China Watch

BEIJING VIEWS ON YUAN DEVALUATION

China Team

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- We found support among Beijing economists for our call on yuan depreciation
- Whether gradual or immediate further tariff escalation is likely next year
- China's leadership is in wait-and-see mode ahead of the US mid-term elections

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Markets: Beijing analyst views on RMB outlook

- **We found support among Beijing economists for our call on yuan depreciation**
- **Whether gradual or immediate further tariff escalation is likely next year**
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Last week I joined Bo Zhuang, our Chief China Economist, in discussions with Beijing-based economists. We met with Chinese economists from both the sell- and buy-side as well as with several local Western analysts. Having stuck our necks out in early August calling a 15% yuan depreciation by mid-2019, we were pleasantly surprised that none of the local analysts we talked to thought this was out of the question. Indeed, one chief economist said that the government had realized that a flexible currency policy was in China's interest. While the extent of RMB depreciation would depend on the size and timing of President Trump's tariff escalation in 2019, local analysts underscored that letting the market push the currency to weaker levels was far preferable to an attempt to defend any given level. They were quick to add that they expected the PBoC to actively manage the currency's decline, intervening to dampen volatility and to avert sharp swings in the currency.

The primary arguments against our yuan depreciation call are that it would accelerate capital outflows and fuel US retaliation. Our discussions in Beijing failed to turn up much concern among analysts about a surge in capital outflows. Since the August 2015 currency debacle, controls have been tightened significantly both on households and corporates (see our 4 October 2018 China Watch). Meanwhile, the threat that the US would take actions against China if the yuan weakened, e.g. by naming the country a "currency manipulator", can be seen as an empty gesture given the continuing escalation of Trump's trade war; the US is already moving to exert maximum economic pressure on China. The recent US Treasury report to Congress on FX policies of US trading partners found no evidence that China was a currency manipulator but noted that its currency practices were a "source of particular concern".

We assume that the further escalation of tariffs would push China's current account into deficit over the course of next year. Meanwhile, the government is likely to hike its budget deficit target from this year's 2.6% of GDP to more than 3% next year. Facing twin deficits in 2019, there should be little surprise when the market drives the yuan to weaker levels. Such an outcome would give President Xi Jinping an opportunity to blame the US while maintaining his commitment to globalization. The analysts to whom we talked emphasized that yuan depreciation and monetary easing were both essential policies; any effort to defend a given level of the yuan would effectively block the easing of monetary conditions that they saw as needed.

Our August forecast assumed that the US would impose 25% tariffs on the bulk of Chinese exports to the US by mid-2019. We came away from Beijing persuaded that the threatened hike of today's 10% tariffs to 25% on US$200bn of Chinese exports next January was highly likely. Local analysts told us that the 10% tariffs had had relatively little impact so far on firms' exporting strategies as both Chinese and foreign firms were seeking to pass on higher costs to US importers and consumers amid relatively strong demand in the US. This highlights that so far exporters in China are not experiencing much pain from the 10% tariffs. One of our sources told us that many US firms had developed contingency plans to move production out of China but for now were waiting to see what Trump's next steps would be.

From President Trump's perspective, the further escalation of tariffs is essential to force concessions from China. We came away from our Beijing discussions with a sense that the next steps might be phased in gradually owing to their much greater impact on US inflation. China's import share of the goods included in the first US$50bn in tariffs is estimated at 8% and that of the second US$200bn tranche at 17%. The import share of the remaining US$250bn that could be hit with tariffs, however, is much higher at 40% and for some product lines such, as mobile phones and PCs as high as 70-80%. This generates the possibility that the final round of tariffs could be more carefully targeted with regard to both the level and the timing of their impact owing to China's market dominance in such sectors.

Whether gradual or all-in-one-go, Trump's tariff escalation has the ultimate goal of creating effective leverage on China's industrial policies. We found no support in our discussions for the view that such a goal could be achieved. Nonetheless, there was agreement that China's leadership had not as yet developed a set of strategic policies to counter the threat posed by Trump on trade and broader non-economic issues, especially in the military sphere.

There was consensus in our talks that the Chinese leadership is now in wait-and-see mode. The main reason for this view was that the US political scene was likely to be volatile ahead of and through the November mid-term elections. We argued that policymakers were likely to be disappointed in their expectations because China no longer had any friends in Washington, either among Republicans or Democrats- should the latter take the House of Representatives next month. Accordingly, we saw no reason to change our judgment that the economic confrontation between China and the US is just getting started and that it will prove both long and ugly.

Economics: Stimulus will disappoint

- **Markets are wrong to expect typical China credit easing**
- **Beijing is not panicking: stimulus is on-balance-sheet, slow and sustainable**
- **We expect total credit growth to recover modestly**

The latest credit and investment data, along with the new drip-feed stimulus measures, underscore Beijing's focus on sustainable economic support and financial risk control. Markets have consistently overestimated central authorities' willingness to resort to broad fiscal and monetary easing. Xi Jinping is not panicking and we expect stimulus measure to continue along existing modest lines. We therefore maintain our calls of sub 6.5% yoy growth in Q4/18, a minor uptick in total credit (based on the newly revised TSF data) growth to 13.5% yoy and a rebound to infrastructure investment growth in the coming months.

Credit and property easing are not viable options. As previously noted, we believe China will not resort to significant monetary easing or property market stimulus. A recent trip to Beijing reinforced our conviction that deleveraging and financial risk control remain priorities at the highest levels. China expects a protracted confrontation with the US and is looking to use sustainable stimulus measures to strengthen China's long- and short-term growth prospects. We estimate that credit growth of 17% would be necessary to offset aggressive financial deleveraging earlier this year and the coming trade war-related slowdown. Given the intensifying great power confrontation, Beijing cannot risk another credit expansion of this magnitude, since it could cause Japanification or a financial crisis within five years.

Beijing's stimulus options in order of preference;

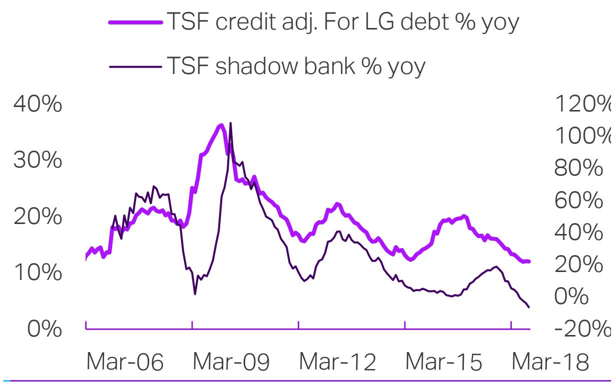
Preferred

1. Targeted tax cuts
2. Direct support to R&D and advanced manufacturing
3. Infrastructure spending
4. Increasing official budget deficit target
5. Using subsidies to boost household consumption
6. Currency devaluation (a prerequisite for aggressive credit growth)
7. Aggressive credit growth, including non-bank financing
8. Broad-based easing in property sector

Last resort

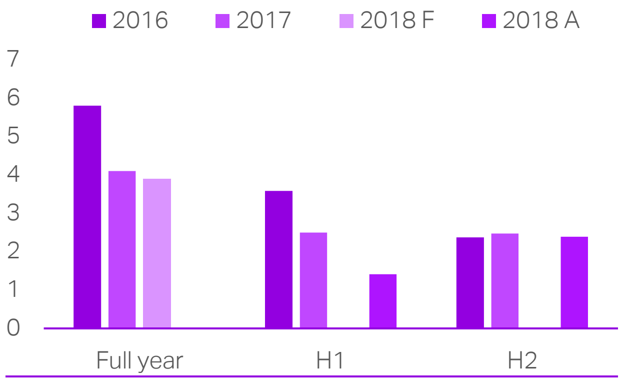
Stimulus with a lag betrays no signs of panic. Authorities have announced a number of support measures, the majority of which will have a delayed impact on growth. The lagged stimulus underscores our view that Beijing is not concerned about the current pace of economic growth. We estimate, Q3/18 real GDP growth at 6% yoy vs the official estimate of 6.5%. Regardless of the actual figure, underlying activity is sufficiently strong for Xi Jinping to rely on tweaking policies, rather than having to resort to aggressive easing.

Chart 1: Local bond issuance supports credit growth



Sources: CEIC, TS Lombard.

Chart 2: Local government bond issuance catches up (CNY tr)



Sources: CEIC, TS Lombard.

Reform-oriented stimulus. The measures unveiled earlier this week are in line with Beijing's reform priorities. Policies such as cuts to personal income and import taxes will support activity and rebalance the economy towards consumption. As regards corporate financing support, the unclogging of monetary policy transmission has long been a priority for the PBoC. The reintroduction of CRMW (a type of CDS first used in 2010), a CNY150bn increase in relending and refinancing limits and the creation of an SME bond platform partly guaranteed by the PBoC will all help facilitate much-needed financing for corporates and SMEs. However, if we consider that net new corporate bond issuance ytd is at CNY1.6trn, it is clear changes to monetary transmission will provide just a trickle of liquidity, not a flood.

Tax cuts target household sentiment and corporate profits. The draft personal income tax reductions unveiled over the weekend are moderately stronger than anticipated. However, we note Beijing still has significant leeway for further tax cuts. Q3/18 tax revenue grew at 8% yoy, slower than 13.1% in Q2/18 and 17.8% in Q1/18, but well ahead of nominal GDP and fiscal expenditure. Meanwhile, personal income tax payments ytd have surged 21.1% to CNY1.1tr, almost on a par with personal income tax revenue for the entirety of 2017. An argument could be made that income tax deductions are normalizing rather than simulative policy. Should the economy continue to show signs of weakness, there is considerable scope for additional targeted tax cuts.

Credit data for September show monetary policy remaining net neutral. Our measure of Total Social Financing adjusted for local government bond issuance has sustained its trend growth, increasing 11.9% yoy (see Chart 1 above). Decreasing shadow bank financing was offset by large increases in local government bond issuance, as authorities responded to Beijing's demand for accelerated spending and bond quota usage. We would caution investors not to overestimate the impact of any surge in special bond issuance on growth because more than CNY500bn of the total special bonds sold ytd are used for local government "land reserves" activities.

We reiterate that the accelerated activity is not stimulus. Local bond issuance in H1/18 was weak (negative 32% yoy), the Q3/18 surge simply brings issuance in line with annual targets, local bond issuance ytd is now growing at 7% yoy. We estimate, that of the CNY3.9trn bond quota, just CNY1.6bn remains to be issued. For special purpose local government construction bonds, the entire CNY1.7trn allowance has been used (see Charts 2 above and 3 below).

Shadow banking contracts. In contrast with government bond financing, our measure for shadow banking (bill financing, trust and entrusted loans) has continued to contract, falling 6.3% in 2018 (see Chart 1 above). The decline was led by shrinking bill financing and entrusted loans.

On-balance-sheet loans recovered after dipping the two previous months. New bank loans ytd jumped 17.7% yoy to CNY13.14 trn and are on track to eclipse last year's CNY13.53trn record.

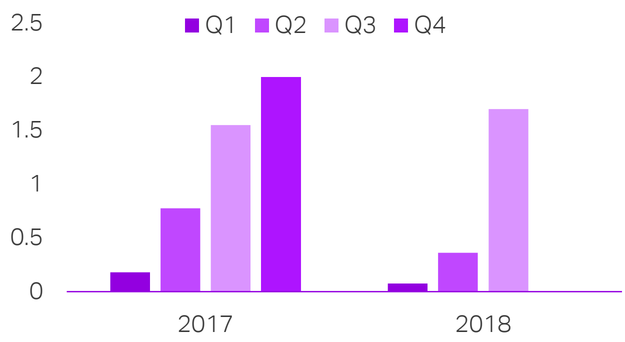
Credit conditions remain tight for corporates. Declining shadow banking activity and net neutral monetary policy means that funding for medium-sized corporates and SMEs remains constrained. Net bond issuance by private sector companies has fallen, while the share of new bond issuance taken by AA+ and AA rated bonds has dropped, too. This is likely due to the crowding-out effect on private-sector financing of the surge in local government bond issuance. The cost of private financing in Wenzhou, a proxy for SMEs, remains elevated. Tough funding conditions for corporates are likely to continue. AA+ and below rated bond spreads over CGBs and policy bonds will continue to widen.

Deleveraging will continue. We do not expect Beijing to reverse course on financial deleveraging to any large extent. We expect total credit growth (based on the newly revised TSF data) to rebound to 13.5% by the end of this year and to 15-16% in 2019. However, the recovery will be much weaker than in the previous credit-easing cycle, in which total credit growth rebounded from 12.6% in May 2015 to 20.6% in November 2016.

Modest investment recovery under way. The State Council has emphasized that "efficient investment should be expanded", especially infrastructure investment in areas like transportation in central and western China. In addition to the financing discussed above, Beijing will attempt to mobilize private capital through PPPs. The government is accelerating existing projects, both PPP and government, and expanding projects in the pipeline. However, the State Council emphasized there should be no overreliance on investment, underlining Beijing's focus on financial risk avoidance.

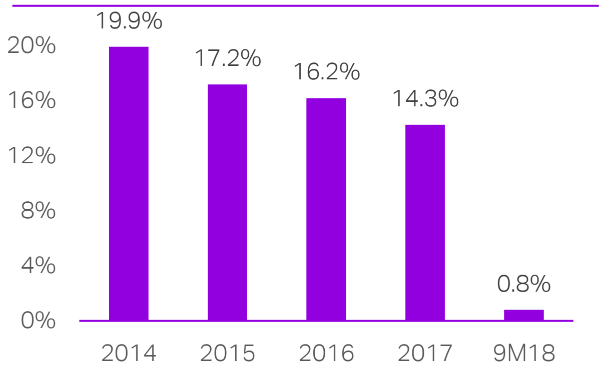
We expect increased bond issuance to lead to a pick-up in infrastructure investment, supporting aggregate FAI. Broad-based infrastructure investment (including official tertiary infrastructure and electricity, water and gas investment in the secondary sector) has been the weakest component of overall investment growth in 2018, at just 0.8% yoy January to September. This is largely a result of the slow issuance of bonds in H1/18 and government restrictions on infrastructure projects. With the restrictions in both these areas are easing, we expect monthly infrastructure investment to reach 5-10% at the end this year.

Chart 3: Dedline spurs local government special bond issuance (CNYtr)



Sources: CEIC, TS Lombard.

Chart 4: Infrastructure investment, yoy



Sources: CEIC, TS Lombard.

Politics: Smiles and handshakes do not mask old tensions

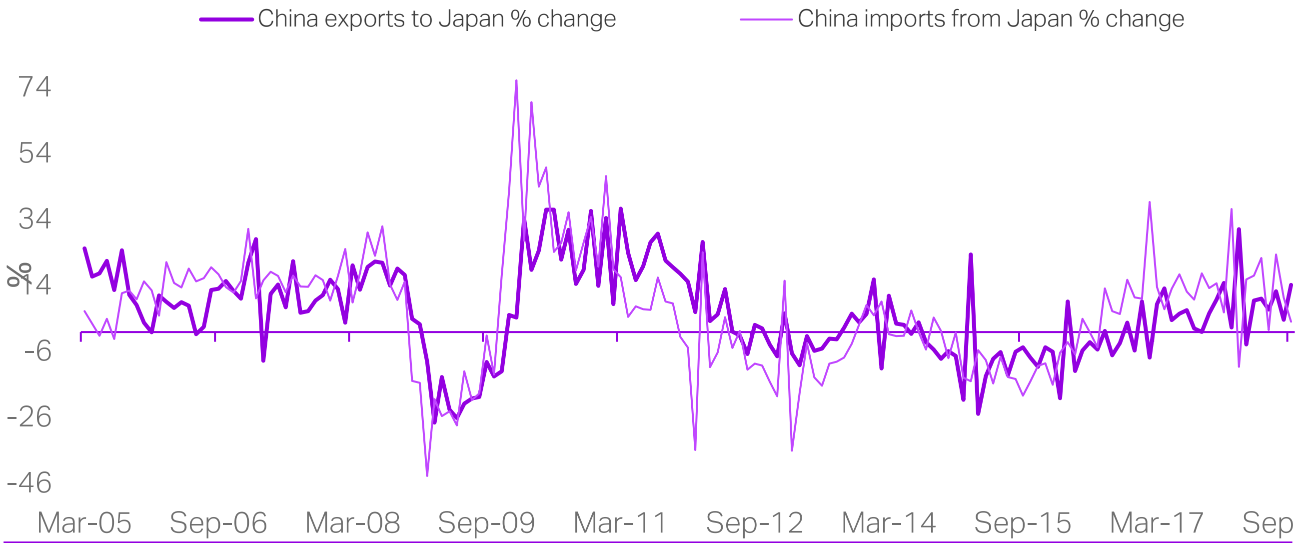
- **The Abe-Xi summit sends a positive signal to business**
- **Deeper economic ties won't change Japan's efforts to contain China in the Pacific**
- **Abe's instinct is to remain close to Trump and maintain the security alliance**

"Japanese rice is tasty", Xi Jinping said at last month's summit meeting between the leaders of China, Japan and Russia in Vladivostok. His headline-friendly endorsement of Japanese grains was intended to boost the relationship that the Chinese leader sees as having got back on the right track.

Today Shinzo Abe is undertaking the first bilateral visit by a Japanese Prime Minister to China for seven years. Amid the uncertainties of the US-China trade war, the 500 business leaders accompanying the Prime Minister will be seeking opportunities in China in line with the establishment, announced on Tuesday, of a joint investment fund between Nomura and the state-led China Investment Corporation.

The upcoming trip will serve as an important symbol of calmer Sino-Japanese relations after recurrent periods of tension 40 years after the Peace and Friendship Treaty of 1978 saw the establishment of diplomatic relations. Faced with Trump's trade offensive, China is increasingly seeking to improve relations with its neighbours by opening up business opportunities. Trump's trade barriers are catalysing the creation of an Asian trading bloc with China at its centre, as outlined in our chief Economist Larry Brainard's recent report. Despite a softening economy and weakening RMB, China has increased imports from Japan, which increased 3.1% yoy (see Chart 1 below), indicative of Beijing's desire to strengthen trading partnerships to ward off the formation of a united coalition against it centred around the US.

Chart 1: Chinese Japan exports and imports % change



Sources: CEIC, TS Lombard

Cooperation on the economic front will not, however, alter the Japanese desire to contain China strategically in the Pacific. PRC efforts to drive a wedge between the US and

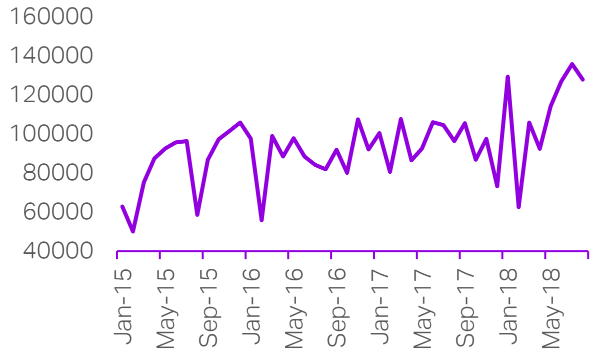
Japan will be unsuccessful as Abe remains committed to the alliance relationship while seeking new avenues for relations beyond it- for instance, with India. China has been lobbying for official Japanese support for the “Belt and Road” initiative, as Japanese legitimation of the scheme would help Beijing counter critiques of it as predatory investor. While Abe will participate in a forum on infrastructure development during his trip to China- more than 30 infrastructure-related agreements are expected to be signed over the next few days- he is unlikely to officially endorse Xi’s pet project but instead speak of “cooperation” in third countries. Abe may have a difficult task in keeping both Trump and Xi happy; but, for the moment at least, the prospect is for economic links between Japan and China to continue to revive, despite ongoing political differences.

Economic ties

Senior Japanese business leaders with whom we spoke ahead of the Abe trip were positive about investment prospects in China. As outlined in our 17 October 2018 daily note, Japanese FDI in China is reviving, consistent with Beijing’s measured opening up to foreign investment. Investment is being led by automobiles and electronics, where companies are looking to take advantage of the “Made in China 2025” programme, which aims to boost the production of energy-saving electronic products and vehicles. Japanese FDI in transport equipment increased 19.84% yoy in 2017. Contrary to the Japanese “China plus one” policy developed in the 2000s, which saw companies move manufacturing away from China to Southeast Asian countries because of rising wages and political risks in operating in the mainland- a series of companies are expanding manufacturing capacity in China, targeting the domestic market. Toyota is growing its factory in Tianjin and plans to open another plant in Guangzhou; Yaskawa Electric, a big maker of robots, expects a positive business environment in China “at least until 2025” and plans to open a factory in Jiangsu Province this year, while the instant-noodle maker Nissin Foods is opening a new factory in eastern Zhejiang Province in response to growing Chinese demand.

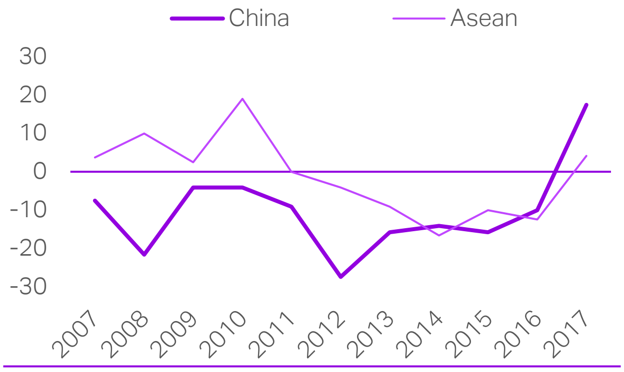
Japanese manufacturers are increasingly satisfied with China as an investment destination: last year, respondents to the Mizuho Research Institute survey reported positive feelings to earnings in China for the first time since the survey started in 2007. Slowing US sales and Trump’s threat of tariffs on Japanese cars are leading Toyota to refocus on the Chinese market, where its sales have picked up 15.5% ytd from 2017. Positive sentiment has led Japan’s biggest car maker to explore joint business ventures with Geeley Automobile; having previously refused to allow access its hybrid technology, it is now looking for a licence agreement with the Chinese company.

Chart 2: All toyota models sold in China



Sources: Toyota; TS Lombard

Chart 3: Earnings satifsfaction DI of Japanese companies (%pts)



Sources: Mizuho Research Institute; TS Lombard

The political relationship

While China and Japan both see much to gain from a closer economic partnership, there remain irreconcilable differences in the security realm as well as the historical enmity dating back to the war of 1894-95 (see table 1 below), for which there was a reminder in the awkward rearrangement of this week's summit. The meeting was originally scheduled to take place on 23 October but the date had to be changed to avoid coinciding with the 150th anniversary of the Meiji Restoration- the modernization process that paved the way to Japan's imperialist expansion. Besides confrontation over the disputed Senkaku/Diaoyu Islands, Tokyo has opposed Chinese reef-building in the South China Sea, where its navy has been active in recent weeks, including deploying a submarine for the first time along with two destroyers for military exercises.

Coming at a time when the Trump administration, too, is stepping up its activities in the region, the move sends a clear message to Beijing that deepening economic cooperation will not over-ride Abe's strategic priorities and his attachment to the US alliance. The Prime Minister has invested a lot of political capital forging close relations with his fellow golfer in the White House, meeting him eight times (more than any other country leader) and speaking by telephone nearly 30 times. Japan is coordinating with the US on initiatives targeted at curbing Chinese influence in the region, including the "Quad" group (which also includes India and Australia), and through continued joint military exercises in the South China Sea.

Still, Trump's withdrawal from the TPP, his exclusion of Japan from the list of nations exempted from steel and aluminium tariffs, the side-lining of Tokyo in negotiations with North Korea and the President's tirades against the trade deficit must all serve to warn Abe against over-reliance on Washington to protect Japanese interests in foreign policy. He is, therefore, expanding and nuancing Japan's strategy of countering Chinese influence, independent of the US, most notably in continuing to promote the updated "TPP-11" trade deal, and in coordinating with the Indian navy in the East and South China Seas.

Table 1: Sino-Japanese relations - cycles of friendship and tension

1978	Deng Xiaoping visits Japan; the signing of the Treaty of Peace and Friendship sees Tokyo and Beijing establish diplomatic relations
1982	Revision of Japanese WWII history textbook causes outrage in China
1985	Officials criticize PM Nakasone's visit to the Yasakuni Shrine
1989	Japan stops aid and imposes sanctions after the Tiananmen Square massacre; Japan is one of first countries to restore high-level relations after a few months
1992	Emperor Akihito's historic visit to China
1995	China's nuclear tests prompt Japan to suspend foreign aid
2005	Anti-Japanese protests in Chinese cities sparked by suspension of foreign aid
2007	Wen Jiaobao becomes the first Chinese PM to address Japan's Diet, both sides agree to smooth over differences in shared interpretation of history
2008	Japan PM Taro Aso visits Beijing on 30th year of Peace and Friendship Treaty
2010	China takes over Japan as world's second largest economy; captain of Chinese fishing trawler arrested after collision with Japanese Coast Guard patrol near Senkaku Islands causing outrage in China
2012	Japanese government purchases three islands from private owners sparking anti-Japan protests; China skips IMF meetings in Japan; bilateral trade declines
2013	China announces air defence identification zone over much of East China Sea, including disputed islands; Abe visits the Yasakuni Shrine (his one visit as Prime Minister to date)
2014	Abe and Xi meet at APEC summit, exchange frosty greetings
2018	Abe and Xi meet at Vladivostok and hold friendlier meeting

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