China: Downgrade GDP and yuan forecasts from double hit of global supply and demand

Even though China's coronavirus cases are subsiding, supply chains will remain broken from the suspension of factory operations globally, and as demand from the rest of the world shrinks, dealing a double blow to China's factories and exports. We are downgrading our 1Q GDP forecast to 3.6%. The yuan is likely to weaken to around 7.20 per dollar at end-1Q20

A busy road in Shanghai

More supply chains are broken and global demand will shrink

As China’s coronavirus cases subside, the rest of the world has more confirmed cases, including China’s manufacturing partners in Europe, the rest of Asia and the US. This means supply chains are broken.

Equally important, demand from these economies will shrink substantially when people avoid shopping and gathering at restaurants, just like the experience of China during the past two months. This is another severe hit for China's factories and exporters, as orders should pull back.

Fiscal support is key to recovery

The government has increased its support for smaller companies to survive through the pandemic, and has delivered a lot of fiscal spending to maintain GDP growth.

- Fees and taxes have been cut to ease cash flow pressures of smaller companies, including exporters and manufacturers. This in turn should stabilise employment. With that, the recovery of domestic consumption will be easier, and as the coronavirus subsides more employers will operate and pay wages, allowing consumers to spend as they did previously.
- Fiscal stimulus on 'new investments' has been confirmed by the State Council. This includes speeding up the 5G network infrastructure, building more big-data centres, and transportation networks. These aim to support GDP growth.

These fiscal measures amount to 6% to 6.5% of nominal GDP in 2020, an increase from our initial estimate of around 4%. In addition, the government has continued to ramp up fee and tax cuts. We see the fiscal measures not so much as a package but as more fluid measures, which the government aims to increase further if needed.

Monetary policy is supplementary to fiscal

The People's Bank of China cut the target reserve requirement ratio by 0.5-1.0 percentage points for inclusive finance, and this scheme extends to more banks. This will help affected smaller companies directly by both extending their existing loan repayments and obtaining new loans to ease cash flows. But the degree of help depends on how the banks assess the credit risks of small firms versus the interest savings from participating in the inclusive finance scheme.

The chance of another rate cut in March has been reduced as the targeted RRR cut should put enough downward pressure on interest rates in the month, and banks' interest rates for inclusive finance should be lower than lending to bigger corporates. That is, the targeted RRR cut should serve the purpose.

We don't rule out a policy rate cut of 10 basis points in April for the 7D reverse repo, 1Y Medium Lending Facility and 1Y Loan Prime Rate if the spread of the coronavirus globally does not fall substantially.

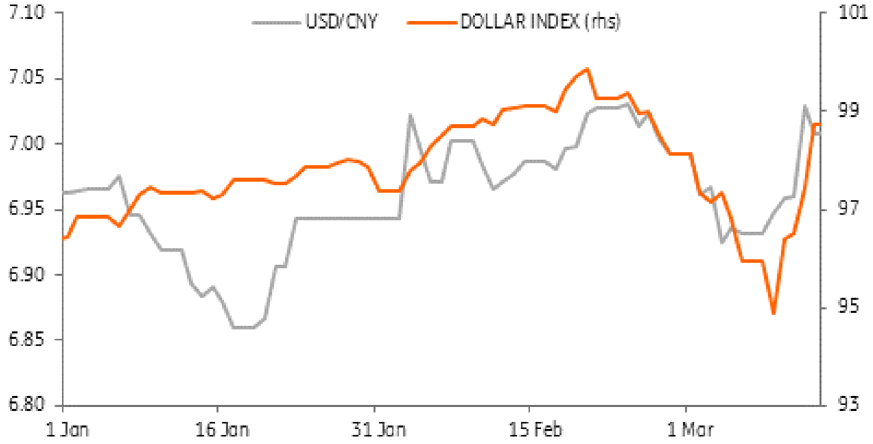
USD/CNY and USD/CNH likely to cross 7.0

The yuan has been more stable than the dollar during the outbreak of the coronavirus.

But this should not stop the USD/CNY and USD/CNH crossing 7.0. The dollar is expected to strengthen further from the increasing flight to safety demand for US Treasuries as the number of confirmed Covid-19 cases increases.

We revise our forecasts for USD/CNY and USD/CNH to 7.20, 7.25, 7.00 and 6.90 for the end of each quarter from 1Q to 4Q in 2020.

Yuan to weaken further against the dollar during the global flight to safety for US Treasuries



Source: ING, Bloomberg

Broken global supply chain and sudden shrinkage in demand a double hit to China

With the broken global supply chain, there will be an abrupt shrinkage in global demand during the pandemic. Even though there is fiscal spending to support GDP growth, we further downgrade China's 1Q20 GDP growth to 3.6% from our prior forecast of 4.4% published in early March. We also reduce our full year 2020 forecast to 4.8% from our previous 5.2%.