CHINA UPDATE

Gus Faucher
Chief Economist

Stuart Hoffman
Senior Economic Advisor

William Adams
Senior Economist

Kurt Rankin
Economist

Abbey Omodunbi
Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

TRADE WAR: CHINA TO LOOSEN MONETARY POLICY AND ALLOW YUAN TO DEPRECIATE TO OFFSET ESCALATING TARIFFS

The US escalates tariffs and China retaliates, fitting the standard definition of a trade war

The United States raised tariffs on $200 billion of Chinese imports from 10 percent to 25 percent on May 10 after trade talks that week failed to yield an agreement; President Trump has promised to raise tariffs on the rest of the US's $540 billion in Chinese imports if a trade deal is not reached. China's Ministry of Commerce immediately promised retaliation after higher US tariffs, but unlike China's previous reactions, did not announce categories of US exports that would be targeted. The latest US action is a response to China's move a week earlier to rewrite the trade deal more favorably for them. Press reports indicate that Chinese negotiators had closely watched President Trump's attempts to pressure the Federal Reserve to cut US interest rates, believed he was becoming concerned about the US growth outlook, and so would accept more concessions to end the trade conflict.

Tariffs now enacted will probably stay in place at least into 2020, and possibly into 2021. The absence of immediate Chinese retaliation suggests China miscalculated how hard they could push for US concessions, like US negotiators earlier in the process, expecting a breakthrough deal that so far has not come. Both sides seem to underestimate the other's ability to withstand tariffs, and the passage of time may be the only way to convince them otherwise. Repeated rounds of escalating tariffs and retaliation fit the standard definition of a trade war.

China's economy to weaken as trade war drags more than stimulus boosts

Higher US tariffs will amplify headwinds for Chinese economic growth in 2019 and 2020. Real GDP growth was a better-than-expected 6.4 percent in year-over-year terms in the first quarter of 2019, with faster real estate investment providing a large boost to top-line growth. Industrial production of cement manufacturers and other nonmetallic mineral product manufacturers, a good proxy for the construction industry, grew in the first quarter of 2019 at the fastest pace since 2011 (See chart 1). But other sectors were shakier, even before this latest round of escalation: Nominal fixed investment in equipment fell 0.8 percent in year-over-year terms in the first quarter, the indicator's worst performance since comparable data began in 2004.

CHART 1: LOPSIDED GROWTH— MULTI-YEAR HIGH IN CEMENT MANUFACTURE, MULTI-YEAR LOW IN EQUIPMENT CAPEX

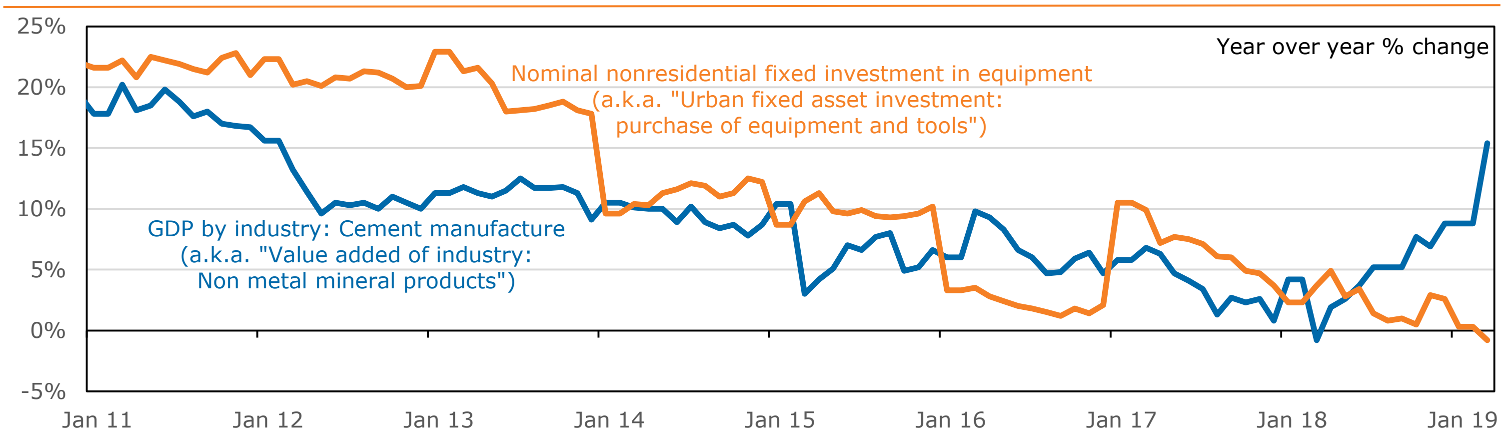

Chart sources: NBS, CEIC, Moody's DataBuffet

China's labor market weakened as a result: the survey-based unemployment rate for China's 31 largest cities rose to 5.1 percent in March, the highest since August 2016. China's unemployment rate will be highly volatile in 2019 since it is reported without adjustment for regular seasonal variation, but will trend higher over the course of the year. The trade war will not cause a Chinese recession, but it will probably cause several quarters of below-trend economic growth.

GDP growth set to slow to under 6.0 percent in year-over-year terms in the rest of 2019

Chinese real GDP growth will slow and average 5.9 percent in year-over-year terms for the second through fourth quarters of 2019, then average 6.0 percent in all of 2020. This is a mark-down of PNC's prior forecast for 6.2 percent growth due to lower exports to the United States, which account for just under 4 percent of Chinese GDP; falling investment in export-oriented industries; and the blow to business and consumer confidence from a global environment that is increasingly inhospitable to China's growth model.

China's central bank will ramp up stimulus measures, fueling a depreciation of the yuan

China's central bank will add to monetary stimulus to cushion the slowdown: The People's Bank of China (PBoC) will likely cut the benchmark reverse repo rate 20 bps to 2.35 percent by the end of July from 2.55 percent currently, matching the Federal Reserve's interest rate on excess reserves. The PBoC will also reduce the reserve requirement ratio to maintain credit growth, which will outpace real GDP growth in 2019 as policymakers prioritize stimulus over reducing leverage. The Shanghai Composite jumped 3.1 percent in the first trading day after US tariffs increased as Chinese traders anticipated this stimulus.

China's yuan will depreciate as its central bank cuts interest rates. PNC forecasts for the yuan to depreciate to 7.15 per dollar by year-end 2019 from 6.82 today and 6.70 in mid-April, and average around that level in 2020 (See chart 2). This forecast is about 7 percent weaker than PNC's prior forecast. Given China's substantial footprint in the global economy, a weaker yuan will spill over to pressure many other foreign currencies to either depreciate against the US dollar or appreciate less than they otherwise would have. The dollar, which is strong in the spring of 2019 on a trade-weighted basis, will probably hold unchanged in the rest of 2019 and 2020, even if other foreign tail risks like Brexit are resolved.

Chinese stimulus increases longer-term downside risks to the economy

More broadly, the escalating US-China trade war increases the tail risk to Chinese and global growth from either a hard landing in China or a geopolitical confrontation with the West. On the economic front, China's reliance on real estate investment to offset a weakening export sector is reminiscent of Japan's economy in the years before its bubble burst in the late 1980s. The more reliant China becomes on real estate for growth, the more unmanageable the financial and political forces pushing housing prices higher will become. On the political front, if the US-China commercial relationship continues to deteriorate, it will be a less effective moderating force to contain any diplomatic crisis when tensions over some geopolitical issue inevitably arise.

CHART 2: CHINA'S CURRENCY FORECAST TO DEPRECIATE IN 2019 AND 2020 AS THE PBOC CUTS ITS POLICY INTEREST RATE

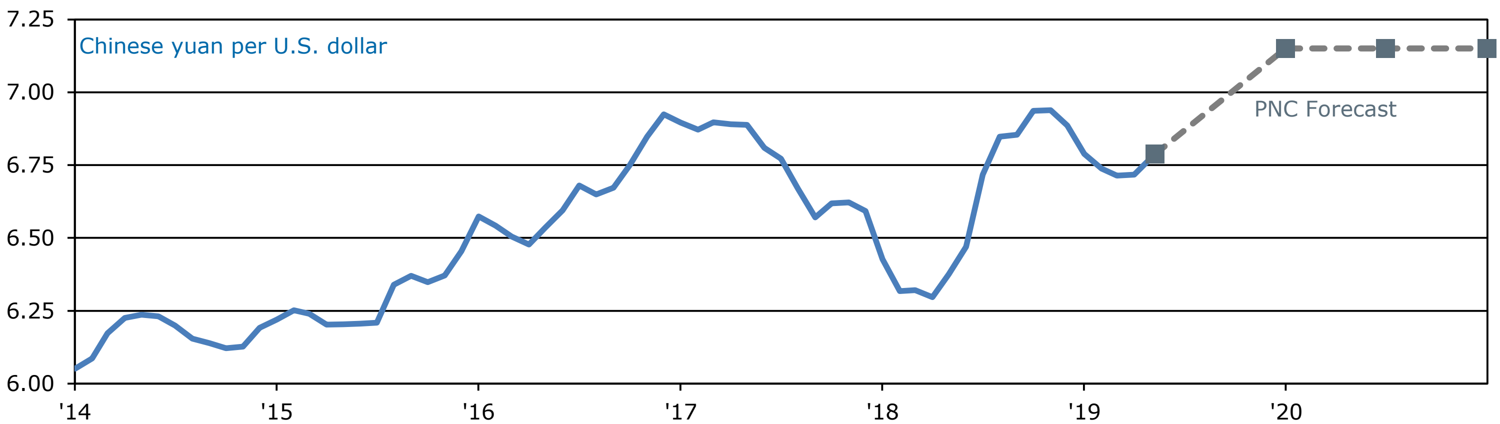

Chart sources: CEIC, China Foreign Exchange Trading Center, PNC Economics

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.