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# MACRO OUTLOOK

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Growth To Stabilize as Beijing Prepares for a Rockier 2020



## KEY TAKEAWAYS FOR 4Q2019

- China's growth will likely remain stable through 4Q2019, with minimal risk of the growth rate dipping below 6%.
- Looking beyond 4Q2019, however, the growth picture becomes muddier because of a series of headwinds, ranging from property sector slowdown to softness in the global economy.
- As such, Beijing will likely again refrain from major stimulus for the rest of the year, while at the same time prepare for the anticipated growth slowdown. If there is the possibility of any major stimulus, it will likely only come at the very end of the year to pave the way for 2020.

With China's third-quarter growth coming in at 6%, the lowest since 1990, it has reignited market anticipation for stronger stimulus. However, the weak headline figure belies an economy that had found its footing by September and will likely soon stabilize.

This means there is less urgency to ramp up stimulus. Instead, current policy support will be ratcheted up for the remainder of the year. As the economy stabilizes, Beijing will use the rest of the year preparing and refining its stimulus tools in anticipation of a global economic contraction in 2020.

The rest of this outlook will focus on near- and medium-term growth prospects, examine why the economy will stabilize, even if short-lived. Finally, I will forecast policy actions that Beijing will likely take in the fourth quarter to close out the year.

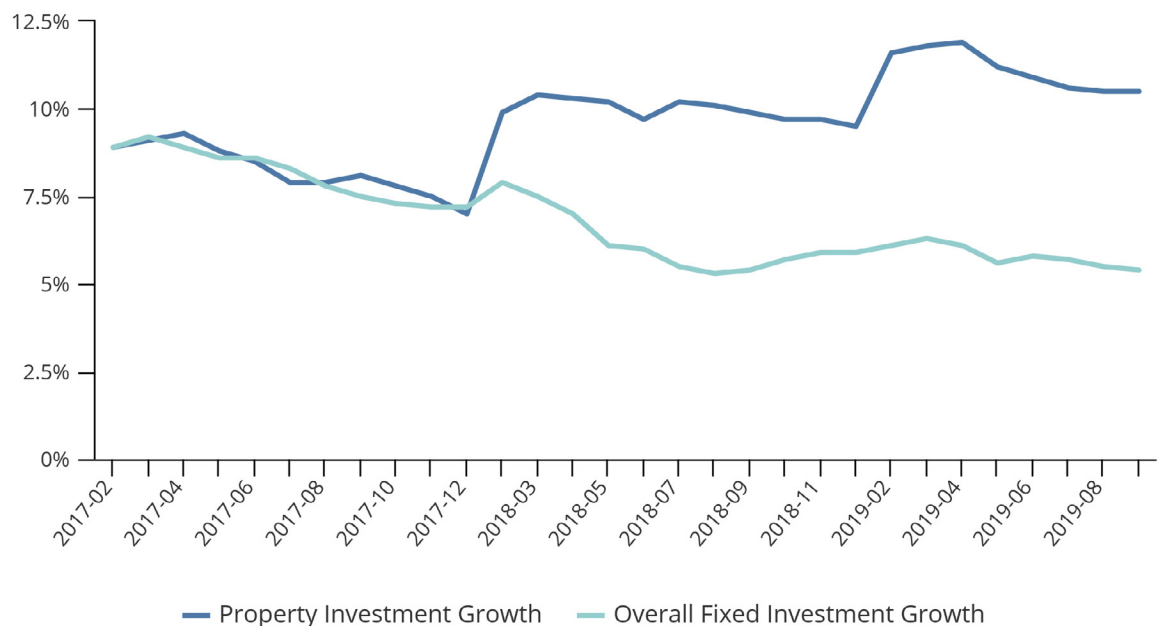
## RESILIENT PROPERTY SECTOR AND FISCAL SPENDING WILL SUPPORT GROWTH

During July and August, the Chinese economy seemed on the verge of collapse. For example, monthly growth of industrial value-added and energy consumption both fell to nearly zero. Yet by September, most economic indicators had rebounded from their summer lull. Barring any further escalation of the trade war, I believe there is minimal risk of growth falling below 6% in 4Q2019.<sup>1</sup>

A couple reasons inform this view. One is the resilience of the property sector and two is the rebound of fiscal spending since September.

Despite Beijing's [hawkish signals](#) in the second quarter on containing property sector overheating, it has actually remained one of the few bright spots this year. Property investment has seen double-digit growth since the start of 2019 and has been one of the key drivers of growth (see Figure 1).

Figure 1. Property Investment Has Been Significantly Stronger than Overall Investment (%)



Source: National Bureau of Statistics.

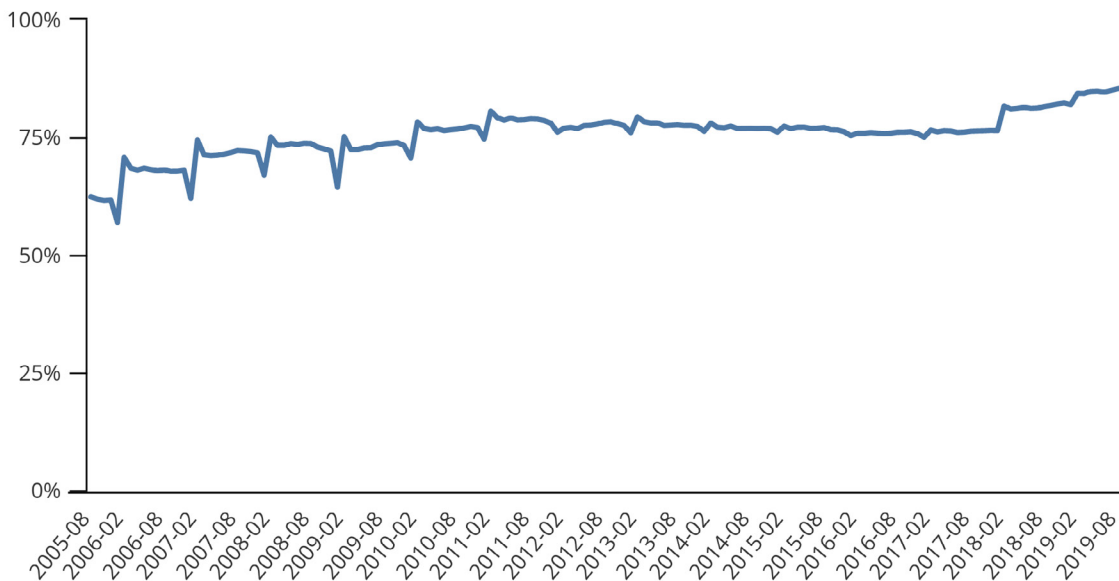
But this resilience isn't likely to last beyond a couple more months. Even as investment in property has held up, other proxy indicators unanimously point to a sector that is weakening. For example, total land sale growth among the top 100 cities has slowed down since August and has veered into negative territory since early October. Property price growth, too, has moderated significantly since June.

What appears to be happening is that property developers took to heart Beijing's earlier warnings about the property sector crackdown. That assumption has led developers to believe that price growth will be lower than their cost of borrowing. This means land already purchased needs to be built out and sold as quickly as possible. Otherwise, they risk losing money as revenue from property sales will grow slower than the cost of covering interest expense.

This is why property investment and construction activity growth on already purchased land have remained robust while new land sales have slowed sharply.

Moreover, a long backlog of orders will also support investment in the near term. As a portion of total sales, housing presales is more than 10% higher than the long-term average (see Figure 2). So even after property sales begin to slow, this backlog will sustain investment for some time.

Figure 2. Presales Will Sustain Property Investment in Near Term (%)



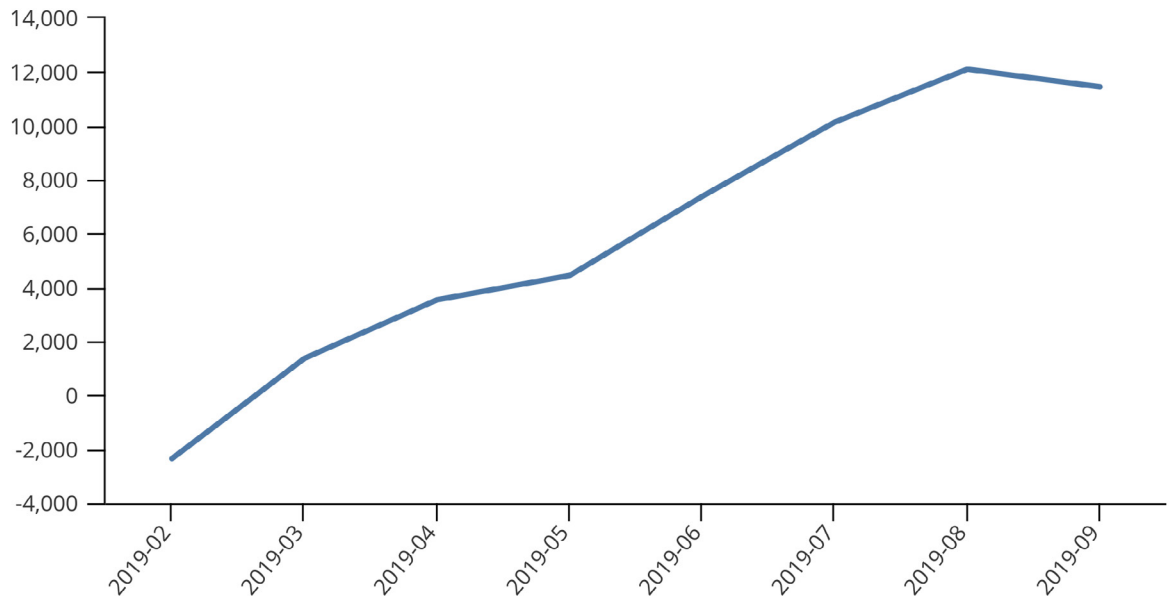
Source: NBS.

These two tailwinds will likely persist and support growth in coming months. But as new land sales continue to weaken and the backlog gets depleted, property investment over the medium term will decline and turn into a drag on growth.

In terms of the rebound in fiscal spending in September, that has much to do with Beijing spending idled funds that were already allocated in the third quarter. For instance, fiscal expenditure throughout 2019 has consistently lagged behind government borrowing, an

acute problem for local government project bonds (see Figure 3). What is more, the gap between the fiscal deficit and borrowing widened during the summer, with unused funds rising from 738 billion yuan (\$104 billion) in June to 1.2 trillion yuan (\$170 billion) in August.

Figure 3. Local Government Idled Funds Accumulated Rapidly Through August (in 100 million yuan)



*Note: Idled funds are calculated as the difference between local government funding deficit and local government project bond borrowing.*

Source: Wind.

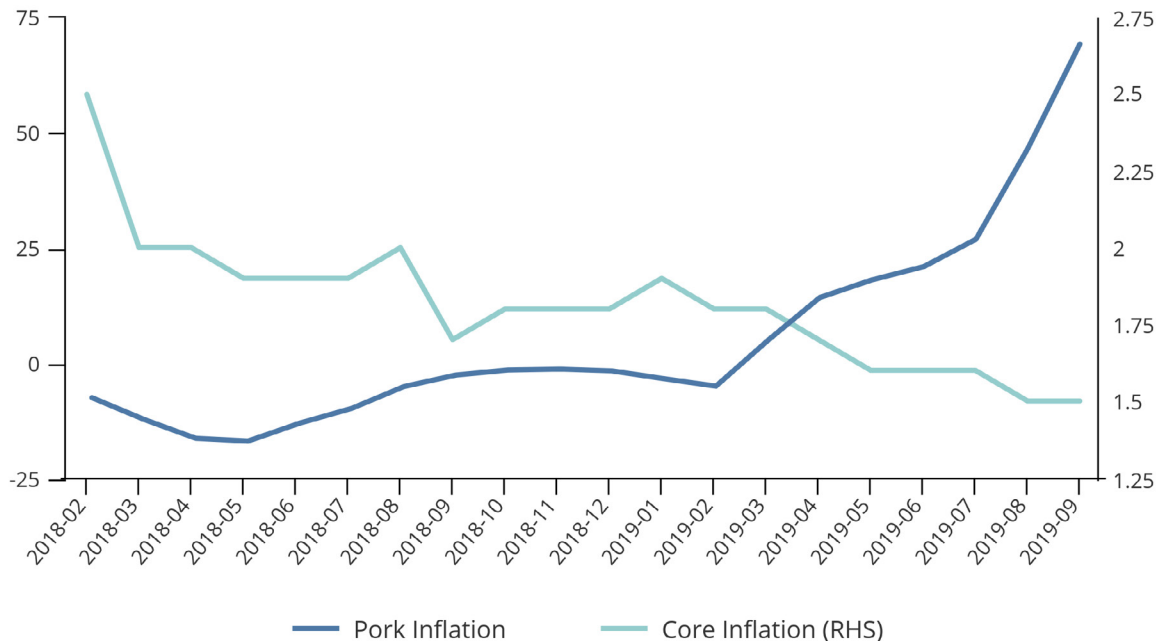
Indeed, this delay in converting borrowing into spending was mainly responsible for the weakness in third-quarter growth. If the government had not allowed the gap between the fiscal deficit and borrowing to widen, that would've raised the fiscal deficit by 406 billion yuan (or 1.7% of 3Q2019 GDP). Even with the numerous negative shocks to growth in the third quarter, such as the escalation in the trade spat, an increase in the fiscal deficit/GDP ratio of 1.7% would've likely prevented the sharp slide in growth.

This gap between borrowing and spending isn't likely to be sustained, and September showed the first signs of the fiscal deficit expanding again. Delayed spending means that the government now has more money to spend in 4Q2019, so fiscal spending will be a bigger driver in stabilizing the economy. This implies that at least part of the third-quarter weakness was temporary and unlikely to last.

## DARK CLOUDS GATHERING ON HORIZON

The temporary growth stabilization notwithstanding, the Chinese economy is still weaker than at any point since early 2019. The unemployment rate is edging towards Beijing's red line of 5.5%. And, despite the almost doubling of pork prices, inflation for almost everything else continues to decline (see Figure 4).

Figure 4. Excluding Pork, Inflation for Everything Else Has Been Trending Down



*Note: Core inflation excludes energy and food.*

Source: Wind and author calculations.

Plenty of other downside risks remain on the horizon. The uncertainties around the trade conflict will continue to negatively affect Chinese growth, not necessarily directly but indirectly by dampening private investment. For instance, if property investment is excluded, then private investment growth is now close to zero.<sup>2</sup> In addition, the trade conflict has had global ramifications, as evidenced by the recent softness in other major economies. Weak global demand will in turn further drag down China's export sector that has already turned to negative growth in September.

As such, conditions could deteriorate rapidly in coming months, and Beijing needs to capitalize on the current stable environment to actively prepare for a more challenging 2020. This has implications for Beijing's policy choices in 4Q2019.

For one thing, Beijing has more breathing room and will not need to implement an urgent stimulus. Instead, it has the liberty to refine its stimulus tools to deal with headwinds and minimize the negative effects from any stimulus. And this approach is very clearly showing up in both monetary and fiscal policy.

### *Interest Rate Cuts Will Be Met Through Competition*

After the initial cut of the loan prime rate (LPR) by six basis points (bps) in August, the LPR was cut again by five bps in September and saw no change in October. The smaller LPR cuts are certainly related to the reduced urgency for stimulus, but that doesn't mean the lending rate cut has stopped.

Rather, lending rate cuts are taking place in an indirect way, via increasing competition among banks. Previously, Chinese banks effectively operated as a price cartel that imposed a floor on the lending rate, usually at 90% of the benchmark lending rate.

Along with the LPR, the People's Bank of China (PBOC) also introduced penalties for price cartel behavior of any kind—those banks caught engaging in such behavior will not pass the regulatory review. Indeed, by September, [more than 8%](#) of loans were already below the previous floor.

The abolition of the interest rate floor will introduce more competition among banks over time. For instance, it's usually the biggest and most credit-worthy borrowers that receive the lowest interest rate. But without the interest rate floor, banks will make less on interest from their biggest customers. This will make lending to smaller or less creditworthy borrowers relatively more appealing and induce banks to more actively lend to small and medium enterprises (SMEs). It could lead to a virtuous cycle of lower interest rates overall and greater credit availability for SMEs. Put differently, in the near term, the drop in the lending rate will be driven less by LPR cuts but rather by banks offering discount rates as a result of greater competition.

Inducing competition between banks is going to be a gradual process. After all, it is unrealistic to expect bank behavior to change from being a price cartel to more competition overnight. But Beijing can take the time now to lay the groundwork for what will be an arduous but ultimately beneficial process. Compared to across-the-board rate cuts, lowering the lending rate through competition is less likely to trigger financial speculation.



Despite the more gradual pace, the cumulative size of the lending rate cut will still be substantial. Given the continued decline in inflation and uncertainties around growth, there is still need for more significant rate cuts. Therefore, the cuts that have already happened are merely the tip of the iceberg, and I maintain that the lending rate will drop by around 20 bps through 4Q2019. Meanwhile, both LPR and central bank lending rate cuts will resume in late fourth quarter.

### *Spending Money Faster*

Recent news of Beijing asking local governments to submit next year's [investment plans](#) earlier than previously has led to speculation that one form of stimulus will be moving next year's borrowing up to 4Q2019. But this speculation seems unfounded. As the analysis above shows, borrowing is not the real constraint. And since 1Q2020 looks more challenging than now, it makes more sense to concentrate stimulus for the first quarter next year.

What's behind the request for advance submission of local investment plans is likely aimed at avoiding the protracted delay between spending and borrowing. That's because the lag is mostly the result of a lack of planning rather than a lack of investment opportunities.

Since overall infrastructure investment growth is still positive, it is highly unlikely that the delay in fiscal spending is the result of a shortage of projects. This is because fiscal expenditure accounts for only around half of total infrastructure investment. And compared to other forms of funding for investment, fiscal borrowing has the lowest cost. Therefore, even if there is not enough shovel-ready projects, fiscal investment will be the least affected.

Rather, it is more plausible that local governments didn't anticipate the scale of fiscal spending this year, which has increased by almost 1 trillion yuan (\$140 billion) compared to last year. So they have been slow in figuring out how all the money should be spent. Therefore, better planning will help to avoid a repeat of large-scale spending delays like this year.

## CONCLUSION

An uneventful fourth quarter will likely yield to a rockier 1Q2020. Even though the risk of China's growth slipping below 6% is minimal in the near term, growth headwinds—namely property sector slowdown and global growth uncertainty—are gathering strength and could put more significant downward pressure on the Chinese economy.

In the meantime, Beijing will use this temporary reprieve to lay the groundwork for stimulus tools that will hopefully have fewer negative spillover effects, including lowering the lending rate through encouraging competition between banks. Should Beijing announce a more robust stimulus, it will likely be announced around the end of December with an eye toward supporting growth in 2020.

### Endnotes

[1] At first glance, it appears that Beijing still needs at least 6.2% GDP growth this year and in 2020 to meet its target of doubling GDP between 2010 to 2020. Yet, the general economic survey conducted in 2018 will likely revise up China's cumulative growth between 2013-2018 by around 0.5% (the revision will be announced in late December). Therefore, China should still be able to meet its doubling GDP goal with growth around 6% in 2019 and 2020.

[2] This assumes private property investment growth is the same as overall property investment growth. Property accounts for 1/3 of total private investments.