China tweaks policy mix to support growth

China's aim to sustain both rapid growth and financial de-leveraging is becoming ever more challenging as weaker global growth and heightened policy uncertainty create external headwinds. In fact, softer external and domestic demand over the last year has prompted the Chinese government to gradually loose monetary and fiscal policies. Our analysis delves into the four factors that pinpoint China's slowdown as well as both monetary and fiscal measures undertaken by authorities to respond to overall demand weakness.

On the current economic slowdown.

First, lagging indicators have softened. China's GDP growth has slowed in recent quarters, from 6.8% in Q1 2018 to 6.5% in Q3 2018, the worst quarterly performance since the aftermath of the Great Financial Crisis.

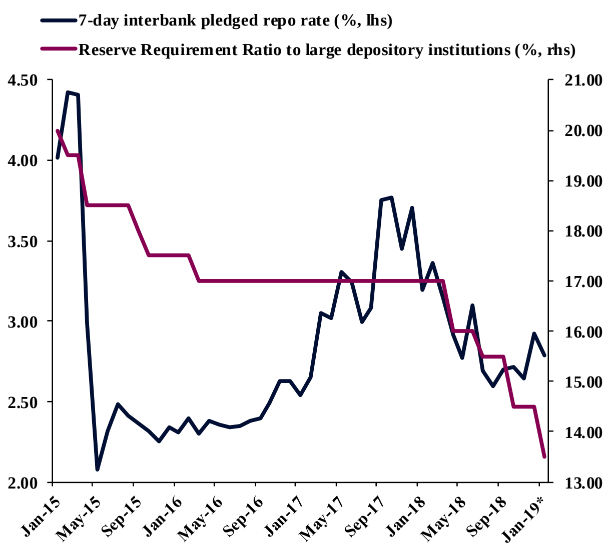
Second, while official figures for Q4 2018 are still not out, coincident indicators are pointing to another soft quarter. Growth in retail sales and online retail sales of goods and services are hovering around multi-decade or even all time lows on a y/y basis. After two months of stagnation around the 50 level, the official manufacturing Purchasing Managers' Index (PMI) figure slid to 49.4 in December 2018 to mark the first contraction in more than two years.

Third, leading indicators are pointing to further weakness over the coming months. New orders and new export orders, forward looking subcomponents of the PMI, were also below the 50 level.

Fourth, signals for the external sector are negative. Global demand for Chinese goods is looking particularly sluggish as trade data from early-reporting key bilateral partners was also negative, reaffirming weaker export orders. South Korean and Taiwanese exports to China contracted as well (13.9% and 6.6% y/y, respectively) last month. As the two countries are major exporters of industrial inputs to China's export sector, this may reflect the waning of the so-called front-loading effect in US-China trade, i.e., US based companies increasing imports from China before new tariffs come to effect. While trade tensions with the US have eased after the Trump-Xi meeting in Buenos Aires, there is still a lot of uncertainty regarding the potential application of additional tariffs to Chinese exports to the US after the 90-day trade truce ends in March 2019.

All of the above is weighing on the delicate balancing act that the Chinese authorities have been attempting to pull off for much of the last two years. After a long period of debt-fuelled economic growth that risks longer-term financial stability, the government has been trying to rein in excessive credit growth and cut debt levels. But policy makers do not want de-leveraging to slow GDP growth much below the 6-6.5% target. Between Q4 2016 and Q1 2018, regulatory controls aimed to limit off balance-sheet or 'shadow' lending activity and monetary policy delivered tighter domestic liquidity. Over recent months, demand weakness has tilted the balance more towards the need to sustain economic growth.

Key indicators for China's monetary policy



Sources: Haver Analytics, QNB Economics analysis

On the monetary front, the People's Bank of China (PBOC) has been using several policy tools to ease liquidity. After following most US Federal Reserve (Fed) rate hikes with 7-day open market operations (OMO) reverse repo rate hikes between January 2017 and March 2018, the People's Bank of China (PBOC) has been standing pat despite three additional Fed rate hikes. The PBOC's net injection of funds through OMOs has contributed to loosen the 7-day interbank pledged repo average interest rate in recent months. Moreover, reserve requirement ratios (RRR) to banks, an important instrument to manage the money supply, were lowered by 350 basis points since March 2018, including the most recent action on January 4th 2019. This added to the PBOC's December 2018 decision to create a new Targeted Medium Term Lending Facility (TMLF). With lower rates and longer maturity than other facilities, the TMLF will provide banks with additional funding to ramp up credit to the private sector, especially to small and medium enterprises.

On the fiscal front, new initiatives are creating a more supportive policy stance. Since April 2018, the government has already announced VAT rates reductions, lower social security taxes, special tax deductions for individuals of different income levels and a lifting of tax-free income thresholds. All these reforms are set to boost private sector spending.

On the quasi-fiscal side, after a low start in the first two quarters of 2018, the central government instructed local governments to accelerate the issuance of new special bonds targeting special funding needs, such as land development. The action is supporting the stabilization and even slight recovery in infrastructure investment growth.

The accommodating shift in China's monetary and fiscal stances is expected to continue as domestic and external demand weakens. All in all, supportive policies are expected to place a floor under GDP growth at around 6% y/y for 2019.

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