ABN·AMRO

China Watch

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No barking but biting in Year of the Dog

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- **Seven key China-related questions as we enter the Year of the Dog**
- **Trade tensions with US flare up, as protectionism dog starts biting**
- **With ongoing targeted tightening, we expect resumption of gradual slowdown**
- **Import growth will drop in value terms, but only moderate in volume terms**
- **Financial deleveraging in progress, although overall debt levels are still rising**
- **Risks remain, but rising tech giant China could also surprise to the upside**
- **We have revised our USD-CNY forecasts to 6.50 end-2018 and 6.70 end-2019**

Introduction

On 16 February, China's lunar Year of the Dog started. That coincides with a long holiday break in which 'the world's largest factory' closes down as Chinese visit their families. As the timing of the LNY break changes each year, some monthly data are highly distorted. Meanwhile, on the very same day that the Year of the Dog started, the US Commerce Department proposed to install heavy curbs on US steel and aluminum imports from China and other countries. US president Trump – a Dog according to the Chinese Zodiac – has to decide on these proposals by April. In this report, we will look at these and other China-related issues in Q&A form.

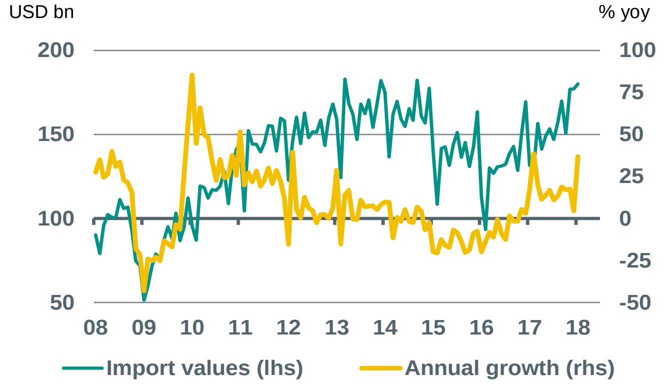
1. Will we see a major, damaging trade war between the US and China?

Not likely, but risks are rising. Last month, the US introduced import tariffs on solar panels and washing machines (see our reaction here). This issue has become more serious with the recent US proposals for the installment of high import tariffs and/or stringent import quota (there are various alternatives) on steel and aluminum. Last year, the US only ranked 26th as a destination for China's steel exports, but China has been accused for transporting steel to the US through other countries such as Vietnam. As the US is China's key trading partner (around 20% of exports), an escalating trade dispute would be felt and would risk retaliation. The latest proposals would not only hurt China, but may also effect a range of other countries including the EU. China and others have already stated in the run-up to president Trump's final decision that they would bring this case to the WTO, while working out potential retaliation measures. Retaliation would probably be concentrated on farm products, as these would hurt US states with a strong Trump support base. In our base scenario we still do not expect a major, damaging trade war between China and the US, as we expect them to be aware of the high related costs given the large mutual interdependencies. However, risks are rising now the trade protectionism dog has started to bite.

2. Will China's imports collapse?

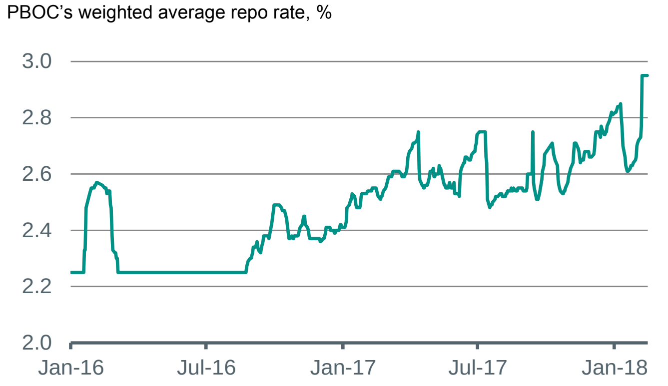
No. True, our baseline scenario assumes import value growth to slow materially this year (in line with consensus), from around 16% in 2017 to below 10% this year. This partly reflects base effects including price fluctuations. In volume terms, the slowdown should be much more moderate, in line with our view of a gradual GDP slowdown. Meanwhile, as China is a key global manufacturing hub, parts of imports are highly correlated with exports. Hence, a rise of trade protectionism affecting Chinese exports also poses downside risks to Chinese imports. Note that the very strong growth of import values reported in January 2018 (+37% yoy) is strongly biased by the timing of the Chinese New Year (2018: mid-February / 2017: late January/early February). The increase was much less impressive in monthly terms (+1.7% mom). Note that import volume figures for commodities do point to a structural growth slowdown for a while, although in January there was a sharp spike in for instance iron ore and oil imports. All in all, we have to wait for the February and March trade data to get a clearer picture of current trends.

China's import growth projected to slow this year



Source: Thomson Reuters Datastream

PBoC tightens interbank market …



Source: Bloomberg

3. Will Beijing continue with targeted tightening?

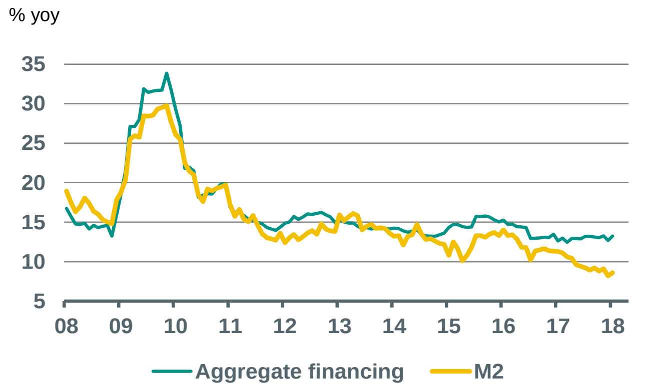
Yes. The CPC congress in October 2017 made clear that the fight against financial risk, inequality and pollution is high on president Xi's priority list. This was worked out further in the Annual Economic Work Conference held late December. As the Chinese economy did a bit better than expected last year, there is more leeway to make progress. In late 2017, environmental policies were tightened and we have seen mini rate hikes and a tightening of regulations over the past months. We expect targeted tightening to continue. Beijing aims to reduce leverage in the most risky parts of the financial system, including shadow banking and the interbank markets, while keeping credit to the real economy flowing.

This policy consists of (1) guiding interbank rates higher and (2) tightening macroprudential rules:

1. In 2017, various policy rates for the PBoC's open market and lending facilities have been raised marginally, to guide interbank rates higher. At the same time, the benchmark 1-year lending rate has been kept at 4.35%, to prevent debt service obligations for heavily indebted companies from rising too much. Meanwhile, the PBoC has safeguarded overall bank system liquidity. Targeted tightening and rising inflation expectations also have caused a rise of bond yields at the longer end of the curve (and a flattening of the 5-10 year part). Five and ten year yields have tested the 4% level, but have fallen back in recent weeks.
2. Beijing has tightened macro-prudential regulation since late 2016. In November 2017, a Financial Stability and Development Committee was founded under the State Council, to strengthen coordination between regulators (PBoC, CBRC, CSRC, CIRC, local governments etcetera). Immediately thereafter, draft guidelines for the asset management sector were

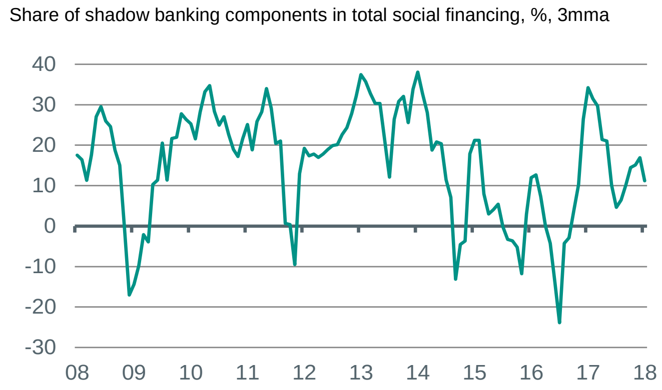
issued. Banking supervisor CBRC recently presented tighter rules for interbank and off-balance sheet transactions and lending to local governments and zombie firms. Shadow banking, property financing and web-based financial activities will be brought under the PBoC's. macro-prudential supervisory framework. Local government finances will put under more scrutiny, and rules for the funding of local infrastructure projects will be tightened.

… and overall credit growth is slowing gradually



Source: Bloomberg, Thomson Reuters Datastream

Containing shadow banking



Source: Thomson Reuters Datastream

4. Has deleveraging really started or not?

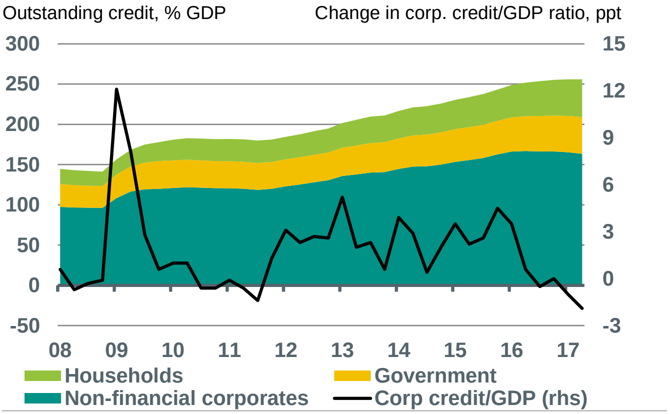
Yes and No. Thanks to the financial deleveraging campaign, leveraged position taking, off-balance sheet activities and shadow banking have been contained. That is illustrated by the falling share of trust loans, entrusted loans and banks' acceptance bills in total social financing, a proxy for shadow banking activity. Another indication of deleveraging is the decline in the outstanding corporate credit to GDP ratio. However, as credit growth still outpaces nominal GDP growth, the total debt burden of China Inc. has not stopped rising yet (although the debt build-up has slowed, as the gap between credit growth and nominal GDP growth has narrowed). So, more is needed to prevent outstanding credit to the real economy from rising towards 300% of GDP or beyond (from almost 260% mid-2017). We should add that this debt is largely domestic: predominantly CNY denominated, largely in state banks' books and with a large chunk outstanding to SOEs. As China's foreign debt is very low compared to the level of FX reserves, foreign creditors cannot trigger a debt crisis in China. So, Beijing has time to engineer an orderly deleveraging.

5. Will we see a sharp slowdown in official growth or in alternative growth indicators?

Not likely. Sure, as Beijing wants to improve the quality of growth by reducing financial risk, inequality and pollution, policy makers will tolerate some slowdown. However, we think they will not tolerate too strong of a slowdown, as that would bring into danger their longer-term development goals and, more importantly, China's 'social contract". With this we mean the implicit notion that the Chinese communist party can keep its political monopoly if it succeeds in delivering economic progress. Early next month, the National People's Congress will set the official GDP growth target for 2018. We think the target will be set at 'around 6.5%', similar to last year. There will be some tolerance should growth fall beyond this level at the end of this year. However, should – for instance – the impact of targeted tightening turn out to be stronger than foreseen and the slowdown become 'too severe', we expect the authorities to reduce or even reverse these policies. In our base scenario, we expect official GDP growth to slow gradually, from 6.9% in 2017 to 6.5% in 2018 (as the effects of targeted tightening and a property market correction kick in).

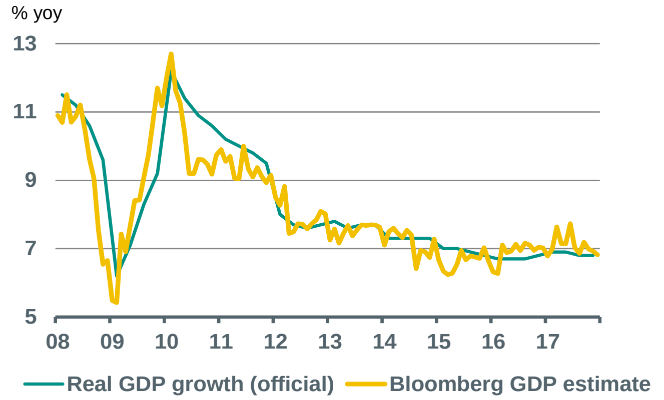
We anticipate alternative growth indicators such as Bloomberg's monthly GDP estimate to drop moderately as well this year. Although there are many risks surrounding our base scenario (also see last month's China Watch, *Goldilocks and the panda bears*), we could also envisage a scenario that China will surprise to the upside again this year. Such a surprise could come from external demand (there are risks from protectionism, but at the same time growth in advanced economies is booming) while China's rise as a tech giant is also creating momentum.

Total credit to GDP keeps rising, though at a lower pace



Source: Thomson Reuters Datastream

Growth firmed in 2017, but gradual slowdown expected



Source: Bloomberg

6. Will capital flows issues pop up again this year?

Possibly, but it is unlikely that they will spook global financial markets to the same extent as they did back in 2015 and early 2016, when rising capital outflows and a weakening yuan were adding to China hard landing fears. Since that episode, Chinese policy makers have shown their skills in managing 'the impossible trinity' wisely. They have shifted the exchange rate anchor from the US dollar to a broader, trade-weighted currency basket. They have succeeded in taming capital outflows, and FX reserves have started rising again since early 2017. That does not only reflect tighter capital restrictions imposed in late 2016, but also shifting yuan expectations. Looking forward, the PBoC may now put some more focus on capital account liberalization, although we anticipate that will remain a gradual, long-term affair. We anticipate that the PBoC will also tolerate some weakening of the yuan versus the US dollar now (see below), although the bilateral relationship with the US will likely continue to play a role as well here.

7. After 9% appreciation, will PBoC now accept a sharp CNY weakening versus USD?

No. Since the start of 2017, the Chinese yuan has rallied by close to 9% versus the US dollar to levels not seen since August 2015. This was in a generally 'weak dollar environment': on a trade-weighted basis the US dollar lost 11% in this same period. The drop in USD/CNY seemed to have been too sharp in the eyes of the PBoC when the pair moved below 6.30. Since then USD/CNY has recovered somewhat. Against this background, we have lowered our USD-CNY year-end forecast for 2018 to 6.50 (from 6.65) and for 2019 to 6.70 (from 6.80). Chinese policy makers appear to tolerate a relatively strong CNY especially if the US dollar is under pressure, but the move should not go too far. Second, although the Chinese economy did a bit better than expected last year, we still expect a gradual cooling this year. Third, we expect a modest recovery of the US dollar as investors are currently too negative, but is unlikely that Chinese officials will accept a sharp weakening of the CNY. Taken all together we foresee some weakening for the Chinese yuan versus the US dollar.

Key forecasts for the economy of China

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	6.9	6.7	6.9	6.5	6.0
CPI inflation (% yoy)	1.5	2.1	1.6	2.5	2.5
Budget balance (% GDP)	-3.4	-3.8	-4.0	-4.0	-4.0
Government debt (% GDP)	15	16	19	22	24
Current account (% GDP)	2.7	1.7	1.5	1.5	1.5
Gross fixed investment (% GDP)	43.1	42.7	44.0	43.2	42.1
Gross national savings (% GDP)	47.5	45.9	46.0	45.2	44.0
USD/CNY (eop)	6.5	7.0	6.5	6.5	6.7
EUR/CNY (eop)	7.1	7.3	7.8	7.5	8.4

Economic growth, budget balance, current account balance for 2018 and 19 are rounded figures
Source: EIU, ABN AMRO Group Economics