China Watch | Economics

CHINA GDP – WAR AND PEACE

Rory Green / Charles Dumas

- **GDP growth rate slows, but clear signs of stabilization emerging**
- **Strong infrastructure investment recovery underway**
- **Net exports support GDP through the trade war**

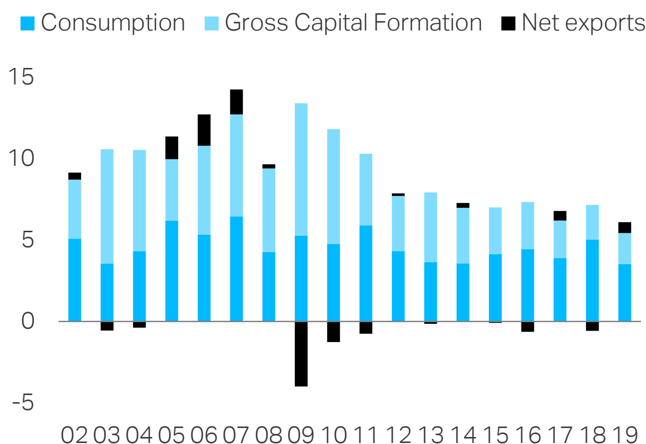
China's economy grew at 6.1% yoy in 2019 - its lowest rate in 29 years, as it battled the trade war and domestic headwinds. The official Q4/19 number came in at 6% yoy. TS Lombard's proprietary estimate of GDP was 4.1% yoy in Q4/19, a marked improvement on Q3's 3.7%. Looking ahead, we expect growth to stabilize at 6% in 2020, supported by the trade truce, a recovery in PPI and smaller but more effective stimulus measures.

The surprise in 2019 came from trade. Despite the trade war, net exports registered their strongest contribution to growth in 12 years. A contraction in domestic demand slashed imports, as TSL's measure of demand growth slumped to 4.3% yoy. Policy measures to reduce reliance on US tech and encourage patriotic purchasing of Chinese goods also weighed on imports. Meanwhile, trade re-routing via an emerging China trade bloc, RMB weakness and price cuts all helped exports. The combined impact was to boost the net-export contribution to GDP.

Phase 1 deal changes trade dynamics. We expect a modest recovery in Chinese exports from the tariff rollback and the pick-up in global demand. However, the deal's high targets for US purchases will also push up import demand. The overall effect will be to lower the contribution of net exports to GDP growth.

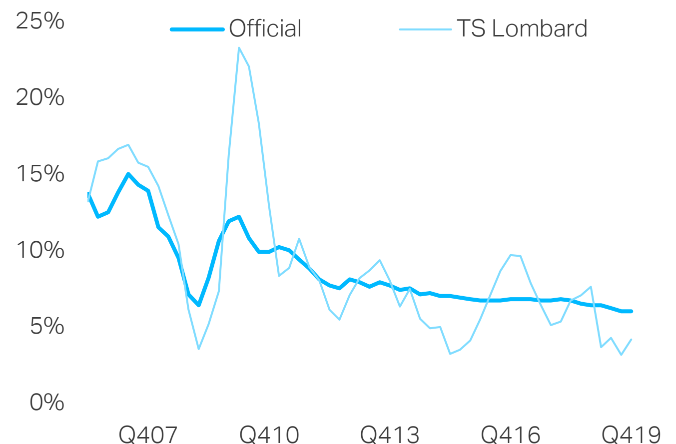
Offsetting the coming decline in net exports is a recovery in investment and consumption. Fixed asset investment grew at its slowest rate on record last year, weighed

Chart 1: GDP (contribution to growth, % points)



Sources: CEIC, TS Lombard.

Chart 2: Signs of stabilization in China GDP



Sources: CEIC, TS Lombard.

down by infrastructure and manufacturing. A shift in fiscal policy from tax cuts to frontloaded infrastructure spending will increase infrastructure FAI growth by approximately 6pp. Frontloading is already well underway: local government special purpose bond issuance in the first weeks of January points to a 300% yoy increase for the month as a whole. Moreover, the share of funds used for infrastructure has risen from 30% to 70%. December data also indicate a recovery is in progress, with infrastructure FAI and industrial production strong.

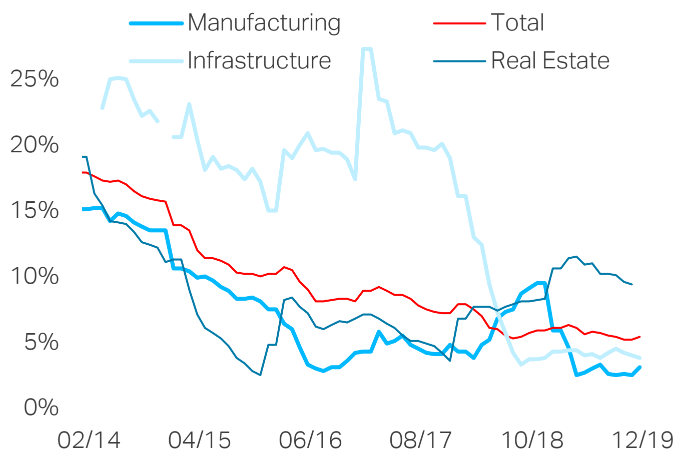
The rebound in Mfg FAI will be more modest. Manufacturing investment is stabilizing at 3.1% ytd yoy, after touching its lowest level in 20 years. We expect modest growth in Mfg FAI of 4% as the collapse in 2019 profits and tepid domestic demand offset improving sentiment and external demand. Property investment, a major driver over 2019, is set to slump on weak house price growth and tougher funding conditions for developers.

Household consumption steady. All three drivers of consumer spending (income, credit, and sentiment) are ready to turn positive. Tax cuts and monetary easing have already boosted incomes and access to consumer credit. Stabilization in the economy and a new positive message from Beijing will turn around sentiment. Again, December data show a clear improvement, retail sales grew at 8%. An added tailwind is the removal of the drag from auto sales. Vehicle purchases account for 30% of the retail sales index. In 2019, a combination of expiring tax cuts, emission regulations, and economic weakness caused auto sales to collapse. Beijing responded by doubling new car purchase quotas in major cities for H2/19 and full year 2020. Such is the pent-up demand that new quotas guarantee new sales. Vehicle purchases will turn positive over Q1/20 for the first time in18 months.

Fiscal and credit stimulus remain moderate, but are likely to prove more effective than measures adopted in 2019. The move in government deficit spending away from tax and fee cuts towards infrastructure will increase the fiscal multiplier. At the same time, our expectation of a tightly managed recovery in shadow bank assets will increase the efficacy of monetary easing. Shadow bank lending is an important channel through which SMEs access credit. We expect 50 bps in RRR cuts and 10-15bps cut to LPR.

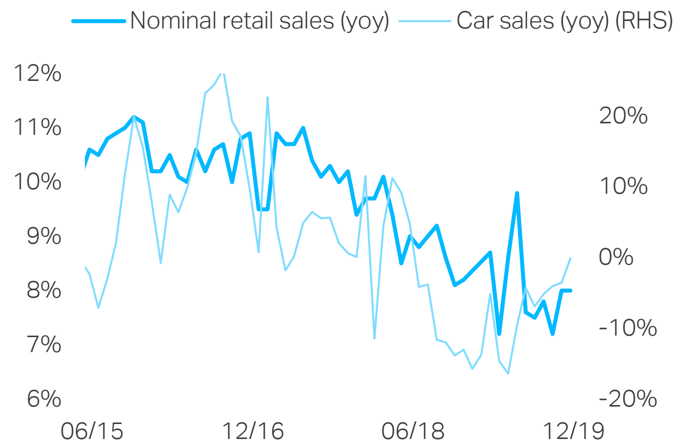
We maintain that the 2020 growth target is likely to be around 6% and that the objective is non-symmetric. We mean by this that if economic activity surprises to the upside in H1/20, the Party – in line with its overarching goal of sustainable growth and its new mandate for "scientific" stimulus – is likely to taper policy support, rather than maintain pro-cyclical measures and drastically overshoot the 6% level.

Chart 3: Investment recovery (ytd, yoy)



Sources: CEIC, TS Lombard.

Chart 4: Consumption danger averted



Sources: CEIC, TS Lombard.

Authors

Rory Green
Economist, China and South Korea

Charles Dumas
Chief Economist