China Watch I Economics

DON'T GET TOO EXCITED ABOUT STIMULUS

Bo Zhuang

- **Beijing is not simply repeating an old-style credit easing to prop up the economy**
- **The positive spill-over effect of China stimulus on the global economy will be offset by further yuan devaluation**
- **Growth will decelerate further until a stronger policy response in H1/19**

China's latest PMI data, released earlier this week, showed manufacturing growth in September slowing to its lowest level in more than two years. An export sub-gauge fell deeper into contraction territory, suggesting that exporters face a worsening outlook over the coming months as the US ramps up tariffs next year. A statement by the Politburo after a meeting on Wednesday signalled that further stimulus measures are being planned as downward growth pressure continues to build. The government has to take "timely" steps to counter this development, the statement noted. At the same time, the State Council released detailed guidance on boosting infrastructure investment, highlighting key projects and designating specific ministries to ensure efficient policy implementation.

This is in line with our judgment in July that the authorities are stepping up efforts to stabilize growth, whereby fiscal policy is leading the way. But in our view, it is crucial to put the on-going stimulus in China into perspective rather than getting over-excited about it while ignoring the details. After the 2008 mega-stimulus programme, China went through another two easing cycles, in 2012-13 and 2015-16, with policies that provided strong support for the global economy. While emerging markets may be sailing into a "perfect storm" scenario in 2019 amid tightening global dollar liquidity, trade-war escalation and higher oil prices, many investors are now looking to China once again to provide the circuit breaker that prevents contagion.

We think the strong investor expectation that Beijing will simply rely on old-style credit easing and fiscal measures to prop up the economy and that this will prove positive once again for other markets is misplaced. Here are the reasons why:

1. **Aggressive credit easing is not a viable option.** China expects a protracted confrontation with the US and is looking to use sustainable stimulus measures to strengthen both its long- and short-term growth prospects. In our view, unless growth faces the imminent threat of collapsing, Beijing will not risk repeating a credit expansion of a magnitude similar to that of 2015-16 because this would likely lead to Japanification or a financial crisis within five years. An important pointer in this context is the fact that the total credit growth rate was at a record low in September, despite easing measures having been implemented from early July onwards.

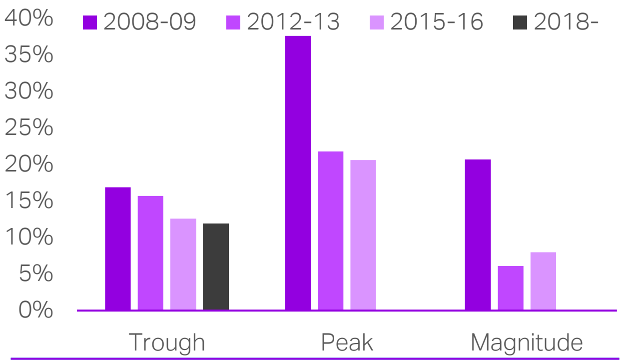
2. **Currency devaluation is on the table.** Outflows are manageable this time round owing to more stringent capital controls, less panicky household and corporate sectors and marginal speculation against the yuan. Naming China a "currency manipulator" can be

seen as an empty gesture given the continued escalation of Trump's trade offensive. As the US moves to exert maximum economic pressure, Beijing has come to realize that a flexible currency policy is in China's interest.

3. **Deleveraging has been paused, not scrapped.** Our recent conversations in Beijing reinforced our conviction that deleveraging and financial risk control remain priorities at the highest levels. Although the pace of long-term debt deleveraging has stalled since July, we believe that the multi-year campaign to curb the rate of debt expansion has not been scrapped. Xi's right-hand man on the economy, Liu He, has long been strongly advocating a shift away from credit-fuelled growth.
4. **A more proactive fiscal policy can be pursued within existing 2018 quotas.** The surge in local government special bond issuance in Q3/18 is merely a case of catching up with the fiscal plan for the full year and does not constitute additional stimulus.
5. **Count the housing sector out.** Since 2016 housing demand in China has been vastly inflated by direct transfer payments from government to households in connection with shantytown redevelopment. Further ramping up the housing sector could significantly increase the risk of the domestic property bubble bursting.

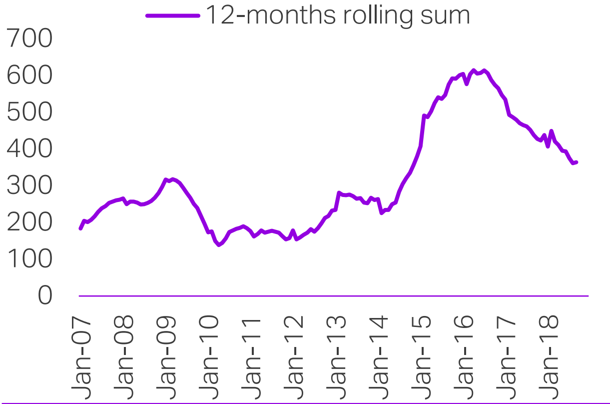
The overall positive spill-over effect from China's domestic credit easing and fiscal stimulus is thus likely to prove more limited than was the case in the past, partly because Chinese authorities will, we believe, choose to allow further passive yuan devaluation as part of their response to the trade war and the growth slowdown. While stronger domestic demand will be positive for countries that export to China, those emerging markets that compete with the PRC and tend to produce lower-value 'homogenous' goods – such as peripheral Europe - will face a significant loss in bilateral competitiveness.

Magnitude of credit easing in the past cycles



Sources: CEIC and TS Lombard.

Trade balance, $bn



Source: CEIC.

We think China will face stronger growth headwinds in the coming months until Beijing ramps up more robust stimulus measures and allows yuan depreciation next spring. We believe growth will decelerate further in the next two quarters because: 1) the negative impact of the first two tranches of US tariffs on US$250bn Chinese products, introduced in Q3/18, is not yet fully reflected in the economic data, although the 12-month rolling sum of the trade surplus dropped 17% yoy in September mainly owing to stronger imports; 2) quarterly real retail sales in Q3/18 were the lowest since Q1/94, which suggests weaker consumption growth is not solely auto sales-related; and 3) headline real estate investment, stripping out land sales, grew -6.6% in September, and since there was massive housing sale front-loading in 2016-17, it is highly unlikely that in 2019 housing sales and investment growth will outperform 2018.

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