China Watch

Group Economics
Emerging Markets Research

Outlook 2019

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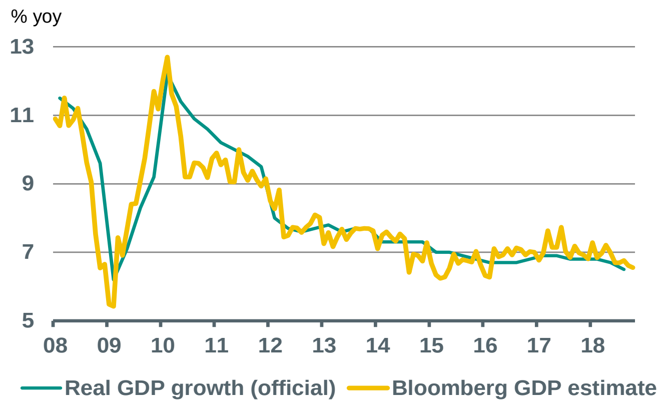
Stimulus offsets trade risks

- **2018 marks the resumption of China's gradual slowdown**
- **… driven by financial deleveraging and initial drags from trade conflict US**
- **Trump and Xi Jinping agree on 90 day truce in Buenos Aires**
- **Should downside pressures intensify, Beijing has more room for stimulus**
- **Yuan weakness also cushions impact tariffs, but we expect some recovery**
- **All in all, we expect China's slowdown to remain gradual in 2019 and 2020**
- **Main risks: tensions with the US, other geopolitical risks, high debt levels**

2018: China's gradual slowdown resumes …

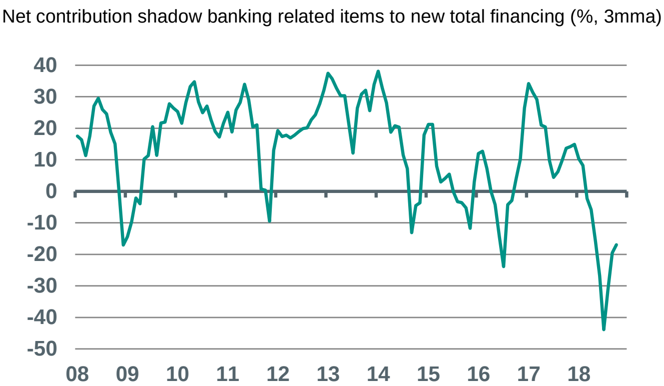
In 2017, China's official growth rate rose to 6.9%, the first acceleration since 2010, supported by a pick-up in external demand and solid domestic demand. In 2018, China's gradual economic slowdown has resumed. Official GDP growth has fallen from 6.8% yoy in the 2nd half of 2017 and Q1-2018 to a post-global financial crisis low of 6.5% in Q3-2018, with the slowdown gaining some pace since mid 2018. As the volatility in China's official growth rates is suspiciously low, we look at Bloomberg's monthly GDP estimate as an alternative indicator. According to this indicator, which shows more cyclical variation than official growth, growth slowed from an average of 7.0% yoy in the first two quarters of this year, to 6.7% in Q3-2018 and 6.6% in October 2018. Meanwhile, as Bloomberg's alternative estimate continues to hover just above official growth numbers, there is not much evidence the official numbers overestimate the real growth rate.

Economic growth to resume a gradual slowdown



Source: Bloomberg

Crackdown on shadow banking

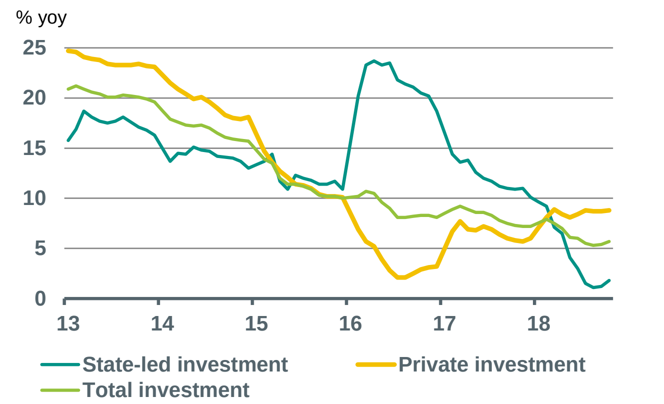


Source: Thomson Reuters Datastream, ABN AMRO Group Economics

… driven by financial deleveraging and initial drags from trade conflict

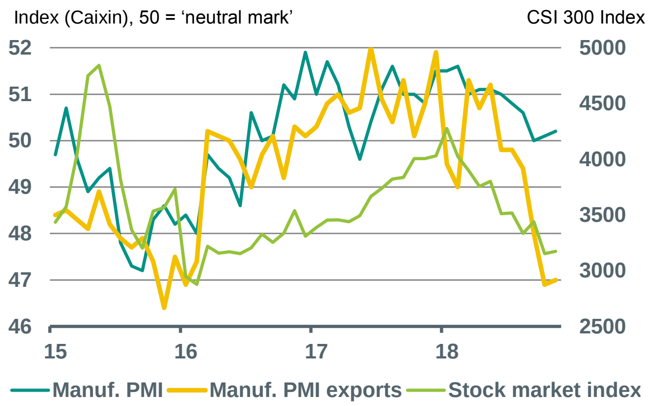
The resumption of China's gradual slowdown is driven by several factors. First driver is Beijing's policy of targeted tightening, also known as financial deleveraging. Main goal of this campaign was to reduce the debt build-up, particularly in the most risky parts of the financial system including shadow banking. This crackdown has caused the contribution from shadow banking related elements to lending growth to turn negative. A second, related factor is the sharp drop in growth of state-led investment. Over the past years, tighter regulation created funding pressures for local government financing vehicles that used to be the key drivers of local infrastructure spending. This has brought overall investment growth down, although private investment growth holds up well and remains clearly above the trough seen in mid 2016. Third, it reflects the initial fall-out from the escalating conflict with the US. While trade tensions have not yet resulted in a weakening of import and export growth (see below), they have hit business sentiment and stock markets. China's manufacturing PMIs (both from NBS and Caixin) have fallen towards the neutral 50 mark in the course of 2018, while export subindices have dived sharply below 50. In our view, the underperformance of Chinese stock markets this year (compared to global and EM indices), is clearly related to the escalating trade conflict with the US, China's largest export partner.

State-led investment has slowed further during 2018



Source: Thomson Reuters Datastream

Tensions US hit business confidence and stock markets



Source: Bloomberg, Thomson Reuters Datastream

After escalation in course of 2018, China and US agree on a temporary truce

After imposing import tariffs on solar panels, washing machines, steel and aluminum in the first part of this year, the US subsequently narrowed its scope on the trade and investment front towards China. That partly stems from the large bilateral deficit of the US with China, which has risen further in the course of 2018. Still, concerns regarding China's rise as a tech power, the treatment of intellectual property and the way the Chinese government supports and subsides the development of technology perhaps play an even larger role. All in all, the US has clearly stepped up China-specific import tariffs. The US also tightened legislation and policies guiding foreign (in particular Chinese) investment into the US and exports of strategic products to China.

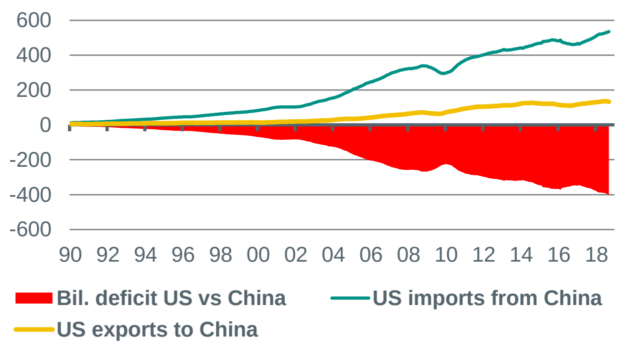
So far this year, the US imposed 10-25% *Section 301*[1] tariffs on a total of USD 250 bn of US imports from China. China retaliated by imposing 5-25% tariffs on USD 110 bn of imports from the US. The US has also threatened to raise the 10% tariff rate over USD 200bn of imports from China to 25% per 1 January 2019 and to broaden the base to all imports from China. As the stakes are being raised, it is clear that downside risks to the Chinese economy have risen. Still, at

[1] In 2017, the US initiated an investigation on China's policies regarding technology transfer, intellectual property and innovation under Section 301 of the US Trade Act of 1974.

1 December presidents Trump and Xi Jinping agreed on a truce, with the US and China putting further tariff hikes on hold for 90 days while resuming negotiations.

US's bilateral trade deficit with China has risen further

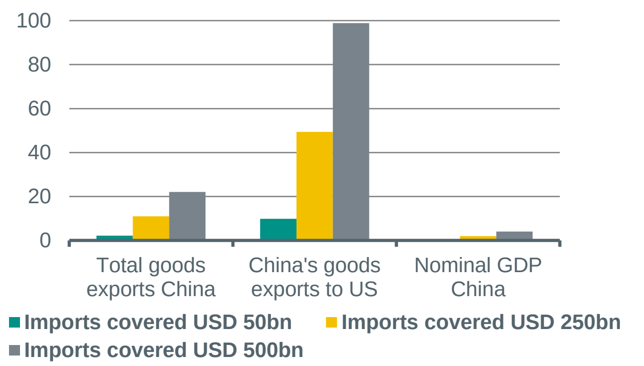
USD bn, 12 months' rolling sums



Source: Thomson Reuters Datastream, US Census Bureau. ABN AMRO GE

Stakes in trade conflict have been raised

In % of …



Source: ABN AMRO Group Economics, EIU, Thomson Reuters Datastream

Export and import growth still solid, partly reflecting frontloading

So far, Chinese exports and imports do not seem to have been affected by the escalating trade tensions, at least not in a negative way. Exports (in dollar values) have grown by 12.5% yoy ytd, almost double the pace of 2017. This may be partly explained by frontloading given the threat of further tariff hikes next year. Strikingly, Chinese exports to the US have grown at double digit levels since the US announced to implement import tariffs versus China last spring. A weakening of CNY versus USD (by almost 10% since March) has also supported export growth. The strong export data contrast sharply with the drop in PMI export subindices, highlighting downside risks related to the trade conflict. Meanwhile, despite the resumption of China's gradual slowdown, import growth (in dollar values) has remained very strong, at over 20% yoy ytd (2017: 16%). While a future slowdown in export growth would likely have a negative effect on import growth (given that part of imports are export-related), recent policy measures such as the stepping up of infrastructure spending and a general reduction of import tariffs should be supportive.

Export and import growth still solid

Values, in USD, % yoy, 3mma

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

PBoC cuts bank RRRs to safeguard liquidity

Reserve requirement ratio, large banks, %

Source: Thomson Reuters Datastream

Beijing has added fiscal stimulus and softened its financial deleveraging campaign
In reaction to the downside risks from previous financial deleveraging and rising tensions with the US, Beijing has changed course in terms of macro economic management. Supporting growth has become the key policy priority. The authorities have eased fiscal policy and have softened – but not completely abandoned – their financial deleveraging campaign. On the fiscal front, Beijing has for instance ordered local governments to issue more special purpose bonds to finance local infrastructure projects. Meanwhile, the banking supervisor has cut risk weights for local government bonds. All of this has indeed resulted in an increase of local government bond issuance, although for some local governments annual quota have now been reached. The government has also implemented and/or announced a wide range of tax cuts, in the sphere of personal income, VAT, corporate income, exports and imports. The government is also tweaking its environmental policies, by easing anti-pollution curbs. On the monetary front, the PBoC has cut bank RRRs further to add liquidity to the banking system. Furthermore, the central bank has taken various measures to support lending to private firms and SMEs. The PBoC has also provided credit support to ease corporate bond default pressures, as the number of corporate defaults (mainly private companies) has risen this year.

… and we expect authorities to add more stimulus should downside pressures intensify
If needed, the government still has a large toolbox to add more stimulus. On the fiscal front, the government could for instance lower tax rates (such as VAT) further and could take more steps to ease funding conditions for local governments. On the monetary front, we expect the PBoC to cut bank RRRs further, while it will keep using its open market and lending facilities to smooth liquidity pressures. Our base case assumes the PBoC will keep the benchmark policy rate (1-year lending rate) on hold at 4.35%. Still, given that inflation remains contained (and below the 3% target), the central bank may opt for cutting these rates as well in a bad weather scenario. On the macroprudential front, if need be the authorities may start loosening housing (finance) policies further. China's property and land markets have shown resilience this year, as the government already softened its stance. Still, given that housing prices have continued to rise and Beijing has learned lessons from past overbuilding practices, we do not expect easing of housing (finance) policies to be as aggressive as compared to previous cycles.

Yuan weakness also cushions impact of tariffs, but we expect some recovery in 2019-20
Besides the easing measures mentioned above, the weakening of the yuan versus the US dollar (by around 10% since March 2018) also helped to cushion the negative impact of trade tariffs on China's competitiveness. In our view, this depreciation has been triggered by market forces following the escalation of trade tensions. In our base scenario, we still do not expect the PBOC to tolerate much sharper depreciation versus USD, for two reasons. First, Beijing has learned lessons from the market turbulence seen in 2015-16, when sharp CNY depreciation expectations triggered large capital outflows and downward pressure on FX reserves. Capital outflows have indeed risen this year and FX reserves have started to fall again, but not as dramatically as the moves seen in 2015-16. Second, in its last bi-annual report on macroeconomic and foreign exchange policies of major trading partners published in October, the US Treasury's language versus China turned more hawkish. It is likely that currency developments will be included in future negotiations between the US and China. In our base scenario, we expect dollar strength to fade next year. All in all, we expect CNY to recover versus USD (our end-of-year forecasts for 2019-20: 6.70). In fact, after the Trump-Xi agreement, CNY recovered quickly to around 6.90 per

USD. That said, in case of a severe escalation of tensions between the US and China, the yuan may drop well below 7.0 in our view (see our CNY outlook for more background).

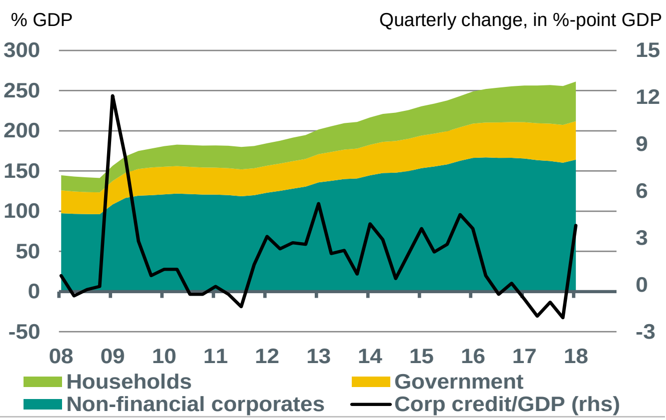
Domestic debt levels will likely rise further, but foreign debt levels still low

While the financial deleveraging campaign has helped containing shadow banking, the government tries to keep credit to the real economy flowing. Annual lending growth has remained quite stable this year, but as nominal GDP growth has fallen (reflecting a.o. a drop in the real growth rate and producer price inflation), overall indebtedness has started rising again. Although the pace of leveraging up has slowed in recent years, outstanding credit to non-financial sectors reached a record high of 261% of GDP in Q1-2018. Two third of this outstanding credit is owed to the corporate sector, included state-owned companies. For the first time in a year, the ratio between corporate domestic debt and GDP rose in Q1-2018. Given the government's renewed focus on growth stabilisation and supporting lending to private firms/SMEs, domestic debt levels will likely rise further in 2019-20. Meanwhile, in our view the government will refrain from aggressive easing, as it does not want to lose complete sight of its goal to stabilise overall macro leverage. Still, the fact that foreign debt levels remain very low (below 15% of GDP and around 0.6 times exports) is a mitigating factor and will help reducing the risk of future rating downgrades.

Trade tensions are impacting China's reform agenda …

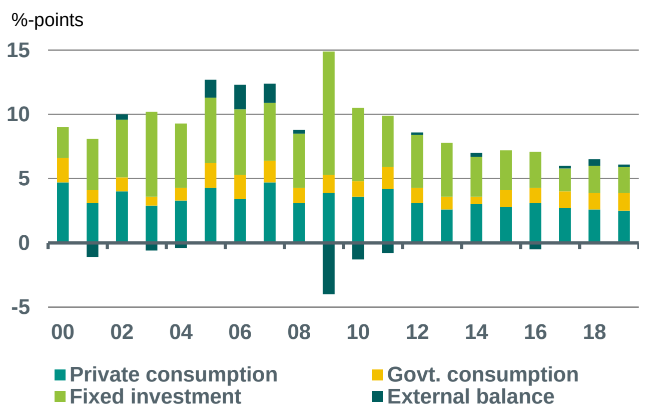
The recent announcement of an initiative to develop artificial intelligence is in line with the government's strategy to move China's industry higher up the global value chain, as laid out in its *Made in China 2025* plan launched in 2015. That said, it is clear that this strategy has unnerved Washington. The more hawkish US policies will create obstacles and will likely drive Beijing to put more efforts in reducing dependence on the US in terms of strategic imports like semiconductors. Meanwhile, the trade tensions with the US seem to have to some extent contributed to China's preparedness to reform and open up in certain areas. That is shown by the further reduction of import tariffs, the liberalisation of the FDI regime, the opening up of the financial sector to foreign firms and the attempts to create a domestic level playing field between state-owned and private firms. Although Beijing will refer to these moves as long foreseen structural reforms needed to tweak China's growth model, it is likely that the trade tensions have speed up the process a bit.

Debt levels still rising; pace of leveraging up has dropped



Source: ABN AMRO Group Economics, Thomson Reuters Datastream

Consumption key growth driver



Source: EIU

… while economic rebalancing continues

Meanwhile, China's multifaced transition is underway. On the supply side, this transition relates to a move from heavy industry to high-tech industries and to services. Within industry, high value added ‘new technology’ sectors continue to outperform traditional sectors such as heavy industry. Services continue to grow faster than industry and already account for more than 50% in value added terms. On the demand side, the move from an exports and public investment based growth model to one based on consumption is also proceeding. Over the past years, private consumption has surpassed investment as the key driver of growth, as consumption growth has remained solid while investment growth has slowed significantly over the past couple of years. Meanwhile, as import growth continues to outpace export growth, the growth contribution from net exports is expected to drop, with the current account nearing balance in 2019-2010.

All in all, we expect China’s slowdown to remain gradual in 2019 and 2020

All in all, our view is that in case downward pressures on growth intensify in 2019, for instance due to US trade policies versus China, the government will add further stimulus to safeguard growth. Therefore, we do not foresee a sharp deceleration on our two-year forecast horizon, but expect China’s gradual slowdown to continue. We think the moderate slowdown in domestic demand will be mitigated by the various stimulus policies set in place. We expect investment to even pick up in the short term, before resuming a gradual slowdown in the course of next year. In sum, we expect official GDP growth to fall from 6.7% in 2018 to 6.3% in 2019 and 6.0% in 2020. We expect alternative growth estimates to drop moderately as well in 2019-20.

Key macro-financial and geopolitical risks remain

We expect China’s soft landing to continue, but we see a wide range of macroeconomic and geopolitical risks that could derail this relatively benign outlook. We will mention the in our view most important ones here. A key risk stems from a possible further deterioration in the relationship with the US, should the unavoidable strategic competition between these two giants not be managed prudently. We could see a further rise/broadening of import tariffs and more tightening of investment and export restrictions. This could ultimately even spill-over into a broader ‘cold war’ with possible military tensions, also given regional uncertainties related to for instance Taiwan, North Korea and the South China Sea. Another key risk stems from China’s (still) high debt levels, as the recent change of macroeconomic policies could jeopardise the hard-won stabilisation of macro leverage ratios. A disorderly deleveraging would have far-reaching consequences for financial stability and could trigger a hard landing, although that is not our base case.

Key forecasts for the economy of China

	2016	2017	2018e	2019e	2020e
GDP (% yoy)	6.7	6.9	6.7	6.3	6.0
CPI inflation (% yoy)	2.1	1.5	2.0	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	44.0	43.0	42.0
Gross national savings (% GDP)	45.9	45.8	45.5	44.1	43.1
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