



# Sinology

by Andy Rothman

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- \* Investor sentiment recovered and real activity stabilized in the first quarter, with only a modest credit boost.
- \* I expect to see further improvement in the coming quarters, without significant stimulus.
- \* The biggest risk to these expectations would be the failure of Trump and Xi to reach an agreement to avoid a trade war. Given that both leaders seem flexible and keen to strike a deal, I think that risk is low.

## THE WORLD'S CHEAPEST STIMULUS

With just a modest boost to credit, the Chinese government succeeded in strengthening investor sentiment and stabilizing real economic activity during the first quarter of the year. The growth rates of income, retail sales and industrial production were stronger than in the fourth quarter of last year, without a dramatic stimulus. The central bank has signaled that it is comfortable with growth prospects for the coming quarters and wary of unnecessarily raising the national debt burden, so any additional stimulus will likely be even more modest.

In my view, the biggest weakness in China last year was poor sentiment among the country's entrepreneurs and investors, despite reasonably healthy macro activity and strong corporate earnings growth. This provided the government with an opportunity to take several inexpensive steps to boost sentiment.

As expected, the state-controlled banking system increased credit flow during the first quarter, but—also as expected—the increase was modest. The growth rate of outstanding augmented total social finance (TSF), the most comprehensive metric for credit in the economy, accelerated to 11.3% year-over-year (YoY) in March, up from 10.8% in February and the first month over 11% growth since September. But, to put this into context, the 11.3% pace in March was slower than the 12.6% pace in March 2018; the 14.6% in March 2017 and 16.6% in March 2016.

Another way to illustrate the modest scope of the credit stimulus is to look at the gap between the growth rate of augmented TSF and the growth rate of nominal GDP. In the first quarter of 2019, the gap between the growth rate of credit and of nominal GDP was 3.5 percentage points (pps), roughly the same as the 2.3 pps gap in 1Q18, and significantly smaller than the 9.7 pps gap in 1Q16. To put this into further context, in 2009, as Beijing was responding to the Global Financial Crisis, the gap was 26.8 pps.

It is also worth noting that the government has not abandoned its financial sector de-risking campaign. Off-balance sheet, or shadow credit, *declined* 10.3% YoY in March, compared to *increases* of 5.5% in March 2018 and 11.5% in March 2017.

Beijing also refrained from turning on its traditional public infrastructure stimulus taps. Infrastructure investment rose only 4.4% in the first quarter, compared to 5% in 4Q18 and 13% in 1Q18.

In addition to the modest boost to credit, the other steps taken by the Chinese government to improve sentiment were:

**Intensive and apparently flexible negotiations with the Trump administration, leading to expectations that the tariff dispute will not escalate into a trade war.** Treasury Secretary Steven Mnuchin recently said, "We're hopeful that we're getting close to the final round of concluding issues."

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This dispelled the key reason for pessimism, as Chinese investors had told me they were concerned about far more than just a disruption of shipments to what was China's top export market. They worried that Trump might escalate the conflict beyond tariffs, limiting the ability of Chinese to study in the U.S., or banning Chinese imports of American semiconductors, which are a foundation of China's tech sector. The negative consequences of a possible Cold War-style relationship between the world's two largest economies weighted heavily on domestic sentiment last year.

**Xi Jinping resumed his rhetorical and policy support for China's private firms, which account for most employment and all net new job creation in China.** During the first three quarters of last year, for reasons that remain unclear, Xi had voiced strong support for state-owned enterprises (SOEs), while expressing little love for entrepreneurs, leaving them apprehensive about the future. During the last several months, however, Xi has gone out of his way to embrace entrepreneurs and to instruct banks to boost lending to smaller enterprises.

**Value-added taxes (VAT) and personal income taxes were cut, delivering a boost to consumer and producer sentiment.** These steps are part of a long-running effort to reduce taxes and fees, and are not a short-term stimulus, but the impact on sentiment was material. (Removing 84 million workers from the personal tax rolls never hurts consumer sentiment.)

The most striking impact of all of these steps was that during the first quarter, the Shanghai Composite Index (A-shares) rose 24%, and as of April 16 was up 30% year-to-date, almost erasing the 25% full-year decline in 2018.

Improved sentiment also delivered a modest boost to economic activity. Most first-quarter macro numbers were stronger than expected: up from the fourth quarter, although still weaker than during 1Q18.

One of the brightest spots was strong income growth, supporting the largest part of the Chinese economy, consumption and services. The cut to personal income taxes led the real (inflation-adjusted) growth rate of per capita disposable income to reaccelerate in the first quarter, rising 6.8%, up from 6.1% in 4Q18 and 6.6% a year earlier. This drove real retail sales up 6.9% YoY in the first quarter, up from 6.0% in 4Q18 but down from 8.1% in 1Q18.

The consumption story has stabilized but has not fully recovered: the nominal growth rate of household consumption, based on a quarterly survey, slowed to 7.3% in the first quarter, down from 8% in 4Q18 and 7.6% a year ago.

Manufacturing also stabilized, with industrial value-added rising 6.5% in the first quarter, up from 5.7% in 4Q18 but down from 6.8% in 1Q18.

The most disappointing data point signaled that privately owned firms remained cautious in the first quarter, as their investment rose by only 6.4%, down from 8.7% in 4Q18 and 8.9% a year ago. I will be watching closely to see if the confidence of China's entrepreneurs returns later this year.

In the coming quarters, I expect to see additional modest improvement in macroeconomic conditions, due in part to stabilizing sentiment and a weaker base. I also expect that growth rates for corporate earnings will remain healthy, although a bit slower than last year. The biggest risk to these expectations would be the failure of Trump and Xi to reach an agreement to avoid a trade

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war. Given that both leaders seem flexible and keen to strike a deal, I think that risk is low. Trump seems to believe that resolving this problem is important to his re-election prospects, and Xi wants to avoid a conflict that could escalate into a trade war, jeopardizing China’s long-term economic development.

While a Trump–Xi deal is likely on the horizon, it will not resolve the longer-term challenges in bilateral relations. But, taking a trade war off the table is a prerequisite for starting to address those challenges.

Regards,

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Sources: Matthews Asia, CEIC, Ministry of Finance