ABN·AMRO

China Watch

Group Economics
Emerging Markets Research

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Growth slows after tightening

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- **Markets have turned nervous again over China over the past weeks**
- **This reflects further signs of an economic slowdown, after a strong Q1 …**
- **… and targeted tightening aimed at reducing riskier forms of leverage**
- **We expect 'balanced approach' to continue, no full-stop tightening**
- **We still believe China's economy will slow gradually, not collapse**
- **Import growth to slow faster than GDP growth this year**

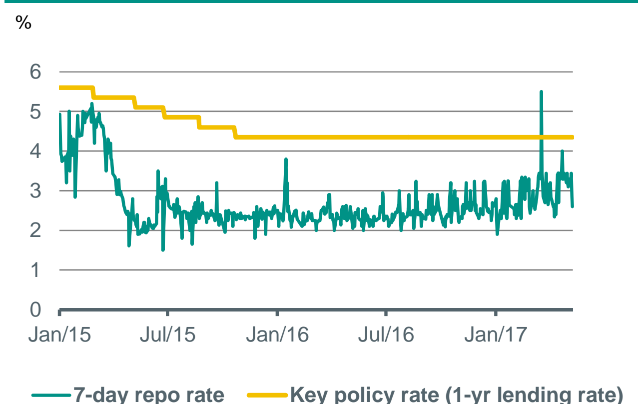
Markets have turned nervous again over China …

Over the past weeks, we have seen a return of market jitters surrounding China. After a strong rally in late 2016 and early 2017, Chinese metal prices have corrected sharply downwards. Moreover, the Chinese stock market underperformed, losing almost 7% since mid April compared to further gains in most stock markets elsewhere. In our view, the return of these market jitters relate to the stepping up of Beijing's targeted tightening policies and fears that these will result in an economic slowdown. We should add that these financial market movements are less severe than the moves seen in 2015/early 2016 so far. In 2015 and early 2016 unexpected and poorly communicated shifts in China's exchange rate policy and a quite sharp CNY depreciation versus USD also added to market turmoil. By contrast, currently the yuan is quite stable versus the US dollar. Besides, while signs that the Chinese economy will slow have increased, economic performance in the first quarter was better than expected.

Market jitters return, shown by stock and metal markets

Source: Thomson Reuters Datastream

Interbank rates have risen, but remain volatile



Source: Bloomberg, Thomson Reuters Datastream

… as President Xi Jinping himself reiterates the drive for financial deleveraging …

Beijing has stepped up targeted tightening policies aimed to prevent asset bubbles and to contain financial risk, by reducing risky leveraged position-taking and shadow banking and by cooling overall credit growth. These policies have been on the agenda already since the autumn of 2016. However, after the stronger than expected economic performance in Q1 (with growth peaking at 6.9% yoy) and signs that the curtailment of shadow banking had proceeded less than expected, the authorities have intensified their communication and rolled out even more measures. And this policy is backed at the highest political level. At the Politburo meeting in late April, President Xi Jinping called for ‘prevention and control of financial risks’. Xi mentioned six core aspects of maintaining financial stability: deepening financial reform, strengthening regulatory supervision, tackling hidden risks and control leverage ratio, facilitating financial sector support for the real economy, improving capabilities of financial leaders and improving the regulatory system within the CCP.

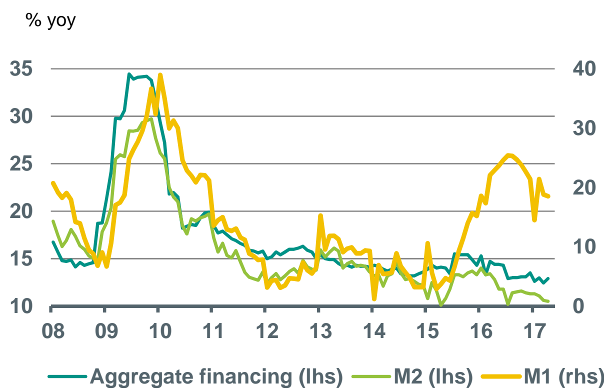
… and regulators present a range of targeted tightening measures …

The ‘tough language’ of China’s leader coincides with a wide range of measures taken by the main regulators. The central bank (PBoC) for instance hiked interest rates on its open market and lending facilities in recent months, steering interbank rates higher. Meanwhile, the banking supervisor (CBRC) tightened regulation for lending to the property sector and raised the risk weights for private ABS. Mortgage lending rates have also been raised over the past weeks. In early May, the Ministry of Finance, the National Development and Reform Committee and four other government departments tightened regulation for local government financing. A big data monitoring system will be introduced to monitor local government spending and financing through of so-called *Local Government Financing Vehicles* (LGFVs). The insurance and securities regulators have also presented tighter rules. Following these and other tightening measures, there have been more signs of banks being faced with funding pressures. Property sales volume have dropped in April. There has also been a decline in issuance of trust, bonds and wealth management products (WMPs). This was illustrated by the drop in aggregate financing seen in April., although this drop was less than expected while new bank loans continued to expand.

Balanced approach to continue, no full-stop tightening

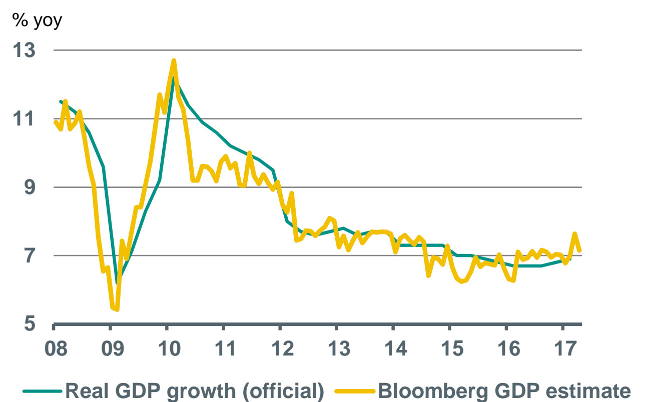
We expect the PBoC to continue with these targeted tightening policies. Still, we think that the authorities will not pull the monetary brakes too aggressively, as that could put the hard-won macroeconomic stability at risk. The tightening policies are aimed at addressing the riskier parts of the financial system in order to contain credit growth and prevent bubbles, but not to kill all credit that is supportive to the real economy. This balanced approach is also illustrated by the fact that the PBoC continues with adding liquidity to the banking system if circumstances ask for that. For instance last Friday, the PBoC conducted CNY 459bn (around USD 67bn) through its Medium Term Lending Facility against unchanged yields. There are also signs that the authorities are carefully monitoring interbank and lending rates and are recently softening their approach following weaker data. All in all, also given the fact that headline inflation remains low (at 1.2% yoy in April), we still expect the PBoC to keep the one-year benchmark rate steady at 4.35% as to mitigate the risks of higher interest rates for debt-burdened SOEs. The authorities are also prepared to add fiscal stimulus if needed, with for instance President Xi committing an additional USD 124bn in supporting the One Belt One Road initiative in the run-up to the forum held in Beijing this week.

Monetary aggregates show gradual slowdown since 2016



Source: Thomson Reuters Datastream

Bloomberg GDP estimate falls back from March spike

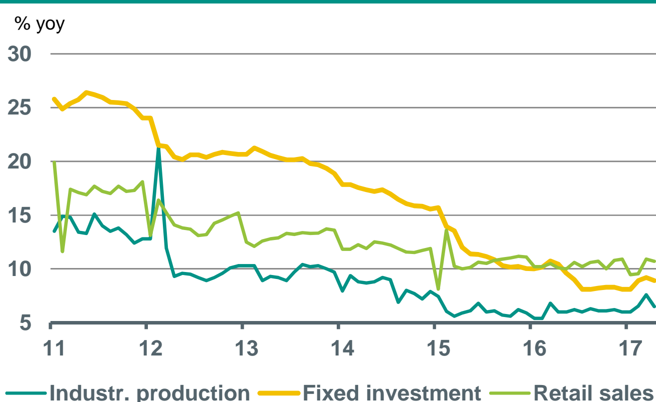


Source: Bloomberg

… and China's economy to slow gradually, not collapse

In our previous China Watch, we concluded that growth had likely peaked in Q1 and is expected to resume a gradual slowdown in the course of this year. And indeed, PMI data weakened in April and car production and sales fell significantly reflecting a tax increase on smaller cars. Industrial production growth fell back to 6.5% yoy, confirming that last month's number (7.6%) was an outlier, but remains higher than the 2016 average (6%). Fixed investment and retail sales slowed to 8.9% yoy and 10.7% yoy in April (March: 9.2% and 10.9%), but also remain relatively strong. After jumping to a 3.5 year high of 7.6% yoy in March, Bloomberg's monthly GDP estimate fell back to 7.15% yoy in April. This is still above the official growth rate in Q1 of 6.9% yoy. All in all, we still expect a gradual slowdown and not a collapse. This reflects Beijing's balanced approach and the authorities' desire to preserve macro-economic and financial stability in this politically important year. We expect annual growth to slow from 6.7% in 2016 to (around) 6.5% in 2017 and (around) 6.0% in 2018.

Monthly activity data slow from strong March levels



Source: Thomson Reuters Datastream

Annual growth imports and exports slows

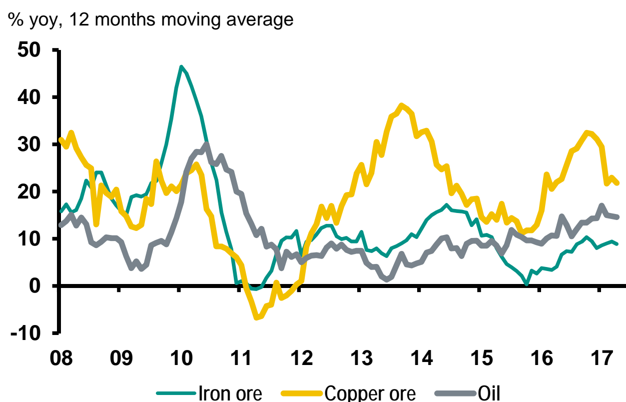
Source: Thomson Reuters Datastream

Annual growth imports and export slow in April after 'bumper Q1'

China's foreign trade data added further proof to our view that growth has likely peaked in Q1. Goods imports rose by 11.9% yoy in USD value terms in April, down from an average of 24% yoy in Q1). This slowdown is more or less in line with our expectations and partly reflects strong base effects and a logical cyclical correction from a very strong Q1. Import

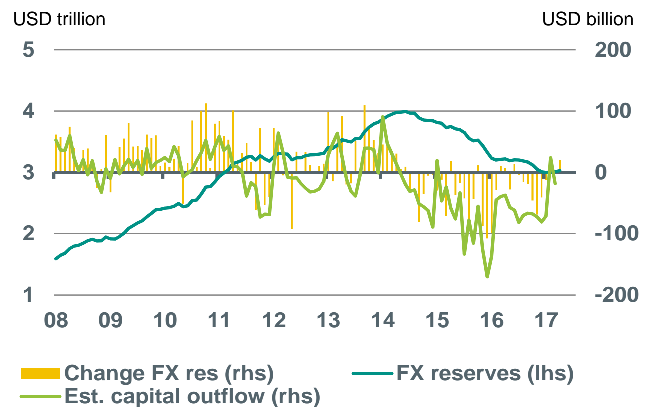
volumes of key commodities such as iron ore, oil and copper ore fell in monthly terms, although average annual growth over the past twelve months is still clearly in positive territory. Looking forward, we expect import growth to slow further in the course of this year, reflecting the fading of base effects and the expected slowdown in domestic demand (in fact, we expect import growth to slow faster than real GDP growth during 2017). Meanwhile, export growth in USD terms (8.0% yoy in April) also slowed more than expected, although remaining clearly in positive territory after an extended period of negative annual growth in 2015/16. This is in line with the PMI export subindices dropping by around 3 points in the past few months. We think that the risk of a damaging trade war between China and the US has fallen, as China has not been labelled a currency manipulator and the US needs China to keep North Korea in check. In fact, the US and China published a joint statement last week on the initial results of the 100 day action plan launched during the Trump-Xi summit in April.

Commodity imports slow, but still robust in annual



Source: Thomson Reuters Datastream

FX reserves show further signs of stabilisation



Source: Bloomberg, Thomson Reuters Datastream

FX reserves show further signs of stabilisation

Thanks to Beijing's tightening of capital restrictions, the stabilisation of the USD-CNY rate, the PBoC's aims to drive market interest rates higher and an improved risk sentiment, capital outflows have abated and FX reserves have firmed. FX reserves have fallen by around 25% since the June 2014 peak to just below USD 3 trn last January, but have since risen for three months in a row. The monthly increase rose to USD 20.5 bn in April. According to Bloomberg estimates, China was faced with net capital outflows again in March (following net inflows in February for the first time in two years). However, at USD 18bn these were far below the levels seen mostly throughout 2015 and 2016. While we cannot exclude that periods with rising outflows will return, for instance related to the Fed rate hike cycle or China growth concerns, we still expect the authorities to remain able to keep the situation under control and prevent a massive CNY depreciation versus USD. Measures taken to support capital inflows (e.g. opening onshore FX derivative markets to foreign investors, opening interbank bond market) and the gradual introduction of China in global bond and equity benchmarks will also help keeping net outflows in check. Also here we expect the authorities to follow a balanced approach, weighing the benefits of capital account liberalisation with those of preserving macro-financial stability.

Key forecasts for the economy of China

	2014	2015	2016e	2017e	2018e
GDP (% yoy)	7.3	6.9	6.7	6.5	6.0
CPI inflation (% yoy)	2.1	1.5	2.0	2.0	2.5
Budget balance (% GDP)	-1.8	-3.4	-4.0	-4.0	-4.0
Government debt (% GDP)	15	15	16	19	22
Current account (% GDP)	2.6	2.9	1.5	2.0	2.0
Gross fixed investment (% GDP)	44.8	43.1	42.0	42.2	40.4
Gross national savings (% GDP)	49.4	47.7	45.2	44.7	43.2
USD/CNY (eop)	6.1	6.5	7.0	7.0	7.1
EUR/CNY (eop)	7.4	7.1	7.3	7.7	8.5

Economic growth, budget balance, current account balance for 2017 and 2018 are rounded figures
Source: EIU, ABN AMRO Group Economics

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