Summer less ‘hot’ than in 2015

- Market fears regarding China have abated sharply compared to summer 2015
- This reflects several factors, including improved communication from Beijing
- Latest macro data in line with our base scenario of ongoing gradual slowdown
- Trade data remain remarkably weak, but bottoming out looks to continue
- Transition still bumpy, as risks related to a.o. debt and overcapacity remain

For a China economist to return from summer holiday last year …
What a difference one year can make for a China economist to return from summer holiday. In August 2015, a series of small devaluations of the Chinese yuan versus the US dollar spooked global financial markets. While the devaluation was not that impressive, a mere 3% in cumulative terms, it followed a sharp correction of the Chinese stock market, as well as a series of disappointing macro data and a sharp decline in commodity prices. Coupled with the traditional doubts on China’s data quality, which typically pop up in difficult times, hard landing fears went through the roof one year ago. This story more or less repeated itself at the start of 2016. In the first trading days of this year, a renewed stock market correction (after some regulation prohibiting the sale of certain shares expired), ongoing CNY depreciation following a shift in the exchange rate regime towards a basket and a disappointing PMI number triggered another wave of global market panic.

Stock market has stabilised, CDS premium has fallen
Moderate CNY depreciation supports competitiveness

… was completely different than this year
China’s macro data are still not very impressive, with for instance investment and trade remaining weak. However, financial markets do not seem to care much at all at the

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moment. With Brexit fears having been digested quite smoothly so far and with the Fed’s rate hike path expected to be gradual, emerging markets in general seem to have profited from an improving risk sentiment. So has China. After an sharp post-Brexit vote depreciation of the yuan versus the US dollar, the currency has even appreciated in recent weeks. The CDS premium for China has come down as well.

**Beijing shows steep learning curve in term of policy communication**

Besides a general improvement in risk sentiment, there are a couple of other reasons why markets have become less China-phobic, at least for now. First, the macro data continue to point to an ongoing slowdown, clearly not a hard landing, supported by targeted stimulus. Some macro indicators have even improved compared to last year. Second, although China’s stock markets are still underperforming, they have stabilised. Third, commodity prices have recovered, with China’s imports of commodities more robust than the headline import value numbers suggest. Fourth, investors have had (and still have) other big issues on their mind, such as Brexit or other political risks in Europe and elsewhere. Last but certainly not least, Beijing’s communication skills have improved, particularly since the Lunar New Year Break in February 2016. Since then, the PBoC has become more active in providing guidance around currency and other developments.

While improving policy communication remains a key challenge, Beijing has clearly shown a steep learning curve in our view. This also helps explaining why markets have become less concerned about a largescale CNY depreciation versus the US dollar and why net capital outflows have abated and China’s FX reserves have stabilised, after a sharp fall in the last part of 2015 and early 2016.

**July macro data a mixed bag**

Meanwhile, the latest macro data are a mixed bag. Early August, Caixin’s manufacturing PMI for July showed the largest single-month jump in three years (by two full points), bringing the index back above the neutral 50 mark for the first time since February 2015. Caixin’s services PMI fell by 1 point to 51.7, but the composite output index rose to a two year high of 51.9. The ‘official’ manufacturing PMI indices for July published by NBS fell marginally to just below the neutral 50 mark, while the official services PMI remained high (just below 54). Meanwhile, the activity data for July published mid August were weaker than for June, but are still in line with our base scenario of an ongoing gradual slowdown. Industrial production growth cooled to 6% yoy (June: 6.2%), partly driven down by the
effects of flooding, while retail sales slowed to 10.2% after a peak in June. Investment
growth slowed further, falling to 8.1% yoy (June 9%), as private investment cooled to an
historic low of 2.1% yoy. Whereas Bloomberg’s alternative GDP estimate dropped a bit for
July, to 6.9%, this index continues to hover above the official growth numbers (which were
confirmed at 6.7% in Q1 and Q2). This may help explaining why fears about China
official GDP data being out of sync with reality seem to have faded somewhat.

Trade picture remains weak
Exports contracted by 4.4% yoy in July, by similar levels as in previous months. This partly
reflects exchange rate (as well as price) effects. In CNY terms, exports terms rose by
2.9% yoy. The export outlook remains cloudy, despite the CNY depreciation of about 5.5%
in real effective terms since mid-2015. This also reflects the weak state of global growth,
with spill-over effects from Brexit potentially adding further to that. The export sub-index of
Caixin’s PMI remains below the neutral 50 mark, although rising to 48.7 in July.
Meanwhile, imports contracted stronger in July (-12.5%) than in previous months, but this
partly reflected base effects with imports being flat on a monthly basis in May-July. Price
and exchange rate effects also play a role (in CNY terms, the annual contraction was
-5.7% yoy). Our overall import volume estimates remain in negative territory as well, but
these estimates are quite rough and tentative. Real import volumes for key commodities
continue to grow, although import volume growth of iron ore and oil cooled in recent
months. Still, headline import numbers remain weak for a country growing by over 6.5%,
although some bottoming out looks to take place. This implies that besides soft domestic
demand more factors are at play. One factor is the building-up of domestic production
replacing import demand for certain products, while another is the spill-over from weak
global trade as some imports are strongly liaised with Chinese production for exports.

Producer price deflation abates further, while headline inflation remains low
In terms of price developments, the ongoing easing of producer price deflation remains
the most eye-catching story. In only one year, the annual decline in factory gate prices has
fallen from around 6% to 1.7% yoy in July (the shallowest pace of decline in two years).
This stems mainly from the rebound in commodity prices, but the effects of capacity

reduction in sectors such as coal and steel are also playing a role. Meanwhile, headline
inflation has fallen from 2.3% yoy in February-April to 1.8% in July, driven down by lower
food price inflation. Core inflation, which has been hovering between 1.5-2% in recent years, edged up somewhat to 1.8% yoy in July, but remains relatively low.

**Credit growth seem to have reached a turning point** …
New lending flows, both total financing and bank loans, fell sharply in July, to the lowest levels in two years. However, that is not something to be concerned about. First, lending volumes typically fall in July, as banks tend to pile up lending in June for accounting reasons. The clear exception to this rule was July 2015, when state interventions to prop up the collapsing stock market led to unusually strong lending data. M2 growth also slowed in July, to a 15-month low of 10.2%, but the PBoC has stated that this was mainly due to the base effect from July 2015 and expects a rebound in the coming months. However, it is clear that the overall credit growth is now on a downward trend, as the authorities have become more prudent and more aware of the problems surrounding China’s debt.

… **after a shift in policy focus**
Beijing’s shift in focus to address longer-term financial stability risks is visible in an intensification of policy initiatives aimed at addressing problems related to China’s debt build-up (total credit is equivalent to 250% of GDP, consisting for 70% of corporate debt), overcapacity issues or potential bubbles in the housing market. The regulators have taken several steps to crack down on shadow banking. Recently, the PBoC announced that it will stop issuing new licences to non-bank payment agencies for a certain period, while the CBRC has communicated it would tighten regulation for so-called Wealth Management Products. The authorities have also tightened corporate bond borrowing rules. Moreover, local governments of cities facing an overheated housing market are tightening housing market regulation. The authorities are also proceeding with addressing overcapacity issues, while at the same time trying to ease the pain of consolidation by special measures.

**Still, targeted stimulus policies to remain in place**
Although Beijing’s focus seem to shift more to longer-term financial stability risks, we do not expect them to tolerate a sharp cooling of credit growth threatening the hard-won economic stabilisation. We expect monetary policy to remain quite accommodative, with around 100 bps in additional RRR cuts and one 25 bp policy rate cut and the continuation of policies to safeguard banking liquidity and extend special lending. We expect Beijing to continue with targeted fiscal policy to counterbalance the ongoing drags on the economy as well. Beijing has already hinted on special measures to support private investment and to support imports related to high-tech and consumer sectors, while a relaxation of housing finance regulation will likely be used should real estate market cool too much.

**To conclude**
We expect China’s gradual slowdown to continue, keeping our growth forecasts of 6.5% and 6.0% for 2016 and 2017. Still, although market sentiment versus China has calmed and the authorities succeeded in stabilising the economy, risks surrounding China’s transition remain given for instance high debt levels, remaining overcapacity, deterioration of banks’ asset quality, weak private investment and weak foreign trade. All in all, trying to guide a heavyweight slowly downhill remains a complex and difficult task.
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<th>Key forecasts for the economy of China</th>
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<td>Current account (% GDP)</td>
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**Economic growth, budget balance, current account balance for 2016 and 2017 are rounded figures**

*Source: EIU, ABN AMRO Group Economics*