China Watch I Economics

DIFFERENT CYCLE, NEW OPTION

Bo Zhuang

- **The current market optimism about the Chinese stimulus will be short-lived**
- **Easing is constrained by the elevated debt level and the overheated property sector**
- **Devaluation will become an acceptable policy option under the new conditions following Trump's moves**

The latest tit-for-tat tariffs have set the scene for a further escalation of the trade war between China and the US. After the US had announced last week it would impose 10% tariffs on US$200bn worth of Chinese imports, the PRC authorities quickly hit back with increases in duties ranging from 5% to 10% on US$60bn worth of US imports. If no deal is reached with Beijing, the US tariff hike will be ratcheted up to 25% in January 2019. In our view, that would be a market-negative event.

Yet investors seem to shrug off these latest developments because of reports that the Chinese authorities is stepping up efforts to support growth once again. Strong market expectations of an old-style credit easing and fiscal stimulus have led to a bigger overall risk appetite in recent weeks. Meanwhile, the negative impact of the first tranche of the US tariffs on US$50bn Chinese products introduced in July and August has not yet been fully reflected in the economic data.

We believe the current market optimism about the Chinese stimulus will be short-lived because the ongoing domestic easing cycle will be weaker than the previous ones and thus market expectations will not be met. The continued deterioration in economic data and the escalation of the trade war will make the market less optimistic about medium-term fundamentals. Given the threat of tariffs rising to 25% in 2019, we continue to expect the Chinese authorities to opt to allow passive devaluation as part of their response. This would mean the yuan facing a further 15% market-driven devaluation over the coming six to nine months, although we now believe it could take longer to materialize than we had envisaged when we first advanced our currency thesis in August (see our 9 August 2018 China Watch).

Why this time round is different

Apart from challenging the capital outflows argument (see our 27 September 2018 China Watch) against a drop in the currency, our off-consensus currency call has raised objections that Chinese policymakers will respond to the tariffs by deploying the familiar array of domestic stimulus measures because this is the less risky course. We disagree and contend that there is now less room to manoeuvre owing to the rising debt level, the emerging current account deficit and over-leveraging in the household sector. The scope and magnitude of current policy easing is limited compared with previous episodes. The government has made clear that it is not intending to reverse course on financial regulation and deleveraging and that housing policy tightening will continue. Hence, the burden of policy easing lies on fiscal policy. Soon, we believe, devaluation will become an acceptable policy option under the changed conditions following Trump's moves: the leadership's mindset is now geared towards making depreciation more acceptable.

In 2015-16 defending the yuan was crucially important for the Communist Party to avert a domestic financial crisis. Back then, there were large capital outflows, nominal GDP growth was just 6.5%, the corporate sector was suffering from deflation; the stock market had just crashed and household confidence was weak. Any failure to defend the yuan would have triggered an immediate financial crisis, and the Party and the leadership would have run the risk of being blamed for incompetence at a time when Xi Jinping was still establishing his new power structure and had to prepare the ground for the 2017 Communist Party Congress.

This time round, outflows are manageable owing to more stringent capital controls (see our 27 September 2018 China Watch), less panicky household and corporate sectors and marginal speculation against the yuan. Xi has achieved his main political power ambitions through the Congress, the constitution of a new Politburo Standing Committee, the promotion of associates such as Liu He and the legislature's abolition of the presidential term limit. This gives him a freer hand to adapt policies to respond to the offensive of the Trump administration, which is steadily widening beyond trade and thus makes it easier to frame the response in nationalist terms as standing up to US "containment". For example, accepting downward market pressure on the currency can be presented as having been forced on the PRC by the scale of the US moves without Xi having the abandon the role of 'champion of globalization' that he has been playing over the past two years.

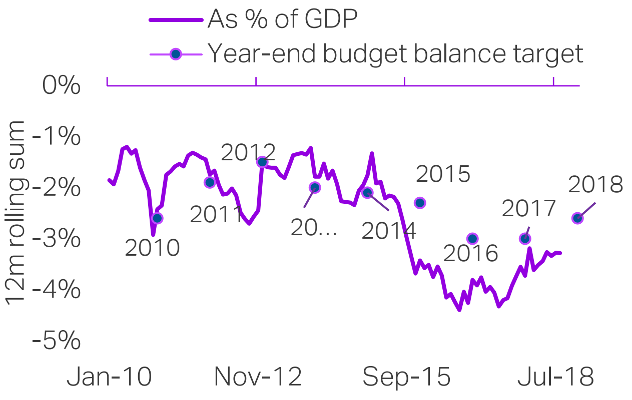
In our view, it would be riskier to stoke domestic demand through across-the-board credit easing and higher leverage in order to keep growth above 6% in 2018-9. Such an approach would defeat the longer-term goal of financial deleveraging and make a financial crisis more likely. If China went further down this route, it would face either Japanification or a financial crisis within the next three to five years. In other words, defending the yuan through domestic stimulus and aggressive credit easing would be more likely to plunge China into a debt crisis than to save it from one. Following the latest trade moves, a cheaper yuan would help offset some of the impact of the tariffs on exporters without significant spill-overs to domestic sectors.

More proactive fiscal policy within existing quotas

The most recent State Council meeting, which took place in September, emphasized that "efficient investment should be expanded", especially infrastructure investment in areas like transportation in central/western China. No doubt, the government will accelerate projects already under way, increase the number of projects in the pipeline and make better use of private capital to support infrastructure investment. But it is worth noting that the State Council statement included the comment that there should be no over-reliance on investment; this likely reflects continuing concern among some policymakers about potential over-investment.

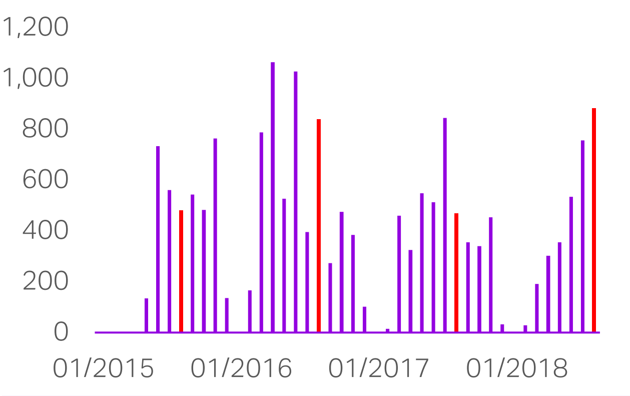
Large-scale fiscal stimulus is now a market misperception. As we previously highlighted (see our 19 July 2018 China Watch), there is still room for proactive fiscal policy in H2/18. In the first six months of this year, the sharp decline in infrastructure investment growth was, in part, a direct outcome of slow local government bond issuance. In July and August, new issuance of local government bonds jumped to RMB1.6trn, compared with just RMB1.4bn in the entire first half of 2018. In August the Finance Ministry issued guidance on local government special bond issuance that requires local governments to speed up issuing the special bonds used to fund infrastructure projects. Specifically, local governments have to meet no less than 80% of their annual special bond net issuance quota by end-September and the remainder in October. But these recent policy statements, including that ordering the acceleration of local government special bond issuance are all part of the current quotas, which was announced during the NPC plenary session in March. So, it is merely a case of catching up with the fiscal plan for the full year and thus does not constitute additional stimulus.

Budget deficit



Sources: CEIC and TS Lombard.

LG bond issuance, RMB bn

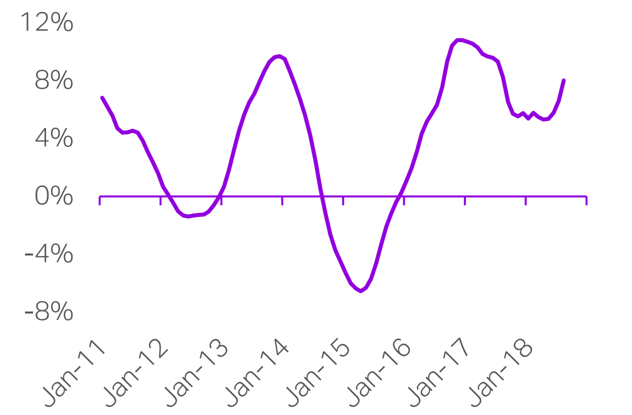


Sources: CEIC and TS Lombard.

Count the housing sector out

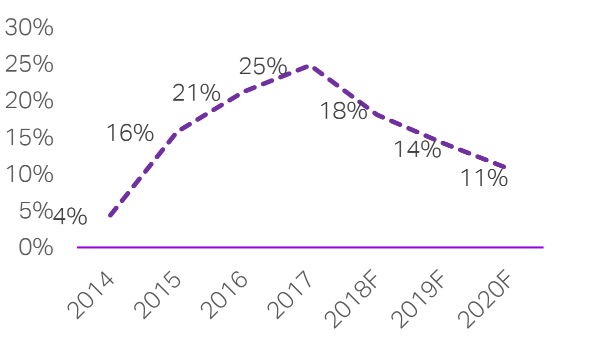
Property demand has been significantly front-loaded over the past three years. During previous economic slowdowns, house prices decelerated before policy easing and started to rebound thereafter. This time round, house prices started to rebound in early 2017 and property investment has exceeded market expectations since last year. Beijing has aggressively encouraged local governments to increase cash payments for shantytown redevelopment since 2016 (see our 5 July 2018 China Watch) so that residents can buy existing private housing. As a result, housing demand in the lower-tier cities has been vastly inflated by the direct transfer payments from government to households in connection with shantytown redevelopment. We estimate that in 2017, redevelopment accounted for some 23% of property demand in terms of gross floor area. This tells us that Chinese housing demand has been significantly front-loaded by the shantytown programme.

Average property prices, % yoy



Sources: CEIC and TS Lombard.

Share of shantytown-related housing demand



Source: TS Lombard.

As we highlighted in July (see our 5 July 2018 China Watch), the China Development Bank has tightened the use of the PBoC's low-cost pledged supplementary lending guidelines for this redevelopment in order to rein in the financial activities of local governments. Given the tighter financing and a smaller number of redevelopment units in 2019-20, government transfer payments for such shantytown redevelopment will inevitably drive down housing transactions and investments. Meanwhile, the government's new push for rental housing will only marginally cushion the slowdown in the overall property market (see our 15 February 2018 China Watch).

Further ramping up the housing sector could significantly increase the risk of the domestic property bubble bursting. On a longer-term perspective, we believe China's annual housing sales measured by gross floor area will probably peak in 2018.

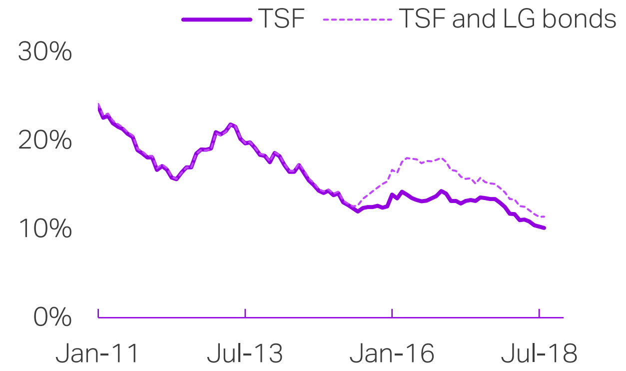
Since property demand has been significantly front-loaded, housing stimulus may no longer be an option. As a result, the burden of an investment-led stimulus would fall on infrastructure. China would have to allow aggressive credit easing and fiscal expansion to boost infrastructure investment growth in order to offset the earlier financial deleverage and the impact of the trade war. We estimate that the total credit growth rate would have to return to above 16% to achieve that offsetting. This means that China would have to reverse its earlier efforts towards deleveraging, which, in turn, would push up the overall debt level and increase the risk of a debt crisis in the medium term.

Putting credit easing into context

So, we think the authorities are unlikely to fall back on the old familiar recipe of credit- and investment-led stimulus to support growth. We don't expect them to reverse course on financial deleveraging to any large extent. Faced with a trade war to which there is no foreseeable resolution, the leadership wants to push through measures that will strengthen the economy in the medium to long term rather than falling back on policies that may give an immediate boost but undermine China's ability to resist US pressure.

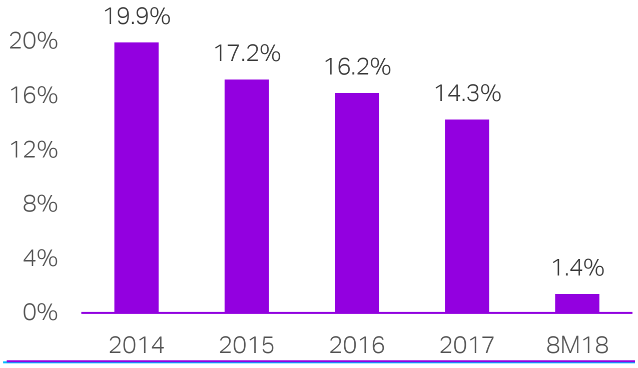
A pointer in this direction is the fact that total credit growth rate was at a record low in August – despite what was seen as an official policy easing message sent by the State Council in early July. The volume of credit supply is always more important than the cost of credit because private companies often have difficulty tapping into official fund sources, which means they do not have to worry about the cost of funding. We expect total credit growth to rebound from the current level of 11.4% in August to around 12.5-13% by the end of this year and 14.5% in 2019. But 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 18.1% in April 2016.

Total credit growth, yoy



Sources: CEIC and TS Lombard.

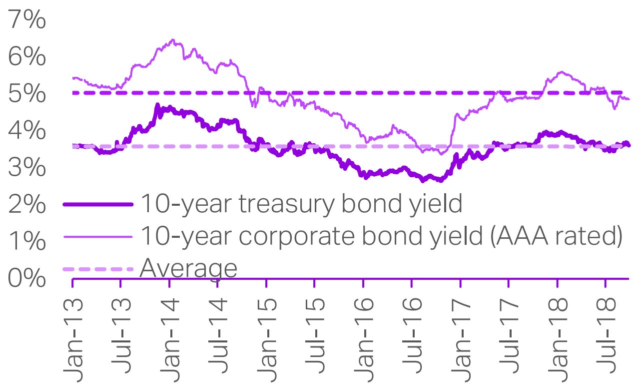
Infastructure investment, yoy



Sources: CEIC and TS Lombard.

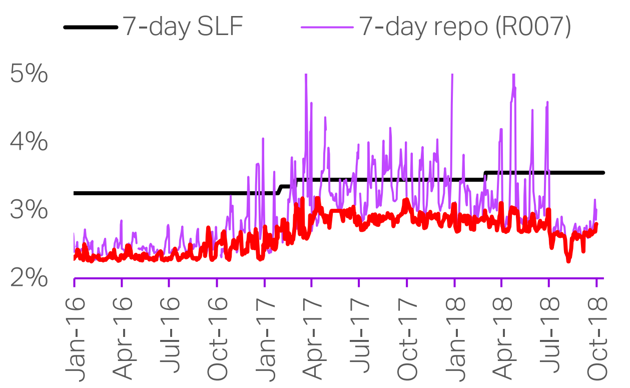
Looking beyond credit growth, it could be argued that since SHIBOR rates are back down to 2016 levels, China is moving to ease aggressively. In our view, the lower rates suggest only that liquidity is abundant within the financial sector and thus that financial deleveraging efforts have stalled. If we look at the other interest rates, 10-year government bond and corporate bonds yields are both significantly higher than in 2016. And short-term rates such as the seven-day repo rates (R007 and DR007) are all higher than two years ago. Anecdotal evidence from local media suggests that corporates do not see much improvement in funding. Official monetary policy since early July has merely halted its earlier tightening bias. That in itself does not imply outright easing.

Long-end rates



Sources: CEIC and TS Lombard.

Short-end rates

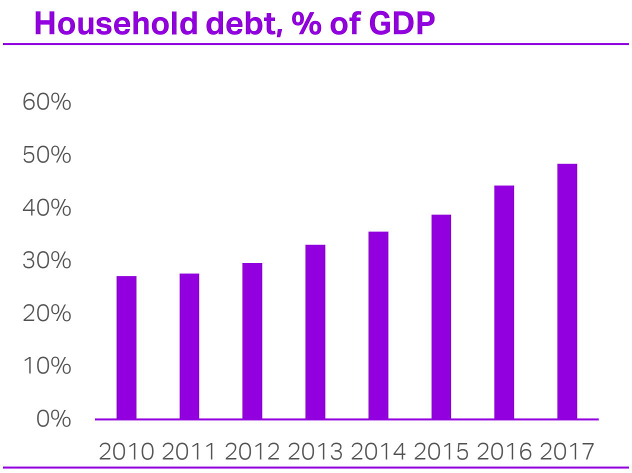


Sources: CEIC and TS Lombard.

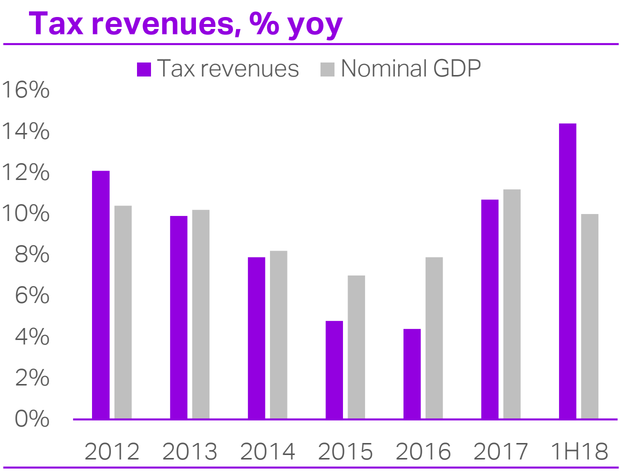
The reality of the tax cut

Apart from increased support for infrastructure investment, other measures have been introduced to lower corporate financing costs and reduce the corporate tax burden. It is true that China's overall effective tax rate combined with social security contributions is among the highest in the world. Premier Li and the State Council have issued more than 40 statements since early 2017 pledging to lower the corporate tax burden. Some headline tax rates, such as VAT, have been trimmed. But the reality is that tax collection has been significantly stepped up to crack down on tax evasion, thereby offsetting the reduction in tax rates. Despite the headline-grabbing official target of taxes and fees being reduced by RMB1.1trn in 2018, tax revenue growth (14.4%) outpaced nominal GDP growth (10%) in H1/18.

We believe there is a fundamental contradiction between tax cuts and strong government. Tax cuts require downsizing of the public sector and restrictions on government power. But local governments are faced with ever-rising debt burdens, and slashing taxes could force the central government to take on a much higher share of government debt. Beijing has so far been reluctant to deliver further – and more aggressive – tax reductions. We believe that if there is no material upward revision in the official budget deficits, the overall cut is not going to be meaningful for the corporate sector.



Sources: CEIC and TS Lombard.



Sources: CEIC and TS Lombard.

Less room to leverage household sector

After several rounds of stimulus driven mainly by credit growth, China's total debt-to-GDP ratio has surged to more than 260%, up from 150% in 2008. In previous easing cycles, the main concern may have been that local governments and SOEs would take on too much debt. This time round, the room for households to accumulate more debt is limited – the ratio of household loans to disposable income has jumped to more than 80% this year from 30% in 2008. Household debt at 50% of GDP may not be alarming in terms of global comparison, but debt has doubled as a share of the economy since 2008 and has risen especially precipitously in 2016-17. In just five years, mortgage debt has increased by RMB10trn. Debt repayments are now carving into consumption patterns, and high household indebtedness is problematic for policymakers because households are more likely to deleverage during a downturn.

First best option is still not on the table

Apart from aggressive easing to support growth and yuan devaluation, another option to deal with the challenge facing China would be to accept much lower growth rates, i.e. 5% or below. That would mean making aggressive adjustments and implementing far-reaching reforms (such as letting zombie firms go bust and cleaning up NPLs). But we think China will stick to its goal of doubling real GDP over the period 2011-20, not least because of the political importance of the 100th anniversary of the establishment of the CCP, which falls in 2021. To achieve that goal requires an annual GDP growth floor of 6.1% in 2019-20, which should be achievable given that, judging from official figures, growth is likely to come in at 6.5% for 2018 as a whole.

Conclusion

Our analysis above suggests that the magnitude of the current easing cycle has been limited so far, compared with the broad-based measures seen in 2012-13 and 2015-16. Current policy easing measures focus on existing fiscal targets and on removing the tightening bias of monetary policies. The scale is constrained by the elevated debt level and the overheated property sector, while the authorities remain reluctant to adopt broad-based easing because it risks exacerbating the debt problem and causing a property bubble.

We view yuan devaluation as Beijing's likely stimulus response to offset the negative impacts of the full-scale trade war on growth. We expect the yuan to depreciate by 15%

from current levels if 25% tariffs are imposed on all exports to the US. A combination of economic, financial and regulatory changes since the 2015 step devaluation has made the central authorities more confident about allowing the depreciation of the currency without risking excessive domestic turmoil. Moreover, alternative options such as economic slowdown and fiscal/monetary stimulus now pose a greater risk to China than does currency devaluation.

We maintain our lower-than-consensus GDP forecast of less than 6.5% in H2/18, despite the fine-tuning policies. Overall infrastructure investment growth will rebound to around 10% before the end of this year, up from 1.7% in Q2/18. Next year could see both external demand tied to the trade war and the domestic property investment front experiencing headwinds. Although we do not expect a catastrophic impact on growth from an escalating trade conflict, the indirect impact is likely to be felt via business sentiment, domestic investment and consumer confidence, which could pose a further downside risk in 2019.

Author

Bo Zhuang
Chief Economist and Director, China Research