Economics

DBS Focus

China Outlook 2020: A Better Year Ahead

Economics

Group Research

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- *China's economic and financial imbalances notwithstanding, it is far from a "Minsky Moment."*
- *Threat of value chain relocation restricted to low value-added industry only, so far.*
- *Property bubbles are gradually deflating, but challenges remain.*
- *Risks of runaway capital flight are low.*
- *Tail risks will come primarily from the geopolitical spectrum.*

The macro picture for 2020

China's growth outlook for the remainder of the year and into 2020 is expected to weaken further due to headwinds including drag from the ongoing trade war with the US and tighter financial regulations. GDP growth will moderate to 5.8% next year, slower than the 6.1% forecast for 2019. Intensified policy support is a necessity to buttress the economy. Fiscal policy will likely continue to focus on infrastructure spending and tax cuts, whilst further monetary policy easing through a combination of the reserve requirement ratio and interest rate reductions is warranted in the face of benign core inflation and falling producer prices.

	2018	2019F	2020F	2021F
Real GDP, yoy%, ave	6.6	6.1	5.8	5.6
CPI, yoy%, ave	2.1	2.6	2.3	2.5
M2, yoy%, ave	8.1	8.5	8.7	8.9
Private sector credit, yoy%, ave	7.8	9.0	10.0	11.0
Current account, % of GDP	0.4	1.0	0.7	0.5
Trade account, % of GDP	2.9	3.5	2.7	2.3
Financial & capital acct., % of GDP	1.0	-1.0	-0.7	-0.5
Overall BOP, %GDP	0.1	0.0	0.0	0.0
Reserves, USD bn	3.17	3.1	3.05	3.02
Fiscal balance, % of GDP	-2.7	-2.9	-3.7	-3.8
Exports, yoy%	9.9	0.0	-0.5	2.0
Exports to the US, yoy%	10.1	-0.2	-0.7	1.5
Policy rate, eop	4.4	4.4	4.4	4.4
10-yr rate, eop	3.31	2.80	3.00	3.00
USD/CNY, eop	6.88	7.10	7.05	6.85

Challenges for the near term

The issue facing China is not about whether the authority could hold the real GDP growth rate at 6% next year. Achieving our projected 5.8% growth rate next year neither safeguards the fragility of smaller banks nor the stability of exchange rate conditional primely on the dynamics of US-Sino relationship. Given the tremendous coverage of China macroeconomics, all the risks are well-known and thoroughly analyzed. The challenge is to imagine the "unknown unknown."

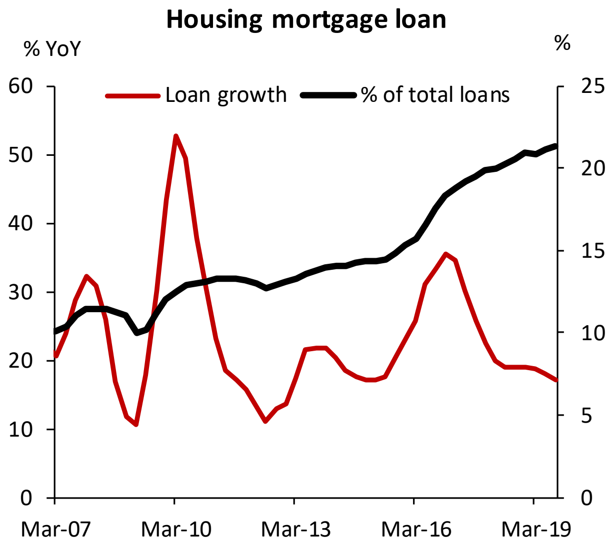
Banks

The US subprime crisis taught the world that a highly leveraged economy coupled with a banking sector that concentrates on one asset class is a blend ripe for eruption when fundamentals worsen.

China appears to be far from the "Minsky Moment"[1]. even though China's absolute total debt level, according to Institute of International Finance, reached 303% of GDP at 1Q19. The main assets of Chinese banks are loans to households and SOEs. Household balance sheets are still lowly leveraged. Mortgages made up of 21.4% of total outstanding loans as of 3Q19. This is far below around 75% in the US in 2008 (The US figure included a substantial portion of securitized mortgage).

As far as loans to corporate are concerned, they represent a whopping 60% of total loans in 2019. According to earlier Global Financial Stability Report (GFSR), around 15.5% of total loans extended to corporates are potentially at risk. The total is around USD1.3tn, compared to about USD1.7tn in bank Tier-1 capital. This asset class is the China's Achilles' heel.

But the gist of the matter is that the state owns both enterprises and the banks, and it has enormous political power to keep them afloat regardless of their financial health, lest not forgotten bank deposits amounted to RMB196tn should provide adequate cushion to



Source: CEIC and DBS Group Research

any unforeseen shocks. The costs of sustaining them however compromises the effectiveness of monetary policy to buttress the real economy. Subsequent increase in liquidity is used to service interest payments on old debts. Also rising credit risks negate downward pressure on interest rates.

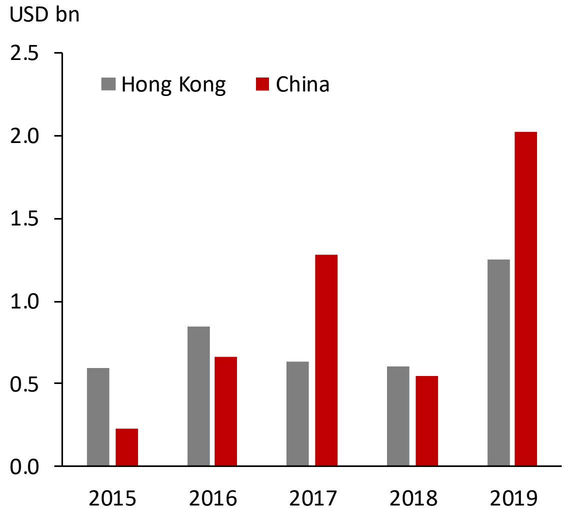
Relocation of value-added chain

Most foreign invested enterprises cannot neither afford wholesale relocation of their plants out of china nor replacing Chinese suppliers easily. It is true that FDI going into Vietnam either from China/Hong Kong has been accelerating. But these are mostly lower end manufacturing which had been planning to diversify well before the US-China trade war due to structural reasons: (1) rising labor costs, (2) an aging population, (3) rising social insurance commitments, and (4) increasing stringent compliance requirement on environmental protection etc.

[1] A Minsky Moment is a sudden collapse of asset prices after a long period of growth, sparked by debt or currency pressures. The theory is named after economist Hyman Minsky.

Even then, Nike and Adidas, producing 50% and 40% of their sneakers in Vietnam, still manufacture most of their sport-wears in China because of a very skilled labor force trained for decades in making apparel alongside presence of an efficient value-added chain.

FDI to Vietnam (Jan-Sep)



Source: CEIC, DBS

Relocation decisions facing high tech manufacturers are even more complicated because key considerations include accessibility to vendors, size of the labor market to warrant adequate supply for future capacity expansion, logistics support alongside the simplicity of the regulatory environment and availability of tax incentives. It is thus a challenge for hi-tech enterprises to make concrete decisions for relocations.

Two decades ago, China was primarily assembling products designed and manufactured in Japan, South Korea or even Taiwan. China steadily climbed up the value-added supply chain through acquisition of tech knowhows and persistent state supports. Firms in China can do industrial prototypes of whatever and scale up production for clients readily. Nowadays, hi-tech manufacturing in China has become more vertically integrated as evidenced by declining dependence on foreign inputs for production of exports. On the other hand, rest of the world is increasingly dependent on China's supply of intermediate goods for their exports.

Property sector

The authorities have managed the demand and supply side of the property market well, as evidenced by stability of residential pricing and the absence of loan defaults in this sector. The average net debt to total equity ratio of the property sector in 1H19 is held stably at 66%, same as 2018, but down from the peak of 71% in 2014. It is unlikely that they will change the policy mix next year – restraints of funding channels to developers and ongoing presence of sale price increment restrictions.

On the supply side, the central and local governments will continue to restrain liquidity from flowing too much into the hands of property developers via trust financing and USD bond issues. In 1Q19. For example, the proceeds from the newly issued offshore bonds of developers are limited to the purchase of long-term bonds issued by the National Development and Reform Commission.

Such move exemplifies the determination of the authority to control leverage of this sector. As a result, banks in general are charging higher interest rates to them. The prime policy goal here is to slow down land bank replenishments of major property developers because most of them are low in land banks. Authority sees rising risks of higher land costs will consequentially translate into higher property prices. Strict controls on funding for the property sector will remain next year. Even with further cuts on headline reserve requirement ratio by the PBoC, it won't particularly help property developers too much.

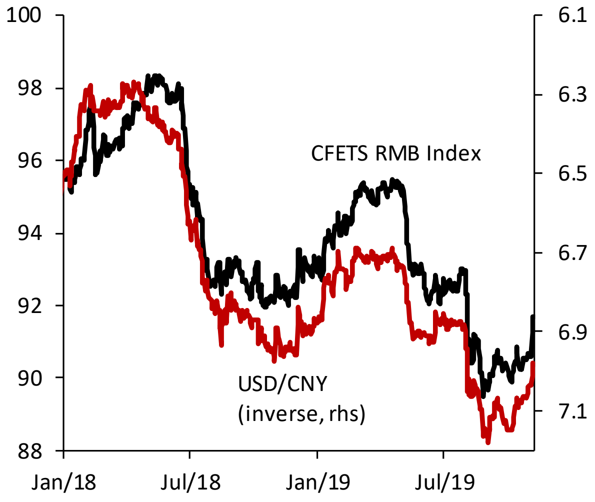
Performance of the demand side has remained decent. National residential sales in Gross Floor Area terms had already returned to positive territory since August 2019. In September, nationwide residential average ASP increased 9.1% YoY. The property price index for 55 of the 70 sampled cities tracked by the National Bureau of Statistics continued to post moderate increments on a MoM basis, particularly in Tier 2 cities, even under the presence of price restriction policies. If the economy were to decelerate notably in 2020, the authority may allow property prices of selected projects to increase mildly.

Capital flows

In August, the Chinese yuan breached the sensitive level of 7 to the dollar for the first time in a decade. USD/CNY has since been trading in a range of 7.0-7.15. A thaw in frosty trade relations between China and the US would help put a floor on the exchange rate. **The risks of runaway devaluation and resultant capital flight are much lower now than before.**

Even under the event of another breakdown in China-US trade negotiation, PBoC could easily reintroduce the countercyclical factor into the yuan's daily reference rate to curb depreciation expectations. State-owned banks could also engage in swap contracts to fend off volatility, without draining PBoC's forex reserves. Meanwhile, hiking reserve requirement ratio for banks settling forex forward yuan positions is another option to discourage USD purchases. Mopping up offshore liquidity via central bank bill sales has also proven to be an effective tool to support the currency.

USD/CNY exchange rate



Source: Bloomberg, DBS

Conclusions

China's macro risks are mostly long term in nature tending to evolve slowly. There are no shortages of analysis claiming the devastating impact of them under certain assumptions. Yet, there are no crisis in China hitherto. That however leaves no room for complacency because "unforeseen" crisis always stems from the "unknown unknown".

Politics has already taken the front seat position from economics to lead and drive market forces in recent years. Confluence of political and economic factors often develops multiple leads without strong conclusions. For example, politics in Washington/Beijing dictates the outcome of the trade-deal. The interactions are hard to predict precisely and timely.

We can take some comfort from the known risks which will most likely be under control in 2020. The unknown portion will have to come from the geo-political spectrum.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).