China Watch

CHINA TURNS INWARDS

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Politics

- NPC policies proposals support Xi's vision of a self-reliant China
- Global policies are ceding to domestic ones, as seen by the shift in emphasis from "Belt and Road" to "Greater Bay Area"
- Two pieces of legislation to pass through the NPC this week will exacerbate the US-China "tech war"

Economics

- Government work report sets 6-6.5% GDP target; we expect 6.2%
- Sustainable fiscal stimulus will support a moderate growth rebound
- NPC credit goals are unfeasible, further stimulus will cause broad credit revival

Markets

- The authorities will struggle to deliver a boost to growth via monetary measures and will be forced to introduce additional stimulus
- Magnitude and real economy impact of monetary stimulus will disappoint

Politics: China is its own best-friend

- **NPC policies proposals support Xi's vision of a self-reliant China**
- **Global policies are ceding to domestic ones, as seen by the shift in emphasis from "Belt and Road" to "Greater Bay Area"**
- **Two pieces of legislation to pass through the NPC this week will exacerbate the US-China "tech war"**

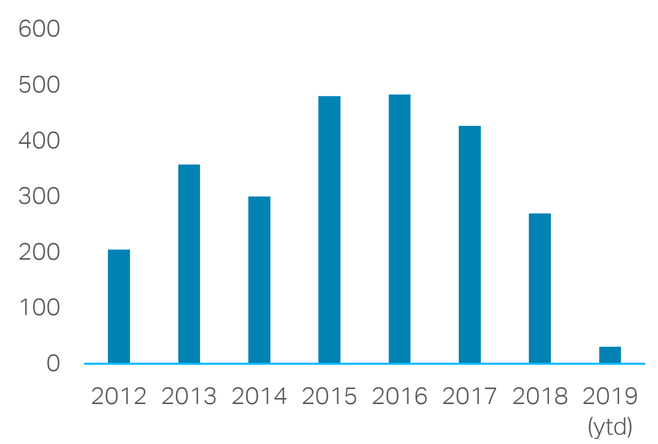
Some of the 3,000 delegates gathering in Beijing for the 10-day annual National Party Congress were caught dozing off during Premier Li Keqiang's long speech setting out the government's growth targets and policy initiatives. The key message, for those who stayed alert, was the need to "mitigate external risk" and promote "internal stability". Behind the slogans lie important policy changes that will affect the future of US-China relations and the direction of China's fiscal policy.

The short-term strategy to mitigate "external risks" means diversifying away from the US. For the first time, Li codified the policy of "promoting the diversification of export markets", a goal that our Chief EM economist Lawrence Brainard forecast would be Beijing's response to the US-led trade war (see our 11 January 2019 China Watch). As the world's attention is focused on the rumoured meeting between Xi Jinping and Donald Trump in Florida at the end of this month that is set to re-set Sino-US trading relationship, the domestic push in China is to lessen dependence on trading ties with the US. We can expect further measures from local governments to support manufacturers akin to efforts by the Guangdong and Zhejiang governments to help struggling exporters through tax cuts and land subsidies while they restructure their business strategies (see the "Economics" section below for more detail).

China is turning inwards. The long-term strategy is to make China a "self-reliant" economy harnessing government support to promote domestic high-tech innovation, upgrade manufacturing productivity and incentivize citizens to consume products made at home. Behind this over-arching goal, laced with nationalist rhetoric, is a dampened appetitive for FDI (see the chart on the left-hand side below) under the "Belt and Road" (BRI) initiative and a focus on domestic investment under the "Greater Bay Area" (GBA) plan.

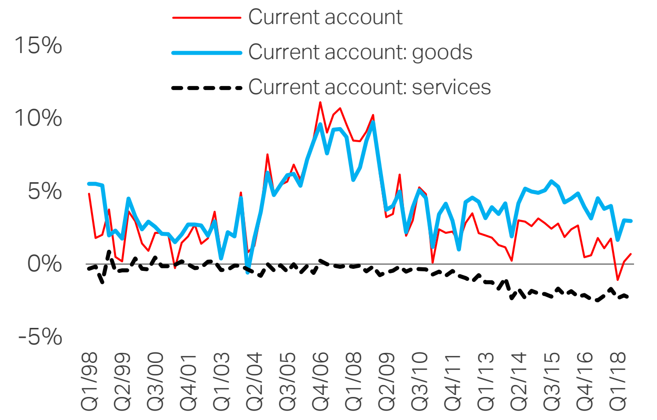
From global to domestic China. Xi Jinping's pet project, the BRI initiative, has been strategically downplayed in official media this year as funding has declined. The current account will move to deficit this year and Beijing has less cash than when the policy was first iterated in

Value of Chinese FDI transactions (US$bn)



Source: RWR Advisory.

CA balance, % of GDP



Source: CEIC.

2013 (see right hand-side chart above). This downward pressure is only likely to increase as any trade deal with the US will mandate China to increase imports from the US. At the same time, a growing chorus of unofficial voices within China are questioning why Beijing is spending so much money abroad when it faces a slowing economy at home.

Turning inwards

The confluence of the trade war and the slowing domestic economy has led Chinese policymakers to turn increasingly inwards and focus on developing local sources of growth, notably through the "Greater Bay Area" (GBA) project. The central government's marketing efforts have been redirected from touting the BRI to promulgating the GBA, a project that serves its economic aims and dovetails with Xi Jinping's ambition to make China the world's leading technology superpower. Released last month, the guiding principles of the GBA blueprint are:

- To promote financial, trade and transport connectivity between Hong Kong, Guangdong, Shenzhen and surrounding cities
- To support high-end tech innovation in Shenzhen, with manufacturing centred in Dongguan, Zhuhai and Foshan
- To use Hong Kong and Macao as international finance centres that will help internationalize Chinese innovation

The GBA is still in its incubation phase. Businesses and local politicians will be scrambling to come up with initiatives that work towards GBA in a bid to get central government funding. The initiative will see more government support for fledging high-end firms that work in industries that the central authorities see as vital to securing China's national security – namely, AI, robotics and quantum computing. Property developers, too, benefit from the increased migration of workers to the targeted regions and government support for local housing projects.

Alarm bells will start to ring in Washington as politicians cry that China is trying to build its own "Silicon Valley". The current focus is on how China has dropped its "Made in China 2025" plan in order to ease trade tensions with the US, but the ambitions that underpinned it are still very much alive, as the GBA plan and Li's rally cry to "promote the accelerated development of emerging industries" demonstrate.

The NPC will approve the Foreign Investment Law this week, after being fast-tracked for approval as Beijing sought to demonstrate to the US it was working to bolster its IP protection regime. The legislation does ban formal mechanisms for forced technology – such as mandates issued by local governments to foreign firms to surrender IP to local firms. But it will not end unofficial practices that result in technology transfer, such as regulatory authorities demanding that foreign firms hand over blueprints, which are then passed on to domestic competitors.

The Export Control Act will be approved this week, too, introducing a control regime that closely mirrors the one established under the auspices of the US Department of Commerce as Washington tries to use export-control mechanisms to stop China from accessing US high-end technology (see our 21 February 2019 China Watch for more details). The Export Control Act that will be submitted to the NPC explicitly states that if China is subject to discriminatory export-control measures by another country, it is permitted to initiate retaliatory measures. The act's language is strikingly similar to that of the US Export Control Reform Act (ECRA): both bills empower the authorities to block the sale of products related to "national security". The inherently ambiguous nature of what constitutes "national security" means that politicians in either country will be able to exploit export controls as they seek out tools other than tariffs in their economic and technological rivalry.

Economics: Stimulus outline

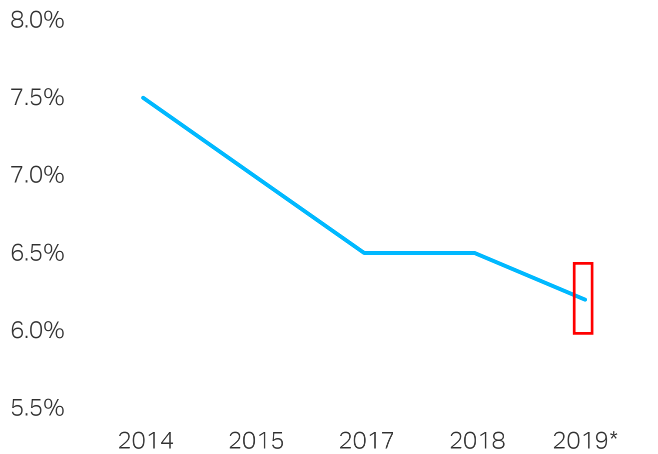
- **Government work report sets 6-6.5% GDP target; we expect 6.2%**
- **Sustainable fiscal stimulus will support a moderate growth rebound**
- **NPC credit goals are unfeasible, further stimulus will cause broad credit revival**

The reduction of China's 2019 GDP growth target to 6-6.5% from "around 6.5%" shows Beijing's readiness to accept a moderate slowdown. But it still means the Government Work Report (GWR) has adopted a target above China's potential growth rate. We expect GDP growth of 6.2%, compared with 6.6% in 2018, achieved via modest stimulus. The above-potential growth goal is primarily the result of the political ambitions of Xi Jinping to deliver on the Communist Party's commitment to double living standards between 2010 and 2020. That requires expansion of 6.1-6.2% in 2019 and 2020, enabling Xi to declare victory at the centenary celebrations of the establishment of the Communist Party in 2021.

Since the Party Congress in October 2017, senior officials have been stressing the need for quality growth while downplaying GDP targets. After fulfilling the Party's doubling pledge next year, the leadership will have much more freedom to set a lower target, in line with underlining growth potential. We expect China to exceed its potential rate in 2019-20 and then abandonthe 6%+ level thereafter. We believe domestic stimulus and credit easing will remain restrained, compared with the 2015-16 easing cycle.

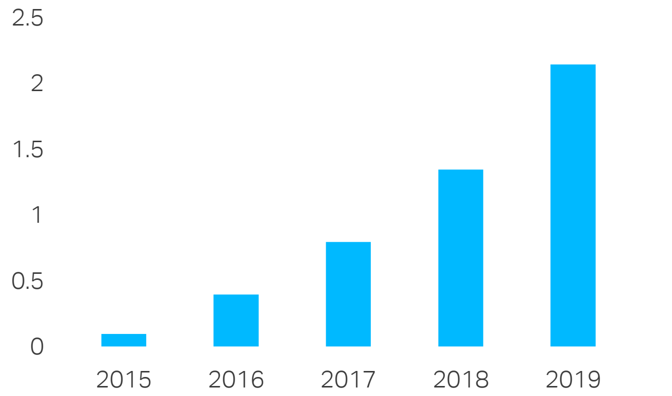
The GWR reiterated that monetary policy would be "prudent", specifying that M2 and TSF growth should be in line with nominal GDP growth. As with the PBoC's Q4/18 monetary policy report, the word "neutral" to describe the central bank's stance was removed. As we expect nominal GDP growth to decelerate rapidly to ~8% owing to PPI deflation in H1/19, an increase in total social financing in line with nominal GDP appears unfeasible. However, the government is not looking to carry out "flooding easing". Instead, it will continue to pump liquidity into official channels, such as bank lending and bond issuance, while keeping a cap on shadow banking. We call this "measured easing" focused on providing cheaper liquidity via on-balance

GDP growth target (% yoy)



Source: CEIC.

Special purpose local government bond quota (CNY trn)



Source: State Council.

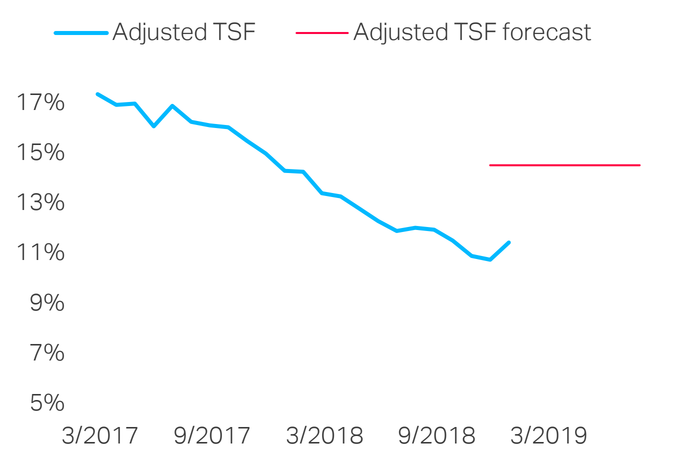
sheet channels, which means it is different from the "broad easing" of 2015-16. Overall, we continue to expect total credit growth to pick up to around 14.5% by yearend. In addition to moderately stronger credit growth, we expect another 150-200 basis points of broad-based RRR cuts and a targeted 20-30bp reduction in policy interest rates, including the SLF and MLF.

The report pledged a more proactive fiscal policy in 2019. The official budget deficit target was raised to 2.8% of GDP from 2.6% in 2018. The GWR approved a special local government bond issuance quota of Rmb2.15trn, up from Rmb1.35trn last year. The budget deficit will come mostly from tax and fee cuts. The top corporate VAT rate for manufacturing firms will fall from 16% to 13%, saving companies around Rmb800bn, as forecast. Meanwhile, employers' mandatory social security contribution has been lowered from 20% to 16%. The GWR put the total reduction in corporate taxes and fees at Rmb2trn. In addition, the NDRC has announced plans to cut the average price of electricity charged to companies by another 10% to reduce the non-tax burden on industrial and commercial users. Local authorities, particularly in export-oriented manufacturing provinces, have already lowered provincial tax rates and fees. This new sustainable stimulus will support long-term growth. However, because the multiplier of tax cuts is lower than that for infrastructure spending, fixed asset investment growth is unlikely to surprise on the upside in 2019.

Infrastructure growth revival. While the GWR does not provide total infrastructure investment targets, it does include specific figures for rail, road and waterway spending. The combined total set in this year's GWR for rail, road and water spending is RMB2.6trn, 44% higher than 2018 and an increase in nominal terms of RMB800bn over 2018 and RMB 300bn over 2017. This confirms our previous expectations that state-led infrastructure investment will be the principal driver of FAI in 2019. In addition to the GWR statement, moribund infrastructure projects have restarted, PPP approvals accelerated, local government bond quotas expanded, and bond issuance frontloaded. Infrastructure investment growth plummeted in 2018, as we had forecast, but is likely to rebound to 8-10% in H1/19. The yoy comparisons will be particularly strong in H1/19 as infrastructure investment was exceptionally weak in the first half of 2018. With PPI and industrial profits falling, manufacturing investment will be a drag on total FAI.

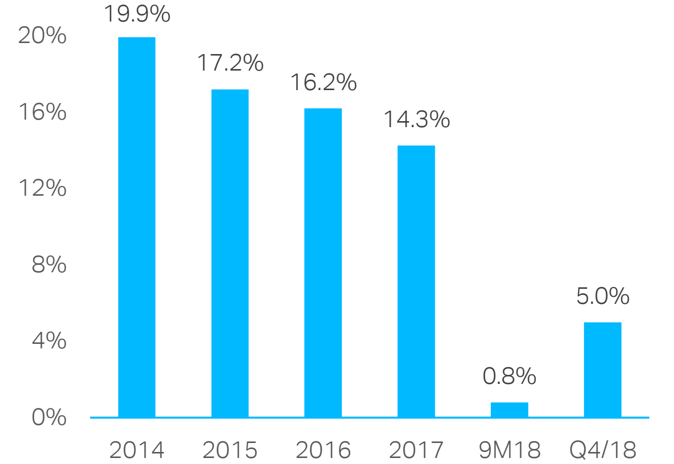
Although a sharper-than-expected slowdown in property investment remains a risk, we do not expect housing support to deviate from city-specific fine-tuning. While there were stronger hints of property tax legislation, we believe weaker housing sales and dampened price expectations have reduced the urgency and likelihood of a tax being introduced this year.

Credit rebound under way (% yoy)



Sources: TS Lombard, CEIC.

Infrastructure investment (% yoy)



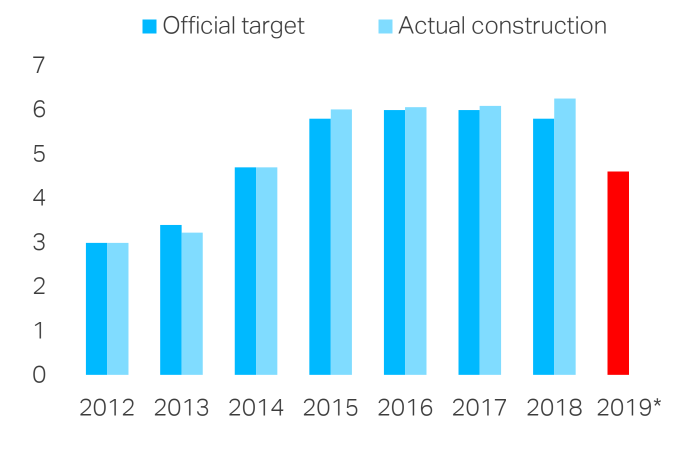
Source: CEIC.

Surprisingly, the report did not include a new target for shantytown redevelopment, meaning this will not be a focus of government policy; last year, work began on 6.3mn housing units, overshooting the goal of 5.8mn. Local government targets for shantytown redevelopment so far this year are running nearly 40% below 2018 levels, and the central authorities have already announced that they will reduce the proportion of "cash compensation" for residents forced to move house. Together with our expectation of no national-level easing (for instance, by lowering the mortgage down payment ratio or the introduction by the PBoC of a special discount for home loans), we think property sales and housing investment will probably surprise on the downside, despite easier monetary policy.

Employment targets remain unchanged and the labour risk is limited. The GWR kept official job creation and unemployment rate goals unchanged from 2018. Beijing, contrary to an increasing amount of commentary in Western media, does not see an employment risk. We concur with the official view. Much of the China-jobs-scare analysis has focused on internet-related indicators, Baidu searches, jobs listing on websites, and anecdotal reports of job cuts by high-profile tech firms. These are all important but miss Beijing's most sensitive labour demographic – blue-collar workers. In terms of calibrating China's response to unemployment, it is not white-collar or service jobs that count but migrant workers.

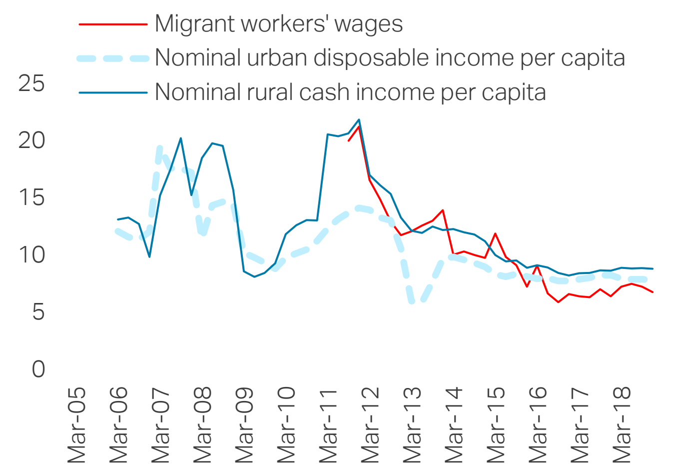
Migrant labour does not use social media or websites to find work. The key to tracking migrant labour flows, is to look at wage growth and local city and provincial level media. Our analysis here shows that the labour market weakened moderately in Q4/19; however, the decline slowed in January and February. Local media reports indicate a labour shortage in eastern manufacturing provinces as workers from central China have been slow to return after the

Shanty town development (mn houses)



Source: State Council. *No official NPC target; TSL estimate

Income and wage growth, % yoy



Source: CEIC.

spring festival.

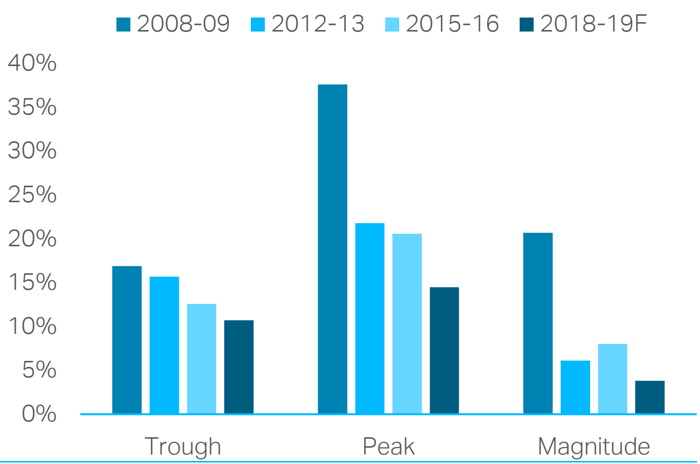
Markets: China's underwhelming monetary stimulus in charts

- **The authorities will struggle to deliver a boost to growth via monetary measures and will be forced to introduce additional stimulus**
- **Magnitude and real economy impact of monetary stimulus will disappoint**

One of our current themes is that monetary stimulus in the current cycle will disappoint. Most investors expect China's current economic stimulus efforts to be as effective as they have been in the past. We disagree. Our judgment is that the authorities' current plans are likely to fall short and that additional measures will eventually be rolled out later in H1/19 in order to keep growth from falling further and to engineer a recovery later this year.

To illustrate our view, we compare recent easing cycles with reference to the increase in credit growth. We measure growth from the cyclical trough to the subsequent peak, measured in percentage points; for the current cycle we forecast a peak credit growth rate of 14.5% yoy later this year. We calculate the yoy increase in the rate of total credit expansion (defined as total social financing plus local government bond issuance) during the following cycles: 2008-09, 2012-13 and 2015-16 and 2018-19F. These comparisons are shown below.

Credit easing in past cycles, Credit chg in %

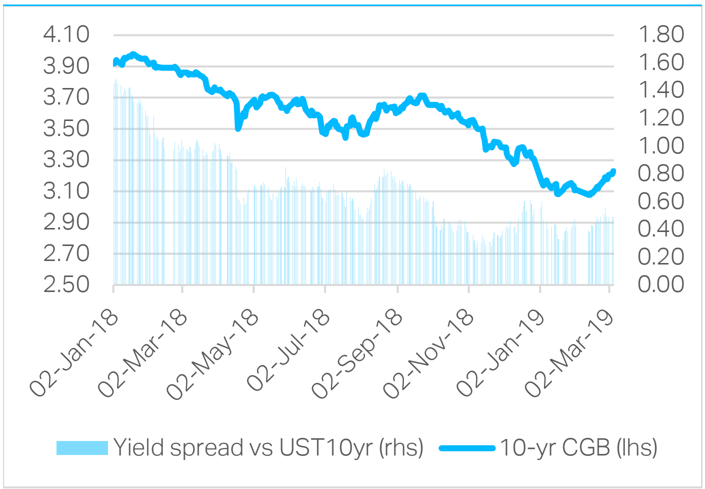


Source: CEIC, TS Lombard; magnitude is % chg peak-%chg trough

For the current cycle we project that total credit growth will pick up from the 10.7% yoy rate in December 2018 to 14.5% later this year for an overall increase in the rate of credit expansion of 3.8pp; this compares with increases of 20.7pp in 2008-09, 6.1pp in 2012-13 and 8.0pp in 2015-16. In other words, we expect the magnitude of the current credit cycle to be half that of the most recent (2015-16) cycle. The primary reason is the commitment of the top leadership to the deleveraging campaign: although it has been put on hold, we believe it is unlikely to be reversed.

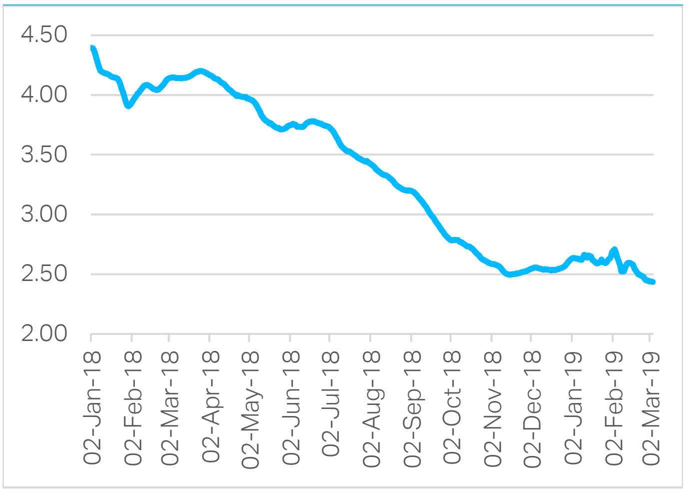
The distinctly different nature of the current monetary stimulus cycle is also evident in recent monetary data. The two sets of charts below highlight that market interest rates declined in various credit market segments in 2018. The yield on the 10-year China Government Bond fell from a peak of around 4% in January 2018 to a low of 3.10% last month, before rising slightly to 3.20% currently. A similar trend was evident in short-term market rates: the seven-day annualized yield on Yu'e Bao's money market fund fell from 4.35% in January 2018 to 2.45% currently.

China govt 10-yr bond, in % and spread to UST



Source: Bloomberg.

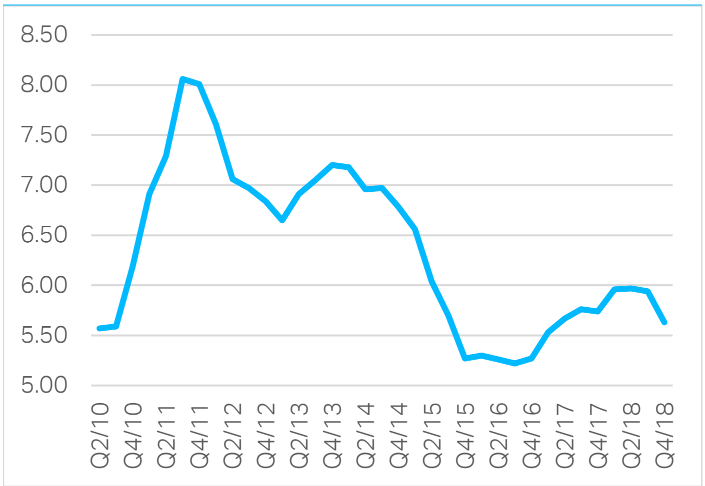
Money mkt fund, 7-d avg. annualized yield, in %



Source: CEIC; Yu'e Bao Money Market Fund

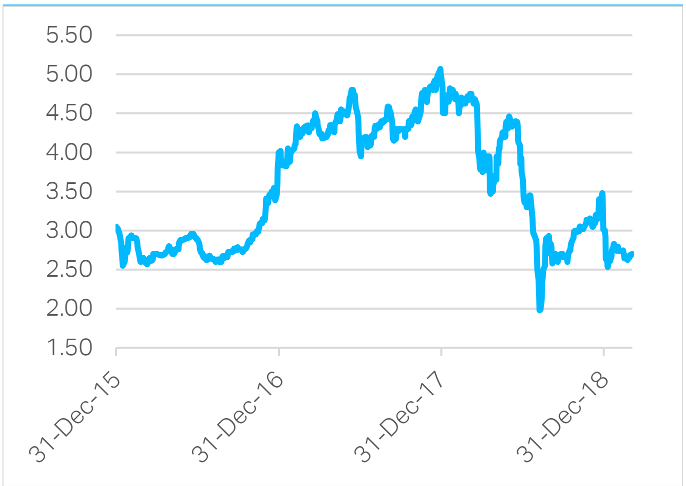
Declining interest rates are also evident for commercial banks' lending and funding activities. According to PBoC data, the decline in average bank loan rates last year was just 34bp - from 5.97% in Q2/18 to 5.63% in Q4/18. Banks' funding costs via NCDs reflected a more marked decline: three-month NCD rates fell from 4.80% at the beginning of last year to a low of 2% in August 2018; thereafter, NCD rates rose sharply before stabilizing around 2.70% currently.

Average commercial bank lending rate, in %



Source: PBoC.

3-mo NCDs, in %

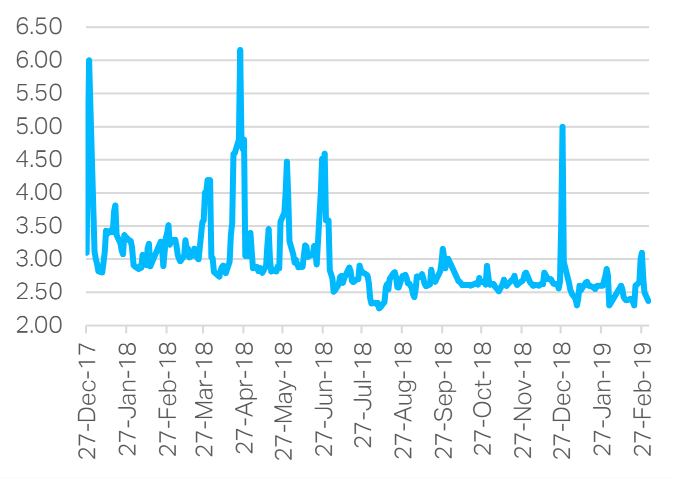


Source: Bloomberg.

We interpret the declining yields as largely driven by expectations for slowing growth, new monetary stimulus via RRR cuts and other non-interest rate measures. What they do not reflect is cuts in benchmark policy interest rates by the PBoC. Policy rates, in fact, were hiked last year: 10bp on the PBoC's Standing Lending Facility to 3.55% in March and 5bp on the one-year Medium-term Lending Facility to 3.30% in April. The PBoC operates in the money markets at variable interest rates to control liquidity via reverse repos, but the bank has not cut policy interest rates as part of its monetary stimulus efforts.

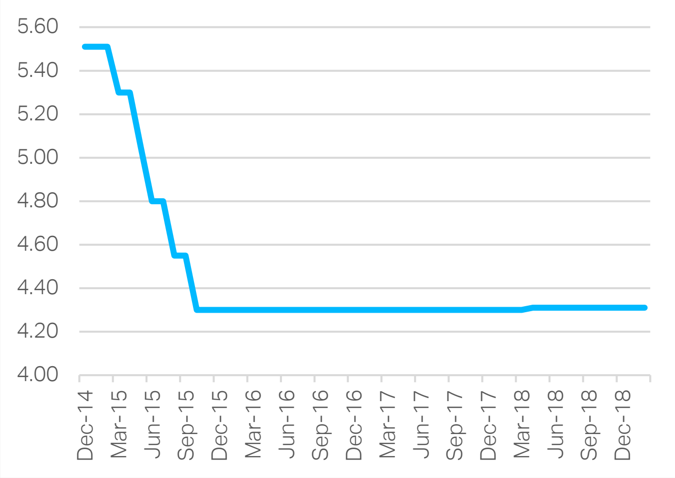
Monetary stimulus is being provided by direct lending initiatives rather than by cutting policy rates. For example, the trend in the seven-day financial repo, which is important for funding purposes on the part of non-bank financial institutions (i.e. shadow banks), showed marked volatility up until July last year but then stabilized roughly in the 2.50-2.70% range when the deleveraging campaign was put on hold at that time.

7-day financial repo (R007), in %



Source: Bloomberg.

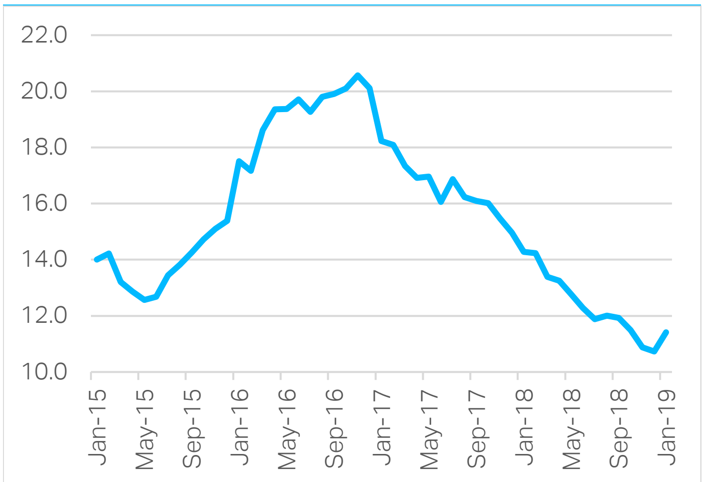
Prime lending rate, in %



Source: Bloomberg.

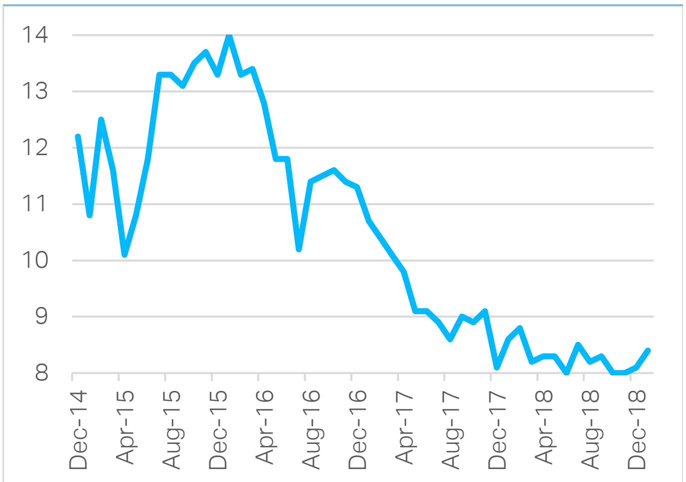
Turning now to monetary aggregates, the data suggest that the current monetary stimulus has not as yet had much impact on credit or money supply growth. Our interpretation is that monetary policy is only now turning to boost credit volumes via direct lending measures, marking a shift from a neutral policy stance in 2018 to what we characterize as "measured easing". Our calculation of total credit, which includes total social financing and bond issuance (see chart on the left-hand side below) shows that this January there was a reversal in a two-year-long declining trend, from growth of 10.7% yoy in December to 11.4%, but this is still very far behind the surge in credit in 2015-16. As regards monetary aggregates, M2 growth has been locked in the 8-9% range throughout 2018. This week's National People's Congress, called for M2 and TSF growth in line with nominal GDP. As we expect nominal GDP growth to decelerate rapidly to ~8% owing to PPI deflation in H1/19, an increase in total social

Total credit growth, in % yoy



Source: CEIC.

M2 growth, in % yoy



Source: Bloomberg.

financing in line with nominal GDP appears unfeasible. Beijing will need to introduce further credit stimulus to achieve its GDP growth target.

The monetary authorities are actively creating new ways to boost lending. Among them are a new targeted lending facility for loans to private borrowers and mechanisms to facilitate capital-raising activities by commercial banks. The basic problem, however, is that the economy's monetary transmission multiplier is broken, so even more credit is needed to generate the same amount of growth as before. The deleveraging campaign has been successful in squeezing shadow banks, but commercial banks are ill equipped to step into the breach. Far-reaching financial reforms are needed to create the necessary conditions for sound lending to private-sector borrowers. In the meantime, more money will be thrown into stimulus efforts, which will inevitably struggle to stabilize the economy.

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