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MUFG Bank
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CNY/CNH – At the intersection point

16 August 2018

Key Points:

- **US-China trade war does not appear to close to a resolution, but at least they will talk again later this month**
- **There is some early sign of softening domestic demand, without new growth-biased policy tweaks, but MOF did urge the local governments to speed up issuing special bond and using the funds**
- **PBOC's monetary policy fine-tuning has not yet bolstered aggregate financing growth, but some more measure is expected to come**
- **Adjusting deleveraging has not yet derailed previous effort, with declining measured shadow bank lending**
- **After all, no major revisions could be made to our expectations: China's growth moderation and a weaker yuan**

US and China: Tit-for-tat tariffs to have a breakthrough soon?

Finally, US invites China to talk later this month

Today (16 August 2018), Ministry of Commerce (MOC) announced[1] that **the Chinese delegation led by Vice Commerce Minister Wang Shuwen will meet with the US group led by Under Secretary of the Treasury for International Affairs David Malpass in late August, at the invitation of the US to discuss China-US trade and economic issues** (Table 1). This will mark the first official exchanges since earlier negotiations broke down in June.

TABLE 1: US AND CHINA'S TIT-FOR-TAT TARIFFS: SUMMARY

Effective date	US	China
US: 23 March 2018 China: 2 April 2018	Under Section 232, US imposed tariffs on imports of certain steel and aluminum products at 25% and 10%, respectively	China imposed reciprocal tariffs on USD 3 billion of imports from US including the first batch of USD 1 billion, including fruits, ginseng and wine etc., and the second batch of USD 2 billion, including pork, recycled steel, etc, at 15% and 25%, respectively
US & China: 6 July 2018	Under Section 301, US imposed the first round of 25% tariffs on USD 34 billion worth of imports from China, including plastics and other intermediate goods used in manufacturing	China imposed reciprocal 25% tariffs on USD 34 billion of imports from US, including soy beans, agricultural products, cars, and aquatic products etc.
US & China: 23 August 2018	Under Section 301, US will impose the second round of 25% tariffs on USD 16 billion worth of imports from China, targeting "Made in China 2025", i.e., mostly industrial goods such as tractors, plastic tubes, and measurement equipment like speedometers	China will impose 25% tariffs on an additional USD16 billion worth of imports from US, including petroleum products, plus items like coal, medical instruments, waste products, cars and buses
As soon as in early September	US plan to impose an additional 10 % (which could be 25%) ad valorem tax on a list of at USD 200 billion (which could be as high as USD 500 billion) worth of Chinese products	China plan to levy duties at 5% to 25% (which the effective tariff rate is about 13%) on about USD 60 billion worth of US imports, as counter measures

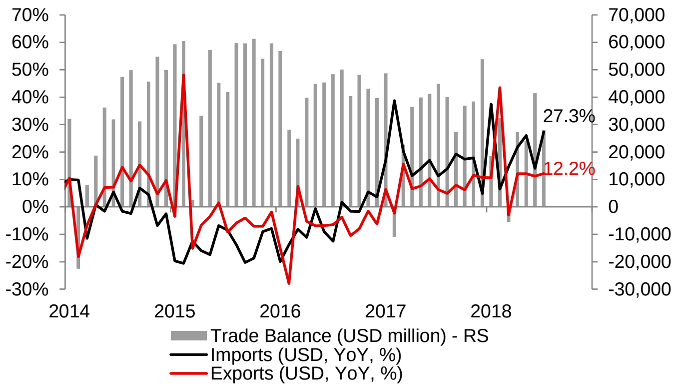
Source: MOFCOM, USTR, Bloomberg, Xinhua, MUFG Bank

[1] MOC's press release, 商务部副部长王受文将应邀率团赴美举行中美经贸问题副部级磋商 (Simplified Chinese), 16 August 2018

External demand outlook would probably be clouded by the US-China trade war which does not appear to be close to a resolution

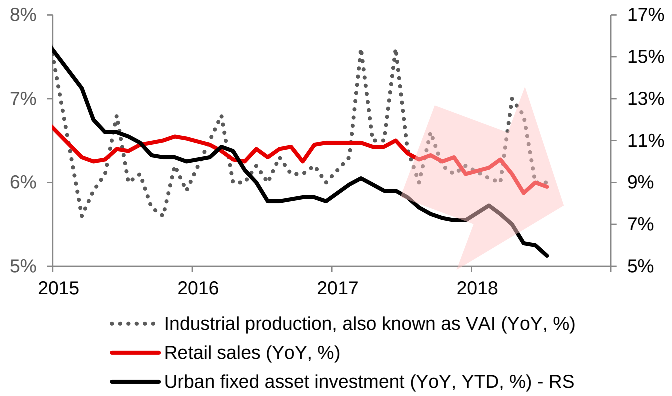
As highlighted in *Asia Cross Current: CNY/CNH – A bumpy depreciation path* (20 July 2018), **China's current strong trade momentum** (Chart 1), with imports and exports (in USD terms) surging 27.3%YoY and 12.2%YoY, respectively, **is unlikely to be sustainable** in the face of higher-base effect and more importantly the US-China trade war which does not appear to be close to a resolution. To hedge against higher import costs, some traders and manufacturers might have and will continue to **front-load sales ahead of the tariffs**, somewhat supporting China's trade momentum in the near term.

CHART 1: SO FAR ROBUST MERCHANDISE TRADE ACTIVITIES



Source: CEIC, MUFG Bank

CHART 2: DOWNTREND MONTHLY ACTIVITY INDICATORS



Source: CEIC, MUFG Bank

Disappointing monthly activity indicators in July

China's economy shows further signs of cooling

China's economic growth appears to moderate at the beginning of the third quarter, as monthly activity indicators continued its downtrend (Chart 2).

FAI growth continued its downtrend, probably due to deleveraging and external uncertainties, but on a positive note, POEs led SOEs in terms of FAI expansion pace

Urban fixed asset investment (FAI) growth slowed to a record low of 5.5%YoY YTD in the January-July period from 6.0%YoY YTD in the January-June period, probably due to deleveraging that drove financing costs and external uncertainties. This came below consensus expectations of 6.0% and 2017 full-year growth of 7.2%.

Despite the downtrend in the headline FAI growth, the growth for FAI from private enterprises (POEs) accelerated to 8.8%YoY YTD in the January-July period, a four-month high, from 8.4%YoY YTD in the January-June period, continuously outpacing that from state-owned enterprises (SOEs) which slowed to a record low of1.50%YoY YTD in the same period from 3.0%YoY YTD in the January-June period (Chart 3, Page 3). As highlighted in *Asia Cross Current: CNY – Drilling down to examine a good start of the year* (15 March 2018), **this encouraging trend would be more promising if the National Bureau of Statistics** (NBS) **could have shed some light on the impact of the implementation of the mixed ownership reform of SOEs on the number of SOEs and POEs and their corresponding FAI**.

Property development investment growth quickened slightly to 10.2% YoY YTD in the January-July period from 9.7%YoY YTD in the January-June period and 10.2% in the January-May period, probably thanks to a pick-up in both property sales and new home prices:

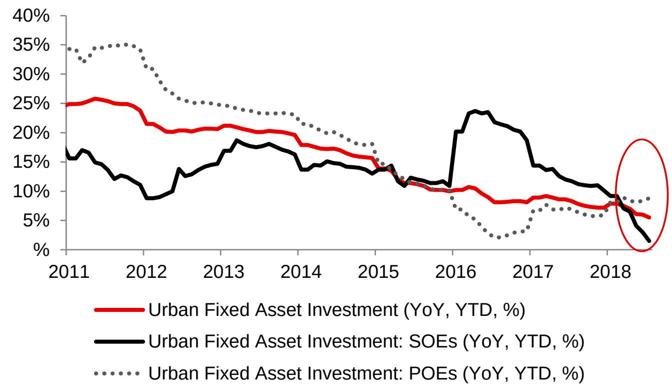
Despite no signs of relaxing home-purchase restrictions, China's housing market would probably perform better than previously expected this year

- **Property sales on the uptrend**: In the January-July period, gross floor area sold for commodity housing increased at a faster pace of 4.2% YoY YTD (> 3.3% in the January-June period and 2.9% in the January-May period), and contract sales value also rose at a faster pace of 14.4%YoY YTD (> 13.2% in the January-June period and 11.8% in the January-May period).

- **Rebound in new home prices**: In July, 70-city new home prices (average, YoY) surged to an 11-month high of 6.6% and top 15-city new home prices (average YoY), jumped to a 10-month high of 1.6% (Chart 4), defying home-purchase restrictions.

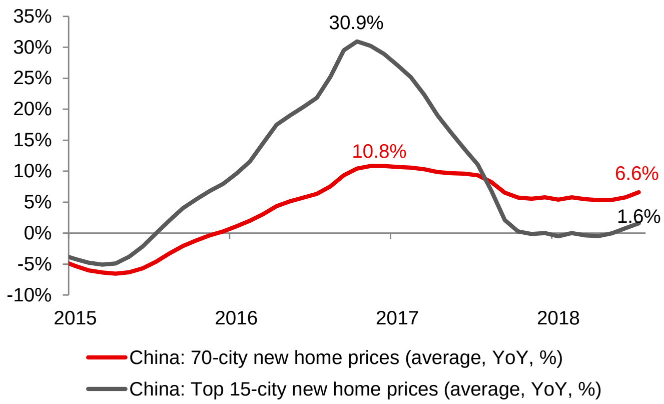
China's housing market would probably perform better than previously expected this year; however, the room for further improvement is limited, as the Chinese authorities would probably maintain its home-purchase restrictions (if not tighten further), especially when the National Development and Reform Commission spokesperson Cong Liang said in a briefing yesterday (15 August 2018) **that *China will firmly curb rise in home prices***, according to Bloomberg.

CHART 3: FAI GROWTH – POES LED SOES



Source: CEIC, MUFG Bank

CHART 4: NEW HOME PRICES REBOUNDED



Source: CEIC, MUFG Bank

Early signs of softening domestic demand

There was some early sign of softening domestic demand which was the key growth driver in the first half of the year

Although China's exports of industrial goods (in value) rose at a faster pace of 8.7%YoY in July (> last 2.8%YoY and 2018 YTD 6.0%), **industrial production (VAI) growth only stayed steady at 6.0%YoY in July**, the same as in the previous month, which was also below consensus expectations of 6.3%. This might reflect **some weakness in domestic demand**.

Meanwhile, Chinese consumers might have become more cautious about spending, as indicated by **growth moderation in retail sales in July** (8.8%YoY < consensus 9.1% < last 9.0%), somewhat weighing on domestic demand (which was the key growth driver in the first half of 2018).

Strong stimulus measures not on the card yet

After the rather disappointing July data, the Chinese authorities have not yet rolled out any new policy measure, so *Asia Cross Current: CNY/CNH – Unsurprising growth-biased policy tweaks* (24 July 2018) stands still.

Faster implementation of growth-biased policy tweaks: Proactive fiscal policy

Since urban fixed asset investment growth slowed to a historic low in the January-July period and there was some early sign of softening domestic demand (as discussed above), the Ministry of Finance (MOF) unsurprisingly announced on 14 August 2018[2] to urge local governments to speed up issuing special bonds, aiming to stabilize investment, expand domestic demand, and strengthen areas of weakness (*稳投资、扩内需、补短板*).

[2] MOF's Treasury [2018] Number 72, 关于做好地方政府专项债券发行工作的意见 (Simplified Chinese), 14 August 2018

Local governments will speed up issuing special bonds and using the funds, to somewhat bolster infrastructure investment

Key takeaways of MOF's announcement are summarized below:

1. **Most special bond issuance to be completed by October:** New special bonds issued in the first nine months should account for no less than 80% of CNY1.35 trillion (i.e., the quota this year) by the end of September, while the majority of the remaining 20% should be issued in October.
2. **Great flexibility of bond issuance**: Requirements for the seasonal balance of issuance is cancelled, and the duration limit on the bond portfolio is lifted. Besides, provincial-level governments and authorized municipal governments are allowed to issue special-purpose bonds to raise funds for the development of public-interest projects
3. **Speeding up the use of special bond funds**: Some local governments are allowed to pre-spend the budgeted bond funds, even before the issuance of local bonds, and the funds will be replenished in time after the bonds are issued.

This would probably render some support to fixed asset investment growth, in particular infrastructure investment which rose only 1.8%YoY YTD in the January-July period (< last 3.3%YoY YTD in the January-June period).

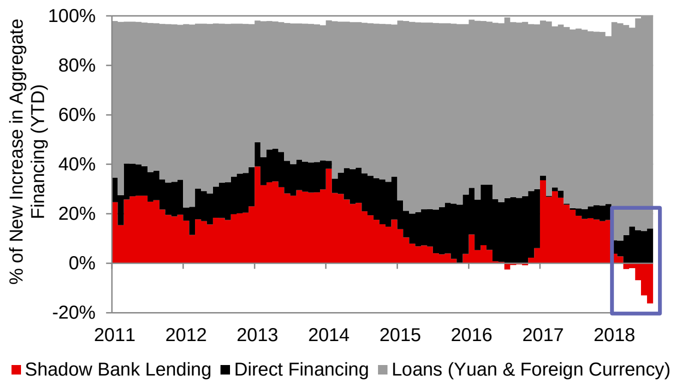
Faster implementation of growth-biased policy tweaks: Prudent and neutral monetary policy

No key changes to PBOC's monetary policy, which its stance remains prudent and neutral, with some ongoing pre-emptive fine-tuning

The People's Bank of China (PBOC)'s monetary policy report for the second quarter this year[3] and the latest credit and money supply figures for July confirmed their **commitment to reduce financial risks, in particular shadow bank lending** (Chart 5), **albeit with some fine-tuning to credit growth** (Chart 6) which would probably stay in a range of 8% to 9%.

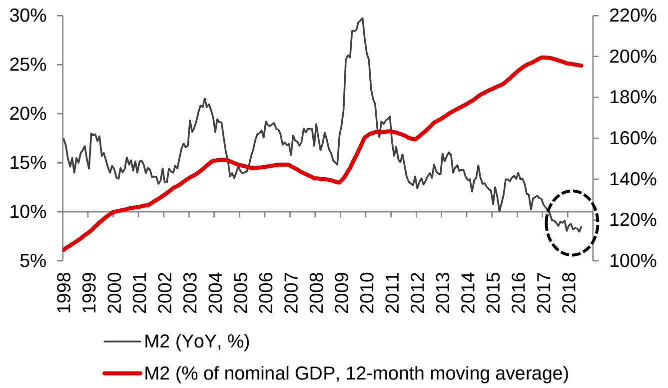
It is worth noting that the so far three target reserve requirement ratio (RRR**)** reductions this year and somewhat quickening credit growth in July have not yet bolstered **aggregate financing growth which slowed to 10.3%YoY in July from 10.5% in June and 10.9% in May under the new definition**[4].

CHART 5: MEASURED SHADOW BANK LENDING CONTINUED TO DECLINE



Source: CEIC, MUFG Bank

CHART 6: CREDIT GROWTH QUICKENED IN JULY FROM A HISTORIC LOW IN JUNE



Source: CEIC, MUFG Bank

[3] PBOC's monetary policy report for 2018 Q2, *2018年第二季度中国货币政策执行报告*, 10 August 2018

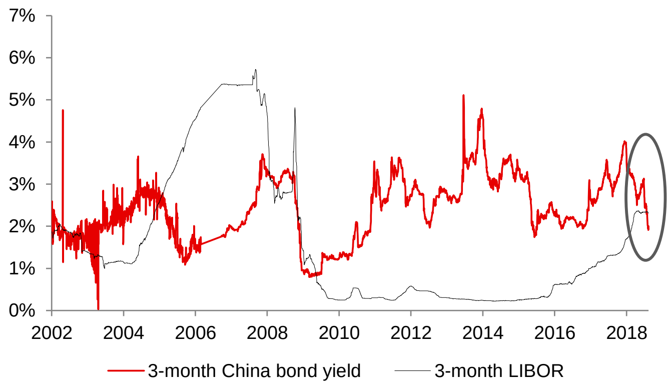
[4] Two new components, securities backed by banks ("存款类金融机构资产支持证券") and write-offs of bad loans ("贷款核销") are added under other financing ("其他融资") of the aggregate financing (Source: PBOC's July Aggregate Financing Report, *2018年7月社会融资规模增量统计数据报告*, 13 August 2018)

The next target RRR reduction will probably be announced as early as late this month

Going forward, we maintain our views that **the next target RRR reduction could be announced in late this month or early September this year** to incentivize financial institutions to reduce financing costs and support refinancing needs for micro-enterprises. In other words, this would probably help improve the transmission mechanism from the ample interbank liquidity to the broader based real economy. Besides, some further efforts would be made to ensure the delivery of the state financing guaranty fund this year.

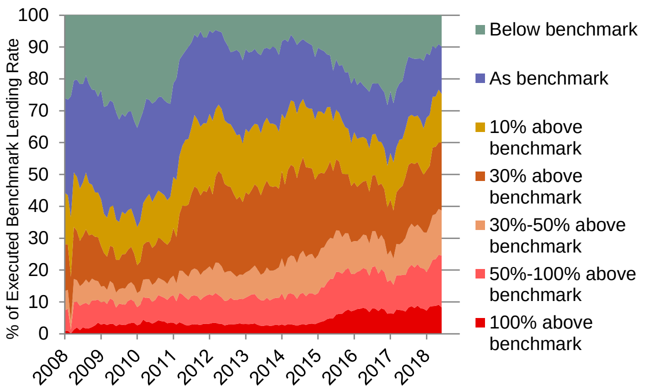
PBOC would probably maintain its prudent and neutral monetary policy stance, with some ongoing pre-emptive fine-tuning, via open market operations and other monetary tools such as medium-lending facilities (MLF), as we previously discussed in our **24 July note** and **20 July note**. **Reducing the benchmark lending rates does not appear to be on the card**, in the light of growing capital flow risks with narrowing interest rate differentials between China and US (Chart 7), while **the so far increasing actual lending rates, which 75.2% of loans was granted at a rate above benchmark lending rates in July and 24.6% of loans was granted at a rate of at least 1.5 times benchmark lending rates** (Chart 8), **could decrease somewhat, conditioning on whether the transmission mechanism would be improved**.

CHART 7: US 3-MONTH LIBOR EXCEEDED CHINA 3-MONTH BOND YIELD



Source: Bloomberg, MUFG Bank

CHART 8: HIGHER ACTUAL LENDING RATES MIGHT DECLINE



Source: CEIC, MUFG Bank

Conclusion & FX implication

Our expectations for China's economic growth moderation and a weak yuan remain intact

All in all, our expectations remain the same, including:

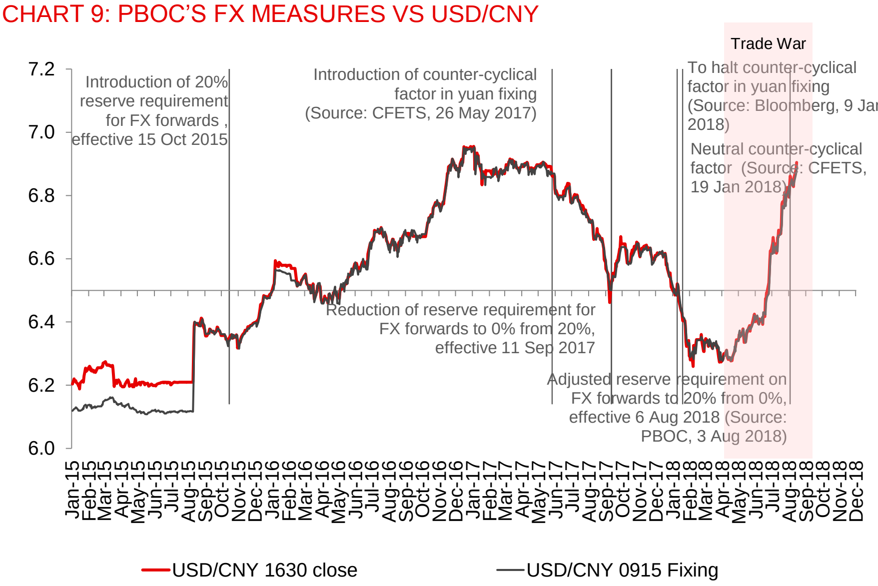
1. **China's economic growth moderation**, against the backdrop of the tit-for-tat trade dispute with US, and somewhat softening domestic demand amid reappearing credit issues and modestly cooling property market
2. Factors behind **a weaker yuan,** such as weakening growth, narrowing China-US interest differentials, modestly loosening fiscal and monetary policies, and reappearing credit issues, **still stand.**

PBOC announced on 3 August 2018 to adjust reserve requirement on FX forwards purchases to 20% from 0%, effective 6 August 2018 (Chart 9, Page 6). Such requirement was previously reduced to 0% from 20% on 11 September 2017, driving USD/CNY which was at around the 6.50 level to stay roughly above the 6.60 level for about 3 months. Yet, the initial market reaction this round appeared to be temporary, driving both USD/CNY and USD/CNH down by 500 pips, albeit with USD/CNH continuously staying higher than USD/CNY. This implies **market expectations for yuan deprecation have remained rather intact, despite the PBOC's latest measure to curb pro-cyclical market movements**.

Unless some stronger measures are imposed, the Chinese yuan would probably depreciate, albeit on a bumpy path

It is hard to rule out the possibility for PBOC to reintroduce the counter-cyclical factor to the USD/CNY fixing formula and strengthen cross-border flow management. As such, we also maintain our views that **the Chinese yuan would probably depreciate, albeit on a bumpy, but rather contained path**.

CHART 9: PBOC'S FX MEASURES VS USD/CNY



Source: PBOC, Bloomberg, MUFG Bank

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