# Stability, not growth, is China's domestic focus amid the trade war

Weak Chinese exports are hitting the country's supply chains. With no deal in sight in the trade war, we're expecting the Chinese government to step up fiscal stimulus. But it's stability they're after rather than increased growth

China's President, Xi Jinping with US President, Donald Trump in Beijing, 2017

## No trade deal in sight

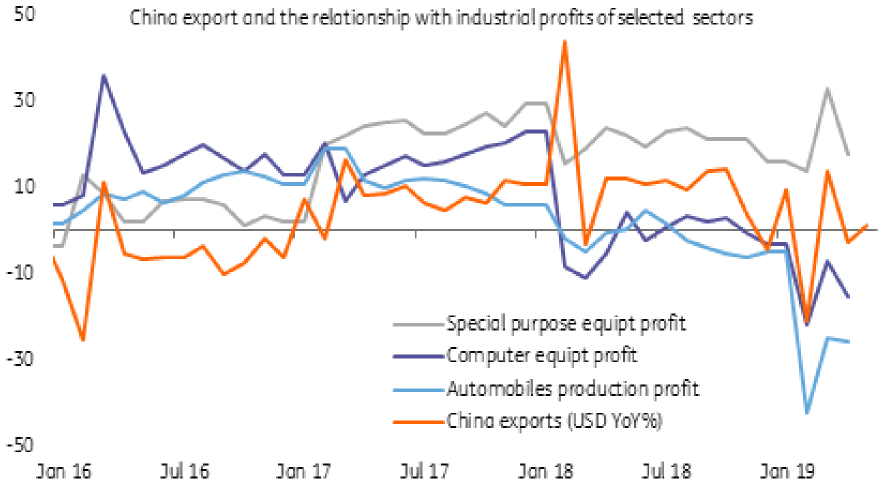
Even if President Xi and President Trump do meet on the sidelines of the G20 Osaka meeting later this month, a trade deal looks almost impossible in its current form. China is not going to capitulate under US pressure to change its laws (it's a matter of sovereignty) and the US will not accept this resistance. A meeting could take place, but we expect it will not undo the current deadlock. A good outcome would be a commitment to resume talks and result in no changes in tariffs. A bad outcome would be an immediate 25% increase in tariffs on China's remaining (some USD300bn) of goods.

## How exports are hurting China's supply chain

Recent data releases highlight the deterioration in Chinese economic activity stemming from damage to export supply chains. This isn't just the effect of US tariffs but also reflects the technology war.

China exports are directly related to the profit growth of computer and special purpose equipment as these are industries highly related to export sales. It's a similar story for automobile production because of the logistic demand and also because exports affect the income of many industries that in turn affect consumption and, of course, vehicular demand itself.

## China exports and the relationship with selected industries' profit




Source: ING, Bloomberg

Moreover, China's exports of smart devices and related products to the US is highly correlated to its domestic production of industrial robots. If China faces an intensifying technology war that continues to ban the use of Chinese made smart devices and 5G equipment, other industries in the supply chain, such as industrial robot manufacturing, in China will also be affected.

## A strong relationship: Chinese exports of smart devices to the US and its production of industrial robots


Source: ING, Bloomberg, CEIC

Expectations for a quick end to either of these conflicts has all but evaporated, and this is weighing on investment intentions, not only in China but around the world. One of the consequences of globalisation is that companies are more interlinked, so problems with China's value chains can cause problems in companies in other countries.

## Activity data in May shows a weakening economy

Industrial production and fixed asset investments grew slower than expected in May. Retail sales came in as expected, but that's not necessarily a good sign either.

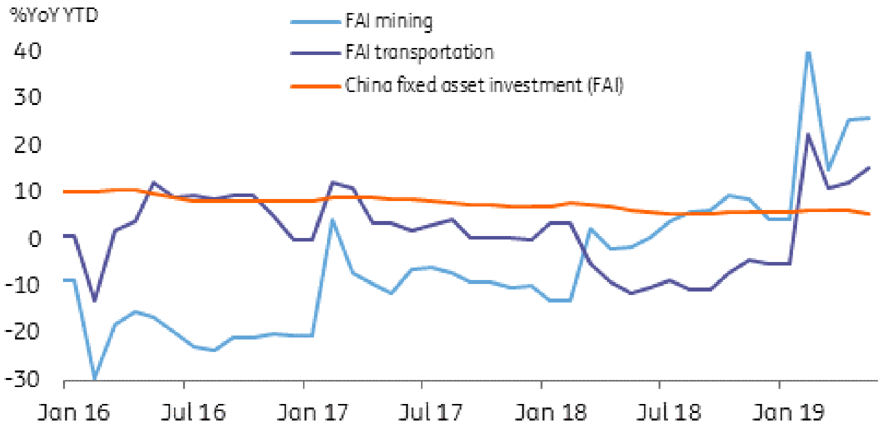
Manufacturing activities, as reflected by industrial production, grew 5.0%YoY in May from 5.4% a month ago. In some ways, this looks bad as it's even lower to the growth lows we saw in the global financial crisis in 2009-2009. But, perhaps, it looks more reasonable when you consider that exporters have expected fewer orders from exports in the coming months due to tariffs imposed on Chinese goods and the ban on using Chinese technology equipment in some countries. Industrial robot production shrank by 9.3%YoY in May after a 7.3% contraction in April.

> *The leverage effect on the economy from fiscal and monetary stimulus should be adequate to keep GDP growth at 6.3% in 2019*

Retail sales grew 8.1%YoY YTD in May from 8.0% in April. Consumption during the long holiday supported sales. But this could be a sign that Chinese spenders stayed at home during the long holiday instead of taking leisure trips to spend in other economies. Consumers are cautious when spending. We keep monitoring items that are more volatile than others during bad times. Spending on automobiles and clothing continued to be very weak at -2.0%YoY YTD and 2.6%YoY YTD. Vehicular sales have been particularly weak due to structural changes in the market caused by technology disruption and this intensifies the current weak economic cycle. Weakening exports and a slowing manufacturing sector could derail jobs and wage growth which could well be reflected in softer retail sales data.

Investment growth was slow at 5.6%YoY YTD from 6.1%. Infrastructure related investments continued to be the sole engine of investment growth, which is the result of fiscal stimulus. Mining investment and transportation investment grew 26.1% YoY YTD and 15.4% YoY YTD in May from 25.7% and 12.3% a month ago, respectively.

## Mining and transportation investments




Source: ING, Bloomberg

## RRR and interest rate cuts expected to support a doubling of fiscal stimulus

China is likely to take pre-emptive action that will help shield the economy from the threat of further tariffs currently being made by US President Trump. We expect fiscal stimulus, mainly through infrastructure investments, to increase from CNY2 trillion to CNY4 trillion in 2019.

> *Our estimate on the size of the fiscal stimulus is more conservative than some other financial houses*

Our estimate on the size of the fiscal stimulus is more conservative than some other financial houses. One prominent pundit sees a stimulus as large as CNY7.2 trillion. We think that's overdone as we believe that although China wants to maintain a growth rate of 6.0% to 6.5%, it does not want to create another wave of over-supply production problems, similar to those after the 2009 crisis. We anticipate that the Chinese government will step up fiscal stimulus more aggressively only if and when the economy is battered seriously by the trade and technology war. That isn't happening yet. It could do, and if it does, then they can expand stimulus further. But it is too early to make such call.

During this trade and technology war, the Chinese government indeed looks for quality growth as much as quantitative growth.

- One indicator to support this view is that shadow banking activities have shrunk since the beginning of the year. Trust loans, entrusted loans and undiscounted bills fell 6.7%YoY YTD, 10.4%YoY YTD and 14%YoY YTD in May, respectively. This is the result of small private companies being able to borrow from banks so they don't need to get loans from the shadow banking sector. Though banks take on more risks it is better than having those risks piling into such a non-transparent part of the economy.
- Another indicator of quality growth is that infrastructure investments nowadays are funded by local government special bonds. Each bond funds one investment project. This makes

the use of fiscal money more visible than back in 2009 when fiscal money could get into speculation property easily and hence created ghost towns that did not have any residents.

If infrastructure investment spending is going to be doubled, the economy needs extra liquidity. We expect the PBoC to increase liquidity by cutting the targeted reserve required ratio (RRR) 0.5 percentage points in 3Q and 4Q respectively. If extra liquidity is needed, the targeted RRR cuts could become broad based. We also believe the PBoC will cut the 7D policy interest rate, currently at 2.55%, by 5 basis points in 3Q and 4Q respectively to 2.45% to drive interest rate lower. This combination of monetary easing policies should keep 7D repo around 2.5%.

The leverage effect on the economy from fiscal and monetary stimulus should be sufficient to keep GDP growth at 6.3% in 2019, which is in the middle of the official target range of 6.0% to 6.5%.

## What about the currency?

First of all, monetary easing in China has no correlation with the currency. As such we don't expect yuan depreciation from further monetary easing.

However, though we agree that USDCNY at 7.0 is just a “round number”, it is too late for the PBoC to change market concerns that USDCNY crossing 7 will create chaos. At the end of 2016 and in October 2018, the USD/CNY didn't cross the 7 handle. The perception in the market that USDCNY 7.0 is a big deal has been consolidated by the PBoC.

Currently the Chinese economy is facing headwinds from the trade and technology war. It is even more difficult for the PBoC to allow the USDCNY to cross 7.

It is equally difficult for the yuan to appreciate as that will create an impression that the PBoC is appeasing the US administration.

We therefore forecast USDCNY at 6.90, 6.95 and 6.90 by the end of 2Q, 3Q and 4Q19.

## USDCNY: We're close to 7, but unlikely to pass it


Source: ING, Bloomberg

As of 14th June 2019

| China | 2018 | 1Q19 | 2Q19F | 3Q19F | 4Q19F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|
| Real GDP (%YoY) | 6.6 | 6.4 | 6.2 | 6.3 | 6.3 | **6.3** | **6.2** |
| CPI (%YoY) | 2.1 | 1.8 | 2.5 | 2.6 | 2.6 | **2.4** | **2.5** |
| PBoC 7D reverse repo rate (%, eop) | 2.55 | 2.55 | 2.55 | 2.50 | 2.45 | **2.45** | **2.40** |
| 10Y govt. bond yield (%, eop) | 3.30 | 3.07 | 3.20 | 3.00 | 2.95 | **2.95** | **2.85** |
| CNY per USD (eop) | 6.88 | 6.71 | 6.90 | 6.95 | 6.90 | **6.90** | **6.75** |

Source: ING

## Author

**Iris Pang**
Chief Economist, Greater China
iris.pang@asia.ing.com