Euler Hermes Economic Research

Economic Insight

China: MONKEY forces for the Year of the Monkey

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Executive summary

- **Markets**: Financial market volatility will remain elevated reflecting an unbalanced rebalancing. GDP growth will decelerate further to +6.5% in 2016 and to +6.4% in 2017 and volatility will increase.
- **Ownership**: Policymakers are likely to step up easing measures with a rise in the deficit target (-3.5% of GDP from -2.3%), eased monetary policy (-50bps policy rate cut, -100bps for Reserve Requirement Ratios) and lower renminbi (6.8-7 RMB for 1 USD). Clearer choices and communication will be provided to reassure the private sector.
- **Non-payment**: In 2016, insolvencies will increase by +20% and DSO to 84 days. Corporate debt is high (160% of GDP) and gearing will increase for industrial sectors (heavy machinery, construction and commodities) while sectors related to consumer demand (food), high end (computer) and subject to government targets (aeronautics, automotive) could experience more limited credit risks.
- ***Kapital*** expenditure i.e. investment: Company profits are expected to stabilize after -2% in 2015 on the back of modest sales volumes, deflationary pressures and tepid external demand. Investment growth will be below +5% in real terms for the first time in 25 years. Ongoing deleveraging, capital flight and lower FDI will limit investment financing.
- **Exports** black hole: China has been on a trade roller-coaster for the past year with limited export revenues in USD terms and causing major disruption to its tier 1 suppliers of raw materials (Malaysia, Latin America, Middle East and Africa) and to partner hubs (Singapore, Hong Kong and Taiwan). Solace could come in the form of a massive mercantilist move (One Belt One Road).
- **Yuan**: Downward pressures are increasing including a weaker export performance, tighter monetary policy in the U.S. and high deflationary pressures. In the short-run, competitiveness gains would be largely offset by another miscommunicated depreciation.

Financial market volatility is a symptom of China's economic woes not the problem – so far

Financial market turmoil stemmed from both poor economic news and policy miscommunication especially on the exchange rate. In spite of significant financial market disruption (stock markets down -43% last summer, for example), the limited relationship between financial markets and the real economy is good news. Market capitalization is lower than 50% of GDP, compared with above 100% in Japan, the U.S. and Hong Kong.

Even if the pass-through is limited, erratic movements on the stock markets (two market shut downs, unprecedented currency volatility) are often rooted in more frequent and acute signs of economic weakness. Diverging leading indicators, weak trade figures, further evidence of capital

Figure 1: Table of latest indicators

Economic dashboard				
Economic activity - hard data	Sep-15	Oct-15	Nov-15	Dec-15
Real industrial production (y/y)	5.7	5.6	6.2	5.9
Nominal Retail sales (y/y)	10.9	11.0	11.2	11.1
Nominal Government expenditures (y/y)	26.9	36.1	25.9	na
Nominal Investment in Fixed Assets in Urban areas (YTD, y/y)	10.3	10.2	10.2	10.0
Nominal USD Exports (y/y)	-3.9	-7.0	-7.0	-1.6
Nominal USD Imports (y/y)	-20.2	-18.6	-8.8	-7.4
Trade balance (USD bn)	59.7	61.3	53.7	59.4
Economic activity - hard data	Q1 2015	Q2 2015	Q3 2015	Q4 2015
GDP (y/y)	7.0	7.0	6.9	6.8
Primary Industry (y/y)	3.2	3.7	4.1	4.1
Secondary Industry (y/y)	6.3	6.0	5.8	6.1
Tertiary Industry (y/y)	8.0	8.5	8.6	8.2

Sources: IHS, Euler Hermes

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outflows and still elevated deflationary pressures are China's woes.

Q4 2015 GDP figures (see Figure 1) point to a further slowdown in economic activity (+6.8% y/y from +6.9% in Q3) even if consumption was boosted by yet another fiscal stimulus. Real disposable income is still on an upward trend (+7.4% in real terms in 2015). Services, the main growth driver, slowed to +8.2% y/y in Q4 (from +8.6% in Q3). Manufacturing accelerated moderately to +6.1% y/y in Q4 (from +5.8% in Q3). Primary sector (raw materials) growth stabilized at +4.1% y/y. This unbalanced rebalancing will continue as GDP growth decelerates further to +6.5% in 2016 and to +6.4% in 2017. Markets will continue to be volatile as fresh economic data come in but further policy support and solid private consumption will keep growth within a sustainable range.

Heightened financial stress could become a problem if China does not address fundamental weaknesses: its policy crossroads, including on the currency, the upcoming wave of credit risk, and the lack of incentives to invest because of the debt overhang. In the short-run, the feedback loop is limited to: (i) private consumption, which may stabilize in Q1 due to lower wealth effects from financial markets; and (ii) a slowdown in services (50.5% of GDP in 2015) as indicated by PMIs (down to 50.2 in December 2015 from 51. 2 in November) as volatility affects financial services (1.3pps of GDP in 2015).

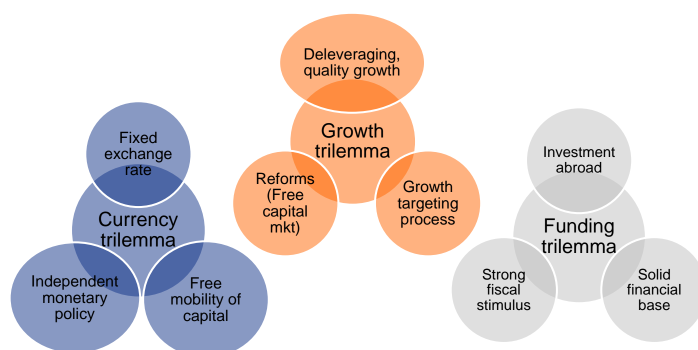
China's policy trilemmas: Choices and communication

China has been at a crossroads for quite some time on key aspects of its policy stance (see Figure 2). Firstly, keeping the RMB stable could be a difficult task. It may prove especially challenging if authorities aim both to preserve monetary policy independence and to further liberalize the capital account. Secondly, maintaining a solid financial base, namely high foreign exchange reserves and sound public finances, will require more selectivity in terms of expenditure. Thus, combining a large increase in foreign investment (through, for example, the One Belt One Road initiative) and strong fiscal support will probably not be sustainable in the medium term. Thirdly, the move to quality growth and the associated reforms (State-Owned Enterprises - SOEs, corporate deleveraging and freer capital markets) entail less control of the growth target. As indicated in our recent report China: Great Wall, Great Mall, Great Fall? Not really…, China needs close to +RMB3.3 of new credit to create +RMB1 of growth, compared with +RMB1.8 in 2011. In the wake of the fifth plenum last November, China's top legislature will have to vote in March on the how to continue its transition.

In the short-term, China will enter a "whatever it takes" mode embodied by stronger fiscal and monetary stimuli. On the fiscal side, the deficit was higher than expected last year (-2.5% of GDP) and Euler Hermes expects an increase to -3.5% of GDP in 2016. A rising deficit will stem from tax cuts for companies and increased government expenditure on infrastructure and social welfare. At the same time, an accommodative monetary stance will be maintained, with a rate cut of -50bps and a cut in the Reserve Requirement Ratio (RRR) of -100bps. Furthermore, we expect the RMB will depreciate to 6.8-7RMB/USD by H2 2016, which may result in +0.2pps of GDP growth through exports but continue to raise concerns about capital outflows.

China's authorities will have to set and communicate clearer priorities for the next two years to avoid perceptions of conflicting objectives and to reassure the private sector. Recent attempts to control financial markets (including circuit breakers and a 1% limit for a company sell-off, started January 9) have proven counterproductive and contrast with officials calling for deeper financial integration. China's iterative policy-making, after strong five-year plans, will continue to be under strong scrutiny. Clear communication will be pivotal.

Figure 2: Triple policy trilemma

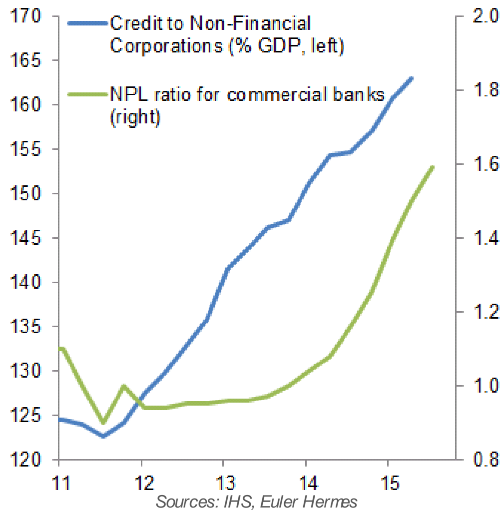


Sources: Euler Hermes

Corporate risk: Are 'zombies' back?

Corporate insolvencies increased by +25% in 2015 and are likely to grow by another +20% in 2016. Company DSO increased to 81 days in 2015 (from 77 in 2014) and is forecast at 84 days in 2016. Eased monetary policy helped drive credit costs lower but high debt stock and higher risk of non-payment for banks limits loan expansion. Corporate debt was 160% of GDP in mid-2015. Bank lending conditions deteriorated. Commercial banks reported a rise in Non-Performing Loans to 1.59% in Q3 2015 (from 1.16% in Q3 2014), which amount to RMB1186bn (approximately USD180bn). Net profit growth slowed markedly to +2.2% YTD y/y in Q3 2015, compared with an increase of +13% in 2014 (see Figure 3).

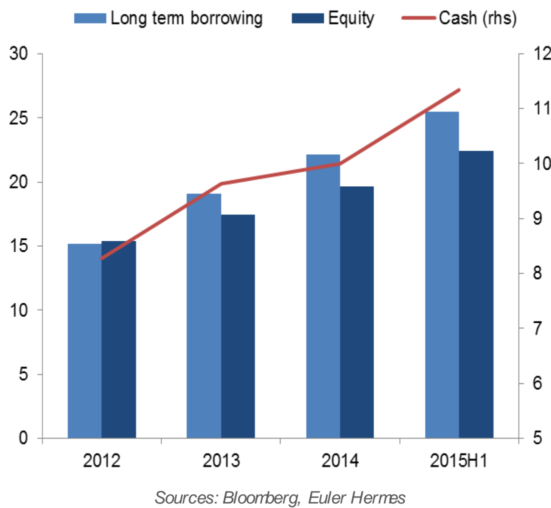
Figure 3: Credit to non-financial corporations and NPL ratio



Sources: IHS, Euler Hermes

High leverage is an issue for the longer term, particularly against a backdrop of profit decline. Using a panel of 2,900 listed companies in China, we analyzed the evolution of debt, equity and cash in China (see Figure 4). From 2012 to H1 2015, long-term borrowing increased by RMB10tn pushing the debt-to-equity ratio to 114% (compared with 98% in 2012). However, net debt-to-equity (discounting available cash) was only 63% in H1 2015, which confirms a sizeable, yet not inextricable, problem.

Figure 4: Equity, Debt and Cash (RMB tn)



Sources: Bloomberg, Euler Hermes

Looking at sectors (see Figure 5), the usual suspects (utilities, materials and industrials) show an increase in their gearing ratios - and declining profits. Unsurprisingly, in these sectors, payments terms also deteriorated over the period, with construction and manufacturing paying two weeks later on average between 2012 and 2015. Sectors closer to household final demand (consumer staples and discretionary) and sectors subject to government targets (including information technology and telecommunication services and transports) show a declining trend in their gearing.

Figure 5: Credit to non-financial corporations and NPL ratio

	2012	2013	2014	2015H1
Energy	46%	50%	56%	58%
Telecommunication Services	27%	42%	43%	44%
Information Technology	46%	51%	54%	54%
Consumer Discretionary	54%	51%	52%	51%
Industrials	94%	100%	104%	104%
Materials	98%	109%	112%	116%
Utilities	213%	200%	183%	164%
Consumer Staples	39%	40%	42%	40%
Health Care	37%	37%	40%	40%
Total	**99%**	**110%**	**113%**	**114%**

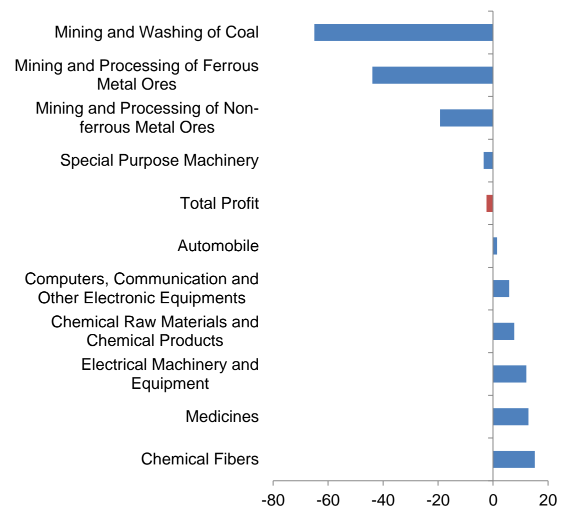
Sources: Bloomberg, Euler Hermes

Balanced, unbalanced or off-balance? Investment will be the key

Company turnover may remain constrained by moderate growth in sales and downward price pressures in 2016. Corporate profits for large industrial companies decreased by around -2% in 2015 though latest indicators point to a moderate improvement (stabilization in 2016). In particular, deflation remains a drag on profitability. Producer prices contracted for the 46th month in December. This happened across the value chain, with PPI for mining down -19.7% y/y in December and PPI for consumer goods -0.4% y/y.

Industrial production increased by +5.9% y/y in December and profits decreased by -4.7% y/y but this headline masks the struggle of medium- and small-sized companies (official manufacturing PMI at 49.6 and 44.9 respectively, compared with 50.9 for large companies). Larger companies benefit more quickly from easing policies but, as shown in Figure 6, even for large companies, capital-intensive sectors (heavy machinery and construction, for example) are bearing the brunt of the Chinese cash crunch. Also note that state-owned companies showed clear signs of weakness in 2015, with lower industrial production growth (+2.6% y/y in December) and lower profits (-21.9% in 2015). The authorities also clearly opted for the end of a long lasting ever greening (support for older industries, often with negative ROI).

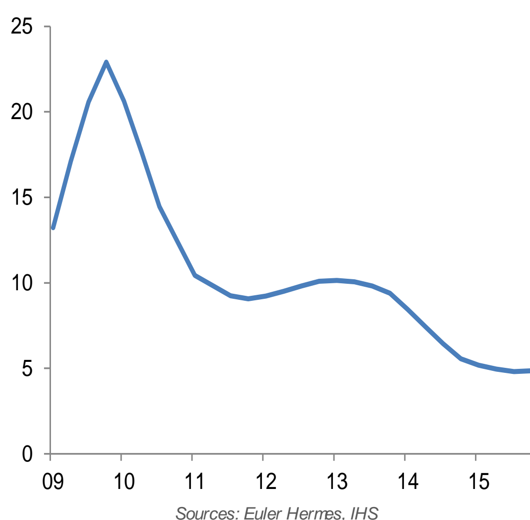
Figure 6: Industrial profit for large companies (2015 y/y)



Sources: Euler Hermes, Wind

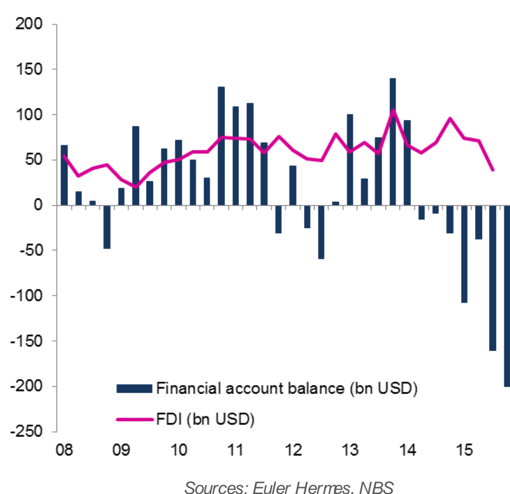
Investment growth will continue to decelerate in 2016 (first time below 5% growth in 25 years; see Figure 7) reflecting continued overcapacity reduction, high corporate risk and weak business sentiment. Financing investment will prove challenging as investor perceptions continue to be negative. FDI inflows continued to decrease (halved in Q3 2015 compared with Q2) and capital outflows intensified to reach USD504bn in 2015 (see Figure 8). Both local savings and foreign investors are needed to finance investment in China in 2016.

Figure 7: Real Gross capital formation (y/y %)



Sources: Euler Hermes, IHS

Figure 8: Financial account balance and FDI inflows (USD bn)

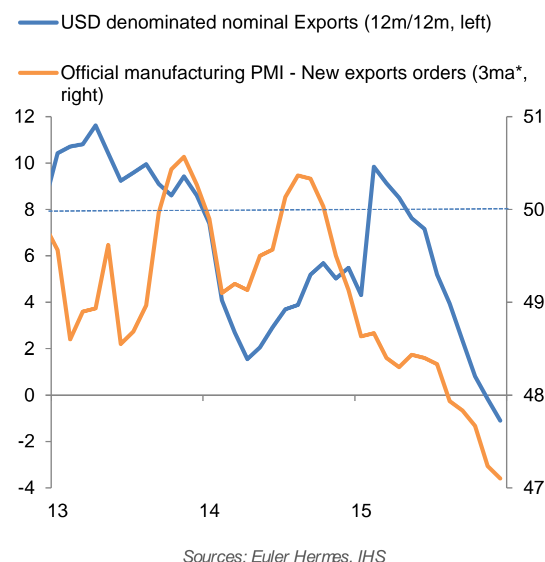


Sources: Euler Hermes, NBS

The end of the trade black hole

Trade figures show a mixed performance, still downward in USD terms but improving in RMB terms and reflecting a weaker currency. USD-denominated exports contracted by -1.6% y/y in December (from -7.0% y/y in November). In RMB terms, exports improved by +2.3% (from -3.7% y/y in November). USD-denominated imports contracted by -7.4% y/y in December (from -8.8% y/y in November). In RMB terms, imports decreased -4% y/y (from -5.6% y/y). As a result, the trade balance was slightly supportive at +USD59.4bn (from USD53.7bn) proving that the trade cycle still shows signs of weakness in Asia. As shown in Figure 9, the export decrease started over a year ago and is not over yet. The bazaar economy model is running out of steam and trade will be a key element of China's efforts to restore growth and influence. The One Belt One Road initiative and being granted Market Economy Status by the WTO could be the cornerstone of a stronger trade policy to support an upward move in global value chains rather than entering another round of currency wars.

Figure 9: Export indicators



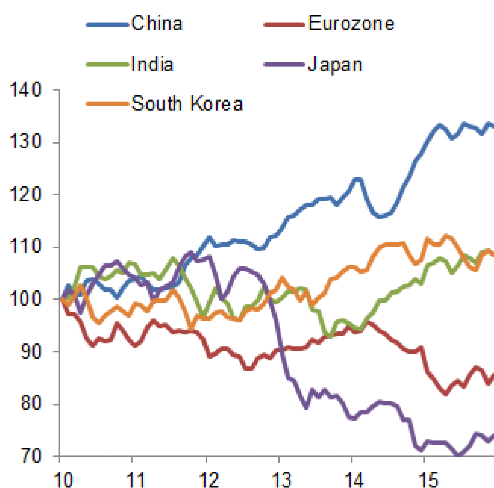
Sources: Euler Hermes, IHS

China's import deceleration has also had unprecedented effects on vulnerable primary commodity exporters such as Malaysia, Indonesia, Chile and Peru, GCC countries and South Africa while South Korea, Australia and New Zealand have been resilient because of strong macro-buffers. China accounts for 15% of primary commodity imports. Its price-maker role is notable for iron ore (48.3% of global imports), non-ferrous ores (29.5%), coal (19%) and crude oil (13.1%). The magnitude of China's deceleration is having a significant impact on global prices. Countries such as Singapore, Hong Kong, Taiwan and South Korea have been pivotal hubs (infrastructure, finance) for China's trade awakening and are now suffering.

The Yuan in the eye of the storm

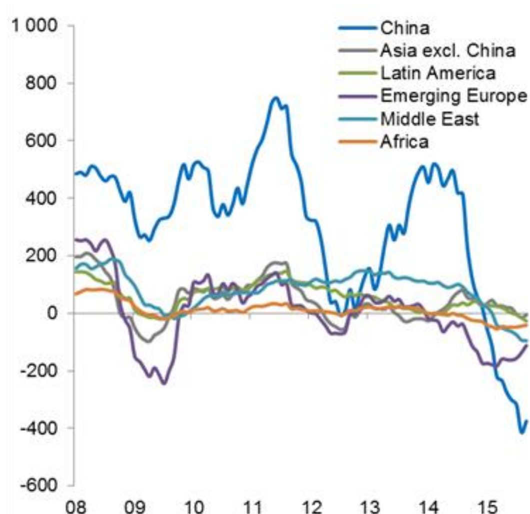
Currency development is both a cause and a consequence of China's difficulties. It is a cause because Chinese exporters suffered from decreasing price competiveness as a result of continued currency appreciation (see Figure 10) in recent years, as labor costs increased. Combined with moderate growth in external demand, it resulted in weaker export performance. Another depreciation of the yuan will create further pressure on countries competing or trading extensively with China, leading to further decrease in their producer prices. This may be the case for countries like Japan, but also for Eurozone countries.

Figure 10: Real effective exchange rate (100 = January 2010)



Sources: HIS, Euler Hermes

Figure 11: Reserves (y/y in USD bn)



Sources: IIF, Euler Hermes

Recent yuan movements are also a consequence from less confidence in the outlook and associated large capital outflows, further pressuring the currency. The current context calls for another round of depreciation: (i) international pressure eased with the inclusion of the RMB in the SDR basket; (ii) economic activity is fragile and export performance weakened; (iii) monetary tightening in the U.S. exerts downward pressure on the RMB/USD parity; (iv) deflationary pressures are elevated with the GDP deflator contracting by -0.8% y/y in Q4 2015; and (v) freer RMB could help reduce the use of foreign exchange reserves, which were depleted markedly in 2015 (see Figure 11). All in all, Euler Hermes expects the RMB will depreciate to 6.8-7 RMB to 1 USD. If communicated effectively, this currency depreciation may not have a negative effect on stock markets. Miscommunicated, as we have seen so far, it will be yet another nudge for the Chinese economy.

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