GENERALI INVESTMENTS

Focal Point

China: Fiscal policy to buffer trade war losses

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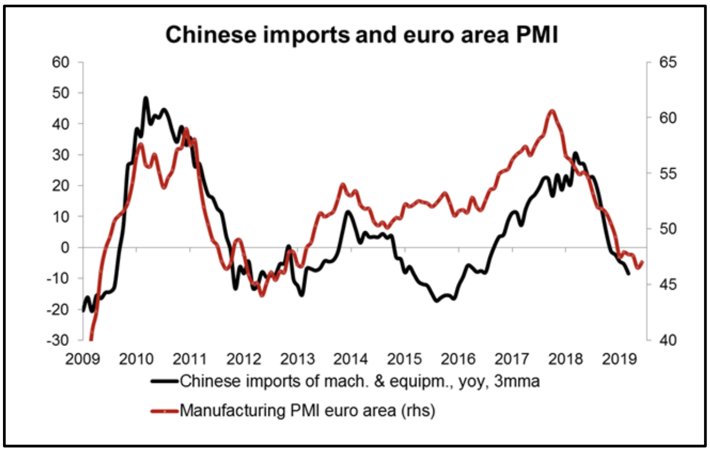
- Considering the headwinds from the US-China trade war, slowing global growth, the repercussions of past regulatory tightening of the shadow banking sector as well as idiosyncratic risks, China growth looks set to soften further.
- This puts Beijing's economic policy into a dilemma. On the one hand, it wants to reach its growth target of 6%-6.5%. On the other hand, China broke up with previous credit-financed demand policy which led to a strong increase in non-financial sector debt to 256% of GDP (IMF estimate) and the need to de-risk the shadow banking sector.
- Therefore, we expect economic policy to basically compensate for the loss in growth but refrains from "big-bang" packages. Assuming the trade war status quo to hold, we expect fiscal policy to substitute for about another 0.8 -1 pp (on top of the 2 pp of GDP package early 2019). We expect the PBoC to cut RRR by another 50 bps this year, followed by 100 bps in 2020. The PBoC recently reformed the Prime Loan rate which could ease by 50 bps.
- While the CNY may depreciate further on market forces, the bar for a deliberate strong devaluation remains high.

China and the US are in the midst of a trade war which has escalated step by step over the last eighteen months and is now covering almost all bilateral trade. The trade war is already weighing on China's growth. Industrial production e.g. fell to the lowest growth rate in 17 years. Recently implemented or announced tariffs are expected to increasingly dampen China's growth, damage supply chains around Asia and also have milder negative effects on the US economy. Europe – of course – will also not go unscathed. For instance, China's imports of machinery and equipment show a high correlation with the euro area manufacturing PMI.



Trade conflict unlikely to end near-term

Current situation: In the latest round of escalation, US President Trump announced in early August to impose a 10% tariff on so far untaxed imports from China worth about US$ 300 bn[1]. Trump introduced the tariff on the return of his trade delegation from talks in China, clearly expressing discontent with the results. The tariff will be imposed in two tranches on September 1 and in mid-December.[2] China retaliated in late August, raising tariffs by 5pp/10pp on US$ 75 bn, to which Trump responded by hiking tariffs on all goods by 5pp. However, recently China exempted some product lines from tariffs and bought more agricultural goods while President Trump delayed the October tariff hike by two weeks. Nevertheless, US tariffs implemented or announced stand now at 30% (up from 25%) on imports worth USD 250 bn from Oct. 15 on, and 15% on remaining imports according to the two mentioned portions. Moreover, Trump labelled China a currency manipulator and the US Department of Commerce levied anti-subsidies duties on special goods. Finally, the Huawei case has not been settled yet.

Trade strategies and Outlook: On the US side, the targets of this trade conflict are clearly wider than the bilateral trade deficit. The US seeks fundamental changes to China's policies regarding intellectual property rights, forced technology transfers, market access and industrial subsi-

[1] According to the US Census Bureau, US imports from China amounted to USD 539.7 bn in 2018, while exports to China reached USD 120.1 bn. Subtracting previously taxed imports of USD 250 bn, the difference is smaller than 300 bn (USD 289 bn). Nevertheless, the press typically refers to USD 300 bn for simplicity reasons. The list of tariffed goods even might result in a slightly smaller figure.

[2] The latter part covers mainly consumer electronics and has been postponed in order not to interfere with the US Christmas shopping season.

dies. Beijing's development strategy "China 2025" has been repeatedly criticized. Even a clash of competing world "superpowers" has been frequently cited. Trump uses rising tariffs to increase the costs of current Chinese policies, pressuring China to agree to his terms. So far, this strategy did not have the desired results. From a Chinese perspective, US demands crossed red lines of China's sovereignty and thus touched issues of "honor", raising the stakes of giving in. Of course, to the extent the conflict is about technological leadership and world dominance, China's long-term economic and political development prospects are at stake.

As a consequence, the outlook remains rather uncertain. Although both sides are likely to engage in further talks (currently Chinese trade deputies are expected to meet with their US counterparts in mid-September, before a minister level meeting in October), strategic aspects could increasingly come into play. One line of argumentation is that Trump wants – of course – to be re-elected. Given the slowing of the economy underway (to be accelerated by the trade war) he could soften his stance and compromise. According to press reports, Trump repeatedly warned China not to wait for the 2020 election for an agreement, threatening that the terms of a trade deal after his re-election will be much tougher. Obviously, timing plays a role. Recently, Trump did not rule out the possibility of an "interim pact" but still favors a "whole deal".

On China's part, given the long-term nature of these decisions, Beijing could well discount the relative merits of a "bad deal now" against a "better deal later". On top, instead of just "waiting" on a new US President, it could try to actively damage Trumps re-election prospects by targeting businesses of US firms operating in China (a past precedent are Japanese cars). The CNY could also come much more into focus. Nevertheless, all this will be tempered by China's needs to limit the damage that is accruing already by the tariffs introduced. China has still a genuine interest in a trade deal. In sum, we assume that the trade war will not escalate, but not be solved quickly either. Markets recently were keen to see the latest "gestures of good will" as sign of a near-term solution.

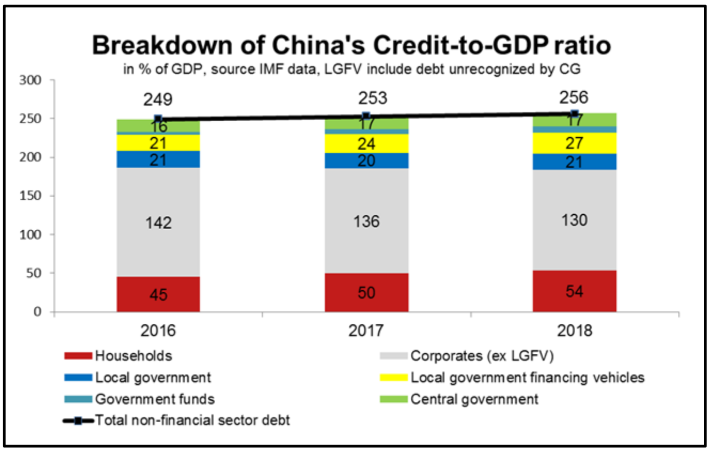
Tariffs put downward pressure on growth

Trade damage: Given the above assumptions, the damage from existing and announced tariffs to China's GDP will become increasingly visible. Tariffs will further cut into trade-related sectors, while – technically – the GDP impact will be dampened by reduced imports. China's exports to the US amounted to 3.5% of GDP in 2018, imports to 1.15%. In the first eight months of 2019, nominal merchandise exports to the US shrank by 9.3% compared to the same period last year; imports from the US dropped by 27.6% yoy. Regarding total Chinese merchandise trade, exports still rose by 0.34% yoy (Jan. to Aug.) with the EU as the main destination of trade diversion. Total imports diminished by 4.4% yoy. China's nominal trade surplus amounted 2018 to 2.7% of GDP, but the surplus will likely widen this year as imports fall more strongly than exports.

GDP impact: While this will help cushion the GDP effect technically, longer-term supply chains will be damaged lastingly once they shifted away from China. So far, overall investment slowing has been in the range of last year and also consumer confidence held up. Nevertheless, manufacturing investment is – not surprisingly – among the underperformers. As another sign of "stress" in the manufacturing sector, producer price inflation has recently turned back into negative territory. China's headline consumer price inflation has been driven up by food prices but core inflation receded to 1.5% yoy, down from 1.9% yoy early 2019. In sum, we see tariffs to damage GDP by about 1.5 pp over the course of the next 12 months, with the latest round of tariff hikes responsible for almost doubling the impact (compared to the previous state of a 25% rate on USD 250 bn). The numbers are in line with an IMF estimates made in June (IMF, G-20 Surveillance Note, Japan, June 8-9, 2019), which showed that a 25% tariff on all US-China trade could dampen China's GDP by about 1.5%, the US GDP by around 0.4% and world growth by about 0.5% until end of 2020. The IMF has recently increased its forecast of the world damage to 0.8%.

Policy response

Economic background: Stronger headwinds will likely prompt Beijing to step up its policy support. However, in our view policy will aim to offset the negative effects but not prepare a "big bang" policy package. China's historical experience with credit-driven spending has been sobering. The large-scale fiscal package at the 2008/09 Great Financial Crisis led to debt sustainability worries at the local government level and has still proved very difficult to sort out. The same was true with the government using its large influence on state-owned enterprises' investment outlays. The need to deleverage and de-risk the shadow banking sector can also be traced back in part to the implied deterioration of risk profiles of these groups of actors. Officially, China's general government debt amounted to 37.9% of GDP and is expected to rise to 51% by 2024. Officially, the fiscal balance is forecast to rise to -2.9% in 2019, from -2.7% in 2018. However, the IMF also calculates a broader, "augmented" debt measure including local government financing vehicles (LGFV) and other off-budget activities. According to these figures, debt could rise from currently 72.7% of GDP in 2018 to 101.4% in 2024. The augmented net government lending probably amounted to 12.7% of GDP in 2019. China's nonfinancial sector debt reached 256% of GDP, jumping up since the GFC by more than 100 pp. Against this background, we believe that the government will support the economy to the extent needed to fulfill its growth target of 6.0% to 6.5% this year, but will not do more given the macro-prudential concerns and also in order to "keep some powder dry".



Fiscal Policy: Beijing already accelerated tax cuts from CNY 1.3 bn in 2018 to CNY 2.0 tr (2% of GDP) in early 2019, focusing on VAT (since April 1) and fee cuts (since May 19). Households benefitted via rising tax thresholds and special deductions. Further tax cuts are possible, but given the nature of these measures as to accrue only over time, there is also room for faster working infrastructure support to pick up. Until July 2019 infrastructure investment only grew by 4.6% ytd yoy, although Beijing raised the quota to issue special bonds to this purpose to RMB 2.1 tr in 2019, up from CNY 1.3 tr in 2018. Other restrictions placed on new local government shadow debt and weak land sales kept the upturn at bay. The government already started to ease these restrictions, allowing special LGB issuances to be used as equity capital in certain projects. A further increase in the quota is under discussion. Moreover, local governments are required to complete this year's special LGB issuance in Q3, so that the money can be deployed more quickly. Nevertheless, authorities seem also to be sticking to their de-risking campaign (largely prohibiting fresh local government shadow debt, clean up irregular public-private partnerships and LGFV projects). In sum, it looks likely that infrastructure investment will rise but only to about 8% yoy in 2019.

Thus, additional measures seem to be needed. The central government can tap shadow funds (an outright supplementary budget never happened before) or fall back to old-style policies as to ask policy banks or SOEs to step in. As part of the tariffs will only be implemented towards the end of the year, Beijing could also delay expenditure into the next year. The IMF sees in its adverse scenario (25% tariffs on remaining imports) an additional 0.8 pp of GDP expansion stance as sufficient, demanding it to be on-budget, centrally financed, pro balancing and targeted to low-income households to maximize the multiplier effect. Measures should include higher social transfers, spending on education and health as well as lower social security contributions.

Monetary policy: Generally, China has eased bank credit and Total Social Financing substantially. In its latest move early September, the PBoC announced a 50 bps RRR cut for all banks (plus another 100 bps for special eligible banks). Since April 2018, cuts now amount to 400 bps (down to 13% for big banks) with 150 bps so far this year. We expect another 50 bps RRR cut in the rest of 2019, followed by another 100 bps in 2020. In addition, the PBoC has recently added some flexibility to its monetary policy by reforming the fixing of the Loan Prime Rate (LPR). The LPR will now be based on a survey of 18 instead of 10 banks and needs to be made with reference to the 1-year Medium-Term Lending Facility (MLF) instead of the 1-year benchmark lending rate. Fixing will be once a month on the 20th. The first one in August – however – only brought about a reduction by 6 bps to 4.25% (1-year MLF rate is at 3.3%). Given the headwinds for the Chinese economy we expect the PBoC to cut the MLF rate by 25 bps over about the next six months. Together with market forced, we see the LPR to diminish by about 50 bps over the same period. However, as only new loans will be priced on the basis of the LPR, it will take some time until lower lending rates will have trickled through. Recently, the PBoC also referenced new individual mortgage loans to the LPR. As a consequence, M1 (which suffered from base effects before) will tend to rise while the impact on M2 is likely small. The BPoC will continue to focus its support on SMEs.

CNY: We expect the CNY to depreciate further against the USD towards USD/CNY 7.30 on market forces. At the same time, we see the threshold for China to deliberately use its currency as a "weapon" as rather high. Risks reach from an induced strong capital outflows to damaging the targeted reputation of the Renminbi as stable, (global or Asian) reserve currency.

Conclusions: In sum, we expect China's growth to continue slowing from 6.2% this year, to 5.9% in 2020 and 5.8% in 2021. This implies that Beijing will agree to let growth slide in a limited fashion. The move has significance as Beijing pledged ten years ago to double real income by 2020, which now – according to our current calculations – cannot be fully fulfilled any more. However, it also supports the view that Beijing has recalibrated (favorably) the relationship between short-term support and structural problems. For global markets, this approach implies a controlled slowing, which should help limiting uncertainty and tends to dampen international business cycles.

Imprint

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