THE DRIVE YOU DEMAND

CHINA POLICY EASING MEASURED BUT MORE EXTENSIVE

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Media Commentary

Key Takeaways

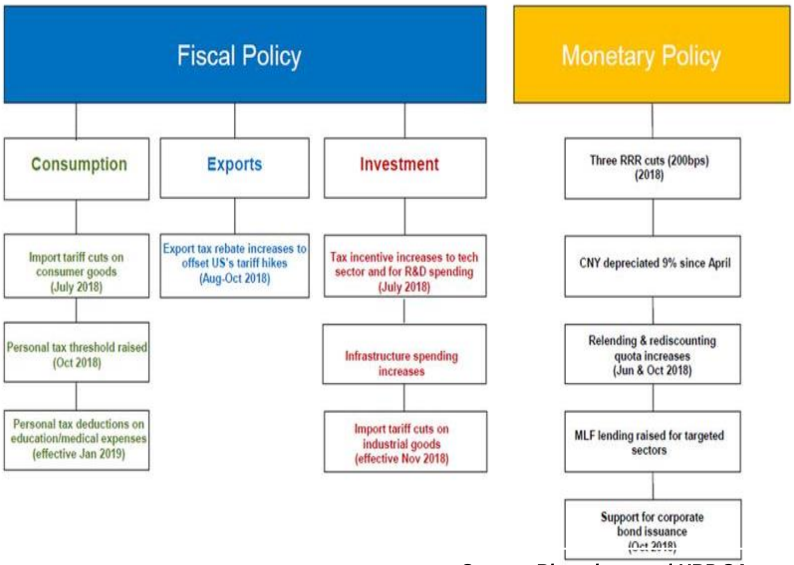
- *Overall policy easing has remained measured on modest growth deceleration.*
- *Policymakers will maintain a multi-pronged approach to avoid stretching both fiscal and monetary easing too much.*
- *Fiscal expansion may run bigger than planned as Beijing remains mindful of excessive monetary easing from already high leverage.*
- *Opening domestic market further is a welcome move but may not fully address Trump's demands on China to resolve the trade war.*

The Chinese equity market failed to sustain the strong rally on October 19 that was induced by Beijing's announcement of expanded policy measures to fight the downswing in the economy and financial markets. Last week's global market sell-off was obviously a big headwind for Chinese equities. But we also think that the lack of details on Beijing's tax concessions was also a reason for the weak market rebound.

Since trade tension with the US started to escalate in the summer, Beijing has implemented waves of small policy measures to cushion the economy.

They include monetary easing and fiscal measures largely containing small tax cuts and tweaks. In addition, the earlier proposal to expand market access for foreign firms was reaffirmed recently with more details – covering sectors from financial, industrial and agricultural.

The table below summarises the major policy support measures implemented so far. They are aimed at cushioning exporters in face of higher tariffs and, more importantly, targeting local consumption and investment to boost domestic demand as trade pressure builds.



Source: Bloomberg and UBP SA

China's multi-pronged policy support measures thus far have been measured but is becoming extensive

President Trump's trade tariff as of today (25% tariff on $50bn Chinese exports plus 10% on another $200bn) will only trim China's GDP growth marginally by about 30-40bps.

If the 10% tariff on $200bn is raised to 25% in January 2019 as promised by Trump, then China will need to protect the growth slowdown from current 6.6% y/y to around 6%. A bigger potential fall will, therefore, demand a larger dose of policy responses.

So far, we have seen Beijing starting with monetary easing (reserve requirement ratio cuts, liquidity injection, targeted lending plus CNY depreciation) before branching out to more fiscal measures. For the former, we still deem it 'measured' easing – essentially encouraging banks to lend to targeted sectors such as private firms and infrastructure projects but balancing by controlling shadow credit growth (although only corporate bond issuances have relaxed noticeably).

Overall, total credits in circulation have improved but not excessively in terms of new flows. Understandably, the spectre of re-leveraging and credit bubble risk is still in the mind of policymakers even though financial de-leveraging has moved to the back seat of Beijing's policy agenda this year.

Fiscal policy becomes more counter-cyclical

On the fiscal front, China wants prudence – like in its monetary policy. But it looks increasingly difficult to limit flexibility as China's already high leverage constrains the extent of monetary easing. That said, the tax cuts and incentives provided so far were small tweaks, such as raising taxable income threshold and tax deductions on children's education and elderly care expenses.

China Fiscal Policy Assessment	2017 1-3Q	2018 1-3Q
Fiscal Deficit (RMB bn)	-1774	-1746
% GDP	-4.0%	-2.7%
	4Q	Forecast 4Q*
Fiscal Deficit (RMB bn)	-1302	-1628
% GDP	-5.5%	-6.4%
	Full-Year	Full-Year
Budgeted Annual Fiscal Deficit (RMB bn)	**-2380**	**-2380**
% GDP	**-2.9%**	**-2.6%**
Actual Annual Fiscal Deficit (RMB bn)	**-3076**	-3374
% GDP	**-3.7%**	-3.7%
Fiscal deposit drawdown (Rmb bn)	696	
% GDP	-0.8%	

Source: Bloomberg and UBP SA

** 4Q/18 estimation is based on annual fiscal deficit of -3.7% of GDP in 2018*

The good news is that China has under-achieved its budgetary plan in the first two quarters quite significantly and have started to spend more handsomely in August-September.

We suspect that the original budget deficit target set for 2018, at 2.6% of GDP, will be raised on expanded fiscal measures. If the actual outcome will be like 2017's level of around 3.7% of GDP,

China can afford to dip into a quarterly fiscal deficit of some 6.4% of GDP in 4Q/18 without worrying too much of major fiscal slippage.

In other words, Beijing can afford more fiscal support measures, and some key policy advisers are alluding that tax cuts amounting 1% of GDP in the coming year will not be too demanding.

Market opening as a bargaining chip

In addition, Beijing has formalised easing of foreign investment limits on a range of industries from banking to agriculture, reducing its so-called 'negative list' of industries where overseas investors are restricted or banned.

Major changes (mostly announced by President Xi Jinping earlier in the year) include removal of caps on foreign ownership of banks, lifting ownership limits on brokerages and insurance companies in 2021, and for passenger car manufacturing in 2022. China will also open parts of its sprawling commodities sector.

Some investors see these changes hitting the heart of Trump's trade dispute with China as the US and EU have repeatedly criticised the lack of openness in China's domestic sector. It includes entry barriers as well as forced technology transfers as part of an agreement for firms that granted market access.

This may be the light at the end of the tunnel only if Trump's bottom line centres on the gaining of China's market access and forcing China to purchases more US products.

If Trump's goal, as many observers believe, is to isolate China, restrain its main global rival, and ultimately sabotage the state-subsidy system and the controversial 'Made-in-China 2025' plan, then these measures may not fully address the issues to resolve the Sino-US trade war.

Can China pull more rabbits out from its magic hat?

China has enough ammunition for continued policy easing but it comes with limits and high costs if pushed rapidly. There is an expectation that Beijing may announce a more concrete policy package after the Party Congress to be held next month.

Overall, we expect Beijing will continue its cocktail, multipronged policy approach. It may, possibly, run a bigger fiscal deficit than it wishes, while trying to prevent excessive monetary easing (due to the already high debt stock).

If the downside risk really intensifies, then allowing a slower growth environment, say between 5.5%-6.0%, without stretching too much on both monetary and fiscal policy front may not be too undesirable an outcome, in our view.

CNY depreciation risk may rise as discussed in our previous missives – for example, if all China's $500bn of exports is taxed by Trump eventually, CNY may depreciate to 7.5-8.0 vs. USD range.

However, it is not without policy constraint on foreign exchange policy as well. The risk of capital flight will rise, and China's rising external debt will be considerably more expensive to service, especially in view of its short-term external debt position that has risen to some $1.1trn already.