China, Peoples' Republic

SEB GROUP – COUNTRY RISK ANALYSIS **November 13, 2019**

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Growth is now losing momentum faster than expected at the beginning of the year not only because of trade tensions with the US, but also as a result of secular decline. That could be further undermined should the situation in Hong Kong provoke Beijing to send in its own police or military forces.

Summary and conclusions

Trailing growth: After a string of good years strong growth seems to be abating. In 2018, the economy continued to expand at a reasonable pace, dropping only slightly to 6,6%. For the current year, observers have become increasingly cautious seeing activity trailing further to 6,1%, following in the same path to 5,8% in 2020. Some part of the slowdown can be referred to the ongoing trade war between the US and China, not only the direct effects of reduced trade but also the negative effect on investor sentiment. That dovetails with the decline in economic expectations as policymakers struggle with sequencing reforms which are paramount in the longer term but could have adverse effects on activity in the short to medium term.

Policy stimuli: New reform policies had lasted no longer than a year when the first signs of unexpected weakening turned up in mid-2018, somewhat before the US had announced its first sweeping tariff hikes. That prompted a rethink among policymakers and the budget for 2019 was made up with an additional fiscal stimulus of almost 1,7%/GDP with the intent to cushion any further deceleration. This raised the fiscal deficit for the current year to 12,7%/GDP according to IMF calculations – the so-called "augmented deficit" -- which is several times the multiple of the official estimate. The latter excludes new local government debt contracted annually through special purpose vehicles. As a result, total government "augmented debt" is set to approach 80%/GDP, high for a low-middle income emerging market country.

Shadow banks down, shadowy banks up: Key to the first reform efforts was to get the burgeoning shadow bank sector under control. Regular banks were ordered to take back loans placed with wealth management companies and similar subsidiaries, including many shady loans. That led to a rise in NPLs, in particular among the myriad of smaller and medium-sized banking institutions which have grown rapidly to a total of 25% of the whole banking system in terms of assets. Reports have pointed out that the Peoples' Bank of China --PBoC (central bank), is viewing this development with growing concerns.

Uncertain outlook: There is no denying that China is no longer the preeminent economic star-performer although one still provided with a war chest of financial resources – including large foreign reserves – helping to cushion any down-turn. A turning point, however, could be events that cross Beijing's political ambitions. Turmoil in Hong Kong could prove such a stumbling block should China intervene with force and trigger US sanctions with spill-over effects on business around the world. The rating agencies have so far remained quiet on the Chinese sovereign. As regards commercial businesses, credit worthiness could deteriorate more rapidly.

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Recent economic developments

Trailing growth: After a string of good years dynamic growth seems to be abating. 2018 showed reasonably robust economic expansion, dropping only slightly to 6,6%. For the current year, forecasts have become increasingly cautious. Forecasts at the beginning of the year pointed to a continued drop of about the same magnitude although slightly more notable than in recent years, but still limited to a fall of 0,4pp to 6,2% for the whole year with a further decline to 6% from 2020. But as the trade war intensified those projections have given way to more downbeat scenarios. Those prompted the government to recalibrate policies reducing the previous focus on financial and economic rebalancing. That turn-about has now started to work. Infrastructure projects at the local government level have been given new impetus and a deeper fall in activity has been arrested. Most observers are now predicting growth for the current year still to weaken further but only to 6,1%, but then to follow in the same path to 5,8% in 2020, marking a deviation to the downside compared with earlier projections.

Trade war: Some part of the slowdown can be referred to the ongoing trade war between the US and China, but not only the direct effects of reduced trade but as much the effect on investor sentiment. Also weakening consumer demand as seen in falling retail and wholesale numbers down to 5,5% growth in recent months has combined with falling house sales reflecting in part previous government decisions to reduce cash-transfers to households moving from shantytowns into new developments. Car sales have continued the gradual decline that began in late 2018. This together with intensified trade war has hit manufacturing with year-on-year growth in the third quarter slowing to 4.8% from 6.0% in the second quarter. These trends dovetail with the decline in economic expectations as policymakers struggle with sequencing reforms that are paramount in the longer term but could have serious negative effects on activity in the short to medium term.

Strong labor market: The labor market has so far weathered growing headwinds to the Chinese economy pretty well. That is much due to the government stepping up its support to local governments' economic programs and state-owned enterprises (SOEs) leaving unemployment cruising around its long-term trend of some 5%. Consumer prices have also remained well behaved around an annual trend growth of some 2-3% but for a shorter period in recent months when swine fever prompted farmers to cull their live-stock. For some period that raised the price of pork, central to the Chinese diet.

Current account surplus about to disappear: Last year saw China's famous current account surplus shrink to only 0,4%/GDP mostly due to buoyant import demand. For the current year the balance will improve to a surplus of 1,1%/GDP as imports now contracts by 4% while exports hold up in line with last year's outcome, although the many twist and turns in the trade negotiations with the US seem now to cause wild gyrations in monthly export numbers.

Not a watershed: However, the decline in the current account balance is not a watershed by itself but may affect market views on financial stability and the exchange rate as well as the policy approach towards capital account liberalization. That could rock the balance of payments causing larger inflows than outflows. However, so far in recent months they have been more dominated by inflows as China A-shares (of the mainland) have been included in the global MSCI equities index prompting investment funds to buy more of them. Combined with similar for sovereign bonds denominated in local currency on Bloomberg/Barclays Global index such new opportunities are driving expectations of $450 bn. additional inflows over next 2-3 years. In the first half of the current year, by contrast, outflows outpaced inflows to the tune of $80bn, making a small dent in the official foreign reserves of

the Peoples Bank of China (PboC) to $3trillion, still sufficient to cover a year's worth of imports of goods and services.

Less volatile stock markets: Having suffered a persistent 25% decline through the whole year of 2018, more than other EMs, driven in part by margin calls and forced selling related to stock-pledged borrowing, the Shanghai stock market index shot up at the beginning of the current year before starting a new downward path. This time, however, it has been in a rather well-controlled and smooth manner losing some 3-4% on the price thus far in the process in defiance of fears that monetary easing could increase excessive security market activity.

Policies

Policy stimuli: The reform policies had lasted no longer than a year when the first signs of unexpected weakening turned up in mid-2018, somewhat before the US had announced first sweeping tariff hikes. That prompted a rethink among policymakers and the budget for 2019 was made up with fiscal stimuli of almost 1,7%/GDP with the intent to cushion further deceleration of economic activity.

The stimulus package included RMB1.3tr in corporate and personal tax cuts and provisions for households to take advantage of special tax cuts including for education and mortgage interests for first time home buyers. These and other measures raised the fiscal deficit for the current year to 12,7%/GDP according to IMF calculations of the so-called "augmented deficit". This is several times the multiple of the official budget estimate which excludes local government annual borrowing through special purpose vehicles.

Augmented debt: As a result, total government "augmented debt" is about to approach the 80%/GDP level about twice as high as the official number. Even though the "augmented" deficit is not enormous compared with many advanced economies it is still high for a low-middle income emerging market country as China. In addition, the central government has permitted local government to use a part of the 2020 borrowing quota in the current budget period, which is set to raise the quasi-fiscal deficit the one filling the gap between the official budget shortfall and the one calculated by the IMF. The IMF admits that the authorities continue to disagree with the "augmented deficit" concept noting that under the 2014 Budget Law, local governments do not bear any responsibility for the financial obligations of local government financing vehicles – LGFV.

Deficit financing: As in previous years, the financing of this deficit is likely to attract domestic interests, in particular among banks which otherwise may be arm-twisted to buy debt issued by their respective local authorities. Less than 5% of government debt in China is denominated in a foreign currency.

Monetary policy easing: To avoid sending unintentional signals across-the-board about monetary easing, the central bank has left its policy rates unchanged but rather focused on banks' reserve requirements. Last September it cut them for the third time in the current year by 50 bsp (basis points) and by up to 100bsp for some qualifying banks thereby releasing about RMB900bn for additional credit extension. Regular reserve requirement was lowered to 13,5%, a drop of 350bsp since the middle of the decade. Other measures to making more credit available to the economy have included injection of increased liquidity through the medium-term lending facility (MLF), and the creation of a new 'targeted' medium-term lending facility. It has also tweaked its exchange rate guidelines to let the Renminbi respond more efficiently – another de facto monetary easing.

Exchange rate flexibility at a cost: the last 12 months period has seen the Yuan

strengthen and then weaken vis-à-vis the dollar by some 15-20% ending so far in 2019 at about RMB7 per US dollar. That is probably more reflective of dollar movements as the deviation has been less notable against other currencies, dropping only 2,5% in effective terms. As a counter measure against further depreciation, the PboC recently reintroduced the 20% additional reserve requirement on forward exchange rate transactions in effect making such transactions more costly. The interpretation of these latest moves from the PBoC is that any kind of sharp depreciation is unwelcome as it may unintentionally trigger large scale capital outflows notwithstanding existing capital controls. These are regarded as strict by some observers while others remain skeptical as to their effect.

Reforms

While the government has recently re-focused on macroeconomic stabilization and the need to keep steady growth, some structural reforms are still taken place, including

- Revisions to the negative list for foreign investors (FDI inflows)
- A new foreign investment law to take effect in January 2020 including provisions on equal treatment of foreign and domestic firms and prohibiting forced technology transfer,
- Restrictions on foreign ownership in futures, securities and life insurance companies to be lifted by 2020,

SOE reforms: The latest IMF country report notes that treatment of non-viable (*zombie*) central SOEs is largely complete but mainly achieved by mergers with or acquisition by other SOEs and less so through bankruptcy procedures. This has resulted in fewer but larger SOEs but probably also reduced competition.

Recently, it has been observed that SOE debt as a share of total enterprise debt have started to rise sharply, reflecting a shift in bank lending towards SOEs away from private firms. None of this seems to prepare for a fairer and more even playing field between private and state-owned companies.

Banking sector

Following a period of restraint when annual credit extension was brought down from more than 50% several years ago to 7% of last year, banks have once again revived their lending activity which is set to grow by more than 10% in the current year. The consolidation of banks with their off-balance subsidiaries have reduced the shadow banking sector by almost a third to RMB68tr. at the end of last year over the span of just a few years. However, many of these credit products were probably of weak quality – often the reason for banks to keep them out of their own balances in the first place.

As a result of this consolidation the level of non-performing loans (NPL) in banks' loan books have begun to rise again. That trend is most pronounced in the myriad of small and medium-sized banks. Moreover, when taking over shadow banks some analysts indicate that the regular banks often place the acquired loans in categories exempt from same supervisory standards as regular loans, giving rise to concerns that there may be hidden NPLs in banks new balance sheets not yet recognized as such.

Last May, a medium sized bank, *Baoshang Bank*, went bankrupt due to weak asset standards and inability to attract liquidity at a reasonable price. It was subsequently

rescued by the authorities. A few months later two other local banks were rescued this time by two SOEs. Although these institutions were too small to have major contagion effects on the whole system, investors have grown cautious funding such banks which are often much dependent on whole-sale and market funding. Such banks, however, can be dominant in local markets due to internal protectionism provided by local governments often in a quid-pro-quo for buying local government debt. That can be a reason for investors to believe in implicit government guarantees even from the central. However, it can also imply a threat of moral hazard. It is not clear if any of the three banks' creditors have lost money so far.

Political developments

Media reports have surfaced on the internet about opposition gathering at the top echelons of the Chinese Communist Party (CCP) in Beijing against Pr. Xi. In early 2018, he granted himself an exception from the unwritten rule that no party leader should sit for more than two five-years periods. Since then he may have consolidated his position sufficiently for markets to disregard any political risk for a decade going forward. However, rulers and policymakers in Beijing are now buffeted by serious events, not only on the mainland but also in its Special Autonomous Region of Hong Kong. We leave that for our next report "Country risk of Hong Kong" to be issued on these pages soon.

Outlook

Barring major events such as unexpected political developments or a crash in parts of the financial sector, we project the next year and the one thereafter to follow in the path of the current. Growth will continue softening but not enough to set policy makers' alarm bells chiming or threaten with social instability. The latter is likely guaranteed as fiscal and monetary stimuli are kept alive. However, this could be at the cost of a new rise in financial and economic imbalances as reforms are shelved to a less rainy day -- a stance coined "stop-go reform policies".

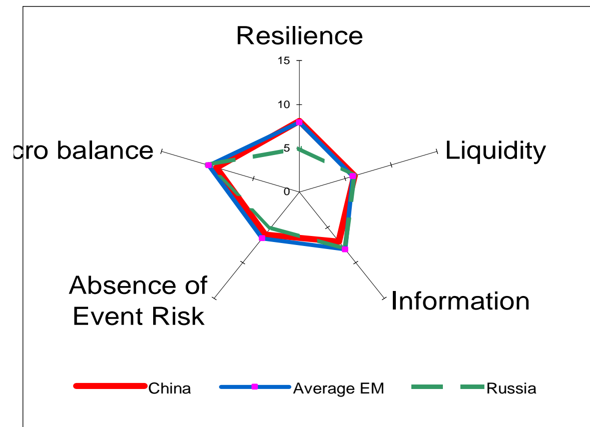
Secular decline: The driving forces behind China's mercurial rise a few decades ago have been relegated to the backseat, including the WTO membership in the early 2000s which ushered in China's integration into the global economy. The other driver was urbanization and internal migration from the country side to higher productivity jobs in the cities. While there are still many rural underemployed working age people, their share of the total workforce is falling gradually to less than 40% by the middle of the next decade. Moreover, their demand on housing and other social benefits for migrating to the cities are growing. While economic growth will drop below the 6% benchmark next year, it could pass the 5% benchmark before the middle of the next decade. Negative growth in the working age population is already subtracting 0,14% from the rate of economic expansion and that is poised to become significantly worse from around 2025.

More policy stimuli will not turn around these trends but rather undermine them. The only measure for arresting the erosion of economic dynamism is accelerated productivity growth. That means

- to eliminate the privileged status of many SOEs in terms of access to credits, protection against competition and implicit guarantees against failure. The present policies of top-down acquisition of zombie SOEs by more viable SOEs is only pushing the envelope to the end of the table.
- It also means getting financial sector developments under firm control by the supervisory authorities and stop using it for quasi fiscal operations.
- Further on it means privatization of many viable SOEs including profitable high-technology SOEs to ensure a level playing field for everyone. .

However, for such measures to raise productivity Beijing may have to accept a new business model which could erode the power base for the current leadership. Judged by the reform measures already put on the table, it is no doubt that many in the bureaucracy and the ruling political class understand these imperatives. However, they may not in equal measure understand also the political imperatives implicit in such a new development model -- an argument underpinned by the attitude of the Chinese leadership to ongoing events in Hong Kong, although that has so far, fortunately, asserted itself only rhetorically. Should the later come out of control and prompt Beijing to send its forces into the city, reactions from other countries, in particular the US, could involve sanctions that would hit also firms from outside US jurisdiction, like the US sanctions regimes against Iran and Russia.

Key ratios	2019
Population (mill.)	1420
GDP/capita ($)	8703
GDP (%chg.)	6.1%
Inflation	2.6%
Trade balance/GDP	1.4%
Reserves/imports (months)	20
Budget balance/GDP*	-4%
Government net debt/GDP*	17%



External ratings:
Fitch: A+
Moody's: A1

Peers:
UAE
Latvia
Spain

Graph: China scores above average on macro balance and liquidity, but is weaker than the average on reliable information. Resilience is about the average of emerging markets but event risk is weaker.

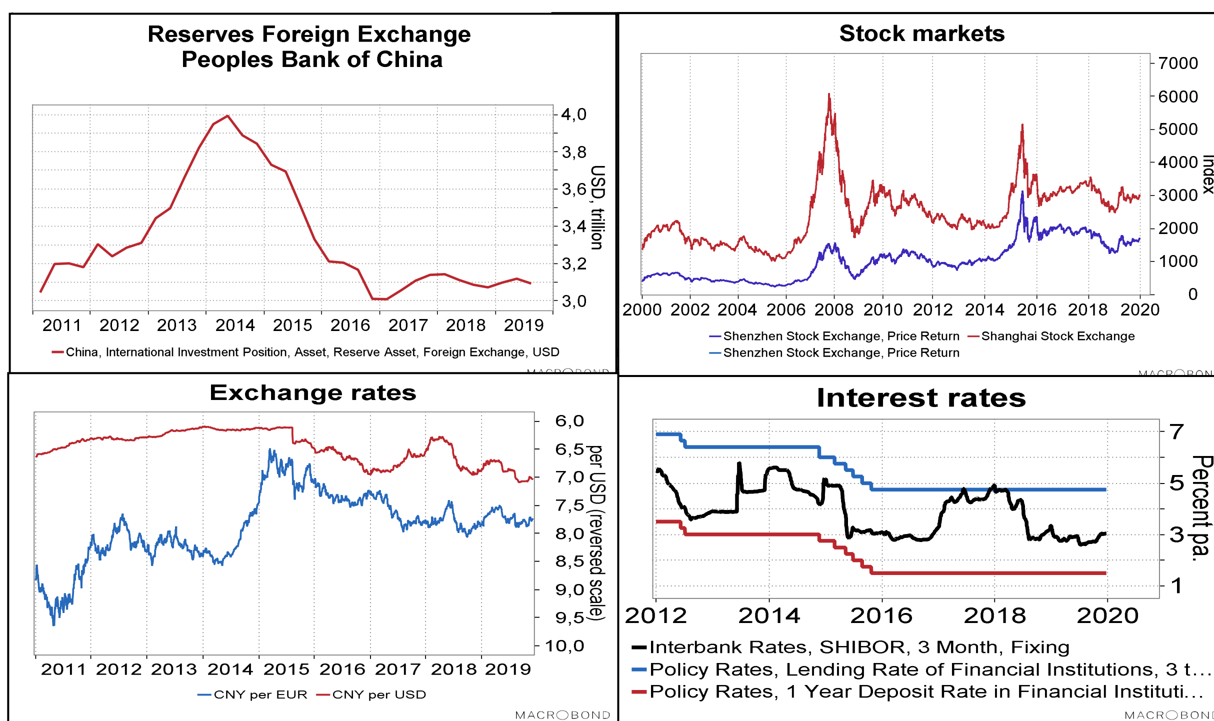
Key data:	2015	2016	2017	2018	2019	2020	2021
GDP (mill.US$)	10960	11181	12265	13700	14450	16243	18129
GDP/capita (US$)	7841	7963	8698	9678	10171	11398	12688
GDP (%chg.)	6,9%	6,7%	6,9%	6,6%	6,1%	5,8%	5,4%
Investments/GDP	46%	46%	45%	44%	43%	43%	42%
Budget balance/GDP*	-3,4%	-3,8%	-3,7%	-3,8%	-3,9%	-4,0%	-3,9%
Govt net debt/GDP*	15%	15%	16%	16%	16%	17%	18%
CPI inflation (%chg.)	1,4%	2,0%	1,5%	2,2%	2,1%	2,4%	2,7%
Money demand (%chg.)	4,4%	6,6%	5,8%	3,8%	4,1%	3,7%	4,5%
Stock prices	3714	3003	3249	2948			
Interest rates	3,8%	3,0%	4,7%	4,0%	3,6%	4,1%	4,2%
Exch. Rate ($)	6,28	6,64	6,76	6,61	6,83	6,58	6,37
Trade/GDP (%)	34%	31%	32%	33%	32%	31%	30%
Oil price (Brent)	$52	$44	$54	$71	$61	$66	$67
Millions US $							
Export of goods	2 142 750	1 989 520	2 216 460	2 439 110	2 527 960	2 730 260	2 957 240
Imports of goods	1 566 560	1 500 640	1 740 310	2 036 360	2 097 200	2 288 520	2 478 060
Other:	-272 025	-286 676	-311 263	-347 480	-360 413	-378 402	-404 059
Current account ($ mill)	**304 165**	**202 204**	**164 887**	**55 270**	**70 347**	**63 338**	**75 121**
(% of GDP)	2,8%	1,8%	1,3%	0,4%	0,5%	0,4%	0,4%
FDI	68 099	-41 674	66 310	99 972	87 075	90 975	94 412
Loan repayments	-83 949	-129 142	-142 763	-150 153	-153 178	-156 265	-159 413
Net other capital flows	-701 365	-102 518	-56 784	14 530	214 697	309 882	335 350
Balance of payments	**-413 050**	**-71 130**	**31 650**	**19 620**	**218 940**	**307 930**	**345 470**
Reserves	3 168 990	3 097 860	3 129 510	3 149 130	3 368 070	3 676 000	4 021 470
Total debt	1 382 080	1 599 820	1 899 470	2 162 170	2 435 980	2 715 870	2 997 090
o/w short term debt	978 697	809 214	944 669	1 059 020	1 098 420	1 139 490	1 181 480

Source: OEF (Oxford Economic Forecasting) and SEB estimates.

* Central government only

Rating history				
Fitch (eoy)	A+	A+	A+	A+
Moody's (eoy)	Aa3	Aa3	Aa3	A1

Type of government:	Communist one party rule
Next elections	None planned
Other:	
Latest PC deal	None



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