Five Vitamin C's for the Chinese Winter

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Executive summary

- **Promote Credibility:** Improving investors' faith in government policies will be pivotal to avoid volatility, maintain adequate capital inflows, and support private investment. Clear communication and a reasonable GDP growth target of +6% ± 0.5pp in 2017 are keys. We expect the economy to expand by +6.2% in 2017.
- **Contain Credit risks:** Corporate debt accounts for 170% of GDP, corporate bankruptcies are set to increase by +10% in 2017 (+20% in 2016). A tighter monetary stance in 2018 could initiate a gradual deleveraging. Fiscal policy will be kept accommodative to support growth.
- **Reduce excess capacities** in basic materials will remain a concern. Demand growth could be modest. Supply growth would adjust at a slow pace as authorities will prioritize employment over overcapacity reduction. Reforms of SOEs – which are major suppliers - will likely be gradual.
- **Manage the Currency:** The RMB could depreciate by -3% in 2017 against the USD. Pressures could mount due to a diverging monetary policy with the US, less favorable news, and higher returns on investment abroad.
- **Focus on Commerce:** USD-denominated goods exports may decrease by -7% in 2016. The US, which accounts for 18% of China's exports, may increase trade barriers. China will seek new commercial drivers: a price competiveness boost (Market Economy Status), new customers and new investment revenues (One belt One Road), strong partnerships and political influence (Regional Comprehensive Economic Partnership).

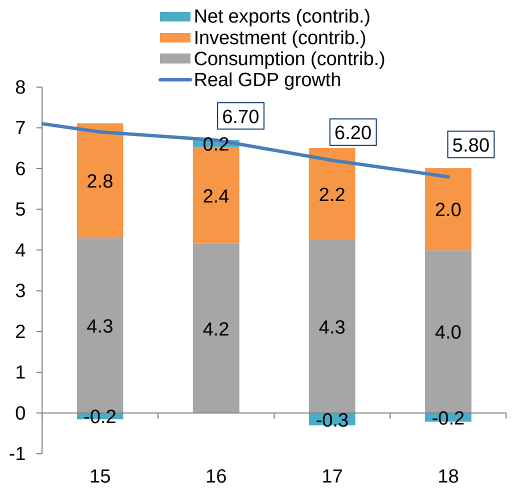
No slump, no jump but mind the bumps

Real GDP growth is expected to decelerate further in 2017 (+6.2%) and 2018 (+5.8%) but remains resilient.

In 2016, the economy has expanded by around +6.7% in line with the government's target of 6.5% to 7%. Domestic demand has remained the main driver thanks to higher public expenditures and firm private consumption. Exports and investment were the main drags.

Going forward, the policy mix would remain broadly supportive ahead of the 19th National Congress of the Communist Party (H2 2017) where the new leadership of the Communist Party would be elected. In particular, fiscal support would be maintained in both 2017 and 2018 to keep growth within an acceptable range: both public consumption and investment would remain

Figure 1: GDP growth forecasts



Sources: IMF, Euler Hermes calculations resilient. The central bank would maintain a cautious accommodative stance trying to support growth without raising financing risk in 2017. In 2018, a more urgent need to contain a further rise in corporate debt would translate to a gradual tightening. Private consumption growth would remain firm, reflecting positive employment growth and rising middle class. Stronger domestic demand would translate into higher imports growth.

Both exports and private investment would underperform. Private investment growth would be limited reflecting weak (international) investor's confidence, the reduction in corporate imbalances (e.g. deleveraging, overcapacity reduction), a more conservative monetary policy and limited growth in demand. Exports growth would be constrained by a modest growth in global demand and a more protectionist US.

We believe that five C's (credibility, credit risk, excess capacities, currency, and commerce) will shape the outlook for China in 2017.

Enhancing credibility over investors will be pivotal

Strengthening authorities' credibility over investors will be pivotal to avoid financial markets volatility, maintain adequate capital inflows and support private investment.

Since 2015, Chinese authorities have been struggling to keep investors calm. Strong peaks of financial stress have been reached with the surprise depreciation of the RMB in August 2015 and the implementation of circuit breakers in the beginning of 2016. Similar stress could be expected with: an adjustment of the property market, the creation of a new financial bubble with the launch of the Hong Kong – Shenzhen Stock Connect and disappointing economic news flows. This would be all the more damageable to China's economy as the country is already suffering from capital outflows: net capital outflows accounts (including the errors and omissions category of the balance of payment) for USD468bn in the first three quarters of 2016.

Improved credibility could stem from further and clear communication with markets participants. This includes further guidance on upcoming changes in the economic environment to avoid overreaction when they are implemented. The publication of guidelines on new exchange rate framework and authorities' proprietary Nominal Effective Exchange Rate in 2015 is a positive example as it enables markets players to follow RMB development with the same lens as the policymakers.

Having consistent and reasonable economic growth targets would also be pivotal. Adopting consistent targets consists in setting "un-conflicting objectives". For example, it is hard to achieve both strong (above +6.5%) and quality (less credit intensive, with reforms) growth. Similarly, it is hard to have a strong fiscal stimulus, invest heavily abroad and keep a strong financial base. A more reasonable approach would be to set lower and larger targets range, move from binding targets to more indicative and flexible targets. This will relieve pressures on policymakers to boost stimulus and let them focus more on the quality of than the quantity.

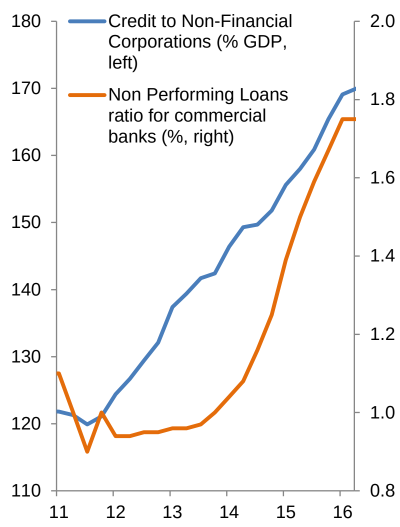
In that context, we believe that a real GDP growth target of +6% ± 0.5pp would be desirable in 2017. +5%, the half of long-term GDP growth could be set as a lower bound for the longer term outlook. In that context, assuming a progressive recovery in local prices due to a rise in commodity prices and RMB depreciation (2017), stronger reduction in overcapacity (from 2018 onwards), we could see a GDP deflator growth of around +3%. With a nominal GDP growth of +8%, China could gain +RMB6.1tn p.a. over 2017-18 (roughly USD890bn at current market exchange rate) which is close to the GDP of Indonesia. Note that this is still above the wealth China used to generate in the 2002-07 period (USD371bn per annum).

Authorities to begin to tackle credit risk

Credit management would be the second item on the agenda. We believe that the authorities will move to a tighter monetary stance by 2018. An aggressive fiscal policy (-3.5% GDP deficit target at least) would be maintained to maintain growth at a decent level.

Credit risk has increased significantly since the Global Financial Crisis. Corporate insolvencies are expected to increase by +20% and +10% in 2016 and 2017 respectively (+24% in 2015). Corporate debt has surged from 132% GDP in 2012 to an estimated 170% GDP in 2016, with an increase of +10pp per annum (see Figure 2). Unsurprisingly, this was accompanied by a deterioration of banks asset. The official non-performing loans ratios have increased to 1.76% in Q3 2016 (from 0.95% in 2012). Credit efficiency has also deteriorated. While the authorities needed to create around RMB1.8 of additional credit to generate RMB1 of additional growth in 2011, they now need to produce RMB3.6 for the same amount of growth. Such trends are not sustainable in the long run. Monetary authorities would need to take actions to lower credit supply growth to a more reasonable level (lower than nominal GDP growth).

Figure 2: Credit risk indicators



Sources: BIS, Euler Hermes

In the short run, they will probably keep policy rates at a low level in order to ease the transition. However, regulation will likely be tightened to avoid further financial distortions namely the creation of other bubbles (in real estate and financial sectors). This includes rules to limit house purchases (already started in some tier one cities), but also prudential rules to limit "risky lending" (*shadow banking* activities). Meanwhile, further measures (targeted rate cuts) to redirect credit growth to fragile (SME, rural companies) and New Economic model related agents (households, services, and innovative companies, e.g.) will likely be implemented. Post-2017, we believe that a gradual monetary tightening could happen with policy rate progressing to 5% (4.35% currently).

Reducing excess capacities is essential in 2017

Thirdly, authorities will have to deal with excess capacity. Sectors with proved overcapacity (steel, machinery and equipment, e.g.) would adjust at a very gradual pace due to supply constraint especially excessive support from the government.

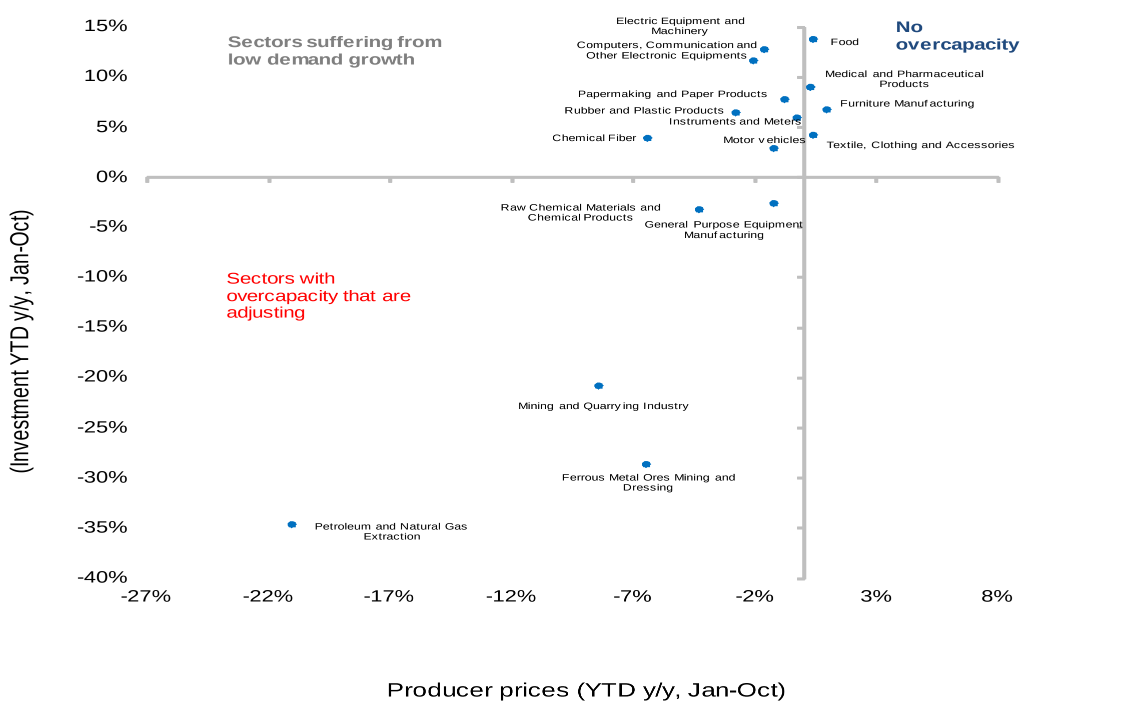
The stimulus initiated over the two past years has helped companies to replenish their balance sheets and bought some time for fragile manufacturers. In particular, higher credit growth had boosted the construction sector which in turn has boosted the demand for basic materials. Manufacturing deflation has eased significantly with year on year producer prices rising for the first time in almost 5 years from September. This led to a rise in industrial turnovers.

However, the problem is far from being solved. Figure 3 plots producer prices and investment growth for selected sectors. Negative growth in producer prices could be a sign of excess supply over demand. Investment is used to estimate supply dynamics. Negative growth could point to an adjustment in supply. We found 3 clusters of sectors.

Firstly, sectors where producer prices and investment suffer from overcapacity and are thus adjusting (Mining, Machinery). Secondly, sectors where investment is growing rapidly while producer prices are declining are to be monitored cautiously (Electronics, Motor vehicles). Signs of overcapacity are appearing as aggregate demand (exports and domestic) is weak but higher investment growth indicates that companies are pricing further growth in demand. Last, sectors strictly related to domestic demand (Food) show positive trend with both continued investment and positive price growth.

Looking ahead, we believe that this "trichotomy" will persist in 2017. First, demand growth for sectors with proved overcapacity is set to remain weak because its main driver (credit growth) is set to slow, products of these sectors will likely be prone to further protectionist measures. On the supply side, progress on SOEs reform (mergers and acquisition, restructuration or selective bailout, or insolvencies) will be pivotal as it could generate fairer competition and diminish market distortions. However, such improvement would likely be very progressive as authorities would like to preserve political stability and thus employment. In particular, we believe that a large employer would be kept afloat through favorable policies (liquidity injection, concessional loans or favorable taxation e.g.) even if it operates in overcapacity sector in the short run.
For sectors in the second category, the challenge will be to keep them on a sustainable trend and avoid creating structural overcapacity. Automotive is a good example where producers' investment should be monitored closely. Domestically, demand has increased due to accommodating taxation (tax incentives on new vehicles e.g.) for example. Assuming these measures fade away, demand growth could decrease rapidly. Last, basic goods (Food, healthcare related, e.g.) directed to the Chinese consumers would likely thrive reflecting growing middle class, improved wages and

Figure 3: Overcapacity at a glance



Sources: NBS, Euler Hermes

government support (cut in consumption tax for cosmetics).

Managing the internationalization of the Currency gradually

We expect more two-way volatility for the RMB in 2017-18 reflecting further liberalization of the currency. On the direction, we cautiously forecast a depreciation of -3% on average in 2017, continued but less depreciation in 2018 (-1%). Four reasons would shape this trend.

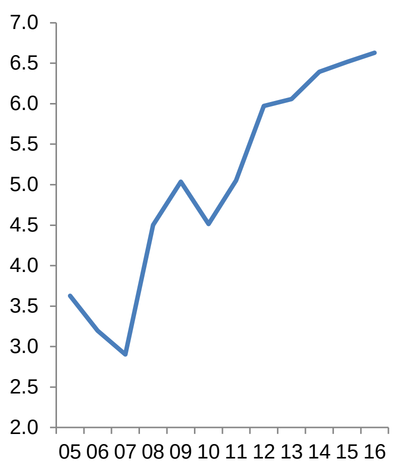
1. **Divergence in monetary policy.** The divergence in monetary policy between the US and China would continue next year with further rise in policy rate in the US. It should be reduced in 2018 with a gradual tightening in China.

2. **Lower economic growth.** Lower GDP growth, and persisting imbalances (high debt) growth would make investors more defensive and create a downward bias on the currency in the short run. More clarity on the policy direction by the end of the next year would alleviate some pressures.

3. **Higher return on investment outside of China.** Domestic investors would look for higher return on investment outside of China. Note that the 6.6 point of capital is needed to generate 1 unit of GDP in 2016 while in 2005, only 3.5 was needed (see figure 4).

4. **Redirection of excess savings.** Further opening of the financial account will favor capital movement and the redirection of excess saving. Note that China's national saving accounts for 46% of GDP in 2016, which is still above 21 points above the global average (25% of Global GDP).

Figure 4: Incremental Capital Output Ratio for China



Sources: IMF, Euler Hermes

Authorities may pursue currency internationalization but at a gradual pace to minimize the impact on growth. They would continue to intervene in forex markets to limit sharp adjustments of the currency, use temporary capital controls and initiate tighter regulation to limit the pace of capital outflows. The authorities recently tighten capital controls especially on transfers of amounts above USD5mn,

In the longer term, further liberalization of the RMB would bring clear benefit. On top of raising prestige and influence, this would help reduce currency risk and trading costs for China and countries involved in the same production network.

It is time to find new commercial drivers

On the trade front, China is at a turning point. USD-denominated goods exports are expected to decline by -7% in 2016 due to subdued demand overseas.
Going forward, the outlook seems challenging as trade relations with the US, it main partner, are about to deteriorate. The new US President voiced concerns about its country's trade deficit with the Mainland and claims that he will increase trade barriers in order to resorb this imbalance.
While it is likely that there will be protectionist measures taken by the US, the magnitude and therefore the impacts are hard to anticipate for now. China has 18% of its total goods exports directed to the US (3.7% of GDP).
Thus, a -10pp decrease of US demand for Chinese goods would subtract mechanically -0.4pp of GDP (-USD41bn).

In that context, China will probably try to find new trade drivers.

Driver #1: Market economy status

Firstly, China could rely on a competitiveness boost if it is granted Market Economy Status (MES), as special clauses of its accession protocol expire after 15 years. If it secures an MES the economic superpower will have the right to trade as a market economy.
This means that trading partners would be obliged to use Chinese domestic prices instead of higher-priced third countries as benchmarks in anti-dumping cases. Granting Market Economic Status to China could boost GDP (+0.2pp, +USD22bn) thanks to a boost in its price competitiveness. However, potential adverse effect for the EU (-USD10bn) and the US (-USD8bn) could act as a drag on the negotiations.
A probable outcome is either a clear and simple non-acceptance by the two superpowers with no change in the current regulatory framework or a mixed solution.

The first solution (clear non-acceptance) will be based on the fact that China is not an economy where market principles apply.
However, this could be difficult to justify considering that countries such as Russia have been granted the MES. More importantly it could lead to economic retaliations from China.
The latter could initiate protectionist measures such as an increase in tariff or indirect measure to curb imports.
It could also reduce financing support to western partners. For example, China promised that it could invest up to +EUR10bn in the context of EU Junker plan.

The second outcome could be a mixed solution where the EU/US acknowledge the end of the current set up and propose a new regulatory framework to limit the shock on their economy. This includes a clear and common definition of a market economy, the introduction of a new methodology to calculate dumping measures.
The "analogue methodology" could be abandoned and countries would rely on "fair international benchmarks" (cost of production of sale of a country in a same level of development e.g.) to estimate dumping margins. Moreover, western leaders would probably negotiate the protection of certain industries (steel, solar, e.g.) that are suffering from overcapacity.

Driver #2: The One Belt One Road Initiative

Secondly, China could seek new customers and new investment revenues through the One Belt One Road initiative. The latter consists in improving connectivity and economic cooperation in Asia, Europe, the Middle East and Africa thanks to massive infrastructure investment plans.
Financing means have already been built up (*Asian Infrastructure Investment Bank*, Silk Fund e.g.), projects are under progress (railways in East Africa, infrastructure projects in South Asia). In the short run, this plan could help Chinese companies to extend their customer base under government support.
Chinese corporates would be well positioned to get tenders related to infrastructure projects. Chinese exporters (construction materials, e.g.) could also benefit from larger opportunities. In the longer term, local implantation of Chinese companies in OBOR countries could translate into higher investment revenues.

Driver #3: Regional Comprehensive Economic Partnership

Thirdly, the mainland can bet on partnerships and increased political influence. While President Trump has indicated that he will withdraw from the TPP, China can for further regional integration with the promotion of the Regional Comprehensive Economic Partnership.
This mega-trade agreement which involves China, ASEAN, Australia, New Zealand, India, South Korea, and Japan represents a market worth around USD22bn, gathers 3.5mn people. It aims at liberalizing goods and services trade, facilitating investment flows and promoting best practices (reduction in Intellectual property-related barriers, e.g.). If the parties were to reach an agreement, regional integration could move a step ahead. On top of fostering intra-trade, the main impact could be a better redistribution of capital between countries in need (current account deficit) and those in excess (surplus).

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