China: Pro-growth policies signal headwinds remain

China set its GDP growth target for this year at 6.0% to 6.5%, lower than last year's target. Pro-growth measures, despite positive progress in US-China trade talks, suggest to us that either China doesn't have full confidence in a trade truce or that the damages from the trade conflict cannot easily be undone

Source: Shutterstock

GDP growth target of 6% to 6.5% worries the market

Although the market probably should have expected a lower growth target, investors reacted negatively when the 6% to 6.5% range for 2019 was announced. Our forecast is 6.3%.

We think it is more important to understand how the Chinese government plans to support the economy to achieve this growth rate, especially in terms of providing job security.

6.0% - 6.5%

GDP growth target 2019

The government emphasised fiscal stimulus more than monetary easing

The fiscal deficit target for this year is 2.8%, higher than 2.6% a year ago. And we know that the actual fiscal deficit is around 0.5 percentage points higher than the planned target.

- There will be CNY 2 trillion of cuts in taxes and fees. Among these, cuts in VAT for various sectors are eye-catching. For example, VAT has been reduced to 13% from 16% for the manufacturing sector, and to 9% from 10% for the transportation and construction sectors.
- There will also be CNY 2.15 trillion of local government special bonds to support infrastructure projects.
- We have estimated that the economy needs CNY 4 trillion of stimulus to be able to grow at 6.0% to 6.5%.

However, the government work report did not highlight monetary policy as a tool for stimulating the economy, and the description of "prudent" has re-appeared, which suggests there could be debates within the government about how strong credit growth should be.

The good news is that private enterprises will get more credit so that they can keep, or even grow, the number of jobs, as the target for such loan growth is set at over 30%.

3%

VAT cut for manufacturers

from 16% to 13%

+30%

Small business loan growth

The surprise is in the yuan mechanism

We are surprised by the wording of the yuan mechanism, which is very vague.

As we discussed in a previous note, the main focus of this government work report, for us, was the description of the yuan's trend, as this is one of the topics to be resolved before any trade agreement between China and the US. The US has already requested that China keep the yuan stable.

The wording of the yuan mechanism in this government work report simply repeats the 2016 version, citing plans to "improve the exchange rate mechanism and maintain the basic stability of the RMB exchange rate at a reasonable and balanced level".

Since 2016, the USD/CNY has closely followed the dollar index. The repetition of the 2016 wording on the exchange rate mechanism could mean that USD/CNY will continue to follow the dollar index. Our forecast of USD/CNY is 6.75 by the end of 2019.

We will have to see if the US accepts this vague exchange rate mechanism as an answer to its request not to depreciate the yuan.

> *"The wording of the yuan mechanism in this government work report repeats the 2016 version.... Since 2016, the USD/CNY has closely followed the dollar index."*

Do pro-growth measures mean the economy will be just fine?

China is again relying on infrastructure investments and construction activities to help its manufacturing sectors. We believe that with so many pro-growth measures, the economy can grow within the target range of 6.0% to 6.5%.

Data related to the manufacturing sector and investments will improve gradually, particularly manufacturing PMIs, industrial profits, raw material prices and fixed asset investments of construction, property developments and infrastructure.

But if consumers worry and job security and wage growth continue to fall, consumption will take a hit. We will put more weight on consumption growth to gauge this year's economic growth.

The fact that China needs such sizeable fiscal stimulus to support economic growth suggests that the headwinds are significant and will not go away easily. The Chinese government is presumably cautious about the development of the trade war. And businesses are also likely to be careful about making big investment decisions until it is very clear that business risks from the trade war have ended.

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