CCXI

Macro-economy

Thematic Study

July 23, 2019

Will the Stable Growth Policy Resist the Downward Pressure on Economy?

- Review and Outlook of Macro-economy of the First Half of 2019

Overview

✧ **The economy receded QoQ, expected to face a greater downward pressure in H2 and grow by 6.1% annually**

GDP growth slowed down quarter-on-quarter (QoQ) in H1, with real GDP growing at 6.3% YoY, down 0.5 percentage point YoY or 0.3 percentage point from the end of last year. GDP is expected to grow by 6.1% annually.

The supply and demand sides were under different degrees of downward pressure. On the demand side, the internal trend of investment was divided. The stable growth policy worked to bolster infrastructure investment, the construction and installation investment supported the fast growth of real estate investment, but manufacturing and private-sector investment were still weak. Under the pressure on government revenue and expenditure, however, the recovery in infrastructure investment appeared limited. The tightening policy on real estate financing may put real estate investment under a downward pressure, which, coupled by sluggish endogenous investment, will keep investment under pressure in H2. The household consumption remains sluggish, showing limited momentum of recovery in the future in the context of slowing growth of household income and high leverage. Exports fell sharply YoY against the background of subsiding export rush effects and ongoing US-China trade frictions. In the future, China will still face the pressure of marginal slowdown amid the slowing global economic recovery and continuing uncertainties in US-China trade frictions. On the supply side, the end demand was low and the total supply continued to slow down. Given the unlikeness of substantial improvements on the demand side, the future production is estimated to remain exposed to a high level of structural downside risk.

Inflation continued to diverge. In H1, the rising prices of fresh fruits, pork and other foods drove up CPI, while the core CPI remained stable. The supply-side structural reform weakened marginally and PPI dropped YoY. In the foreseeable future, CPI trend is expected to remain under control as seasonal factors recede and carryover effects diminish. PPI will be still under a deflationary pressure due to insufficient domestic demand is insufficient and weaker carryover effects.

Financial data have improved overall, but still indicated structural problems. M2 and aggregate finance to the real economy were generally stable in the context of expansionary credit, expected to keep running steadily in H2. But the structural deterioration of financial data deserves attention. In H1, RMB showed a "relatively stable - volatile - relatively stable" pattern of evolvement under the combined effects of many factors. Looking ahead, the pressure of RMB depreciation will ease as the world has entered an interest rate cut cycle.

✧ **Micro entities lacked of vitality due to multiple adverse factors to the stable growth policy.**

At present, China is still in a critical stage of the three major battles, including preventing and defusing major risks. The ongoing economic downturn poses four challenges to China's economy: First, the poor transmission from easy money to easy credit amid the weak financing demand of the real economy may inflate structural bubbles. Second, the pressure on government revenue and expenditure has further increased, resulting in limited room for the fiscal policy to work. Third, as the macro leverage ratio is growing at a faster pace, the debt risk still deserves intense attention. Fourth, given the weaker vitality of micro entities during the economic downturn, the policy will have a limited short-term stimulus effect.

✧ **Macro policies strengthened counter-cyclical regulation to cushion the economic downturn**

The counter-cyclical adjustments made by macro policies in H1 have partially offset the economic downturn. "Stable growth" is expected to remain as the guiding principle for policies in H2: The monetary policy is expected to remain prudent and structural adjustment will continue. The fiscal policy will continue to strengthen and improve its effectiveness, with taxes and charges reduced to revitalize micro entities. Special bonds are expected to play a greater role in stabilizing growth under the heavy pressure on general public finance and government funds. Financial supervision will still focus on "stability" and pay extra attention to preventing "risks of risk handling". Reform and opening-up will be further advanced.

✧ **Summary and Outlook**

Looking forward to H2, China will see continued weakness on both demand and supply sides of the economy. Uncertainties will remain in US-China trade frictions. China's economy will feel a pressure of further downturn. In response to the economic downturn, the policy efforts will intensify to bolster "stable growth". But the continuing high leverage and elevated asset prices in the current economy will continue to restrict the policy intensity and effectiveness in ensuring "stable growth". Given that there remains some room to expand domestic demand, however, though the macro-policy efforts to stabilize growth are constrained, they will function as a "cushion" against economic downturn. Thus China's economic growth is still somewhat resilient.

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Policy Pursuit of Dynamic Stability amid Continuing Economic Downturn; January 14, 2019.

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I. Macroeconomic overview: The economic growth receded Quarter-on-Quarter (QoQ) decline, expected to further weaken in H2 and finish the year with an annual rate of 6.1%

In 1H2019, though the Chinese economy weathered the shocks from various downward risks thanks to the "six-pronged policy to boost stability" and a series of reform measures. As the stable growth policy began to work, the GDP growth rate in Q1 was flat with the fourth quarter of last year, better than the expected. However, the weakness on both supply and demand sides has not been fundamentally changed. In Q2, the Chinese economy felt a greater downward pressure due to the US-China trade conflicts. The main logic of economic operation in 2H2019 will not change much when compared with that in H1. The uncertainties in US-China trade conflicts will remain and the policy will continue to pursue "stable policy". Given the rising constraints on the "stable growth" and the deterioration of the micro-foundation of economic performance, however, the economy may face a greater downward pressure in H2 than in H1. But there is still some room to expand domestic demand. The macro-policy efforts to stabilize growth, albeit constrained to some extent, will function as a "cushion" against economic downturn. Achieving an annual economic growth rate of 6% or higher appears a certainty. GDP is expected to grow by 6.1% for the year.

Table 1: China's Core Macroeconomic Indicators in 1H2019

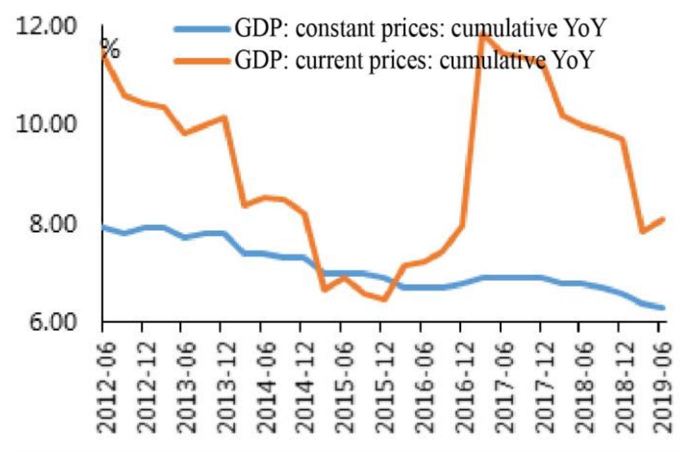
Core indicator	2018 (accumulative)				2019 (accumulative)		Change
	Q1	H1	Q1-Q3	Annual	Q1	H1	
GDP cumulative YoY (%)	6.8	6.8	6.7	6.6	6.4	6.3	↓
Industrial value added, YoY (%)	6.8	6.7	6.4	6.2	6.2	6.0	↓
Investment in fixed assets (%)	7.5	6.0	5.4	5.9	6.3	5.8	↓
Total retail sales of consumer goods (%)	9.8	9.4	9.3	9.0	8.3	8.4	↓
Exports, YoY (%)	13.73	12.52	12.22	9.88	1.40	0.10	↓
Imports, YoY (%)	19.44	20.06	20.17	15.84	-4.80	-0.30	↓
Trade surplus (USD100 million)	448.5	1354.07	2194.01	3511.41	763.10	1811.6	↑
M2, YoY (%)	8.2	8	8.3	8.1	8.6	8.5	↑
Aggregate financing to the real economy (RMB100 million)	58535	100691	154027	192584	81800	132300	↑
CPI (%)	2.1	2.0	2.1	2.1	1.8	2.2	↑
PPI (%)	3.7	3.9	4.0	3.5	0.2	0.3	↓

(Note: ↓, ↑ and ↔ indicate that an indicator in 2Q2019 recorded a decline, increase or flatness over the same period of 2018)

i. QoQ decline in GDP growth showed continued downward pressure on the economy

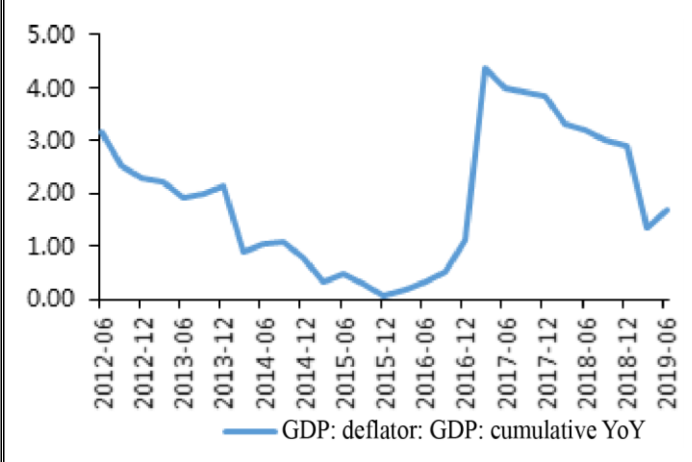
Real GDP grew 6.3% YoY in H1, down 0.5 percentage point YoY and 0.3 percentage point from the end of last year. In terms of quarterly performance, Q1 saw a YoY growth rate of 6.4% and Q2 saw a YoY growth rate of 6.2%. Although Q1 witnessed signs of slow but stable growth bolstered by the effective stable growth policy, as shown by GDP growth flat with Q4 of last year, the supply and demand were both weak in Q2 to further weigh on GDP performance. The increase in CPI led to a rebound in the deflator, with nominal GDP growth rising to 8.08% from 7.84% at the end of last year, down 1.9 percentage points YoY. **By economic sectors,** all the three sectors showed weakening growth. The tertiary sector with faster deceleration took up a smaller share of the economy, suggesting deterioration in the economic structure. **By demand components,** imports and exports slowed down YoY, yet slightly stronger than expected, so the contribution of net exports to economic growth turned from negative to positive, surging by 30.6 percentage points. The contribution of consumption to economic growth dropped significantly, by 18.4 percentage points YoY, but remained above 60%.

Fig. 1: Cumulative YoY Changes in GDP at Current and Constant Prices



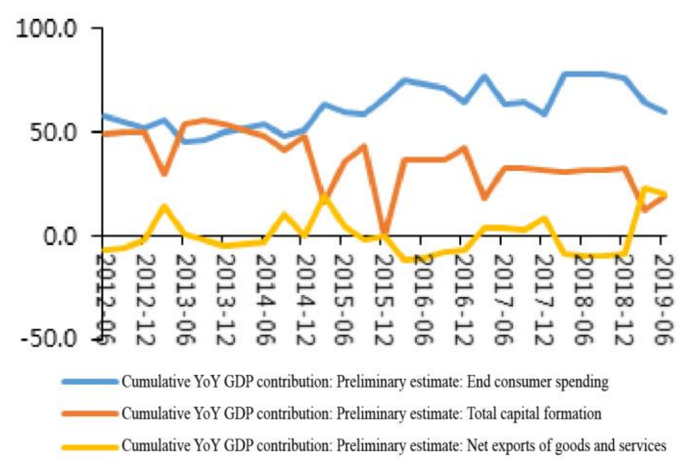
Source: CCXI Macro Interest Rates Database

Fig. 2: GDP Deflator Continued to Decline



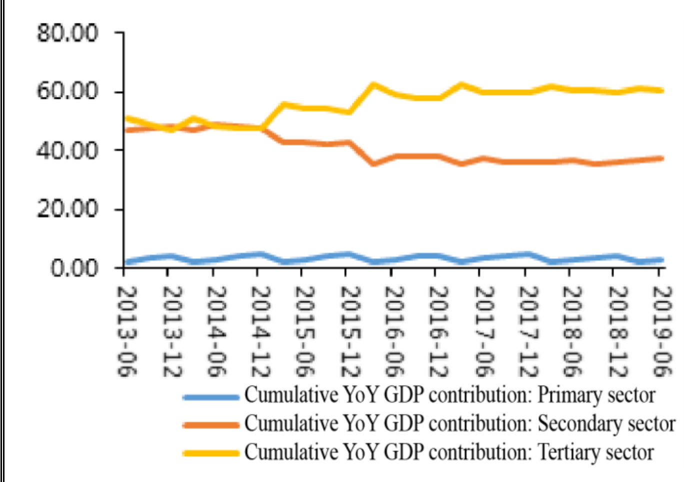
Source: CCXI Macro Interest Rates Database

Fig. 3: Contribution of End Consumption Slumped



Source: CCXI Macro Interest Rates Database

Fig. 4: Contribution of Tertiary Sector Shrank



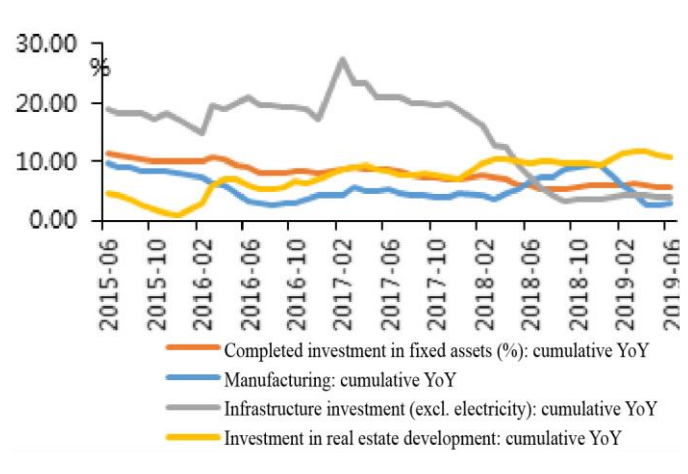
Source: CCXI Macro Interest Rates Database

ii. Infrastructure and real estate bolstered investment, which will still face a downward pressure in many aspects in H2

Investment increased by 5.8% YoY in H1. The growth rate fell slightly by 0.1 percentage point from the end of last year, yet better than market expectations. The recovery in infrastructure investment stimulated by the stable growth policy and the sustained high growth in real estate investment backed by construction and installation investment bolstered fixed asset investment in H1. However, investment in manufacturing continued to be sluggish. In H1, investment in manufacturing increased by 3.0% YoY, which was significantly lower than that either in the same period of last year or for the whole of last year. This was a drag on fixed asset investment.

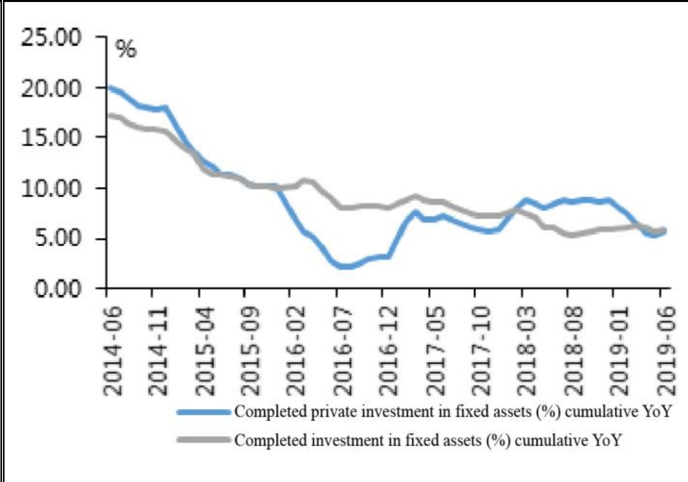
In H2, infrastructure investment is expected to provide limited support for investment due to the higher pressure on the local government's financial revenue and expenditure. Since Q2, real estate regulation has stiffened further and local regulation policies have tightened. In terms of real estate financing, regulatory authorities have given window guidance to some banks with larger size and faster growth of real estate loans, requiring control over the size of real estate loans. CBIRC officials said that CBIRC recently conducted interviews and gave warnings against some trust companies whose real estate trusts had increased too fast and too much recently. In addition, in H1, the real estate bond issues showed an overall downtrend. In addition, NDRC issued a document to regulate the overseas issuance of bonds by property developers, requiring that such issuance should "only replace foreign debts due in one year or less". Property developers' financing via foreign bond issues has been tightened. Real estate financing has been tightened obviously, and real estate investment is facing a pressure of further slowdown. In addition, endogenous investments such as private-sector investment and manufacturing investment are still weak. Though manufacturing investment picked up in the past two months, its recovery will remain modest throughout the year, unlikely to turn into substantial growth supporting the investment effectively. Future investment will remain at lows.

Fig. 5: Investment Slowed down, Real Estate Investment Remained High



Source: CCXI Macro Interest Rates Database

Fig. 6: Trends in Private Investment in Fixed Assets

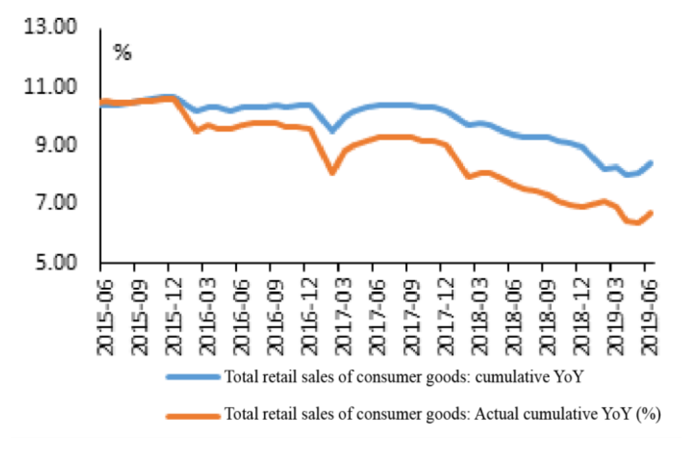


Source: CCXI Macro Interest Rates Database

iii. Household consumption remained sluggish, with limited momentum for future recovery

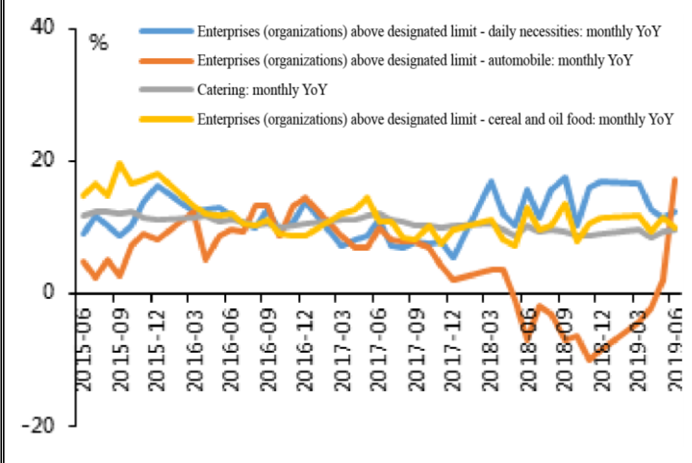
In H1, total retail sales of consumer goods increased by 8.4% YoY, down 1 percentage point YoY, suggesting overall weakness in consumption. By region, in spite of faster growth in rural consumption than urban consumption due to low base and poverty alleviation efforts in rural areas, both urban and rural consumption showed a YoY decline. Urban consumption increased by 8.3% YoY in H1, down 0.9 percentage point YoY. Rural total retail sales of consumer goods rose by 9.1% accumulatively YoY, down 1.4 percentage points YoY. By quarterly performance, as new emissions standards (China VI) push auto dealers to sell old models (China V) faster, the marginal improvements in auto consumption drove total retail sales of consumer goods. In addition, individual income tax cuts bolstered the women's consumption and sales of daily necessities. Total retail sales of consumer goods showed marginal improvements in Q2, growing by 8.4% YoY, up 0.1 percentage point from Q1. However, the annual recovery in total retail sales of consumer goods will be limited in the context of slowing income growth and rising leverage ratio in the household sector, coupled by the short-term policy effects on total retail sales of consumer goods.

Fig. 7: Total Retail Sales of Consumer Goods Regained Pace



Source: CCXI Macro Interest Rates Database

Fig. 8: Consumption of Auto Enterprises above Designated Limit Regained Pace



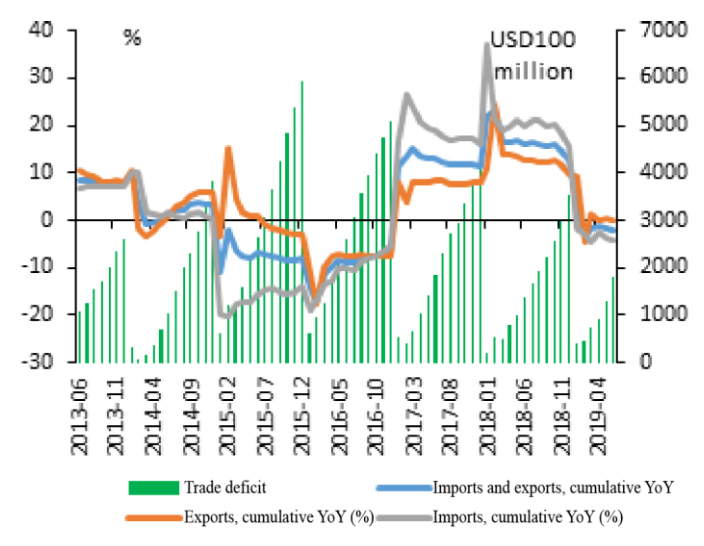
Source: CCXI Macro Interest Rates Database

iv. Global economic slowdown and US-China trade frictions posed uncertainties to exports

Total imports and exports fell by 2% YoY in H1. Among them, exports grew by 0.1% YoY, down 12.9 percentage points from the same period of last year. Against the backdrop of receding export rush effects and continuing US-China trade frictions, however, the growth of exports that remained positive has beaten market expectations to some extent. Imports grew by 4.0% YoY, showing the drag of insufficient domestic demand on imports. Trade surplus was USD181.1 billion, expanding significantly by 29.8% YoY and showing a marked characteristic of recessionary trade surplus. Looking ahead, the World Bank lowered its global growth forecast by 0.3 percentage point and 0.1 percentage point respectively compared with its forecasts in January this year. The weakening global economy and the uncertainties in US-China trade frictions put exports under a pressure of further slowdown. From the perspective of imports, China's PMI import index also continued to fall below the boom-bust line. Meanwhile, domestic household income slowed down and leverage ratio continued to rise, suggesting still-sluggish domestic demand and gloomy import outlook.

Fig. 9: Export Growth Retreated, Import Growth Further Weakened

Fig. 10: JPMorgan Global Manufacturing PMI Continued to Fall



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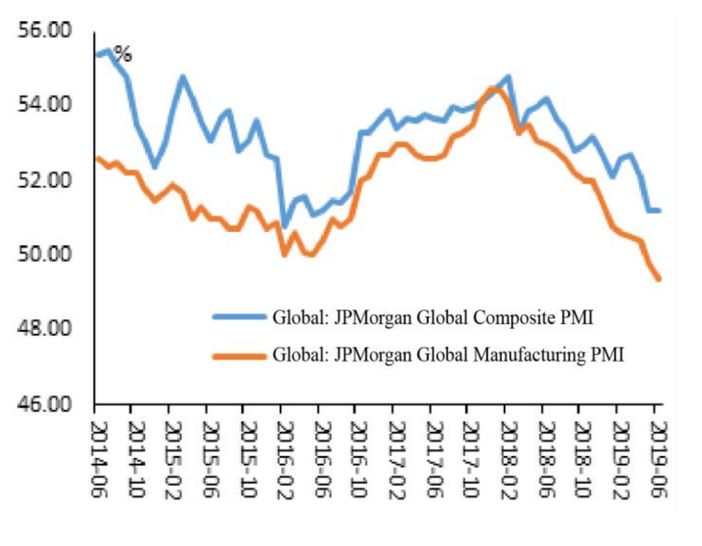
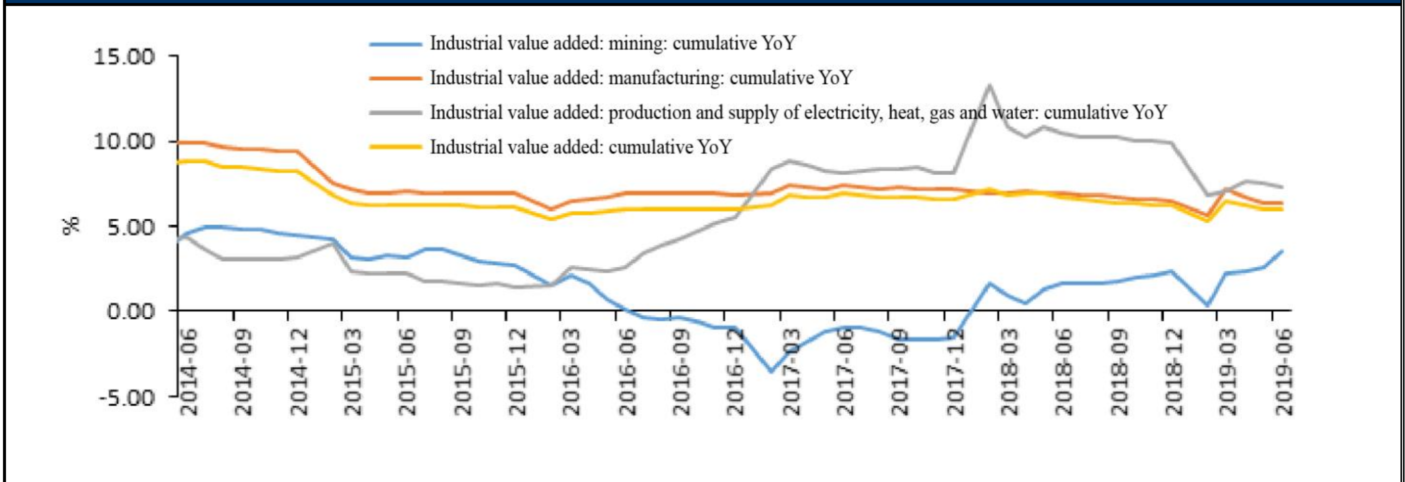


Source: Compiled by CCXI

v. Total supply continued to slow down, posing a still-high structural downside risk in H2

Industrial value added slowed down, with the mining industry seeing stronger cumulative YoY growth than one year earlier. In H1, the value added of industrial enterprises above designated scale increased by 6.0% YoY, down 0.7 percentage point YoY, with the cumulative YoY growth rate down 0.2 percentage point from Q1. The value added of all three categories slowed down, while mining and manufacturing rebounded YoY. Looking ahead, the peak summer production will improve industrial value added. Investment and added value in the upstream mining industry have both rebounded YoY, while the manufacturing industry has slowed down marginally. Given the weak end consumption, however, the acceleration in upstream activity is more likely to resulting in inventory buildup and cannot substantially improve the supply side. The structural downside risk will remain large.

Fig. 11: Industrial Value Added Continued to Fall

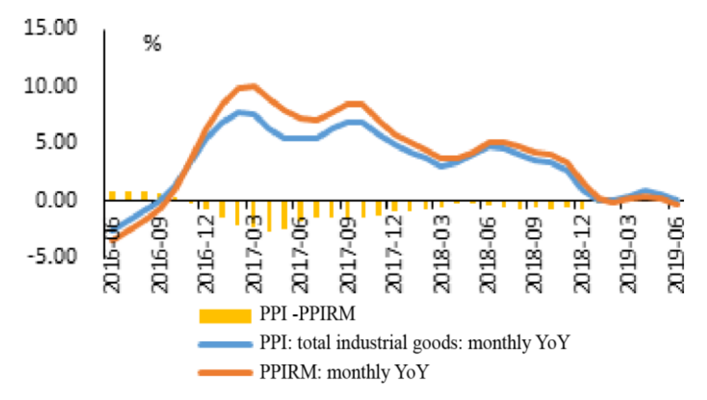


Source: CCXI Macro Interest Rates Database

vi. CPI and PPI went divergent, with CPI controllable and PPI at deflationary risk in H2

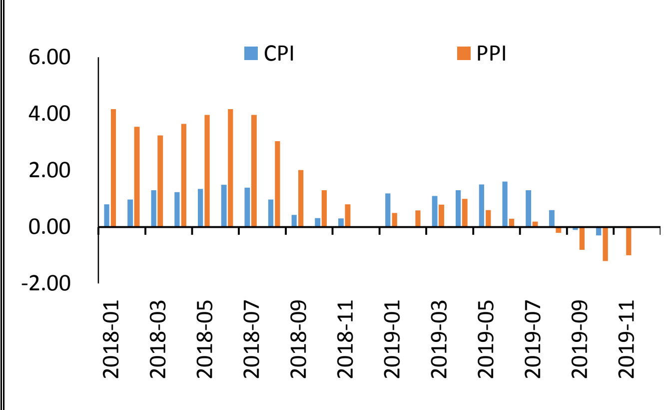
As shown by H1 price data, the sustained sharp rise in the prices of fresh fruits, pork and other foods was the principal contributor to the sustained high CPI. Due to fragile global demand and stagnant international crude oil prices, the prices of capital goods reversed to a decline and PPI dropped at a faster pace YoY. As shown by CPI, the short supply of fresh fruits is unlikely to improve in the short term, but as seasonal factors gradually recede, the prices of fresh fruits will return to normal and weaken as a CPI driver. In addition, pork prices will further rise on the upturn of the "hog cycle", albeit at a slower pace due to structural changes in consumption. Considering the low base recorded last year and carryover effects, CPI is estimated to retreat on insufficient drivers. Inflation will remain relatively moderate throughout the year. In terms of PPI, the sluggish global demand and escalating geopolitical tensions point to limited room for the upturn in international crude oil prices. YoY PPI growth is likely to turn negative in the year due to the domestic economic downturn and industrial deflation concerns, coupled by the low base and carryover effects.

Fig. 12: Trends in PPI and PPIRM



Source: Compiled by CCXI

Fig. 13: CPI and PPI Carryovers



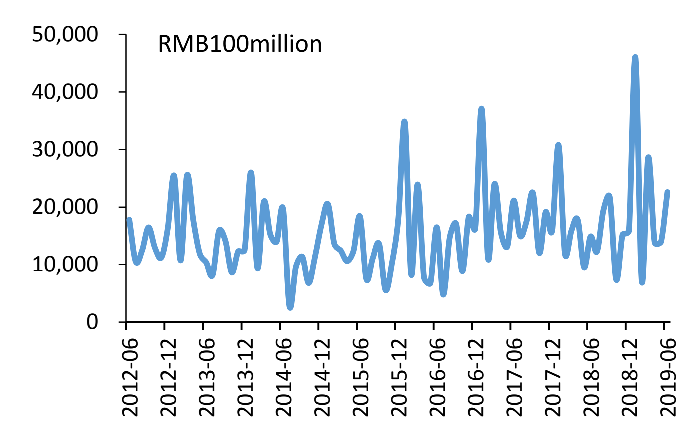
Source: Compiled by CCXI

vii. M2 and aggregate financing were generally stable, but the structural deterioration of financial data deserves attention

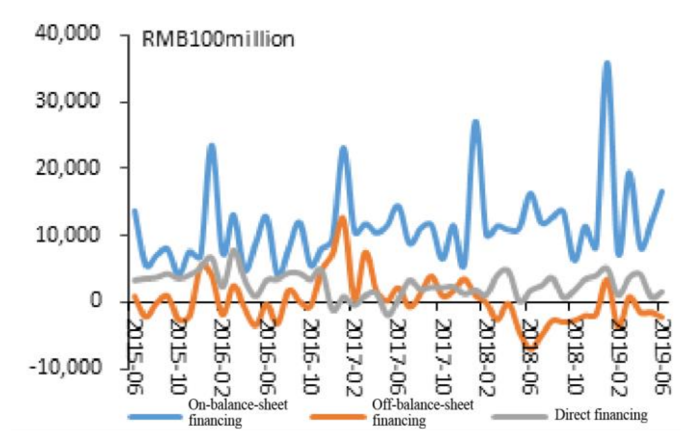
M2 ran steadily in an easy credit climate and aggregate financing recovered YoY. M2 increased by 8.5% YoY in H1, up 0.5 percentage point YoY or 0.4 percentage point from the end of last year. New aggregate financing to the real economy stood at RMB13.23 trillion in H1, an increase of RMB3.18 trillion over the same period of last year. On-balance-sheet financing increased by RMB10.03 trillion, a YoY increase of RMB1.28 trillion, showing continued strong growth. Under regulatory marginal adjustments, off-balance-sheet financing fell sharply. Off-balance-sheet financing decreased by RMB439.4 billion in H1, RMB8193 billion less than the same period of last year, showing an obviously slower contraction in H1. However, the receivership of Baoshang Bank dealt a shock to non-bank liquidity at the end of Q2, which, coupled by the tightening real estate regulation, affected real estate financing that accounted for a large proportion of off-balance-sheet financing. The decline in off-balance-sheet financing showed a weaker trend of marginal contraction. With interest rates staying stable at lows, direct financing increased by RMB1,580.5 billion, RMB287.7 billion more than the increase recorded one year ago, indicating improved financing to the real economy.

Fig. 14: Monthly Trends in New Aggregate Financing to Real Economy

Fig. 15: Trends in Direct Financing on vs. off Balance Sheet



Source: CCXI Macro Interest Rates Database



Source: CCXI Macro Interest Rates Database

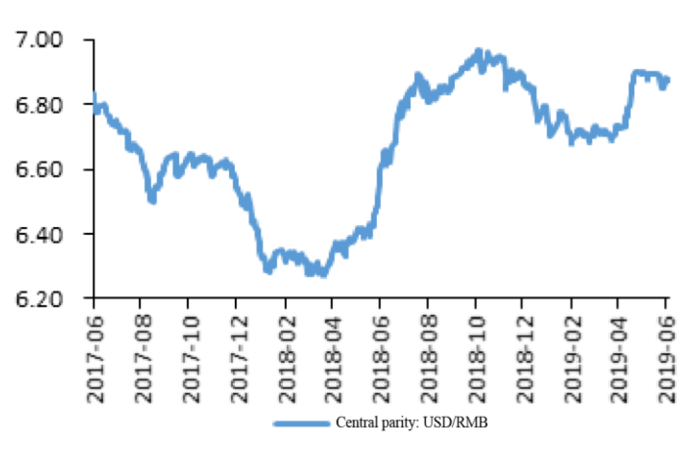
Despite the recovery in aggregate financing in the context of prudent monetary policy and continuing structurally easy credit, its structural deterioration deserves great attention. As shown by the structure of new loans, the proportion of medium- and long-term corporate loans shrank YoY and H1 saw a marked overall decline, indicating enterprises' reluctance to invest. Medium- long-term household loans rose YoY and short-term household loans declined YoY, suggesting passive household investments in real estate and dwindling consumption due to property market recovery in Q1.

Looking ahead, the structural easing policy targeted at small and micro businesses and private enterprises will continue, new loans will continue to firm up aggregate financing and on-balance-sheet financing will remain stable. As local governments successively issued real estate regulation policies in Q2, real estate financing will be tightened in the future. Against this background, the decline in off-balance sheet financing is likely to quicken. The local governments' special bond issues, with a progress exceeding 64% at present, will slow down in the future. Thus local government bonds will weaken as a pillar for aggregate financing. Looking ahead, though aggregate financing shrank in June, it will not tighten substantially in an easy credit environment and, instead, remain relatively stable. In July, a PBOC official vowed to "closely monitor the changes in the economic and financial situation at home and abroad, adhere to the principle of giving priority to the domestic part on the premise of striking a balance between internal and external equilibrium, and focus on timely forward-looking adjustments and fine-tuning according to China's economic growth and inflation level". In addition, banks' perpetual bond issues as a measure to replenish bank capital through multiple channels will continue. Therefore, we believe that M1 and M2 growth will remain stable in H2.

viii. The RMB exchange rate was relatively stable, and RMB was under a weaker depreciation pressure as the world has entered into an interest rate cut cycle

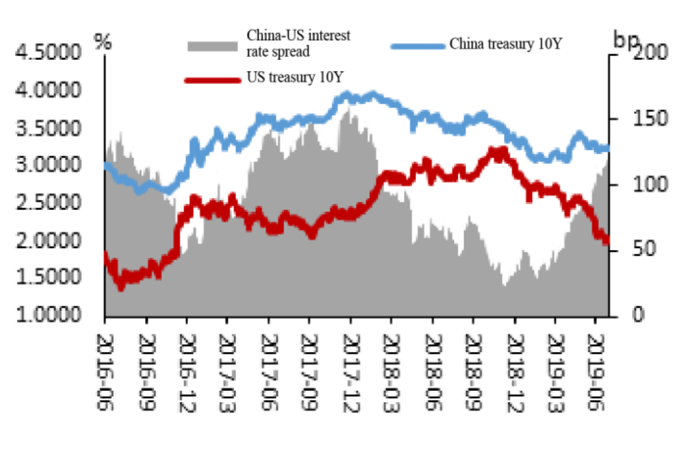
The RMB exchange rate against USD is generally stable. The short-term pressure on RMB has further eased on the Federal Reserve's signals to cut interest rates. RMB showed a "relatively stable - volatile - relatively stable" pattern of evolvement under the combined effects of many factors in H1. At the beginning of the year, RMB was relatively stable as the Sino-US negotiations released positive signals. However, the strong US economic data for Q1 and the resurgence of US-China trade frictions sent RMB into bigger volatility later. The US-China trade tension eased again following the G20 summit. As the US recorded slower than expected CPI growth in June while its core CPI exceeded expectations, which strengthened the expectation of the Federal Reserve's rate cut, RMB exchange rate against USD was stable overall. In addition, foreign investors increased their Chinese bond holdings significantly, playing a positive role in bolstering the RMB exchange rate. The interest rate cut wave spreading over other global economies has eased the depreciation pressure on RMB.

Fig. 16: Trends in RMB Exchange Rate



Source: CCXI Macro Interest Rates Database

Fig. 17: China-US Interest Rate Spread Continued to Widen



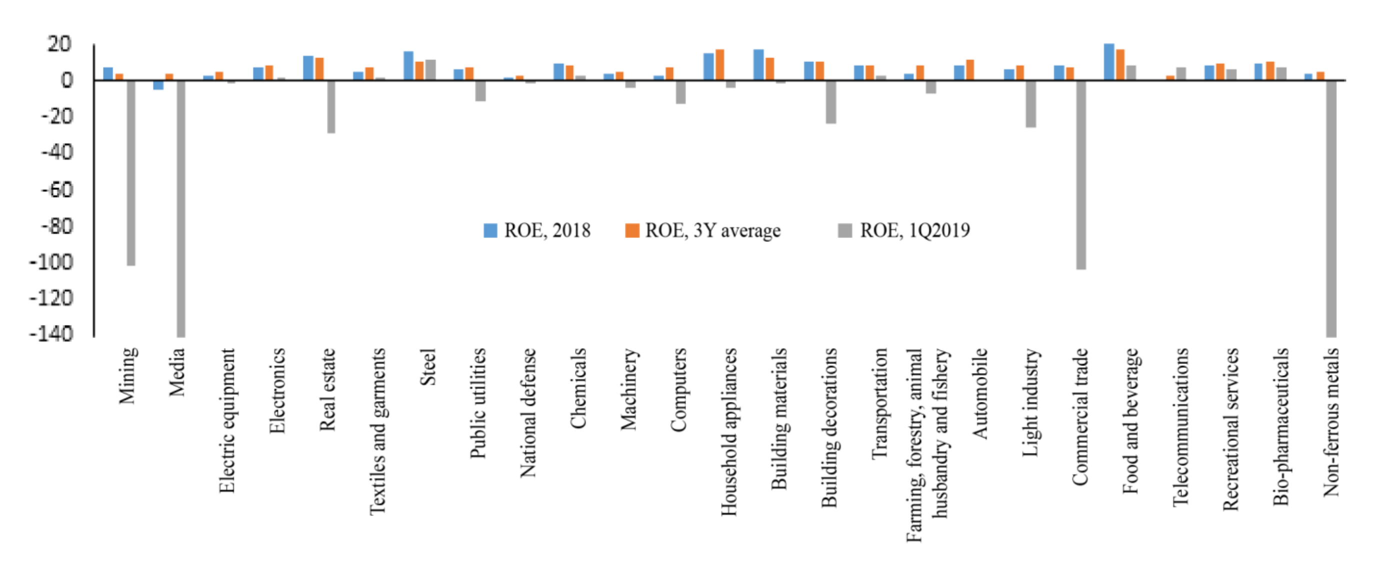
Source: CCXI Macro Interest Rates Database

II. Problems in economic operation: Micro entities lacked of vitality due to multiple adverse factors to the stable growth policy

i. The poor transmission from easy money to easy credit amid the weak financing demand of the real economy may inflate structural bubbles

At present, domestic demand for the real economy is in the doldrums. As shown by ROE data of listed companies, the vast majority of industries registered a lower annual ROE for 2018 than that for 1Q-3Q2018. The ROE decline continued into 1Q2019 in most industries. Endogenous investments such as manufacturing and private-sector investment are sluggish. If the “easy money” policy continues, the massive money supply can hardly be injected into the real economy. Given the low return on investment in the real economy, the profit-driven nature of capital makes it possible for excess money to pursue other profit opportunities in the stock, bond and commodity markets, which may trigger structural bubbles. Since last year, the money flows into some commodity fields have inflated prices rapidly, which still deserves high attention. For example, investors flocked into the apple futures market as the apple production plummeted in the past year, thus pushing up the spot apple prices.

Fig. 18: ROE of Listed Companies Declined Significantly

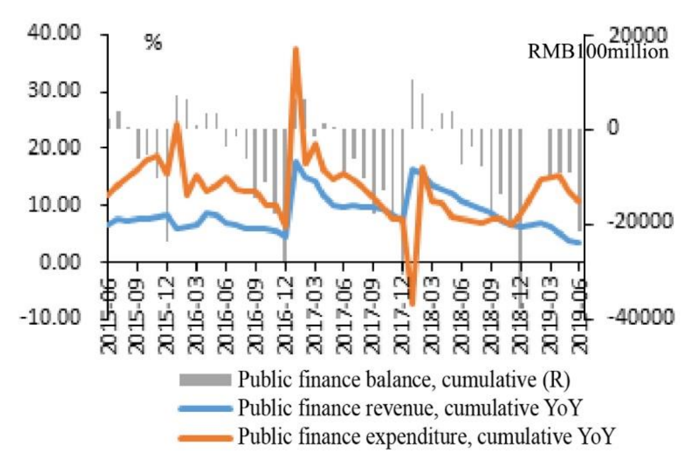


Source: CCXI Macro Interest Rates Database

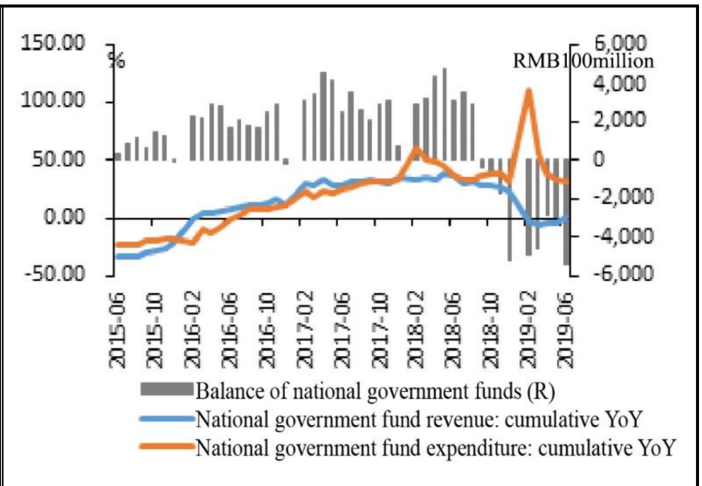
ii. The policy pursuit of stable growth resulted in limited room for the fiscal policy to work

Though the fiscal expansion slowed down in April and May, the fiscal policy showed a pronounced front-loaded feature compared to previous years. Local government expenditure increased by 12.5% in H1 YoY, up 4.7 percentage points from one year earlier. Though the growth of local government fund spending fell by 6.3 percentage points YoY, it still maintained rapid growth of 32.8% against the backdrop of slowing revenue growth. The government funds ran a deficit. From the perspective of revenue, individual tax revenue has refreshed the all-time low of YoY growth rate since Q2. The VAT reduction policy issued in April 2019 has led to a significant reduction in VAT revenue. VAT accounts for a large proportion of China's tax revenue, and the VAT rate for the manufacturing industry, which contributes more than 50% of the VAT revenue, has been significantly reduced by 3 percentage points. This alone will reduce the tax burden on enterprises by about RMB500 billion. As a result, the government revenue in May showed negative growth for the first time this year. Local governments have adopted various policies in response to the decline in government revenue, such as tapping the potential and liquidizing all kinds of funds and assets through various channels, making non-tax revenue rebound, yet still unable to fully offset the decline in VAT revenue. Due to the continuing regulation of real estate, the government fund revenue, which is dominated by state-owned land premiums, is still under further downward pressure, thus restricting the growth rate of government fund spending. Against the backdrop of widening government deficits, therefore, government expenditure in H2 will be slightly stretched, leaving limited room for the fiscal policy to work.

Fig. 19: Public Finance Support for Infrastructure Investment Is Unsustainable	**Fig. 20: Government Funds Turn into Deficits**

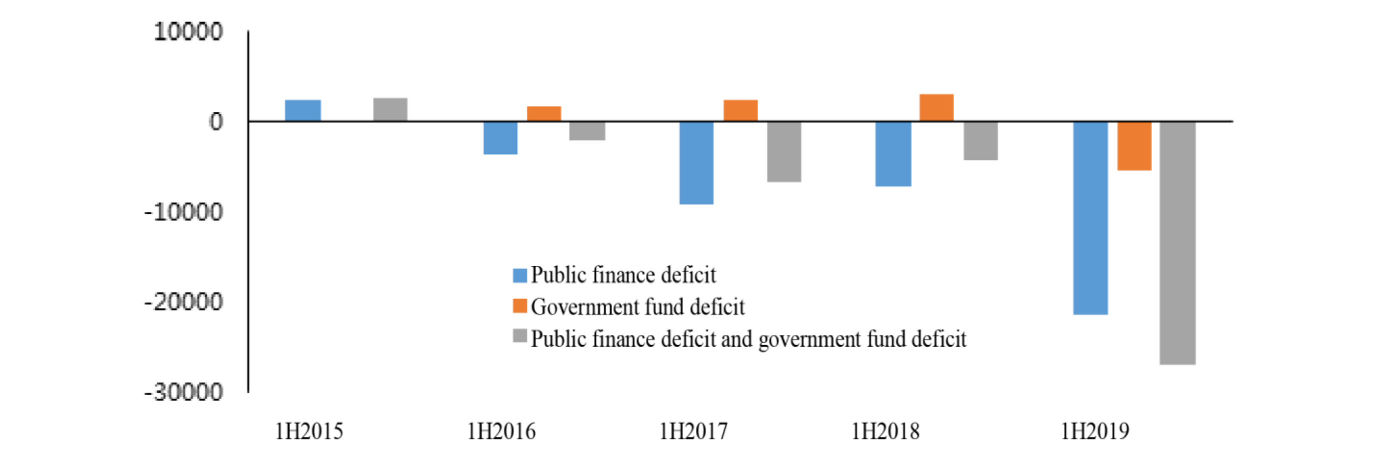


Source: CCXI Macro Interest Rates Database



Source: CCXI Macro Interest Rates Database

Fig. 21: Both Public Finance and Government Funds Recorded Expanding Deficits



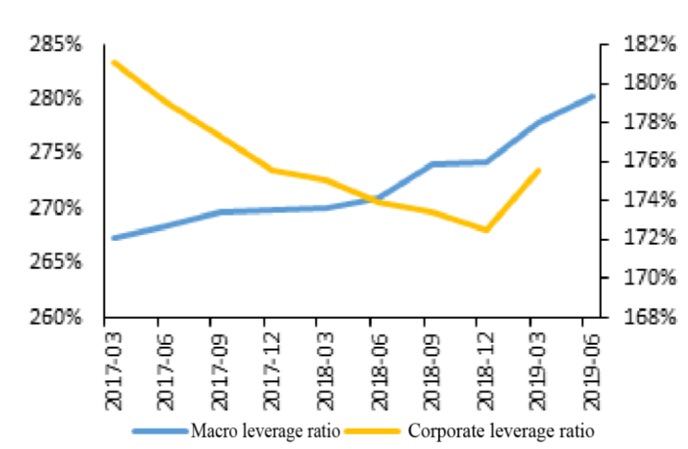
Source: CCXI Macro Interest Rates Database

iii. Macro leverage ratio rose faster, with the debt risk still deserving high attention

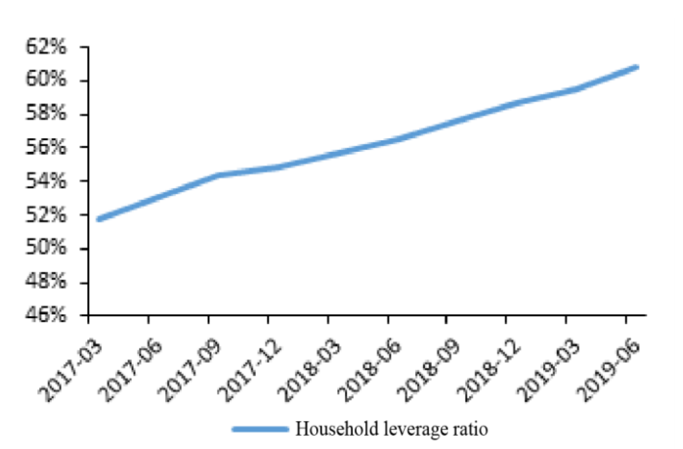
Though the stable growth policy has effectively cushioned the downward pressure of the economy since 2019, the stable growth has to some extent come at the cost of rising leverage ratio. According to CCXI estimates, the total leverage ratio further increased by 2.42 percentage points in Q2 following a Q1 rise of 3.68 percentage points, gaining more than 6 percentage points in six months and putting an end to the marginal slowdown in total leverage ratio continuing from 2016 through 2018. By sectors, the leverage ratio of the non-financial corporate sector reversed to an upturn, the biggest driver of the accelerating total leverage ratio. Driven by the short-term property market recovery in Q1 and the increase in short-term consumer debt, the leverage ratio of the household sector continued to rise. In the context of accelerated issuance of special local government bonds, the leverage ratio of local governments kept rising. However, it is noteworthy that, despite the modest increase in local governments' leverage ratio, the recovery in LGFV financing may add to the hidden debt pressure of local governments as the regulatory policy on LGFV financing has been adjusted since H2 last year to shift from strict supervision to "ensuring the reasonable financing demand of LGFVs".

Fig. 22: Macro Leverage Ratio and Corporate Leverage Ratio Gained Pace

Fig. 23: Household Leverage Ratio Continued to Rise



Source: CCXI Macro Interest Rates Database

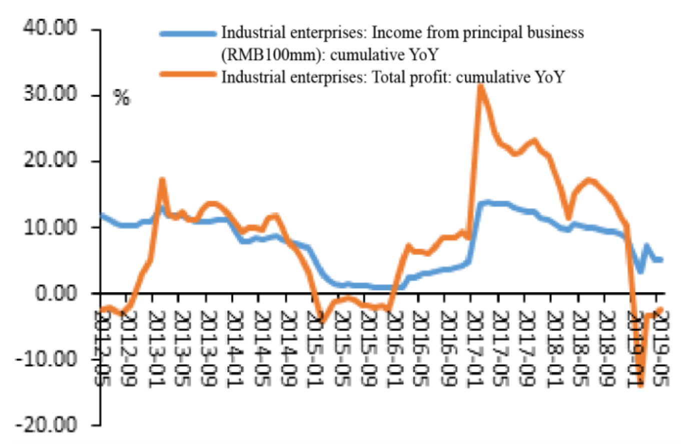


Source: CCXI Macro Interest Rates Database

iv. Given the weaker vitality of micro entities, the policy will have a limited short-term stimulus effect

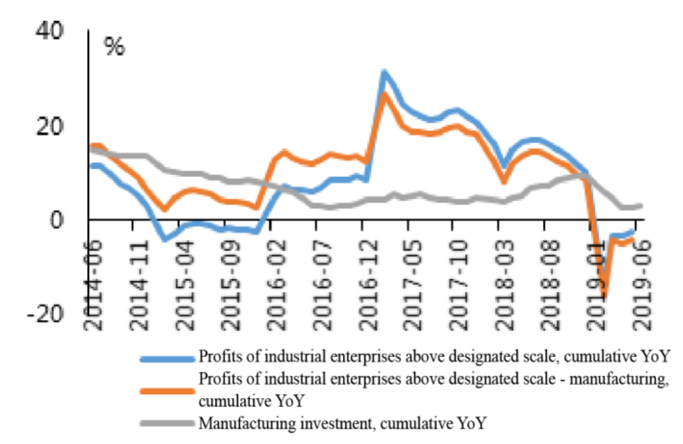
Tax and fee reduction has strengthened, but it is hard to fundamentally improve the profitability of businesses, which to a certain extent restricts the investment and financing needs of enterprises. Policy efforts to cut corporate taxes and fees intensified in Q2, with value-added tax cut in April and social security contributions reduced in May. Such policies had a marked effect on profits of industrial enterprises. In Q2, the slowdown in profits of industrial enterprises continued to subdue, while the growth in the mining industry recovered somewhat. However, the marginal weakening of overcapacity cut efforts led to limited contraction in the profits of manufacturers. Against the backdrop of domestic economic downturn and insufficient demand at home and abroad, it is still difficult to fundamentally improve corporate profits. However, the limited recovery of corporate profits further stifled the investment and financing needs of enterprises. The activity of enterprises is still low.

Fig. 24: YoY Profit Growth of Industrial Enterprises Recorded Slower Decline



Source: CCXI Macro Interest Rates Database

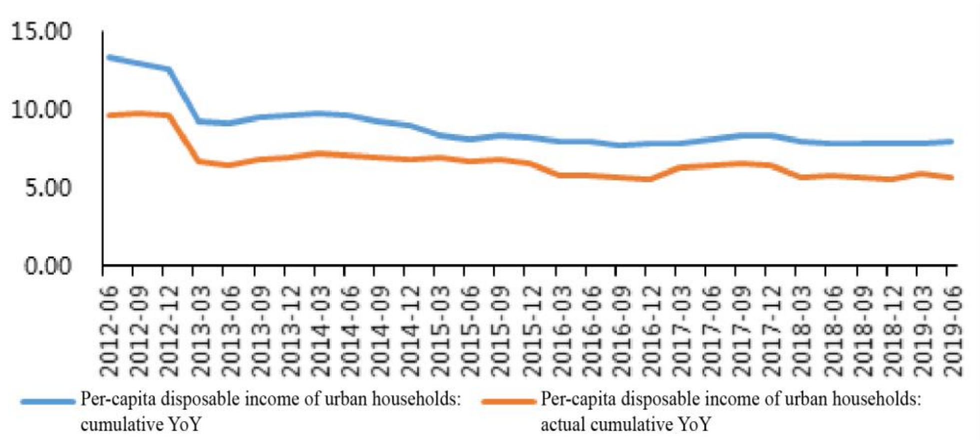
Fig. 25: Subdued Manufacturing Profits Discouraged Investment



Source: CCXI Macro Interest Rates Database

As the weaker growth in household income and the high pressure of debt service have greatly affected household consumption, the policy to boost domestic demand may fail expectations. The per-capita disposable income of households actually fell by 0.3 percentage point accumulatively to 6.5% YoY in H1, and the per-capita consumer spending dropped by 0.2 percentage point accumulatively to 5.2% YoY. The growth rate has continued to decline since June 2018. However, the residential component of per-capita consumer spending of households kept growing fast, increasingly gaining pace in H1. In 1H2019, the proportion of medium- and long-term household loans continued to expand YoY. The expanding debts and slowing income growth in the household sector also suppress the consumption potential. According to PBOC's report on assets, short-term consumption and other liabilities also rose rapidly. The growth rate of net household assets continued to decline. In this context, the government issued policies to stimulate consumption. However, the rising leverage ratio and the heavy debt service pressure in the household sector make consumers unwilling to increase spending. The policies to expand domestic demand are more about overdrawing the future growth potential of the household sector. The policies are difficult to deliver on expectations.

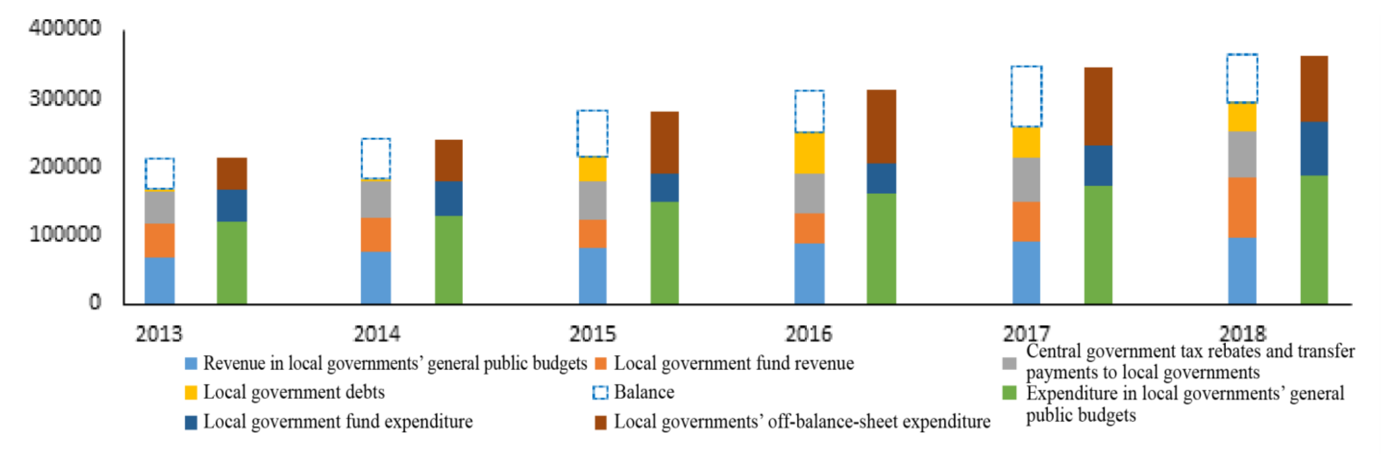
Fig. 26: Slowing Growth in Disposable Household Income



Source: CCXI Macro Interest Rates Database

Local governments were under higher revenue and expenditure pressure in pursuit of stable growth. Local government revenue increased by 3.3% YoY, up 1.7 percentage points over one year earlier. Revenue from local government funds gained 1.6% YoY, a sharp drop of 38 percentage points from one year earlier, mainly due to a 0.8% fall in revenue from state-owned land premiums, a growth slump of 43.8 percentage points over one year earlier. In contrast to the drop in local government revenue, the local government expenditure kept climbing. Local government expenditure increased by 10.8% in H1 YoY, up 4.6 percentage points over one year earlier. The spending out of local government funds increased by 32.8%, and the spending out of state-owned land premiums increased by 11.5%. The deficits of public finance and government funds both expanded significantly. The shrinking revenue and expanding expenditure of local governments add to the risk of financial deterioration among local governments in 2019 in this critical stage of defusing the hidden debt risk of local governments.

Fig. 27: Large Fund Gap of Local Governments



Source: CCXI Macro Interest Rates Database

III. Macro policies strengthened counter-cyclical regulation to cushion the economic downturn

The countercyclical adjustments to macro policies in H1 effectively cushioned the economic downturn. The stable growth policy worked to add certain resilience to China's economic growth, providing a buffer against China's economic downturn. In H2, based on counter-cyclical regulation, macro policies should not only stabilize growth, but also guard against risks and strengthen the ability to cope with various short-term shocks.

i. Monetary policy will remain prudent and structural adjustments will continue

The monetary policy is principally prudent at present. Structural easing will continue, with forward-looking adjustments and fine-tuning made in line with the economic situation. With structural easing policies issued frequently for micro, small and medium-sized businesses and private enterprises, SME loans have increased significantly YoY. China-US interest rate spread continued to widen, from the lowest 30 bps at the end of Q1 to 123 bps at the end of Q2, amid the gradual stabilization of domestic CPI, the global wave of monetary easing and the surging expectation of the Federal Reserve's rate cut. The external environment poses a moderating pressure on the domestic monetary policy. However, China is still plagued with forestalling major risks at home and the monetary policy remains domestically focused. **At present, the transmission channel for the structurally easy monetary policy still needs to be further unblocked. The monetary policy in H2 will still be more of a continuation of structural adjustments on a prudent groundwork.**

ii. Given limited room for the fiscal policy to work, the fiscal efforts to stabilize growth will be limited

At present, the fiscal policy has played a great role in stabilizing growth through a wide spectrum of measures, including tax and fee reduction, consumption enhancement and early issuance of special bonds. The front-loaded government expenditure in H1 has put pressure on the public spending in H2 . **Eligible as capital instruments for major projects, special bonds will remain an important stabilizer for infrastructure and growth in H2.** From the perspective of consumption enhancement, the policy to boost household consumption will have limited effect in the future amid the slowdown in household income and sustained increase in leverage ratio. In terms of tax and fee reduction, the current massive tax cuts suggest impossibility of further tax cuts in the short term. **The future work will focus on further implementation of the tax and fee reduction policy to ensure policy effectiveness.**

iii. The guiding principle of "stable supervision" continues, with emphasis on preventing the "risk of handling risks"

The current regulatory policy focuses on the balance between "forestalling risks" and "stabilizing growth": China will further regulate government investment and make it more market-based, curb real estate financing to prevent overheating property market, strengthen local government debt management and resolutely curb the new hidden debts. Meanwhile, China will relax the application conditions for issuance of corporate bonds by LGFVs to ensure the funding of ongoing projects and promote banks' perpetual bond issues to enhance bank support for the market. Looking ahead, the further economic downturn may force up the leverage ratio: The government guarantee for infrastructure projects will further drive up local government debts. The rising pressure on local public finance will further increase the debt burden of LGFVs. As the stronger financing support for private enterprises is likely to spur further leveraging among private enterprises, the further rise in leverage ratio remains a possibility. **As the financial system still faces structural risks and the market sentiment is relatively fragile, the future regulatory policy should remain stable to avoid the "risk of handling risks".** In terms of real estate supervision, as real estate investment is likely to recede in H2 due to the tight supervision over the property market in H1, the overheating momentum of real estate has been curtailed somewhat. **The real estate supervision in H2 will remain guided by the principle that "houses are for living in, not for speculation".**

iv. Supply-side structural reform and opening-up will be furthered

China's economic structure must be adjusted to reflect changes in external environment and domestic conditions. But there are still many obstacles at present. Therefore, the supply-side structural reform should be gradually refocused. The overcapacity cut reform has begun to deliver results, **but the reform still should be refocused on downstream industries.** Only by upgrading the downstream industries can the upstream industries be endogenously upgraded, so as to fundamentally accomplish the supply-side structural reform. Thus the future supply-side structural reform should focus on downstream industries. **In addition, efforts should be stepped up to coordinate the product market reform with the factor market reform.** At present, the inadequate market orientation of the factor market is the root cause of many problems in the product market. Therefore, reforms should be furthered in labor, capital, land and other factors. In terms of opening-up, **China will further expand the scope of encouraged foreign investments and improve the regional distribution of foreign investments.** In addition to attracting investment, this move will also ease the trade conflicts with other countries.

IV. Summary and Outlook

China's economy weathered the shocks dealt by the downside risk in 1H2019 thanks to the stable growth policy and a range of reform measures. The economy stabilized on a fragile footing, with GDP growing by 6.3% YoY. Overall, despite the stronger macro-control adjustments and reform efforts, the economy is under a greater downward pressure due to a wide spectrum of unfavorable factors. The economy still faces many problems: The monetary policy transmission channel remains to be unblocked and under the pressure of capital flows from the real sector to non-real sector of the economy. The continued rise in macro leverage ratio puts pressure on risk prevention again. The higher pressure on government revenue and expenditure places constraints on the traditional monetary policy. In addition, the fundamentals of micro entities have not improved and the policy is unlikely to deliver on expectations.

Under the downside pressure to both supply and demand sides of China's economy, the stable growth policy is expected to further strengthen in H2, with the monetary policy expected to remain prudent but structurally easy in H2. The fiscal policy will reasonably improve the utilization efficiency of special debt limits, which helps further stabilize infrastructure investment as underpinning of economic growth. Financial supervision will further stabilize to forestall the "risk of handling risks". As China's economy will further slowdown in H2, the leverage ratio is likely to rise passively. As the stronger financing support for private enterprises is likely to spur further leveraging among private enterprises, the further rise in leverage ratio remains a possibility. The downside pressure to the economy and the high leverage ratio put constraints to the stable growth policy. The problems and risks facing China's economy are the combined result of long-term and short-term factors. It takes time to mitigate risks, but there are still some favorable factors for China's economic growth in the long run: The domestic market with huge growth potential, the domestic industrial system based on research and development, the data globalization and related services based on digital economy, the inclusive globalization based on the Belt and Road Initiative and the increasingly mature macro-regulation system have added adequate resilience to China's economy, thus enhancing the endogenous growth momentum for long-term and healthy development of the Chinese economy.

Schedules:

Schedule 1: Relevant Policies Issued in 1H2019

Time	Policy	Contents
March 5	Report on the Work of the Government	To forestall and defuse major risks, we should be clear about potential dangers, continue structural deleveraging, forestall abnormal financial market fluctuations, deal prudently with local government debt risk, and guard against and control externally-generated risks
March 13	The window guidance of Shanghai Stock Exchange and Shenzhen Stock Exchange relaxed the application conditions for corporate bond issuance by local government financing vehicles (LGFVs)	The 50% cap on the proportion of government revenue was lifted for corporate bond issuance intended to refinance the debts with a residual maturity of within six months, but raising supporting funds to replenish working capital is prohibited.
March 18	*Report on the Execution of the Central and Local Budgets for 2018 and the Draft Central and Local Budgets for 2019*	Strengthen efforts to prevent and control local government debt risks
April 23, 2019	*Notice on Issuing 2019 Central Government Budget for Urban Affordable Housing Projects [2019] No.14*	According to the notice, the central government planned to renovate 2,852,900 housing units in shantytown areas nationwide in 2019, far below the market expectation, down more than 50% compared to the actual number (6.26 million units) in 2018. In addition, the central budgetary funds for urban affordable housing projects will be distributed among regions according to their financial difficulty factor, which is determined according to the proportion and shortfall rate of local expenditure on "ensure payment of salaries, normal operations, and the basic well-being of the people" in the standard government revenue.
April 9, 2019	*Guidelines on Promoting Healthy Development of Small and Medium-sized Enterprises*	Under the principle of competitive neutrality, create a fair and convenient business environment to further stimulate the vitality and development momentum of small and medium-sized enterprises (SMEs). Implement the SME Promotion Law, alleviate the difficulties of SMEs, stabilize and enhance the confidence and expectations of enterprises, step up innovation efforts, enhance SME's capability of specialized development and coordinated development of small, medium-sized and large enterprises and promote the healthy development of SMEs.
April 25, 2019	*Guidelines on the Issuance of Local Government Bonds*	The Ministry of Finance issued the *Guidelines on the Issuance of Local Government Bonds* (C.K. [2019] No. 23) (the "Guidelines"), and further raised requirements in accordance with the *Budget Law of the People's Republic of China*, the *Guidelines of the State Council on Strengthening the Management of Local Government Debts* (G.F. [2014] No.43) and relevant regulations on the issuance and management of local government bonds.
April 28, 2019	*Notice of the General Office of the Ministry of Finance on Review of PPP Projects-driven Expansion of Hidden Debts of Local Governments*	Curb the risk of increasing the hidden debts of local governments under the guise of PPP, lay a solid foundation for high-quality development of PPP and re-examine all PPP projects already in the project pipeline.
May 5, 2019	*Regulation on Government Investment Regulation*	On May 5, the State Council promulgated the *Regulation on Government Investment* (the "Regulation"). The Regulation provides detailed requirements on seven aspects of government investment, including decision making, annual planning and project implementation. It specifies project decision-making standards and procedures, key elements of project commencement and implementation, follow-up supervision and management and liabilities for break of law. The Regulation will come into effect on July 1.
May 16, 2019	*Implementation Plan for Deepening the Toll Road System Reform and Cancelling Interprovincial Toll Stations*	The plan clearly requires a push for replacement of outstanding debts of governmental toll roads. Local government bonds are allowed to replace the outstanding debts of governmental toll roads that met the policy requirements as at the end of 2014.
May 28, 2019	*Guidelines on Promoting Innovation in National Economic and Technological Development Zones and Developing Them into New Pacesetters of Reform and Opening-up*	The document sets out 22 tasks in five aspects to speed up the advancement of national economic and technological development zones, which provides certain backing for LGFV companies in these areas.
June 6, 2019	*Implementation Plan for Promoting Renewal and Upgrade of Key Consumer*	With a focus on consolidating, strengthening, upgrading, and ensuring unimpeded flows, promote the renewal and upgrading of automobiles, household appliances and consumer electronics products and promote the recycling of old products.

	Goods and Unblocked Recycling of Resources (2019-2020)	
June 10, 2019	*Notice on Working Hard on Special Local Government Bonds and Companion Financing of Projects*	Proceeds of special bonds are allowed to serve as capital for eligible major projects. Financing of major projects will be advanced in accordance with laws and regulations to keep economic growth within a reasonable range. The notice also requires that financial institutions should be encouraged to provide companion financing and strengthen organizational support.
June 30, 2019	*Catalogue of Encouraged Industries for Foreign Investment (Version 2019)*	While maintaining the continuity and stability of the policies encouraging foreign investment, the catalogue further expands the scope of encouraged industries for foreign investment to promote foreign investment in modern agriculture, advanced manufacturing, high and new technologies, energy conservation and environmental protection and modern services and other fields and improves the regional distribution of foreign investments.

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