China Watch

Group Economics
Emerging Markets Research

Outlook 2018

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Gradual slowdown in 2018, risks remain

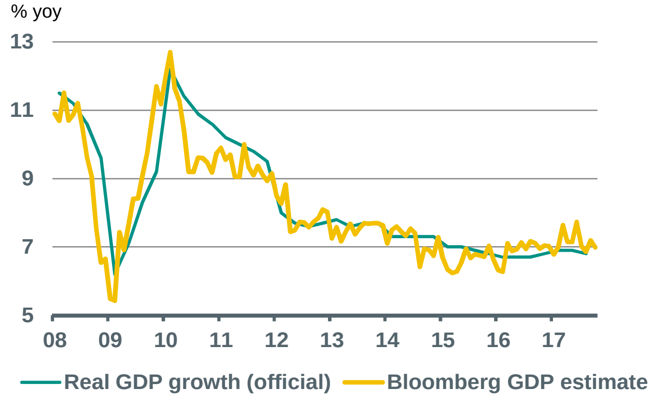
Arjen van Dijkhuizen
Senior Economist
Tel: +31 20 628 8052
arjen.van.dijkhuizen@nl.abnamro.com

- **After better than expected 2017, gradual slowdown to resume in 2018-19 …**
- **… as Beijing continues with targeted tightening and (financial) deleveraging**
- **Rising bond yields add to debt risks; no systemic crisis expected near-term**
- **Structural transition ongoing, rise of high-tech and strategic new industries**
- **Expected import slowdown should remain 'manageable' in volume terms**
- **"Impossible Trinity" managed smartly, modest CNY depreciation expected**
- **Risks remain: a slowing and tightening China will keep markets busy in 2018**

Looking back at 2017, economic growth has done better than expected …

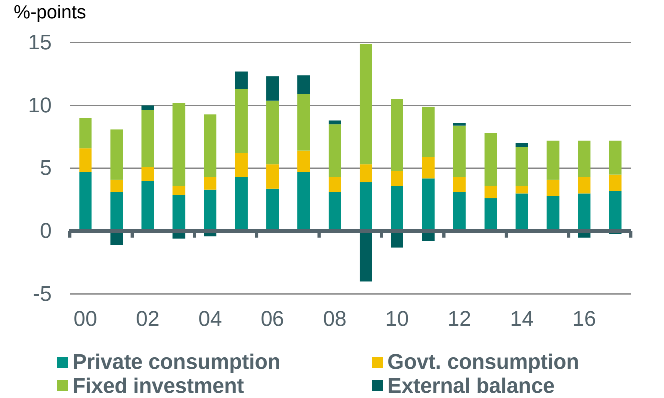
China's (official) economic growth rate has surprised to the upside this year. A year ago, the Chinese economy was expected to grow by around 6.5% in 2017. 'Around 6.5%' was also the growth target adopted by the National People's Congress in March. However, in reality, official GDP growth has risen to 6.9% yoy in the first two quarters of this year, slowing a bit to 6.8% yoy in the third quarter. Hence, we now expect annual official GDP growth to reach 6.8% this year, the first improvement in annual terms since 2010. Alternative growth indicators with more cyclical variation than official growth numbers (such as Bloomberg's monthly indicator or the macro-economic climate index) also point to an economic acceleration since mid-2016 extending into the first half of 2017.

Economic growth to resume a gradual slowdown



Source: Bloomberg

Consumption key growth driver



Source: EIU

… thanks to robust domestic demand and a pick-up in external demand

The firming of the economy in the second half of 2016 and the first half of 2017 was supported by solid domestic demand and a pick-up of external demand. Strong private consumption, with consumer confidence at a 24-year high in October, continues to be the key driver of growth. The real estate sector initially held up better than expected. Meanwhile, the industrial sector profited from reflation, which boosted profit margins and helped SOEs managing their debt loads. Last but not last, a broad-based pick-up in external demand (both from advanced and emerging economies) turned out to be an import tailwind, offsetting the impact of Beijing's targeted tightening policies, as China not only contributed to but also profited from the uptick in global growth/trade.

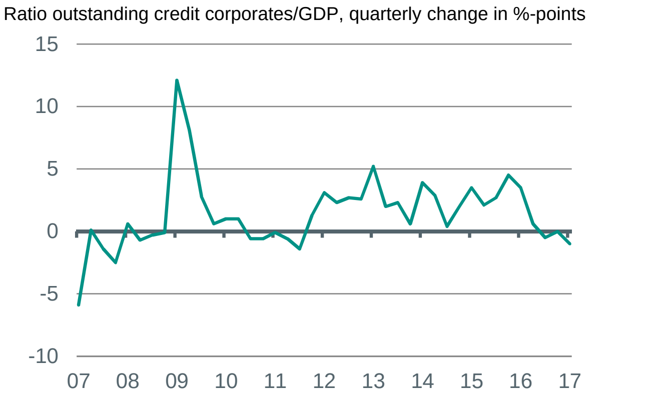
Still, the gradual economic slowdown has resumed from Q3 onwards …

Since 2012, China's official GDP growth has roughly followed the pattern of a gradual slowdown, although with some cyclical variation around this 'trend'. After edging up in Q4-16 and 1H-17, growth resumed a gradual slowdown since Q3-17 driven by a number of factors. First, judging from sales, construction and pricing data, real estate markets are correcting as more local authorities have joined the pack of tightening housing and mortgage policies. In almost half of the top 50 tier-3 cities – where property markets have been the most bullish in 2017 – tighter policies have been introduced. Moreover, the credit impulse has faded as Beijing's financial deleveraging campaign unfolds.

The property market correction is gaining weight

Source: Thomson Reuters Datastream

Leverage corporate sector has stabilized …



Source: Thomson Reuters Datastream

… and we expect it to continue in 2018 and 2019

While the Chinese economy has found a solid footing, we expect the gradual slowdown to continue in 2018 (and 2019). Beijing will likely tolerate slightly lower growth, as long as it is of better quality and more sustainable. At the 19th CPC Congress held in October, more emphasis was put on quality and equality aspects of China's growth model, including environmental goals. Headwinds from ongoing targeted tightening will stay on, while the drag from the property market correction will still be felt. There will also be some impact from tighter environmental policies, including the anti-pollution campaign in the steel-producing northern Hebei region. All in all, we expect growth to drop from 6.8% in 2017 to 6.5% in 2018. We expect alternative growth measures to drop moderately as well next year. For 2019, we expect a further moderation in GDP growth, to around 6.0%.

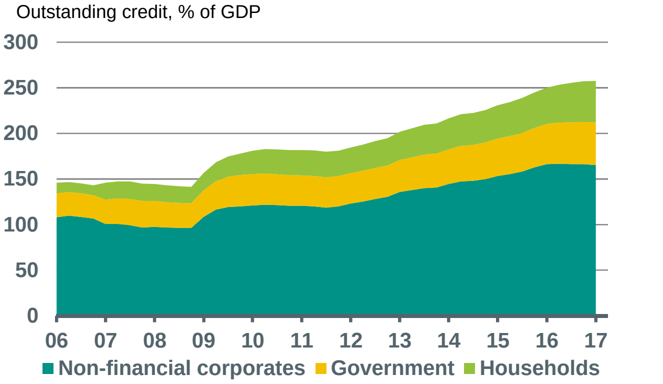
While financial deleveraging has been effective so far …

With growth still comfortably 'above target', we expect Beijing's targeted tightening (or 'financial deleveraging') to continue in 2018-19. In general, these policies are aimed to reduce excessive financial leverage and address the most risky parts of the financial system, while keeping credit to the real economy flowing. That raises the question whether China's policies in this respect have been successful so far. In our view, Beijing has indeed succeeded in reducing excessive financial leverage within the financial sector and containing risks from off-balance-sheet activities including shadow banking, while at the same time safeguarding overall economic growth by keeping credit to the real economy flowing.

… overall debt levels to the real economy keep rising

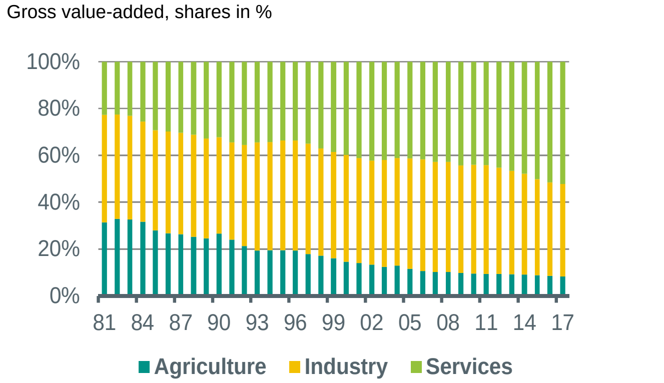
The other side of this approach is that outstanding credit to the real economy keeps rising. As credit growth still outpaces nominal GDP growth, the overall credit to GDP ratio rose to a record high of 258% of GDP per March 2017. Such a level is very high, certainly by EM standards. That said, the gap between credit growth (gradually slowing) and nominal GDP growth (bolstered by reflation) has fallen to a six-year low. Moreover, credit to the corporate sector (the bulk of outstanding credit) has slowed, and the corporate credit to GDP ratio (around 165% of GDP) has not risen since mid-2016. However, the credit-GDP ratios for households and for the general government have increased, to over 45% of GDP per March-2017 for both sectors. All in all, overall debt levels keep rising: the IMF expects China's overall non-financial debt to rise to 300% of GDP by 2022. Coupled with rising interest rates, that will likely create more distress for heavily-indebted companies, a rise in non-performing loans and more 'credit events'. The rising debt load has triggered some rating downgrades this year (although all rating agencies now have a stable outlook). PBoC governor Zhou has pointed out that China has to defend itself against a possible 'Minsky Moment'.

… but overall credit to real economy still rising



Source: Thomson Reuters Datastream.

Services have become the largest sector



Source: EIU

More to be done; base scenario does not foresee hard landing in forecast horizon

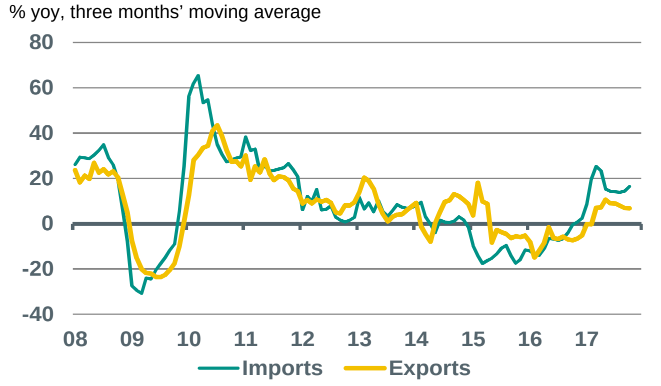
To prevent too strong of a debt build-up over time, more should be done. We expect Beijing to focus more on SOE deleveraging and reform and expect overall credit growth to slow further in the coming years. The question remains whether Beijing can really reduce overall debt without causing a sharp growth slowdown. No one can be sure about the remote future of course. Still, in our base scenario we assume that in a two-year forecast horizon a further slowdown in credit growth can indeed go hand in hand with a gradual slowdown in economic growth. So, similar to the rating agencies, we do not expect a systemic crisis c.q. hard landing in the near-term. That view is also based on the assumption that Beijing would soften the targeted tightening approach and/or add stimulus, should the moderation in growth become too severe. Moreover, China's debt is mainly in domestic hands and denominated in yuan, while foreign debt remains low. Besides, China still has high domestic savings, an external surplus and FX reserves which are very high by any standard. So, a crisis will not be triggered by external creditors, leaving Beijing time to engineer something orderly, at least for the foreseeable future. To put it differently, the high, rising debt burden remains a key risk, but more a long-term than a short-term one.

Consolidation of asset management industry should be beneficial for banks
Meanwhile, proceeding with the "financial deleveraging campaign", the authorities presented draft guidelines mid November to bring China's USD 15 trillion asset management industry under one supervisory regime. These measures should cap the growth in shadow banking and make the industry less complex and risky and more transparent. The guidelines present major constraints for asset managers, including issuers of so-called *wealth management products*. To prevent this new regulation from becoming disruptive, the authorities have proposed a grandfathering period for existing products. We expect these measures to contribute to a further consolidation of the off-balance-sheet segments of China's financial sector. While this could create market turbulence from time to time, it should be beneficial for the regular banking sector.

Structural transition ongoing, high-tech and strategic new industries on the rise
China is proceeding with its necessary structural transformation, albeit slowly. In demand terms, this transformation involves the move from an exports and public investment based growth model to one based on consumption. In supply terms, the transformation entails the shift from (heavy) industry to high-tech and strategic new industries and to services. In order for China to safeguard long-term growth, it has to cut overcapacity and create room for new, fast-growing sectors. Growth in the services sector continues to outperform industrial growth. Since 2012, services are the largest sector in gross value added terms. Regarding overcapacity, according to official sources, the planned 2017 capacity cuts for steel and coal (50 and 150 million tons, respectively) have been more than accomplished. What is more, the outperformance of online spending, the rapid growth of the market capitalization of tech giants Alibaba, Baidu and Tencent and the rising GDP share of R&D expenditure is symbolic for the rise of China's "new economy".

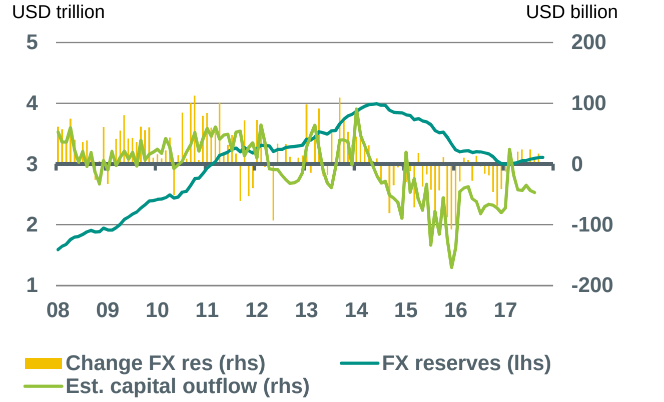
Expected import slowdown should remain 'manageable' in volume terms
Growth of Chinese import values has risen sharply in 2017, to more than 15% yoy, after having been in contraction mode in 2015-16. That recovery does not only reflect the firming of domestic demand, but certainly also the general rise in import prices (after sharp price drops in previous years). Moreover, it reflects the pick-up of exports, as China's global manufacturing status implies that a significant part of imports are strongly tied to exports. For 2018, we expect import value growth to roughly halve, in line with our gradual slowdown view and as this year's favourable base effects will fade. However, we expect this slowdown to be much more benign in volume terms. The recent announcement of import tariff cuts for a broad range of consumer products should also help to keep the risk of an import slowdown manageable. We anticipate export growth to cool somewhat as well in 2018, after the sharp recovery in 2017. We think the risk of a damaging trade war between China and the US – which has never been our base case – has fallen further following president Trump's recent visit to China. Over the longer term, the *One Belt, One Road* initiative should support Chinese exports (and imports) as well.

Import and export growth to slow in 2018



Source: Thomson Reuters Datastream

Beijing has managed "Impossible Trinity" smartly



Source: Bloomberg, Thomson Reuters Datastream

***"Impossible Trinity"* has been managed smartly, modest CNY depreciation expected**

In 2015-16, unexpected moves in the exchange rate regime and rising capital outflows contributed to the flaring up of China hard landing fears. Such fears have eased, as Beijing has followed a steep learning curve in our view. By allowing the yuan to strengthen by around 5% versus US dollar this year while at the same time safeguarding overall external competitiveness, they have not only appeased Washington. This has also helped (combined with the tightening of capital restrictions) to stem capital outflows, that used to be partly driven by CNY depreciation expectations. As a result, FX reserves have risen for nine months in a row now and are almost back to the October-2010 level. All in all, Beijing has proved to be 'in control', as we expected. Going forward, we expect China's opening up of the capital account to remain a very gradual affair, as Beijing is aware of the constraints illustrated by the *Impossible Trinity*. On the currency front, we expect a modest CNY depreciation versus USD to 6.65 per end-2018, in line with our broader USD view (and reflecting differences in growth dynamics and the direction of monetary policy).

Higher inflation and more targeted tightening drive further rise in bond yields

We recently raised our inflation forecast for 2018 to 2.5%, from 2%. That is based on the assumption that food price deflation will abate. It also takes into account that producer price inflation has rebounded to almost 7%, as the increase in metals and energy prices has spread to other commodities. Core inflation has also risen gradually since early 2016, to 2.3% yoy in the past months. Meanwhile, (the announcement of further) targeted tightening and higher inflation expectations have driven Chinese interest rates up. The 10-year bond yield has risen by around 90 bp since the start of the year and by 30 bp since September. Global bond market developments – in the run-up to an expected Fed hike in December – play a role as well here. The rise in interest rates is adding additional pressures to debt-ridden companies. It also could be another drag to lending. We still expect the PBoC to support banking sector liquidity, while leaving the benchmark policy rate at 4.35% next year, and credit growth to slow moderately going forward.

To conclude, China will keep markets busy in 2018 from time to time …

While we expect China's soft landing to continue in 2018-19, we are certainly not blind to the variety of macro-financial and geopolitical risks surrounding China's transition, that could cloud the outlook. Given those risks and in view of China's key role in the global economy and in global trade, the likelihood that global financial markets will be impacted by a slowing and tightening China from time to time is high, even under a gradual slowdown scenario.

… as key macro-financial and geopolitical risks remain

Although we do not expect a systemic crisis in our forecast horizon, the key risk in our view does relate to the ongoing rise of China's debt coupled with rising bond yields. While the authorities would likely step in should systemic risks materialise, there are always implementation risks. A disorderly deleveraging would have far-reaching consequences for financial stability and trigger a hard landing. China-related risks could also arise if policy makers prove to be 'running behind the curve', meaning that they have to tighten policies more abruptly than anticipated. Connected with that risk, a sharper than expected correction in the real estate sector could hurt domestic demand, which would also trigger a stronger than anticipated cooling of imports. That could also follow from a sharper than expected slowdown in export growth, possibly also related to protectionist threats from the US or elsewhere. Other external risks stem from a potential renewed surge of capital outflows and a tightening of financial conditions, in connection with (sharper than expected) Fed rate hikes and other central banks moving to the exit. Last but not least, geopolitical risks (US-relationship, North Korea, South-China Sea) also have the potential to cloud the outlook.

Key forecasts for the economy of China

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	6.9	6.7	6.8	6.5	6.0
CPI inflation (% yoy)	1.5	2.0	1.5	2.5	2.5
Budget balance (% GDP)	-3.4	-3.8	-4.0	-4.0	-4.0
Government debt (% GDP)	15	16	19	22	25
Current account (% GDP)	2.7	1.7	1.5	1.5	1.5
Gross fixed investment (% GDP)	43.1	42.7	43.3	42.2	41.2
Gross national savings (% GDP)	47.5	45.9	45.1	44.3	43.2
USD/CNY (eop)	6.5	7.0	6.6	6.7	6.8
EUR/CNY (eop)	7.1	7.3	7.9	7.6	8.5

Economic growth, budget balance, current account balance for 2017 and 2018 are rounded figures
Source: EIU, ABN AMRO Group Economics