CHINA UPDATE

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POLICY SHIFTING TO SUPPORT TO GROWTH AND THE EXCHANGE RATE AGAINST WANING MOMENTUM AND TARIFFS

> Growth has downshifted again and will likely slow further in late 2018 and 2019

China's economy has downshifted again: Real GDP growth slowed in the second quarter of 2018 to 6.7 percent in year-over-year terms from 6.8 percent in the prior three quarters. The slowdown has persisted into the second half of the year: Growth of investment in fixed assets slowed in each month of 2018 through August, when the CFLP manufacturing Purchasing Manager's Index (a key measure of manufacturing activity) dipped to its weakest in 14 months.

The slowdown is not principally due to trade frictions. In fact, China's trade surplus in goods with the United States reached a record high of $31.0 billion US dollars in August, a tailwind to Chinese growth. Exports to the US grew 13.2 percent from a year earlier, faster than China's overall export growth of 9.1 percent, while imports from the US rose 2.3 percent to $13.3 billion, much slower than overall Chinese import growth of 20.4 percent. Chinese purchases from the US slowed after China's government imposed retaliatory tariffs against US soybean exports. Chinese sales to the United States have held up better; US fiscal stimulus and strong business sentiment are supporting demand for Chinese goods despite the costs of tariffs.

> Despite tariffs, trade is adding to growth; domestic policies are the headwind

Instead, China's economy is slowing because of its own government's policies that limit credit growth and contain financial sector risk. Unlike in the United States, where the Federal Reserve sets the size of the money supply to determine key interest rates and vice versa, Chinese financial regulators independently determine interest rates and the growth rates of money and credit. China lowered effective interest rates in the third quarter of 2018, bringing the benchmark one-month interbank interest rate to its lowest since June 2015 (Chart 1). But the supply of credit to real economy borrowers is nevertheless growing at a historically slow pace. Inflation-adjusted loan growth was the slowest at midyear since 2011, and money supply growth the slowest since at least 1997 (See Chart 2). The drop in interest rates in the third quarter of 2018 signals that credit growth will stabilize and accelerate in late 2018 and into 2019. But Chinese policymakers are intent on limiting financial sector risks, preventing capital outflows, and slowing the growth of corporate debt, and the surest way to reach these goals is to slow growth of money and credit.

CHART 1: INTERBANK INTEREST RATES DROP

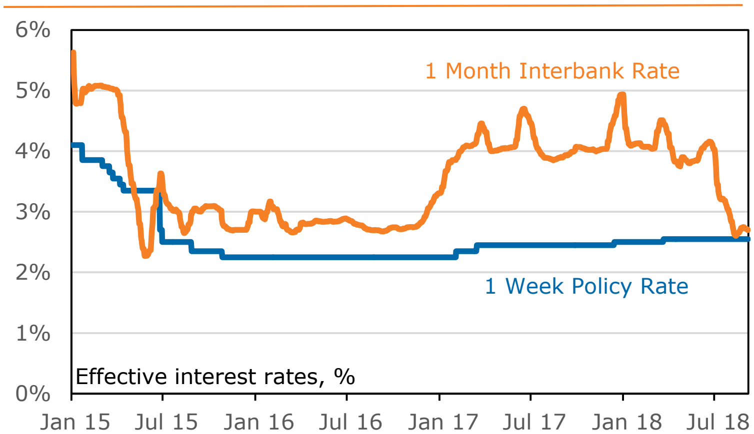


CHART 2: BUT CREDIT & MONEY GROWTH AT HISTORIC LOWS

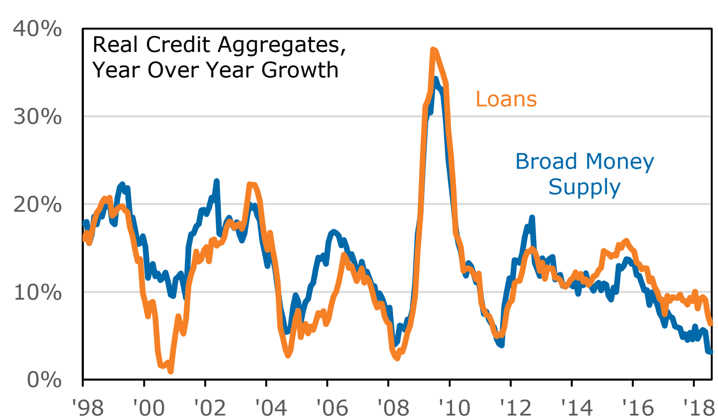


Chart sources: PBoC, NBS, CEIC, The PNC Financial Services Group Estimates
Notes: Policy Rate is the 7-Day Reverse Repo Rate; Credit aggregates deflated by PNC Economics' estimate of the monthly GDP deflator

Tighter fiscal and credit policies to slow real GDP growth to 6.5 percent in second half of 2018 and 6.2 percent in 2019

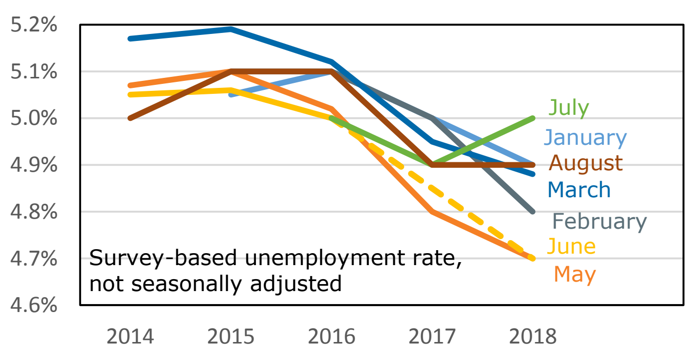
Fiscal policy tightened in 2018 as well. The central government's fiscal deficit reached 4.4 percent of GDP in the four quarters through the third of 2016, the widest deficit relative to GDP since at least 1995, as the government raised spending and cut taxes to offset a housing slowdown and weak export growth. China subsequently reined in the deficit to 3.7 percent of GDP in 2017, and the Ministry of Finance announced in March 2018 a deficit target for 2018 of 2.6 percent of GDP, less than the 3.0 percent targeted between 2012 and 2017. China at midyear began planning cuts in individual income taxes, but their fiscal stimulus will be limited. Historical data on Chinese credit contain four episodes of money and loan growth that were as slow as mid-2018, in 2000, 2004, 2008, and 2011. Each period either coincided with a meaningful slowdown in real GDP growth, or was followed by one that began 1-3 quarters later. The lagged effects of 2018's tight credit and fiscal policy will slow real GDP growth to 6.5 percent in the second half of 2018 and 6.2 percent in 2019. China's unemployment rate, which the National Bureau of Statistics began releasing monthly in 2018, will rise in coming quarters, but from a low starting point of 4.9 percent in August 2018 after declining a quarter percentage point between 2015 and 2018 (See Chart 3).

A trade war is unlikely to cause a recession: Exports to the US are under 4 percent of Chinese GDP

Trade frictions between China and the US increase downside risks to China's growth outlook, but their near-term effects will be smaller than headlines suggest. Even accounting for shipments routed through Hong Kong, China's exports to the United States were less than 4 percent of GDP in 2017, down from near double digits before the Great Recession (Chart 4). In fact, the share of Chinese GDP accounted for by exports to the US is the same as that of the rapidly growing Chinese internet sector. And since US-owned intellectual property (branding, design, and so forth) comprises a significant share of the value of exports to the US, slower growth or even a drop in US-bound trade would not existentially threaten Chinese employment, economic growth, or financial stability. China would be much more worried—and more inclined to change business practices the US finds objectionable—if US allies joined in a multilateral effort to confront its mercantilist policies. But trade and political frictions between the United States and its allies are a thorny obstacle to multilateral collaboration against common competitors like China.

The yuan appreciated to its highest level so far in 2018 at 6.27 per US dollar in April, then depreciated in the summer months to more than 6.90 per dollar in August. PNC Economics forecasts the yuan to regain some of its summer losses against the dollar and end 2018 at around 6.7 per US dollar. This reflects PNC's expectation that the US dollar will depreciate against most currencies, a knock-on effect of a larger US trade deficit (which tends to increase when a country implements stimulus policies, as the US currently is doing). Chinese exchange rate policies like raising the cost of betting against the yuan will also curb further depreciation. The yuan will average 6.7 per dollar in 2019, and see more volatile fluctuations than in 2018 as financial regulators gradually transition China's exchange rate toward a free float.

CHARTS 3 & 4: CHINESE UNEMPLOYMENT IS LOW AND RELIANCE ON EXPORTS TO THE US IS DOWN FROM MID-2000'S



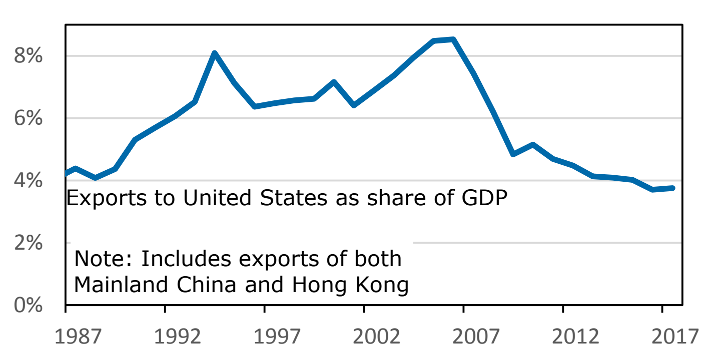


Chart sources: China NBS and Customs, HK Census and Statistics Department, CEIC, PNC Economics' calculations

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