China Bulletin: Economic Policy

Our view on the reserve requirement ratio cut of September 6th and August financial data

On September 6th after market close, PBoC announced a reserve requirement ratio (RRR) cut of 0.5% for all banks, and an additional 1% cut for provincial banks (those whose business is only in local provinces). The announcement states that the cut will release about 900 billion CNY reserves to commercial banks and reduce their funding costs by 15 billion annually.

In line with its LPR reform in August, PBoC aims at streamlining the monetary policy transmission mechanism and reducing financing costs, especially for small and private firms who were squeezed severely by the recent economic slowdown and crackdown on shadow banking. Now with the RRR cut in place, the next LPR quote due on September 20th may trend lower as a sign that the task of lowering financing costs is successfully being achieved. Additionally, PBoC may charge a lower rate when extending MLFs in October or November, further lowering LPR. The effectiveness of this, however, is doubtful as not only is there restricted supply caused by banks' reluctance to extend credit to the lacklustre sector, but there is also sluggish financing demand due to an increasingly bleak fixed asset investment outlook.

Another noticeable point is that recent RRR cuts are often accompanied by PBoC draining liquidity from the market. It de facto causes a structural shift, simultaneously reducing bank funding costs while also reducing the liquidity available to non-bank financial institutions. However, with current ample market liquidity, the draining should only have a marginal effect on financial markets.

August financial data surprised to the upside, mainly due to the pace of crackdowns on shadow banking being slowed. Long-term corporate loans recovered to a certain extent, and if this continues in the coming months, we believe that improved fixed asset investment in manufacturing may follow. Household long-term loans have grown at a very stable rate, despite policy makers persistently tightening housing policy

China growth slowdown continues

China growth continues to slow amid the US-China standoff and an ongoing global slowdown. The most acute pressure so far comes from subdued fixed asset investment, especially in the public infrastructure sector, as shown in figure 1. Housing investment remains upbeat through 19H1, though the market expects decreasing house sales to bring down housing investment from as early as 19Q4 onwards, as discussed in our July report. Infrastructure investment may step in to reduce unemployment once housing investment tumbles, fortified by a large amount of local government bond issuance.

Figure 1 China Fixed Asset Investment by Type

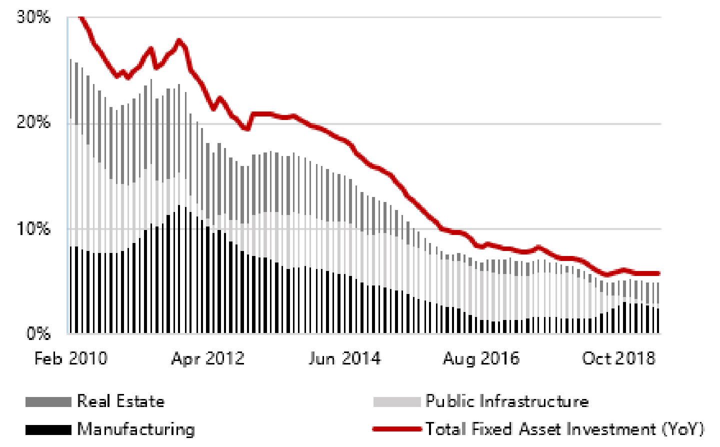
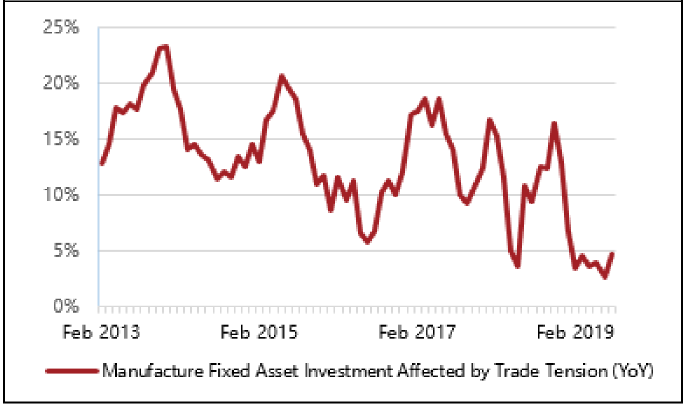


Figure 2 Trade Tension Affected Subsector Investment



Manufacturing fixed asset investment, which is subject to drag from the slowing housing market and external shocks, is crucial to the economic outlook now. Reduced housing investment may bring down the currently buoyant level of investment in construction related sub-sectors from 19Q4, though the damage may be dampened by increased fiscal spending on infrastructure. Trade tension also took its toll on manufacturing fixed asset investment, as displayed in figure 2. The most affected sub-sectors, in our view making up about 14% of total manufacturing fixed asset investment, recorded the lowest year on year growth in more than 7 years. The downturn may fade into 2020, mainly due to the base effect and improved financing conditions for manufacturers, though part of the supply chain is shifting out of China permanently.

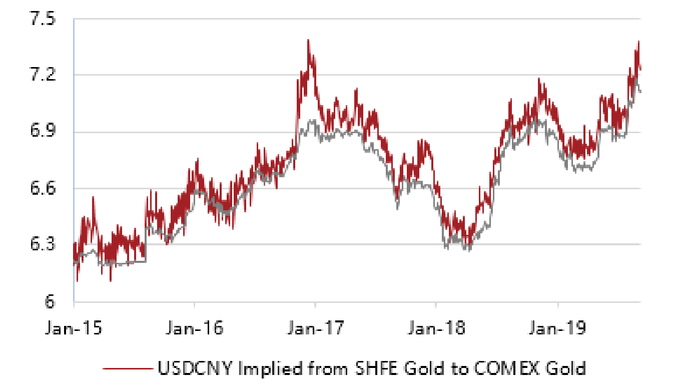
The solution to the permanent supply chain shift is to boost investment in high end manufacturing sub-sectors, including machinery, equipment and medicine production. Fixed asset investment in these sub-sectors, now around 40% of total manufacturing investment, has recovered from the previous trough. Policy tailwinds and more favorable financial conditions could help secure the outlook, though it still needs to be monitored how effective it could be at upholding manufacturing fixed asset investment and economic growth.

Figure 3 High End Manufacturing Fixed Asset Investment

2nd Floor | 75 King William Street
London EC4N 7BE
+44 203 617 5260
marketaccess@chinapostglobal.co.uk
www.chinapostglobal.com

China Post Global
Market Access
Exchange Traded Funds

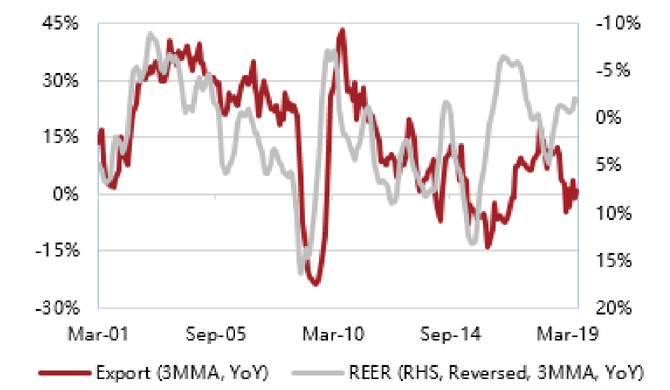
Figure 5 USDCNY Spot and Gold Implied Exchange Rate



Exports stall and CNY close to equilibrium level in the near term

The export sector is stalling around flat after an outbreak of trade tension but is far from the previous low in 2016 with help from the REER depreciation. It is believed that exporters are trying to front run tariffs and so exports may see a sharp decline into 2020, the implication of which would mainly be slowed growth, as analyzed before, and a depreciating currency. PBoC has acknowledged the pressure by loosening its tolerable trading band for USDCNY in early August and, based on the currency's reaction that followed, it is safe to infer that capital outflow pressure is not acute.

Figure 4 China Export vs REER



CNY depreciation expectation is contained at the moment, though PBoC monetary policy tilts slightly towards accommodative. One of the most prominent distinctions of monetary policy from 2015 is that the regulator curbed credit flowing into the asset market and thus curtailed capital outflow. With recent policy combinations and the balance of payments, continuous depreciation is not the base case scenario, and the current level should be close to equilibrium in the near term.

2nd Floor | 75 King William Street
London EC4N 7BE

+44 203 617 5260

marketaccess@chinapostglobal.co.uk

www.chinapostglobal.com

China Post Global

Market Access
Exchange Traded Funds