

THE VIEW

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CHINA'S NEW STIMULUS: A PARACHUTE FOR GROWTH?

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EXECUTIVE SUMMARY



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- On 5 March 2019, at the key annual session of the National People's Congress, China's top legislature lowered the country's economic growth target for 2019 to 6.0%-6.5%. It also announced a significant fiscal package of RMB4.15tn (5% GDP), including tax and fee cuts (RMB2tn) and infrastructure spending (RMB2.15tn).
- These developments came as a response to the slowdown in China, and on top of an already generous, targeted and quite innovative monetary stimulus, composed of both cuts in rates, and non-traditional measures to increase lending to small and micro businesses by 30% in 2019.
- As a result, we expect economic growth in China to accelerate timidly from +6.2% y/y in the first quarter to +6.4% y/y in the second half of the year, as the effects of the private sector-oriented fiscal stimulus could take time to materialize. On the other hand, capital markets are expected to react very positively to the double stimulus, not minding the risks accruing on the horizon.
- This stimulus package is unlike previous ones, and transmission channels within China and to the rest of the world will be different. Consumer goods and services exporters from industrialized countries into China could be the main winners, especially as US-China trade tensions de-escalate. On the opposite, industrial commodity exporters and countries with large financing needs in the emerging world may not benefit as much. In any case, as growth in the US and Europe is decelerating, China's decisive move is more than welcome.

+6.0%-6.5%

China's lowered economic growth target for 2019



WEAKER CHINESE GROWTH RAISED THE ALARM BUT IT WAS NOT THAT BAD AFTER ALL

On 5 March 2019, at the key annual session of the National People's Congress, China's top legislature lowered the country's economic growth target for 2019 to 6.0%-6.5%. It also announced a significant fiscal package of RMB4.15tn (5% GDP), including tax and fee cuts (RMB2tn) and infrastructure spending (RMB2.15tn).

These measures came at a time when worries about a sharp deceleration of activity in China have resurfaced, in spite of past measures to support growth in the second half of 2018. China's economic growth slowed to +6.4% y/y in Q4 (from +6.5% in Q3 2018) due to moderation in exports and private consumption growth. January-February indicators also point to a weak outlook. While it is true that USD-denominated exports made a

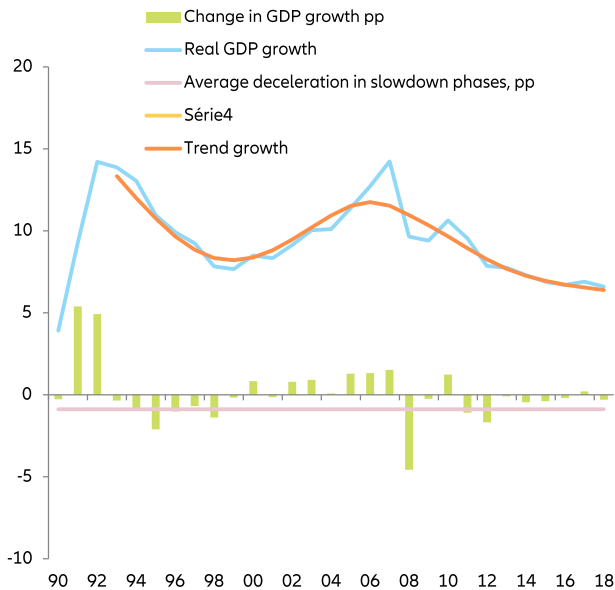
remarkable comeback in January (+9.1% y/y after -4.4% in December), imports continued to contract (-1.5% after -7.6%) and auto-sales plunged for a seventh consecutive month (-15.8% y/y). Earlier this year, fears have resurfaced about the possibility of a hard landing in China. Past crises such as the Asian financial crisis (1997-98) and the global financial crisis (2008) shaved off more than -0.9pp p.a. of GDP growth. The end-2018 deceleration was not a crisis situation.

The Li Keqiang Index¹, a composite indicator based on industrial electricity consumption, railway cargo volume and loans disbursed by banks, suggests a stabilization of activity in December. This stabilization was driven by an increase in credit (outstanding loans up +13.4% in December) and electricity consumption

(+8.8% in December), which were fueled by expansionary policies. PMIs confirm the resilience of the service sector while the manufacturing sector is already in contractionary territory, due to trade uncertainties. All in all, private demand remains solid. The surveyed unemployment rate was at 4.9% at the end of 2018 (after 5.0% end 2017). Per capita disposable income continues to grow at a solid pace (+6.5% in real terms in 2018). And the positive wealth effect coming from real estate (new home prices up +10.8% y/y in January) suggest Q1 disposable income growth will be firm. On the corporate side, industrial profits rose by +10.3% in 2018, helped by a strong H1 2018.

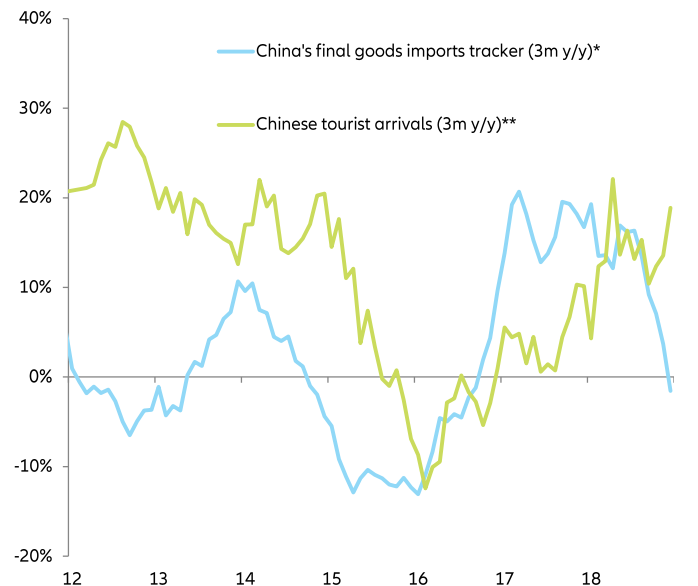
The end-2018 deceleration was not a crisis situation.

Figure 1: China's GDP growth – a long-term perspective



Sources: IHS, Allianz Research

Figure 2: China final goods imports tracker and Chinese tourist arrivals



*Include data from US, Germany, France, United Kingdom, Switzerland, South Korea, Japan, Taiwan, Brazil and Italy

** Tourist arrivals in Hong Kong, South Korea and Japan

Sources: IHS, Allianz Research

As for trade, there is a clear lack of demand from China for merchandise goods. We constructed two indicators: an import tracker based on data from China's suppliers of final goods (consumer and equipment goods) and a tracker of consumer demand for external goods based on tourist arrivals in preferred markets (Hong Kong, South

Korea and Japan). Figure 2 shows that while USD-denominated import merchandise goods contracted on a year-on-year basis in Q4, consumer demand for external goods remained broadly resilient. Our take here is that the decrease of China's imports is the result of: (i) a correction of new orders after a front-loading of imports from the US

(intra-trade dynamic); and (ii) rising import costs due to the RMB depreciation. Data on Chinese tourists going abroad suggest the Chinese consumer is still spending.

¹ Li Keqiang, the Premier of the People's Republic of China, reportedly said that his preferred indicators to measure China's economic growth are: disbursed bank loans, electricity consumption and rail freight. These remarks inspired The Economist to create an index using these three measures.

THE CHINESE REBOUND, POWERED BY A SUPER STIMULUS

We expect a rebound of growth in China from Q2 onwards on the back of less uncertainty, and fiscal and monetary stimuli. Economic growth will gain traction until Q4, led by stronger growth in domestic demand. It could slow markedly in H1 2020, in the wake of a sharp deceleration in the US, but economic growth will stay resilient at +6.4% in 2019 and +6.2% in 2020.

Less trade-related uncertainty

Recent communication from the Trump administration suggests that we are heading for a normalization of relations between the US and China by Q2 2019. This is crucial as continued uncertainties over the trade negotiations prompted

foreign and domestic corporates to delay spending and new orders. We have calculated that economic policy uncertainty has cut the growth of global trade by -0.45 ppt in 2018 compared with the -0.3 ppt direct impact of higher tariffs.

A private sector-focused fiscal boost

While in March 2018 the government was pledging a prudent budget (cutting the deficit target for the first time since 2012), the tone changed in the second half of the year as growth started to slow. From then the government started to announce a wave of tax cuts for R&D intensive companies, households and recently SMEs. Tax cuts amounted to RMB1.3tn last year. The government

also started to speed up project approval for infrastructure spending. This year there is no room for ambiguity. The fiscal stance is clearly expansionary with a targeted deficit raised at -2.8% GDP for 2019 (from -2.6% in 2018). The fiscal route (fiscal multipliers have increased from 0.75 in 2001-2008 to 1.4 in 2010-2015, while the credit multiplier has declined from 0.17 to zero over the same period) is always a Chinese favorite. General government debt accounts for 50% GDP and has a low exposure to external investors (government external debt is c.2% GDP).

+6.4%

Economic growth in 2019



Photo from Unsplash

With RMB2tn tax cuts and RMB2.15tn of local government special bonds to support infrastructure projects, the amount of expansionary measures are roughly equal to 5% of GDP. Even though it is material, the size and the features of this package are different from past ones, notably that in 2008-2009. The amount is similar (c.RMB4tn) but it differs massively in GDP terms (5% GDP against 12.5% GDP). Moreover, the composition is different. While 71% of the previous one was done through infrastructure spending, the current is rela-

tively balanced with 48% centered on tax cuts and 52% on infrastructure spending. Lastly, the latest stimulus is highly targeted with a focus on households and sectors that are key for Chinese economic development (R&D intensive private companies, especially SMEs, e.g.) and sectors that are facing difficulties. China will decrease the current value-added tax (VAT) rate for the manufacturing (to 13% from 16%), transportation and construction sectors (from 10% to 9%).

The impact will take longer to materialize as tax cuts are less meaningful than infrastructure spending: the impact is indirect and hinges on confidence. In addition, tax cuts would likely boost consumption and private sector productive investment (in agriculture, manufacturing, for e.g.).

Targeted monetary innovation

Authorities have already implemented various measures to boost bank credit to the private sector. The Reserve Requirement Ratios (RRR) have been lowered five times in the past year in order to free up commercial bank capital for additional lending. This was accompanied by new regulation (namely in Q4 2018) to encourage banks to lend to the private sector. In the December Central Economic Work Conference, authorities changed the official monetary policy stance from "prudent and neutral" to "prudent with appropriate looseness and tightness". Premier Li Keqiang confirmed targeted support for the economy at his opening speech of the second session of the 13th National People's Congress.

We penciled in a 200bp RRR cut this year to 11.5% for large institutions and one policy rate cut of 25bp (stable at a low level). Research from Liu and Spiegel shows that a cut in RRR enhances credit extension by raising on-balance sheet banking activities. This is crucial at a time when regulation has been tightened for off-balance sheet activities.

On top of these traditional measures, the PBoC/CBRC have adopted a series of new measures to boost bank's capital (perpetual bonds) and further usage of credit target to accelerate capital real-

location to the private sector. As shadow bankers are more constrained, banks face higher credit risk (NPLs up), resources are more limited and the private sector and especially SMEs struggle to access financing. Chinese authorities have taken measures to free up liquidity (through RRR cuts and liquidity injections), provide more incentives to banks to lend to the private sector (targeted medium term lending facility e.g.) and boost alternative sources of funding (corporates bonds with credit risk mitigation warrants; and equity market with temporary supportive interventions).

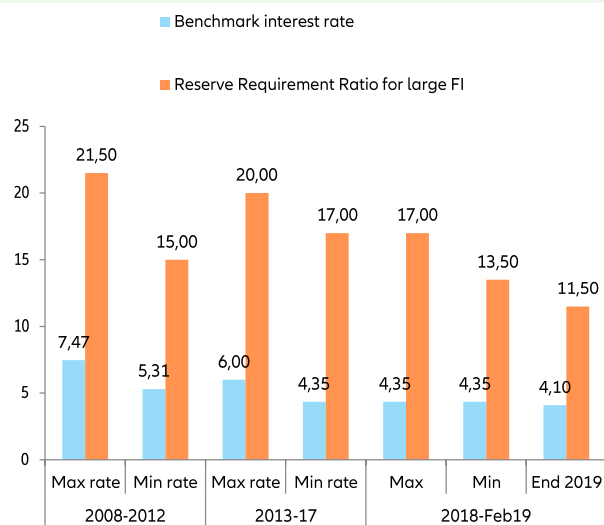
There are already signs that these policies are at work. The outstanding of total social financing, a measure that includes on-balance and off-balance sheet forms of financing to the economy, edged up slightly in January (+10.4% after +9.8% in December), supported by a continued increase in on-balance sheet lending. Off-balance sheet lending remained weak, dragged by tight regulation. Looking at bank surveys, domestic credit to the private sector rose to 13% y/y (compared to an average of 12.6% in December 2018). Good news also came from the financial markets, where we finally started to see a rise of risk appetite: the Shanghai stock market rose by 18% between end 2018 and end Feb 2019. On the fiscal side, the speed-up of infrastructure project approvals

led to a recovery of infrastructure investment: After slowing to +3.3% YTD y/y in Jan-September, nominal infrastructure investment recovered to +3.8% YTD y/y in Jan-December. The impact of these measures should boost capital markets further with: an upside trend for the equity market this year, low government yield (3% end 2019, after 3.3% end 2018 for the 10 year yield) and a stable RMBUSD exchange rate at 6.7 (after 6.6 last year).

From a risk perspective, the impact will be two-fold:

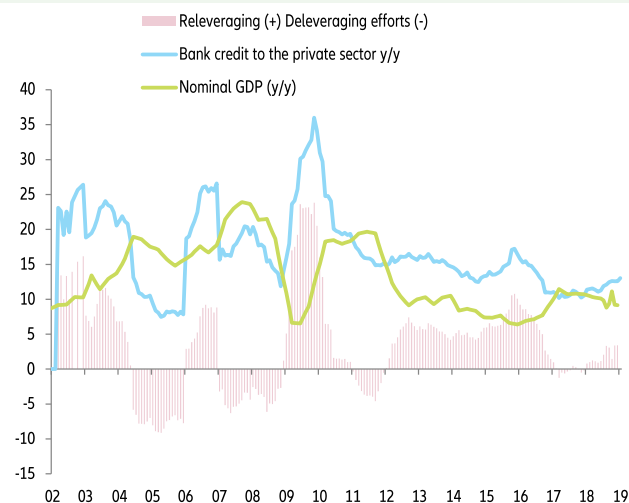
- Increased financial vulnerability. After a period a deleveraging stabilization of credit to private sector growth, we are clearly entering a phase of re-leveraging (see Figure 4). Financial vulnerability will continue to rise as private sector debt increases.
- Elevated credit risk. We expect corporate insolvencies to rise by +20% this year. Corporate profitability will likely be lower due to downward pressures on prices: China's producer price index increased by 0.1% y/y in January 2019, from +0.9 y/y in the previous month. In addition, corporates will struggle to have access to credit from shadow bankers, which provided around 16% of aggregate credit over 2012-2016.

Figure 3: Monetary policy at glance: Benchmark Interest Rate and Reserve Requirement Ratio



Sources: WIND, Allianz Research

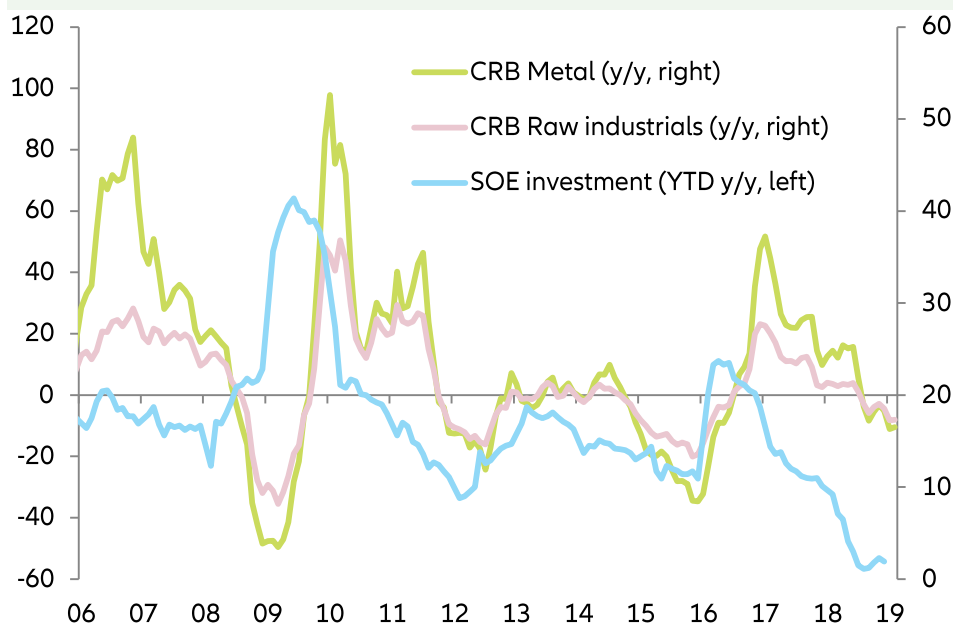
Figure 4: Bank private credit and nominal GDP growth



Sources: IHS, Allianz Research

THE PASS-THROUGH FROM CHINA TO THE WORLD

Figure 5: China's SOE investment and industrial commodities prices indicators



Sources: IHS, Allianz Research

We expect China to contribute 1pp to global economic growth for the fourth consecutive year in 2019 and to give a second wind to global trade.

This special stimulus will particularly benefit foreign consumer goods and services producers, in contrast to previous stimuli when China's SOEs (see Figure 5), the main demand driver behind the demand for industrial commodities, got the lion's share.

The Chinese monetary stimulus should however not have strong pass-through because of the deterioration of the current account balance over the past ten years, but also in the amount of FX detained by the PBOC. Indeed, the current account shrunk to 0.4% GDP in 2018 (from 10% in 2007) and we expect it to be neutral in 2019. FX reserves reduced by -23% between June 2014 and January 2019. In this context, China will likely

keep capital outflows in check through tight regulation and be more selective in its investments. Belt and Road Initiative (BRI) markets will be the main beneficiaries, and ASEAN and Eastern European markets will receive most of 2019 Chinese Foreign Direct Investment outflows.

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