China macro update:

Policy outlook for the Pig year

February 2019

Questions about China's growth trajectory are still abound as we step into the Year of the Earth Pig. However, there are a couple of things that seem like Chinese policymakers will be easing more monetary and fiscal policies to buffer an economic slowdown, while implementing adequate measures to address some of its long-term structural issues such as the role of private sector in the country's economic transformation.

Renee Chen

Senior Economist and Investment Strategist

HSBC
Global Asset
Management

“Be not afraid of growing slowly; be afraid only of standing still.”

- Chinese proverb of unknown origin

Ten years and several economic cycles since the global financial crisis, China finds itself faced with a familiar situation – slowing growth brought on by factors not entirely within its control. But this time around policymakers intend to shore up cyclical growth without falling back on debt-fuelled stimulus (such as the Rmb4 trillion stimulus package in 2008), and they plan to do this whilst attempting to strike a balance between maintaining growth stability and advancing structural reforms.

Amid few signs of a turnaround in the economy and rising risks that the downdraft in growth will begin to weigh on the labour market, managing the growth cycle has become the top policy priority for the Chinese government.

Amid few signs of a turnaround in the economy and rising risks that the downdraft in growth will begin to weigh on the labour market, managing the growth cycle has become the top policy priority for the Chinese government. As a result since late 2018 we have see a slew of intensifying and broadening policy measures and a shift in focus from the de-leveraging narrative that dominated 2017 and H2 2016.

Monetary measures: As headwinds to growth and confidence gather, the People’s Bank of China (PBoC) in early January cut the reserve requirement ratio (RRR) for large commercial banks by 100 basis points, after reducing the ratio by 250 basis points last year. We expect further liquidity easing, including RRR cuts, to encourage bank lending, buy corporate bonds, as well as accommodate more proactive fiscal policy and increased local government bond issuance.

The focus of monetary policy remains on improving the transmission mechanism, and facilitating banks to pass on the lower interbank funding costs to corporate and household borrowers. The PBoC will likely continue to use re-lending & re-discounting, targeted medium-term lending facility (TMLF) and other liquidity facilities, as well as support the use of credit risk mitigation instruments and other credit enhancements to lower funding costs for SMEs and facilitate corporate bond issuance. The PBoC launched a Central Bank Bills Swap (CBS), which may improve the appeal of banks’ perpetual bonds, help their capital replenishment and allow them more liquidity to lend. In addition, the debt-to-equity swap programme could be accelerated, aimed at freeing up more funds for bank lending. Efforts to build multi-layer capital markets for financing will continue. The new wealth/asset management product regulations may be relaxed further to ease the contraction of off-balance-sheet credit.

Fiscal policy will remain in the driver’s seat, with a wider fiscal deficit and a larger quota for local government special bond issuance.

Focus on Fiscal: Fiscal policy will remain in the driver’s seat, with a wider fiscal deficit and a larger quota for local government special bond issuance. The government is likely to roll out a sizeable tax and fee cut, with the reduction expected to reach the equivalent of, or even surpass, 1% of GDP. It already cut the value-added tax (VAT) by 1 percentage point last May and implemented the individual income tax reform, including the increase in standard deduction in October 2018 and then introduced a special deduction in January 2019, benefiting low-income households in particular.

Beyond the VAT cuts, there is ample room to further reduce the corporate tax burden, such as mandatory social security contributions. The approval of infrastructure projects has accelerated since the fourth quarter of 2018. The advanced quota for 2019 special government bond issuance will help to mitigate near term risk of weakening infrastructure FAI.

Property policy fine-tuning: Given the resilience in housing market activities, a large scale property policy loosening led by the central government looks unlikely, but there has been policy fine-tuning in some cities. Broader policy easing is likely should there be signs of a significant market correction. Funding conditions for developers generally remain tight, but the authorities' recent moves to loosen their regulatory grip on the onshore funding market helps.

The easing so far in this cycle has been milder, and more selective than in the last periods of significant growth risks.

Policy effectiveness remains key: Investor skepticism on China's growth outlook is largely focused on the seemingly lack of policy effectiveness thus far. There tends to be some time lag for the feed-through of policy easing to be reflected on the hard data. The easing so far in this cycle has been milder, and more selective than in the last periods of significant growth risks. The need to maintain a tight lid on financial stability risks is a key constraint. Local governments are reluctant to push up spending significantly despite increased financing as they face other constraints such as debt sustainability.

There is also less ammunition than before as debt levels are higher (both local government debt and private sector leverage), the fiscal deficit wider (particularly taking into account the off-budgetary funding gap), interest rates lower and the current account surplus narrower than the onset of the last slowdown.

Importantly, low private sector confidence has weakened policy/credit transmission, amid an uncertain domestic and external environment and doubts about the government's willingness and ability to push through structural reforms. Corporate credit demand for capex remains subdued and banks are reluctant to increase lending (to SMEs) despite liquidity easing (and banks' lending is constrained by capital requirements) amid default/asset quality concerns.

We expect the pro-growth policy measures to eventually help restore confidence and stabilise cyclical growth prospects.

Be not afraid…We expect the pro-growth policy measures to eventually help restore confidence and stabilise cyclical growth prospects. A rebound in private sector confidence, driven for example by improvements in US-China trade relations, clear signs of stabilisation in the Chinese economy, real progress in market-oriented reforms such as SOE reform on the basis of 'competitive neutrality' to create environment for fair competition, etc., could potentially kick-start a positive feedback loop in the near term. However, US-China trade talks remain a wild card for better or worse outcomes. Policy effectiveness (e.g. credit transmission, the multiplier for corporate tax cuts, etc.) remains key to the outlook.

HSBC Global Asset Management (Singapore) Limited
21 Collyer Quay #06-01 HSBC Building Singapore 049320
Telephone: (65) 6658 2900 Facsimile: (65) 6225 4324
Website: www.assetmanagement.hsbc.com/sg
Company Registration No. 198602036R