

## China: Yuan set to weaken further next year

President Xi emphasised the economy has been hit by external forces and needs measures to support growth. At the same time, the National Council announced a stimulus package. While the amount has not been disclosed, we estimate it to be CNY9 to 10 trillion. We also weaken our yuan forecasts for 2019



### Xi highlights external forces as drag on economy

President Xi emphasised that external forces have hit the economy, which we believe is a reference to the bilateral trade dispute between China and the US. The nature of the trade war has become clearer over time: as a technology war (the US avoids using China's technology, and avoids technology being transferred to China), an investment war (US imposes penalties on Chinese tech company in the US), and an additional geopolitical element (naval standoff in South China Sea and military sales to Taiwan).

Xi's message implies that the chance of getting a positive result from trade negotiations between China and the US is small. That means that the possibility of the trade war escalating and continuing to drag on the Chinese economy is high.

## Relying on infrastructure, again

This explains why, on the same day as Xi's comment, the National Council announced a stimulus package, most of which comprises infrastructure investment.

Infrastructure should be the fastest way to boost economic growth. We categorise the package into three parts:

1. Hardware investments, which include railway, highway, waterway, airports. This would increase the demand for building materials and labour. So even if the housing market continues to cool, building materials and labour could be diverted to infrastructure construction projects. These projects should have positive cash flow after completion, so the burden on fiscal support should be temporary. This seems to comfort the market in terms of the risk to local government finances.
2. Environmental protection. These projects include water management and pollution controls. We would describe these as the "software of the economy." It is uncertain to us how local governments could generate a future stream of revenue from these projects aimed at a clearer sky and cleaner air. But they are goals worth pursuing anyway.
3. Social benefits in the form of improving rural living standards, medical care and schooling. These again are software of an economy. The benefits are a higher quality future labour force. But it is difficult to measure if local governments will overspend.

## A lot of money needed but how much?

The stimulus package does not mention a monetary amount. We expect that it would be comparable to the 2009 package, but as GDP has more than doubled, the stimulus amount will also increase. We believe the total package will be around CNY 9 to 10 trillion.

The National Council requests that local governments issue bonds to finance the stimulus, and asks banks to lend to these projects. We expect some local governments will once again depend on local government financial vehicles to fund some of the projects. And we expect banks will lend to projects that are operated by state-owned enterprises. We believe that private enterprises may be involved in some of the smaller projects.

This announcement could increase the risk of higher non-performing loans or defaults in the future. But the authorities clearly believe that the more pressing need is for immediate stimulus now.

### Revising yuan weaker in 2019

The government requests a pool of future infrastructure projects. This means the government is prepared to dig in for a longer-term fight in the trade war with the US. This also implies that the Chinese government might depend on investment to support the economy for a longer time.

Our GDP forecasts are still intact as we consider the government's fiscal stimulus sufficient to provide support as trade tension escalates. We project GDP growth at 6.3%YoY in 4Q18, 6.2%YoY in 1H19, and 6.3%YoY in 2H19.

But we do expect USDCNY to continue to weaken if the trade war continues. We are keeping our forecast of USDCNY and USDCNH at 7.0 by end of 2018, but have weakened the yuan

pairs to 7.30 by end of 2019 (previously at 6.50).