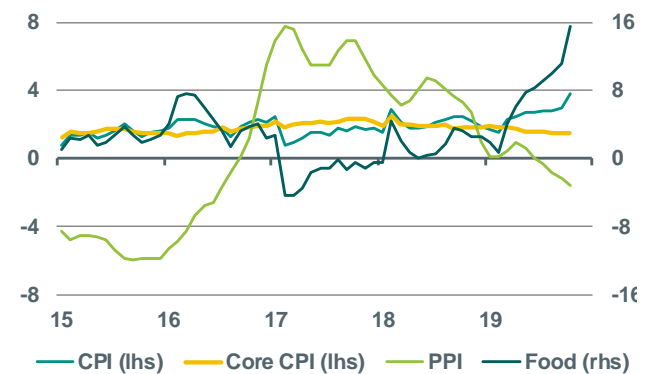
PMI export subindices, 50 = 'neutral mark'



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

### CPI driven up by swine flu related spike in food prices

% yoy



Source: Thomson Reuters Datastream

## Impact of swine flu on consumer price inflation expected to fade this year

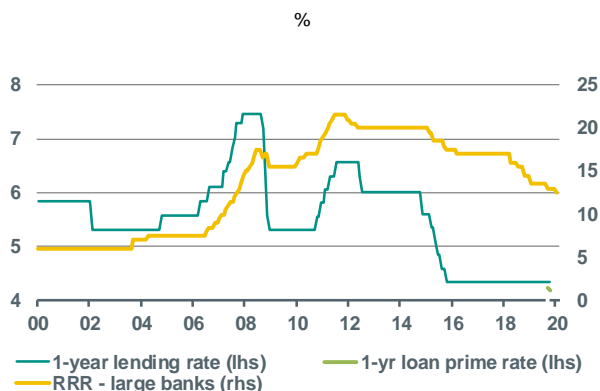
After having dropped to 1.5% yoy in February 2019, Chinese consumer price inflation has risen sharply in the course of 2019 despite the economic slowdown, reaching 4.5% yoy in November (highest pace since January 2012 and clearly above the government's 3% target). That was entirely driven by the swine flu related rise in food – particularly pork – prices. According to some estimates, the outbreak of the swine flu in the summer of 2018 may lead to the halving of China's total pig herd. Food price inflation has risen from 0.5% yoy in July 2018 to an eleven year high of 19.1% yoy in November, with pork prices having more than doubled. Excluding for volatile food and energy prices, China's core inflation has gradually fallen from around 2% yoy in 2018 to around 1.5% in the second half of 2019. Meanwhile, illustrative for the cyclical slowdown in the industrial sectors, producer price inflation (PPI) has entered negative territory again since July 2019. Still, we do not expect PPI to stay negative for a long period, as was the case in 2012-2016 when

a general slump in commodity prices had long-lasting effects. Looking ahead, we expect the impact from the swine flu to fade and annual CPI inflation to drop back towards 3% in 2020.

### Monetary and fiscal easing will remain ‘piecemeal’

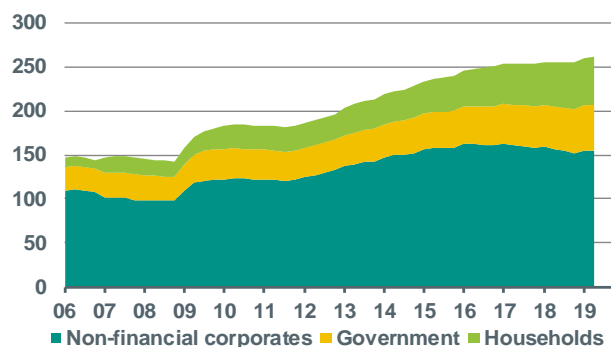
Since mid 2018, with the drag from the trade conflict becoming more serious, Beijing has shifted the policy stance from financial deleveraging – aimed to reduce leverage in the most riskiest parts of the financial sector including shadow banking – to “piecemeal” fiscal and monetary easing. Piecemeal in the sense that Beijing has opted for several rather small easing steps instead of large-scale ‘big bazooka’ stimulus, given that there are still longer-term constraints such as the need to keep overall debt levels in check and to prevent a housing bubble. On the fiscal front, the authorities have cut several taxes and fees and have taken various measures to stimulate infrastructure spending. The State Council has for instance approved raising and frontloading local government quota for the issuance of special purpose bonds, for the second year in a row. On the monetary front, the PBoC has cut reserve requirements for large banks by 150 bp in 2019 and by another 50bp, to 12.5%, in early 2020. That followed a total of 250 bp RRR cuts in 2018. The PBoC also implemented additional RRR cuts for banks that lend a lot to private firms/SMEs. Since mid-2019, the PBoC has also started with mini cuts of several interest rates, while introducing a new benchmark interest rate. That said, compared with previous episodes of easing, the measures taken during the last downturn are less impressive so far. We expect the authorities to continue with piecemeal easing measures to stabilise the economy, but to refrain from large-scale stimulus.

#### Piecemeal easing mainly through RRR cuts



#### China Inc. still leveraging up, but at slower pace

Outstanding credit to real economy, % of GDP



### China's debt keeps rising, but at a lower pace

With the government shifting to an easing approach, China's overall debt burden has started to rise again, although China is not leveraging up as fast as it did in the past. Bank's total outstanding credit to the real economy has risen to 262% of GDP in 19Q2, with 59% thereof outstanding to non-financial corporates, 21% to households and 20% to the general government. Over the past years, non-financial corporate debt has fallen somewhat but household and general government debt has risen. Adding interbank debt to the picture, overall debt has now surpassed the level of 300% of GDP (according to IIF data). The ongoing build-up of debt is going hand in hand with a rise in corporate bond defaults. According to Bloomberg data, total bond defaults have reached a historic high last year. That reflects a combination of slowing growth, rising repayment pressures for heavily indebted companies, difficult funding conditions and the government's abandonment of the 'implicit guarantee approach'.

## Risks to the outlook

While we expect China's economy to stabilise this year, the outlook remains surrounded by a wide range of risks:

### *Strategic tensions with the US will remain ...*

Although the Phase One Deal brings and end, at least for now, to the tariff tit-for-that and reduces – but not eliminates – uncertainty, strategic tensions between the US and China will linger on, particularly on the technology front. The era of constructive cooperation and ongoing economic integration between the US and China has ended. We believe that the relationship between the US and China has been seriously changed under the Trump presidency, suggesting that uncertainties regarding future trade and investment relations will remain and decoupling and shifts in supply chains are here to stay.

### *... making China's transition even more challenging*

China's longer term strategy is to shift its growth model from exports/investment to consumption/services, while moving up the value chain. While this transition will take years, services already passed industry in value-added terms and fast growing new technology sectors have taken over the baton from heavy industry. Still, this transition goes hand in hand with a gradual slowdown in economic growth and is surrounded by risks. Rising tensions with the US has complicated China's ambition to move ahead on the technology front. Whether a country without political freedom will succeed in avoiding the middle income trap (i.e. will be able to push up GDP per capita above middle income levels) will remain uncharted territory.

### *Developments in Hong Kong and Taiwan*

Protests in Hong Kong have intensified in the course of last year (triggered by an extradition bill that has been cancelled), pointing to an underlying discontent about the lack of political freedom and uncertainty about the future of Hong Kong's status (likely in combination with economic grievances, such as the lack of affordable housing). Protesters feel emboldened by reactions from the West (particularly the US and the UK): the start of 2020 was marked by another wave of large-scale protests. The developments have shown that the 'one country, two systems' framework is being challenged. Given that Hong Kong is still valuable for China as an international trading and financial hub, it is likely that Beijing will continue to act cautiously, also taking into account peer pressure. The US, for instance, has adopted a Hong Kong democracy bill, that facilitates an annual review and could trigger sanctions. Meanwhile, the developments in Hong Kong are likely to have impacted public opinion in Taiwan as well. The pro-independence camp in Taiwan is expected to profit from these events, with presidential and legislative elections due on 11 January.

### *Risks related to China's debt bubble and the fading of the 'implicit guarantee concept'*

Last year we have seen an ongoing rise of corporate bond defaults. In terms of related underlying principal, total bond defaults reached a historic high in 2019. That reflects a combination of slowing growth, rising debt repayment pressures and difficult funding conditions, particularly for the private sector (although with some improvement seen after Beijing's shift from financial deleveraging to targeted easing). That said, in relative terms the scale of bond defaults is still manageable. Last year, debt distress has spilled over to the banking system, illustrated by the failures of a couple of small regional banks. The government has taken action to mitigate systemic risks, although these bank failures and the policy reactions mark the end of the era of rapid, unregulated growth for smaller banks. This also reflects the government's abandonment of the 'implicit guarantee approach' and a gradual transition to a more market-oriented approach.

**Key forecasts for the economy of China**

	2017	2018	2019e	2020e	2021e
GDP (% yoy)	6.8	6.6	6.2	5.8	5.6
CPI inflation (% yoy)	1.5	1.9	2.8	3.0	2.0
Budget balance (% GDP)	-3.8	-4.2	-4.5	-4.5	-4.5
Government debt (% GDP)	17	15	18	22	25
Current account (% GDP)	1.6	0.4	1.0	0.5	0.5
Gross fixed investment (% GDP)	42.9	43.1	42.1	41.7	40.7
Gross national savings (% GDP)	46.3	45.2	45.1	43.6	42.2
USD/CNY (eop)	6.5	6.9	7.1	7.2	7.3
EUR/CNY (eop)	7.8	7.8	8.0	8.4	8.8

*Economic growth, budget balance, current account balance for 2019-21 are rounded figures*

*Source: EIU, ABN AMRO Group Economics*

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