China's Central Economic Work Conference emphasises stimulus

The Central Economic Work Conference laid the framework for the economic growth plan for 2019 emphasising fiscal stimulus via local governments and monetary policy through direct financing to private enterprises and SMEs and is overall in line with our expectations

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More fiscal stimulus via local governments

One of the key takeaways from China's annual Central Economic Work Conference, which ran from Tuesday until Friday, was that fiscal stimulus would be bigger from funds raised by local government's special bonds.

These bonds are not within the local government's fiscal budget, but instead will be similar to the local government financial vehicles however with more transparency. Each local government special bond supports a specific stimulus project.

We expect that the special bonds gross issuance in 2019 will be around CNY 3 trillion, which means net issuance of around CNY 2 trillion in line with our estimate of a total fiscal stimulus of CNY 4 trillion. These funds will support local government infrastructure projects. For example, some cities have revived their plan to have more metro lines.

As this issuance will support metals, energy production and construction activities, we believe the positive impact on GDP will be clear and obvious in 2019.

Fiscal stimulus via tax cuts

We know that salary tax reform comes into effect on 1st January 2019, which means a tax cut for most salary earners. Corporates will enjoy tax cuts through different measures such as export tax rebates and some VAT cuts.

But individuals and corporates may not spend the tax savings during challenging times. Individuals are often more inclined to build a reserve in case of redundancy and corporates will deter their investment plans, and surely that means more savings and more deposits in banks for lending. And aggressive monetary policy could mean loan growth will be higher.

It is therefore very challenging to gauge the effectiveness of tax cuts on GDP. The conference also stated its ambition to increase domestic demand, but we remain sceptical how successful this can be when the economy is growing slower in 2019.

Monetary policy to support private enterprises and SMEs

The word 'prudent' was used for the direction of monetary policy, but we interpret this as 'loosening', which means we will see more easing in the months ahead.

Yesterday, the central bank announced a new monetary policy tool called the 'Targeted Medium Lending Facility' (TMLF), which has an interest rate 15bps lower than the regular Medium Lending Facility. The TMLF are loans provided by banks to private enterprises and SMEs and will be a key policy direction for the central bank.

Under the regular conditions, banks' lending to private enterprises and SMEs should bear a higher interest rate than state-owned enterprises in general. TMLF is obviously a tax on banks to subsidise private enterprises and SMEs. Apart from TMLF, we expect four required reserve ratio cuts of 0.5 to 1 percentage point each, and two 7D reverse repo cut of 5 bps each in 2019.

Loosening monetary policy will, therefore, support the weakest part of the economy, and will prevent a series of defaults in 2019 that have emerged since July 2018.

No mention of the exchange rate

The fact that the exchange rate was not mentioned even once can be seen as a signal from the government that it will allow the USD/CNY to cross the 7.0 handle in 2019. During the trade war, it is difficult to stop the yuan from depreciating and at the time of writing this note, USD/CNY spot was at 6.9064, which isn't far away from 7.0.

Once the trade war truce ends after 90 days, then the yuan will depreciate further, and could easily pass 7.0. Our forecast is 7.30 by the end of 2019.

High quality growth is at the top of the agenda

There are seven agenda items for the 2019 economic plan, which are quite similar to what we expected. These include:

1. Developing higher quality manufacturing, which means high-tech manufacturing
2. Building a stronger domestic market, i.e. the application of 5G.
3. Developing rural economic growth
4. Facilitating regional coordination on economic development
5. Speeding up reforms on State-owned enterprises
6. Opening up markets for foreigners. It mentioned "Belt and Road Initiatives"
7. Improving people's livelihood on pharmacies, housing, pension funds, etc.

We feel that the top agenda item of developing high-quality manufacturing is the key growth engine of the economy in 2019. As we have stated several times, we believe the trade war is, in fact, a technology war.

This makes our GDP forecast of 6.3% for 2019 look good.

Trade war is still the biggest risk

The direct and clear direction on fiscal stimulus and loosening of monetary policy indicates the top risk for the economy is the ongoing trade war with the US, and this is something we agree with.

However, the stimulus and the loosening credits to private enterprises and SMEs means that China is piling up debt again. and will undo its efforts to clean up debts in 2015-2017. Re-leveraging is the answer for 2019 to support pro-growth measures.

People will not realise this risk until the debts mature in 2022 - as the targeted medium lending facilities are three-year loans. But hopefully, by then, the trade war will have ended, and the economy will be strong enough to sustain another round of debt-clean-up.

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