INTESA SANPAOLO

China
Economic Focus

The economic slowdown impact on social stability is a further cause for concern for the Party

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ASIA

Country Report

Intesa Sanpaolo
Research Department

International Research Network

Silvia Guizzo
Economist – Emerging Asia

- GDP growth slowed down from 1.6% qoq in Q3 to 1.5% qoq in Q4. Therefore, year-on-year growth has gone from 6.5% yoy in the previous quarter to 6.4% yoy, and to 6.6% in 2018 as a whole, in line with the government target. The reacceleration of the industrial sector, supported by the rebound in construction, was not enough to offset the slowdown in the agricultural sector and especially in the service sector. The OECD leading indicator rose slightly between October and November, in line with the **improvement of some real activity figures,** such as the production of concrete and metals or the increase in the area under construction, **linked to the resilience of the real estate sector. Other figures,** such as the credit trend, the deceleration of consumption, the slowdown in imports and the drop in orders and business confidence **are still consistent with the slowdown in Q1.**
- **The credit impulse was negative again in Q4** and, given the increase in non-performing and default loans, it might only improve modestly in Q1 2019. As a result of the delay by at least one quarter in the shift of the impulse into the production sector, **the economic growth is likely to slow down at least until the first half of 2019** and later re-accelerate, sustained by more expansive monetary policy and the high number of tax measures approved to support households and businesses. **We confirm our forecast of a slowdown in growth from 6.6% in 2018 to 6.3% in 2019.**
- The **risks for 2019** are based on a **downturn** and they are mainly the result of the international escalation of the trade war, which in the worst-case scenario, according to some estimates, could shave China's GDP growth by up to 1.6%. In the light of the truce reached at the G20 and a likely **partial agreement on some requests from the US**, any further tariff increase and a slowdown in exports in the first quarter should be avoided, but **this is unlikely to result into a settlement agreement.** In addition to this risk, there might be a slowdown in domestic demand, as credit and investment trends are below expectations.
- In a Party high-level meeting at the end of January, **Authorities voiced great concern over the risks to social stability** and the continuation of the reforms, as a result **of the economic slowdown in a year with many sensitive anniversaries for the Party,** which could fuel social dissent. In view of the "two sessions", a number of competent Authorities have announced further support in terms of fiscal policy and a "prudent", flexible and targeted monetary policy. We expect the **PBOC to continue to maintain high liquidity through a number of refinancing windows,** providing support in particular to small and medium-sized enterprises. We also believe that it will resort to other cuts in the compulsory reserve and refinancing rates **in yet another attempt at avoiding benchmark rate adjustments.**
- The **trade truce and the substantial downward revision on the Fed rate hike profile have contributed to a re-appreciation of the USD/CNY exchange rate.** A review of market expectations on the Fed's moves more in line with our main scenario and the further easing of monetary conditions expected in China should bring the exchange rate back down. A stalemate in trade relations with the US and macroeconomic data that signal the slowdown in the Chinese economy are further factors of a **downside risk on the exchange rate.**

Sample

Rating

	Previous	Current
Fitch*	A / stable	A+ / stable
Moody's*	Aa3 / stable	A1 / stable

*rating of long-term foreign currency sovereign debt. Source: Bloomberg

GDP yoy and outlook

	2016	2017	2018 F	2019 F
ISP	6.7	6.9	6.6	6.3
IMF	6.7	6.9	6.6	6.2
World Bank	6.7	6.9	6.5	6.2
ADB	6.7	6.9	6.6	6.4
EIU	6.7	6.9	6.6	6.3
Bloomberg Consensus	6.7	6.9	6.6	6.2

Source: Intesa Sanpaolo and OEF, IMF, WB, ADB, EIU, Bloomberg

CPI yoy and outlook

	2016	2017	2018 P	2019 P
ISP	2.0	1.5	2.1	2.3
IMF	2.0	1.6	2.2	2.4
World Bank	2.0	1.6	2.0	2.1
ADB	2.0	1.6	2.4	2.3
EIU	2.1	1.5	2.0	2.8
Bloomberg Consensus	2.0	1.6	2.1	2.2

Source: Intesa Sanpaolo and OEF, IMF, WB, ADB, EIU, Bloomberg

See the final page for important information.

Real economy and inflation

GDP growth slowed down from 1.6% qoq in Q3 **to 1.5% qoq in Q4.** Therefore, year-on-year growth has gone from **6.5% in the previous quarter to 6.4 yoy in Q4.** The year **2018** ended with a growth of **6.6% yoy,** in line with the government target.

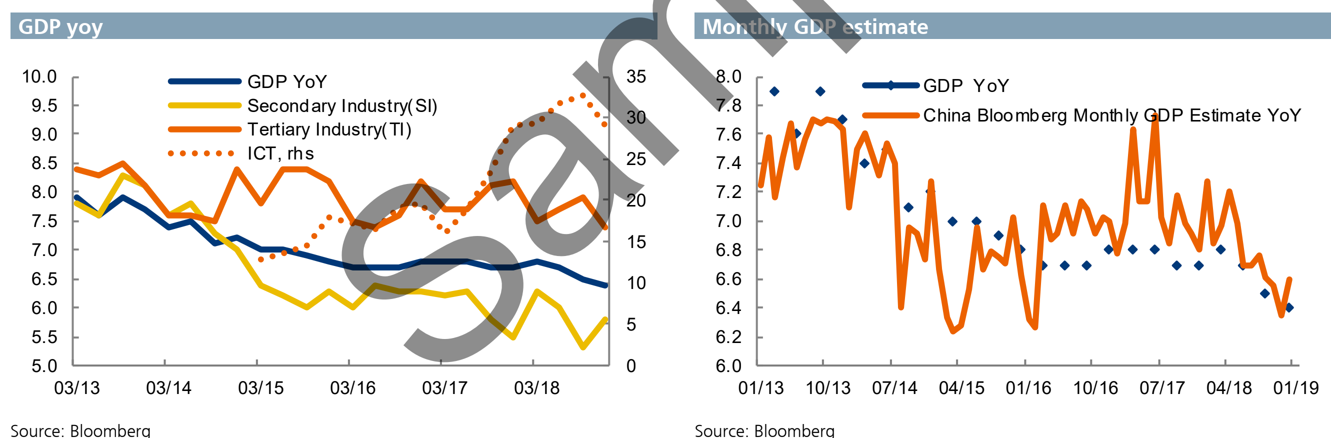
Growth continued to slow down in Q4 with a weakened trend in services

The reacceleration of the industrial sector (to 5.8% yoy in Q4 from 5.3% in Q3), sustained by the rebound in construction, was not enough to offset **the slowdown** in the agricultural sector and especially in the **service** sector (to 7.4% yoy from 7.9% yoy in Q3). In the service sector, the performance of the trade, catering and tourism sectors weighed negatively, hitting a record low in a weakening trend that has gone on since 2Q17, followed by the real estate sector. On the other hand, financial intermediation services and transport services accelerated, and the performance of ICT services, despite slowing down, remained surprisingly high (+29.1% yoy). The **services PMI Markit** index has somehow become stable within the 53 range in Q4, pointing to an **improvement in the sector.** On the demand side, the deceleration affected both consumption and investments, with a negative contribution from the foreign channel.

The OECD leading indicator rose slightly between October and November, in line with the **improvement of some real activity figures,** for example the production of concrete and metals or the increase in the area under construction, **linked to the resilience of the real estate sector. Other data,** including the credit trend, the deceleration of consumption, the slowdown in imports and the drop in domestic orders and business confidence, **remain consistent with a slowdown in the economy in Q1.**

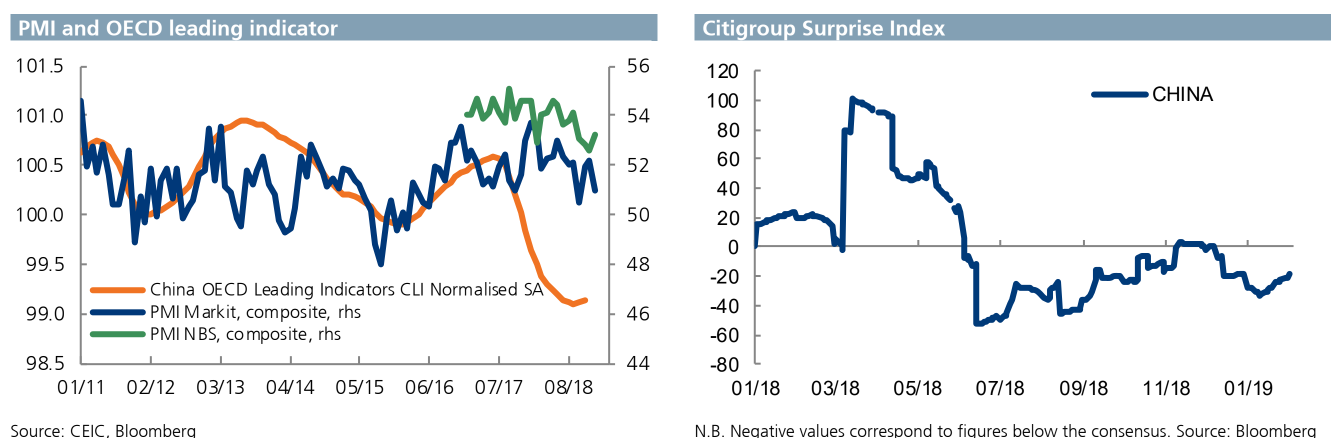
On the whole, monthly figures remain consistent with a slowdown in the economy in the first quarter

Sample



Source: Bloomberg

Source: Bloomberg



Source: CEIC, Bloomberg

N.B. Negative values correspond to figures below the consensus. Source: Bloomberg

The slowdown in infrastructure investments has been partially offset by the acceleration in other sectors

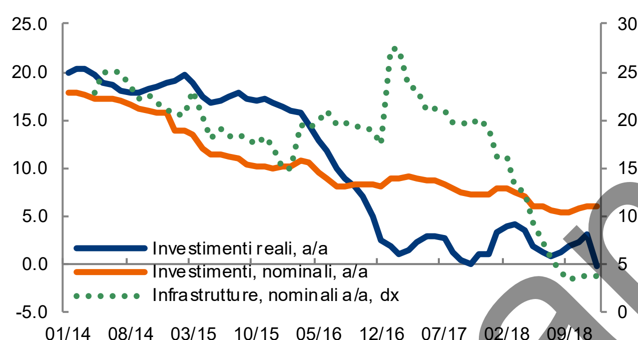
Nominal fixed investments rose by 5.9% yoy in 2018, down from 7.2% in 2017, with a stable ytd growth rate between November and December.

The **moderate acceleration of private sector investments** (from 6% yoy in 2017 to 8.7% in 2018), driven by the mining, manufacturing and real estate sectors, did not completely offset the sharp deceleration of investments by state-owned companies (from 10.1% yoy in 2017 to 1.9% in 2018), mainly caused by the **slowdown in infrastructure** (from 19% yoy in 2017 to 3.8% in 2018).

The **recovery in the investments of the manufacturing sector** (from 4.8% yoy in 2017 to 9.5% in 2018) is driven by the recovery in investments in the metal and chemical industries, but also in ICT, material recycling and environmental management. Instead, investments in the construction and retail trade sectors have continued to decline for the third consecutive year.

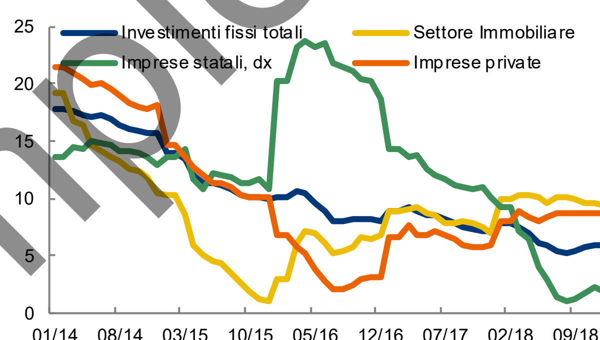
Investments in the **real estate sector at the end of 2018 grew by 9.5% yoy, accelerating compared to 7% in 2017, driven by residential construction** (from 9.4% yoy in 2017 to 13.4% in 2018), with just a marginal deceleration in Q4.

Fixed investments



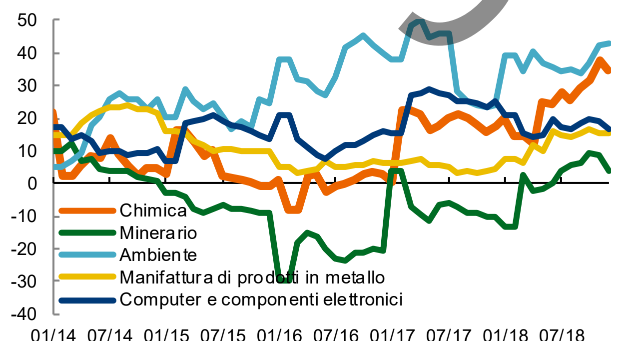
Source: CEIC and Intesa Sanpaolo calculations

Nominal fixed investments by business type (yoy % change)



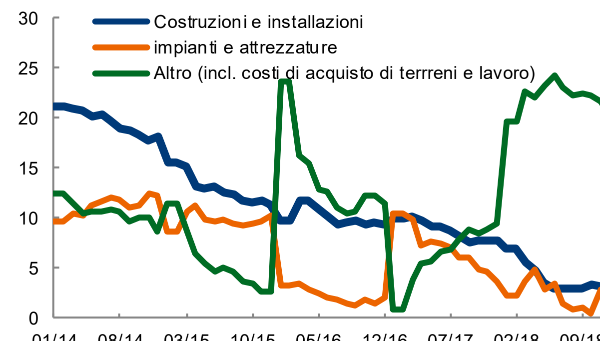
Source: CEIC

Nominal fixed investments by sector (yoy cum. % change)



Source: CEIC

Nominal fixed investments by fund utilisation (yoy % change)



Source: CEIC

Sample

The trend in **house sales** remained weak in terms of sold areas (2.2% yoy in 2018), but it was **significant** in terms of value (+14.7% yoy). Prices of residential properties indeed continued to rise. At the end of December, the Authorities reiterated their opposition to speculation in the real estate market, promising more targeted and diversified measures at city level.

The real estate market is keeping up, but several factors point to a slowdown in 2019

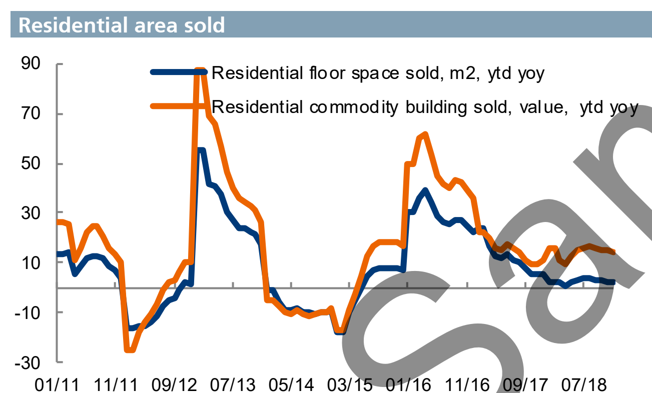
The residential floor area started rose at a fast pace in 2018 (19.7% vs. 10.5% in 2017) and **the area under construction is accelerating**, however the trend in land purchases, with double digit growth and increasingly high prices (14.2% yoy in 2018), is not likely to continue in 2019.

We expect the trend of transactions to weaken during the year due to several factors: anti-speculative measures, only partially loosened in some cities at the end of 2018 (Guangzhou, Hefei, Zhuhai, Heze), will generally remain in place and they could also be tightened in case of further price increases, the effects of the housing modernisation campaign, which supported prices in second and third-tier cities, are waning, long-term loans to households are slowing down and mortgage rates have been on the rise at least until Q3.

Lastly, the reduction in unsold stock compared to the peaks at the beginning of 2017 (-16.8% yoy in 2018 at the national level, and equal to 250 million sqm) may have come to a halt by now, given the increase in the completed residential area expected in the next quarters. Therefore, investment in residential construction should slow down moderately in 2019.

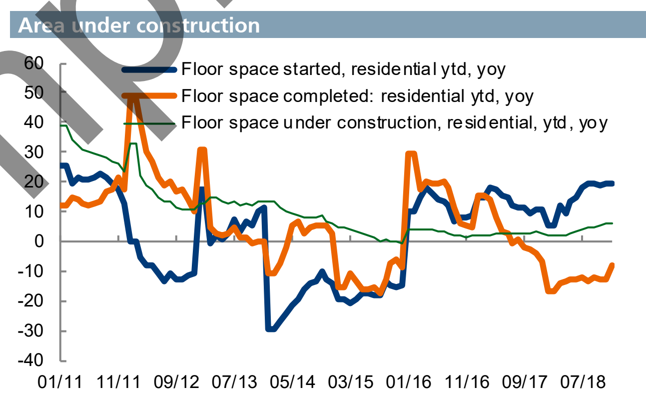
Sample

Residential area sold



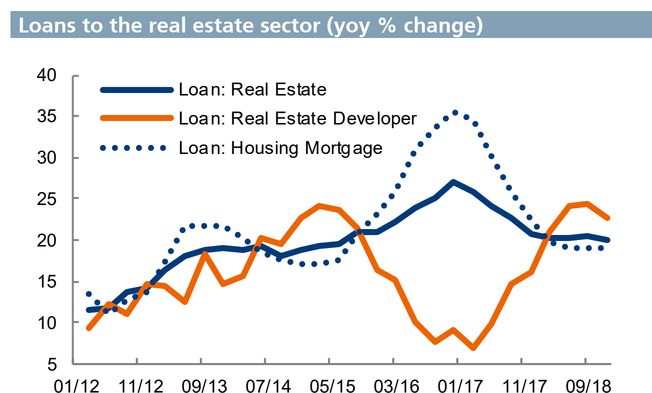
Source: CEIC

Area under construction



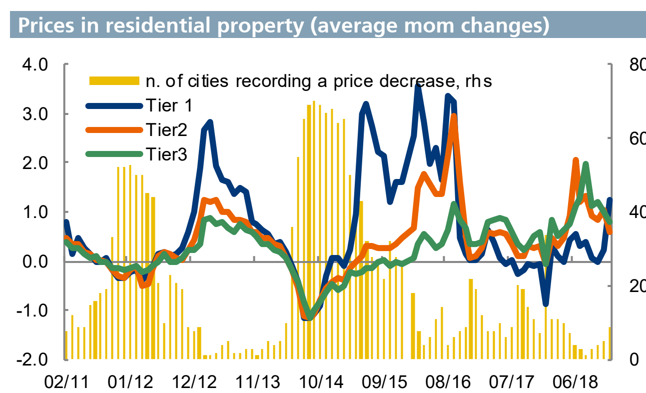
Source: CEIC

Loans to the real estate sector (yoy % change)



Source: CEIC

Prices in residential property (average mom changes)



Source: CEIC and Intesa Sanpaolo calculations

Industrial production rose by 5.7% yoy in December, up vs. the record low of 5.4% yoy in November, thanks to the acceleration of private enterprise production and the rebound of mixed-structure enterprises and cooperatives, while the production of state-owned enterprises slowed down. Quantitative data show an increase in the production of construction material (concrete, steel, etc.), driven by the real estate market, but a decline in the production of cars and computers.

Industrial production has improved in December, but the manufacturing sector is still struggling

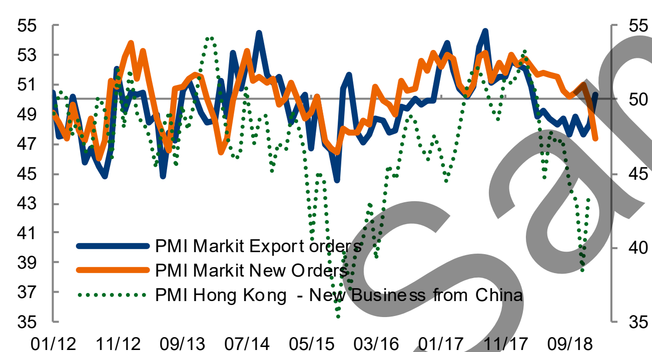
As performance of foreign orders, though weak, marginally improved between November and January thanks to the trade truce, domestic orders deteriorated significantly. It reached record lows in the last two years, and the same applies to stocks and purchases, still pointing to a slowdown in production over the next few months. A favourable base effect and a less restrictive anti-air pollution campaign vs. last year will act as mitigating factors. On the other hand, orders in the service sector increased in Q4, keeping up prospects for the sector.

The level of confidence among industrial enterprises, measured in a survey of the People's Bank of China (PBoC), fell in Q4, both in the evaluation of their own sectors and in the economy as a whole. The index of general business conditions rose marginally after the record low hit in Q3, with a modest increase in turnover and domestic orders as opposed to the indications of the PMI indexes.

The breakdown of PMI index by business type shows that the difficulties in the manufacturing sector, greater for small and medium-sized enterprises, intensified also for large companies, whose profits are clearly slowing down, as they are much more tied to the trend in commodity prices.

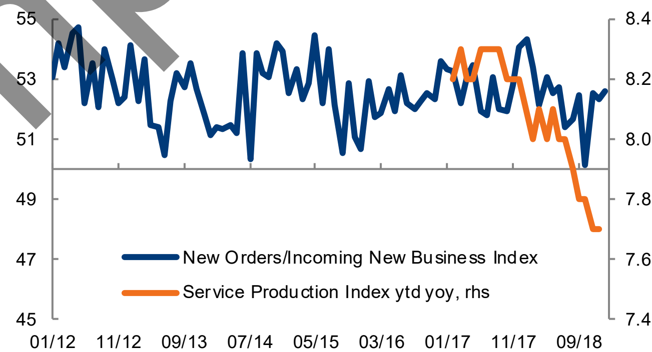
Sample

Slowdown in domestic orders in the manufacturing sector...



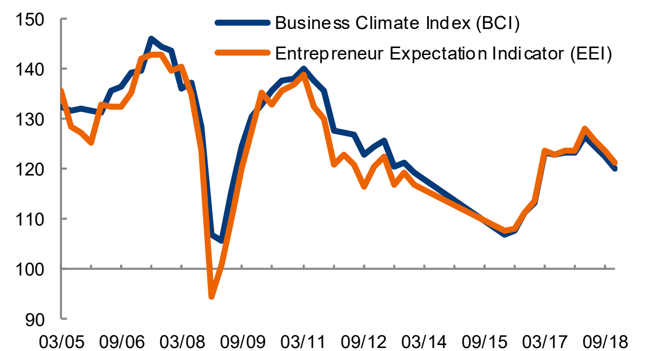
Source: HIS Markit

... and recovery in the service sector



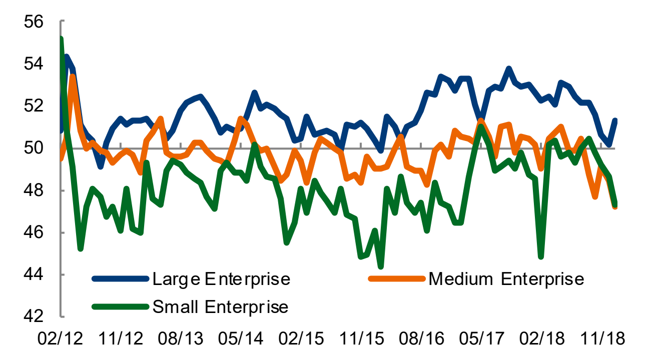
Source: Markit, CEIC

Confidence level among industrial enterprises



Source: PBoC survey from CEIC

PMI by business type



Source: NBS from CEIC

Foreign trade is affected by the slowdown in global demand and tariffs

Foreign trade figures showed a marked slowdown in Q4, and a decline on an annual basis in December. Above all, the trend relating to goods to be assembled for re-export slowed down, having decelerated more than ordinary goods. **Exports rose by 4% in Q4 compared to 11.7% in Q3,** driven down by the slowdown in global demand. In December, exports fell (-4.4% yoy), particularly to the US (-3.5% yoy from +9.8% yoy in November), as a result of the tariffs and, in Europe, especially to France (-5.3% yoy) and Spain (-7.9% yoy). **The trend relating to imports decelerated more abruptly to 4.4% in Q4 from 20.4% in Q3,** with a drop of 7.6% yoy in December, due to the sharp decline in imports from the US (-35.8% yoy), but also from Japan, from the ASEAN area and the Euro area.

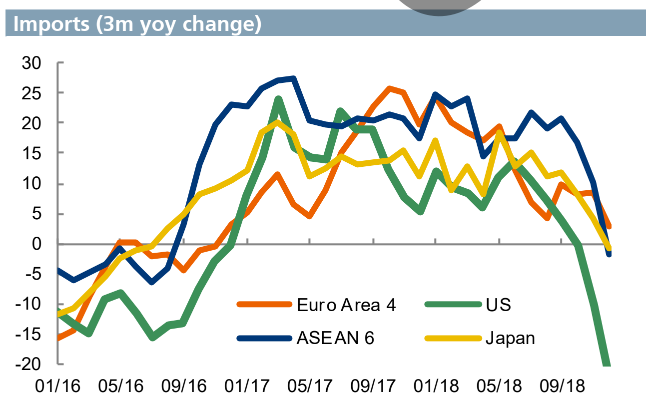
The slowdown in imports is in line with the slowdown in domestic orders in December and January and it adds to the drop in international orders. **The trend in orders and the maturing global cycle of the electronics sector continue to point to a slowdown in foreign trade in 2019,** over which a negative outcome of USA-China talks or of the results of the US survey on imports of cars and car parts represent serious **downward risks**.

Considering the truce reached at the G20, a slowdown in exports may be avoided in Q1, but this is unlikely to result into a settlement agreement

As a result of the truce reached at the G20 between China and the US and a **likely partial agreement** on some requests from the latter, any further tariff increases and a sudden slowdown in exports in Q1 should be avoided. Both parties have an interest in reaching some kind of agreement given the risks of internal slowdown in their respective economies, adding to the slowdown in global demand. However, **a lasting resolution of the trade dispute is unlikely to be reached.** The US and China still have **distant positions on structural issues** at the core of US key demands, first and foremost the request for China to discontinue subsidy policies to its state-owned enterprises (such as Made in China 2025 programme, which China has no interest in abandoning since it is at the core of its development strategy), waive policies of forced technology transfer and increase intellectual property protection. Moreover, the trade dispute is just the tip of the iceberg of a complex **cluster of relevant geopolitical issues ranging from defence and foreign policy** (China increasingly assertive position in the South China Sea and in respect of Taiwan, political and financial implications of the Belt and Road initiative) **to the race for technological supremacy** (5G networks and technology in particular, imposition of standards in the ICT sector and patents). **The outcome of the talks**, that so far are unusually proceeding well, **also depends on the evolution of the Huawei case**, which also involves other countries in relation to the management of 5G networks (Australia, New Zealand, Canada, Poland, United Kingdom, Germany, EU) and which was exacerbated after the arrest[1] in Canada, requested by the American authorities, of CFO Meng Wanzhou at the beginning of December.

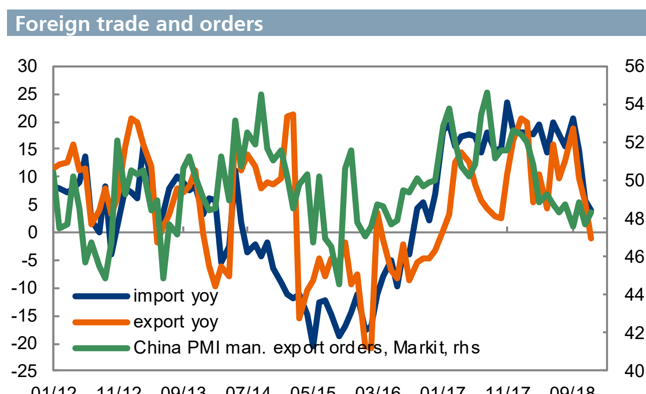
Sample

Imports (3m yoy change)



Source: Bloomberg

Foreign trade and orders



N.B. 12 month rolling sum. Source: Bloomberg

[1] See NYT of 26 January 2019: In 5G Race With China, U.S. Pushes Allies to Fight Huawei.

Consumption is slowing down

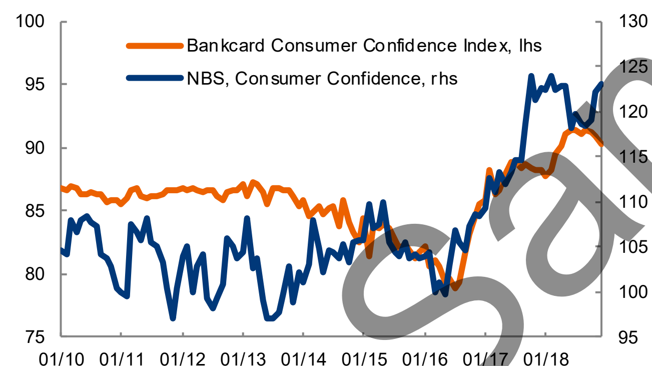
Real per capita household consumption rose by 6.2% in 2018, up vs. 5.4% in 2017, mainly supported by the acceleration of rural household spending; however, the trend **slowed down in the second half of the year** in line with the trend in real income and the retracement of consumer confidence.

Retail sales continued to slow down both in nominal terms (to 8.2% yoy in December from 9.2% yoy in September) and in real terms, driven down by the decline in car sales (-13% yoy in Q4) and a slowdown in other spending segments. The latter also concerned online sales, especially services, despite growth rates continuing to be very sustained (cum. +23.9% yoy in December for goods and services).

However, **the level of consumer confidence surveyed by NBS rose again in the last few months of the year**, heading to the record peaks of the series, unlike that of Bankcard Unionpay which instead, though at high levels, fell. In the labour market, 13.61 million new jobs were created in 2018, just 0.7% above the figure of 2017, with a declining trend in the second half of 2018. Though the unemployment rate is at its lowest levels and job demand is still far above supply, the PMI employment component is weakening and the Manpower survey may have already exceeded the peak in Q3. A deterioration of the **labour market**, the still fluctuating performance of the stock exchange and the trade tensions with the US could bring consumer confidence back into a correction framework in the coming months. However, the consequent **consumption slowdown in 2019 will be modest, mitigated by a high number of tax policy measures** in favour of households.

Sample

Consumer confidence

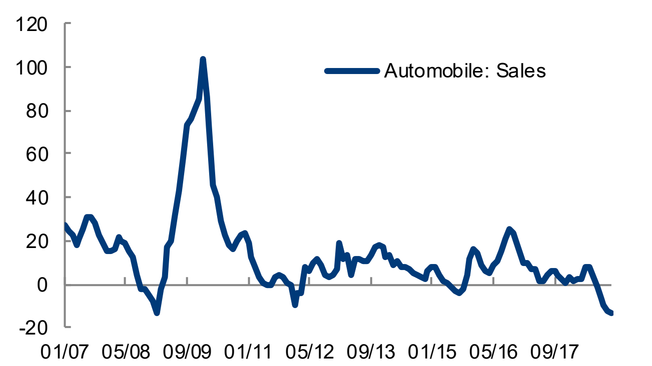


Source: CEIC

Retail sales

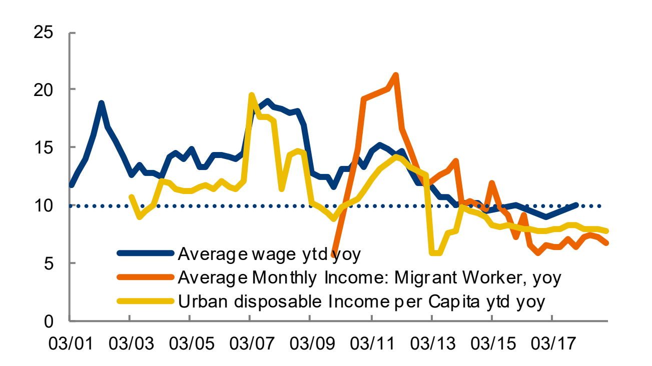
Source: CEIC

Car sales (3m yoy change)



Source: CEIC

Income and wages



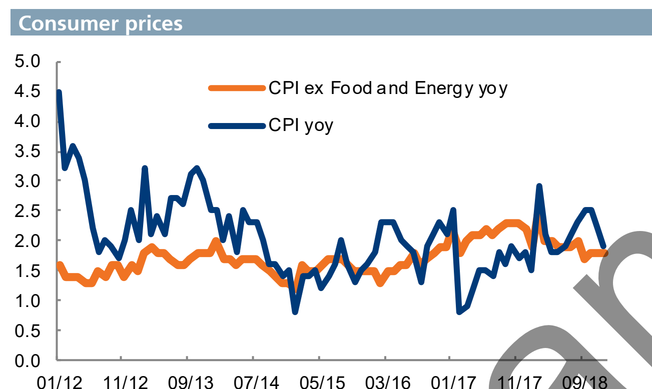
Source: CEIC

Inflation has remained low

Consumer price inflation fell further in December to 1.9% yoy from 2.2% in November, driven down by the decline in prices in the transport and communication sector (-1.9% mom and -0.7% yoy), affected by the fall in oil prices. The trend in food prices remained stable at 2.5% yoy, as well as the inflation trend excluding food and fuels (1.8% yoy). In Q4, the inflation trend benefited from the deceleration of goods inflation and the stabilisation of services inflation (2.1% in the last four months). **Production price inflation fell to 0.9% yoy in December, at record lows in the last two years, from 2.7% yoy in November**, driven down by a sharp slowdown in the price trend of industrial commodities and goods in the manufacturing sector but also by a very favourable base effect.

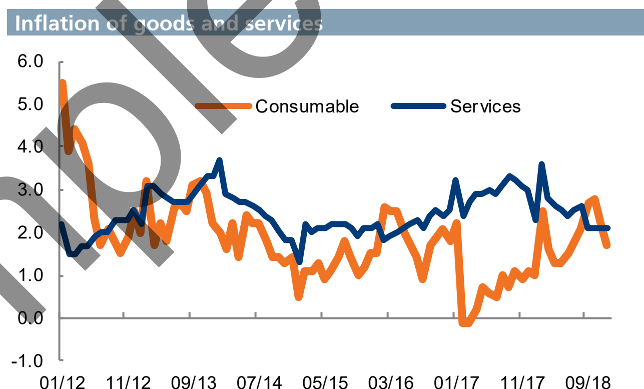
Import prices, which rose to a record high of 11.3% yoy in November, boosted by the depreciation of the exchange rate and tariffs on US products, are showing signs of a reduction as a result of the drop in import taxes for many consumer goods and in commodity prices. Therefore, the inflation trend remains modest and it can't prevent any further easing of the monetary policy in the coming months. **We maintain the inflation forecast with a limited increase to 2.3% in 2019, from 2.1% in 2018**.

Consumer prices



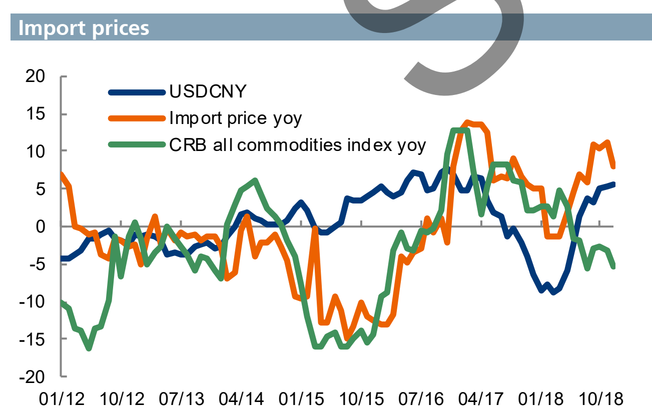
Source: CEIC

Inflation of goods and services



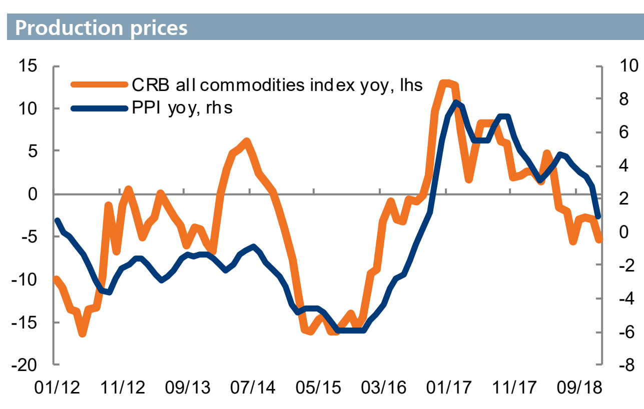
Source: Bloomberg

Import prices



Source: CEIC, Bloomberg

Production prices



Source: CEIC, Bloomberg

Sample

Socio-political context and economic policy

The Party is increasingly concerned over the risks for social stability...

The 4th Plenary Assembly of the Chinese Communist Party (CCP), that was expected in January, was not convened; however, on January 21, a high level ministerial and provincial Party meeting - chaired by President Xi Jinping - was called. The meeting was held at the Party School for a special four-day study session on risk control. In his opening speech, the President stressed that it is imperative for the CCP to pay attention and make a greater effort to prevent and resolve the enormous risks to social stability and the continuation of the reforms that may result from the economic slowdown. The focus areas range from domestic policies to economy and science, from environmental management to foreign policy; complex issues affect each of these areas and, if poorly managed, they could result into serious threats to the long-term guiding role of the Party and the development of the economy. The President warned against events such as "black swans" (unpredictable events with substantial financial consequences) or gray rhinos (visible but ignored threats), underlining the need to find a balance between stabilising growth and containing risks and restructuring companies in bankruptcy (zombie companies) ensuring the relocation of employees, reconfirming the Authority's attention to the labour market trend. President Xi also called for the strengthening of the political and ideological education[2] of the younger generations and emphasised that Party members must prepare to fight a difficult battle, a message reiterated by Wang Huning, the Party's ideologue and the fifth office of the State, in the closing speech of the conference.

… in a year of important anniversaries

The concerns voiced by the President on the risks to social stability creep into the concerns on the slowdown in the economic cycle, that were further reiterated at this meeting but already clearly expressed by the Authorities in autumn. Indeed, 2019 marks three important anniversaries, that have a special meaning for the Party, which could fuel social dissent well beyond the rare but constructive criticisms that emerged in the academia since last summer[3]: the 100th anniversary (4 May 1919) of the student movement which resulted into the founding of the CCP in 1921; the 70th anniversary of the founding of the People's Republic of China (1 October 1949); the 20th anniversary of the gruesome repression of the student protests in Tiananmen Square (4 June 1989) which was very much inspired by the student movement of 4 May 1919. The Cyberspace Administration of China has already launched a new Internet control campaign at the beginning of the month and the anti-corruption campaign launched in 2012 is expected to gain new momentum.

In view of the "two sessions", further announcements of support in terms of fiscal policy to consumers and businesses and less emphasis on investment in infrastructure

Starting from 3 and 5 March respectively, the annual spring meetings of the People's Political Consultative Conference will take place (an institution of a consultative political nature with representatives of minor parties, organisations and individuals, promoting the interests of different social groups) and of the National People's Congress (Parliament), known as the "two sessions" ("liang hui"), during which the public Budget and the Report on the Government's work for 2019 and the final balance for 2018 will be presented, and which will provide more precise information on the economic targets for 2019. Meanwhile, the Authorities have continued to announce new measures to support a more open approach on foreign investments and tax support to consumers and businesses. At the end of December, the Ministry of Finance approved a tariff reduction on 706 products, which came into force on 1 January, and promised further tariff cuts during the year. The State Council approved the quota of local government bond issues for 2019, reducing the amount for special infrastructure-financing bonds from 1,350 billion yuan in 2018 to 810 billion in 2019. Although this year actual issues could again exceed the quota, as was the case in 2018 (issues were equal to 1946 billion yuan), with this reduction the Government seems to want to signal less emphasis on infrastructure investments than in the past. At the beginning of January, the State Council announced its intention to reduce the tax burden for small and medium-sized enterprises by 200 billion CNY per year over the next three years and the NDRC (National Development Reform Commission) pointed out that in 2019 investments will be more targeted

[2] Xi Jinping's Thinking on Socialism with Chinese Characteristics for the New Era.

[3] See Cina Focus Economia of 6 December 2018.

Sample

and efficient and, despite still being focused on infrastructure, they will be targeted to artificial intelligence, Internet of Things, and the technological transformation of the manufacturing sector.

Monetary and credit policy

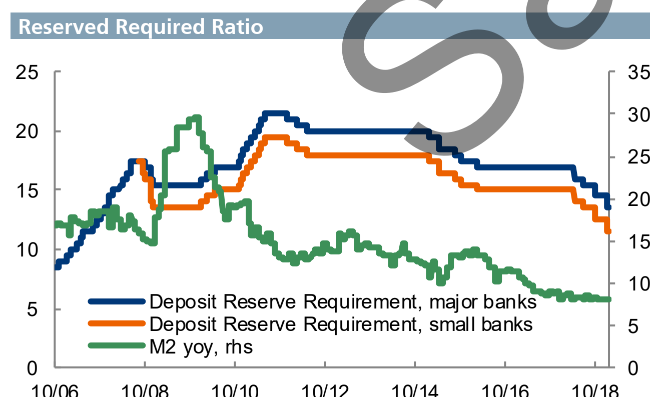
More flexible and targeted monetary policy

At the beginning of January, the PBoC announced a cut in the **Reserved Required Ratio** (RRR) **for a total of 100 bps** in two tranches of 50 bp each, the former being in force from 8 January and the latter from 25 January, moreover loosening the requirements for accessing targeted RRR cuts[4]. Additionally, in January the PBoC carried out the first refinancing transaction through the new "targeted" medium-long term liquidity facility (TMLF), announced on 19 December, with a rate of 3.15%, 15 bps less than the medium-long term window (MLF). On that occasion, the PBoC also **raised its targeted re-financing and redemption quotas by another 100 billion CNY**, the third increase in 2018, after the increase in June and October by 150 billion each, bringing the total increase to CNY 400 billion.

In the press release from the **Central Economic Work Conference**, held from 19 to 21 December, **monetary policy** was no longer defined as "prudent and neutral", a phrase used in recent years, but only **"prudent"**, specifying that it will be **focused on "counter-cyclical adjustments"** with the aim of maintaining liquidity "at reasonable levels", stabilising interest rates and improving the monetary policy transmission mechanism. In January, Governor Yi Gang pointed out that the PBoC wants to avoid a swift credit tightening as much as an indiscriminate loosening. Money market rates, after the peak at the end of the year, fell back to November levels, while those on the government curve fell by another 20-25 bps. The PBoC also announced a **Central Bank Bills Swap programme** allowing primary dealers to **exchange perpetual securities** issued by banks with certain characteristics with much more liquid **PBoC securities**, for a maximum duration of 3 years. Perpetual securities with a rating higher than AA can also be used as collateral in both ordinary refinancing transactions (TMLF, MLF and SLF) and in targeted refinancing transactions (re-lending). The swap programme **does not imply increasing liquidity in the system, but it provides support for the recapitalisation of banks** that are beginning to issue perpetual securities to increase capital and meet Basel III requirements. The simultaneous easing of the restrictions on investment in perpetual securities by insurance companies approved by CBIRC points to the same direction.

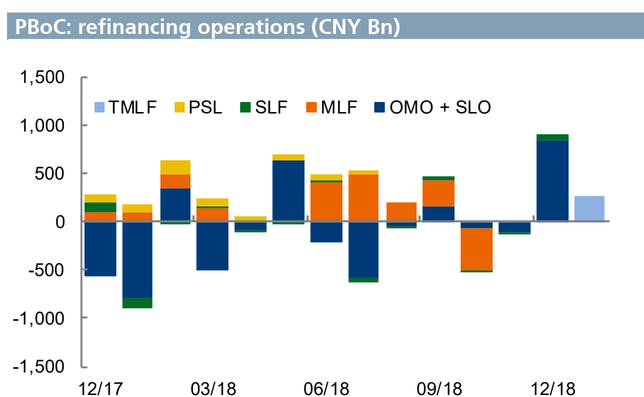
Sample

Reserved Required Ratio



Source: CEIC

PBoC: refinancing operations (CNY Bn)



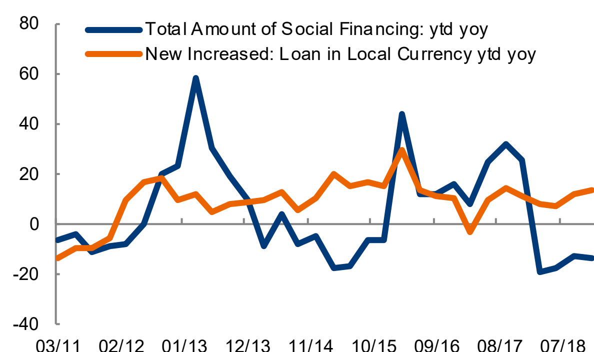
Source: CEIC

[4] Loans to small and micro businesses up to 10 million CNY, compared to the previous 5 million threshold, will be included in the calculation of the requirements to access targeted RRR cuts.

Easing of the monetary policy with a number of instruments avoiding any benchmark rate cuts

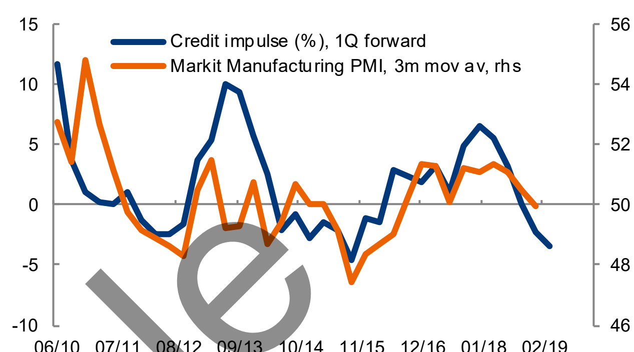
We still believe that the **PBOC will continue to maintain a high liquidity level through a number of refinancing windows,** especially TMLF and MLF facilities and pledged supplementary lending (PSL and relending and rediscount quotas), providing support in particular to small and medium-sized enterprises. We also believe that it will resort to another two cuts in the compulsory reserve by 100 bp each **and two cuts in refinancing rates in an attempt at avoiding any action on benchmark rates.**

Bank Loans and Social Finance flows, cum. yoy change



Source: CEIC

Credit impulse*



*Change in new loans against GDP, 4-quarter rolling averages. Source: CEIC and Intesa Sanpaolo calculations

Sample

In 2018, the Aggregate Financing to the Real Economy (AFRE) was down by 14% yoy compared to the increase of 25.8% yoy in the previous year, due to the decrease in non-bank loans (with the exception of corporate issues) which more than offset the increase in bank loans. **The AFRE stock slowed down** from 12.6% yoy in 2017 **to 9.8% in 2018,** the record low since 2005.

The trend in the stock of bank loans improved, up from 13.1% yoy in November to 13.5% yoy **in December**, while the AFRE trend recorded **another slight slowdown hitting a record low at 9.8% yoy** from 9.9% in November due to the continued decline in foreign currency loans and other non-bank financing categories. The AFRE trend, including all local government issues (not just those of special securities for infrastructure financing), fell down to 9.5% yoy.

The climate survey on the banking sector of the PBOC in Q4, if seasonally adjusted, shows a deterioration in loan applications from companies. The change in the flow of new aggregate loans in % of GDP, or **the credit impulse, recorded a drop in Q 3 and 4** after a flat performance in Q2. Given the increase in non-preforming loans and defaults (136 corporate securities in 2018 compared to only 32 in 2017 according to Bloomberg data), we expect the credit impulse to only show a modest improvement in Q1 2019 thanks to the easing of the monetary policy. Indeed, even assuming an increase in the AFRE flow by 25% yoy in Q1 (which would bring the amount to exceed the peaks recorded in Q1 of 2016 and 2017, i.e. slightly above 7,200 billion CNY), the credit impulse would still be marginally negative.

Considernig the delay by at least one quarter of the shift of the impulse into the production activity, **economic growth may decelerate at least until the first half of 2019.** We confirm our forecast of a slowdown in growth from 6.6% in 2018 **to 6.3% in 2019.** The **risks for 2019** are **downwards** and they come mainly from the international escalation of the trade war, which in the worst-case scenario, according to some estimates, could shave China's GDP growth by up to 1.6%. There are also some risks of a slowdown in domestic demand due to a credit and investment trend below expectations.

Exchange rate

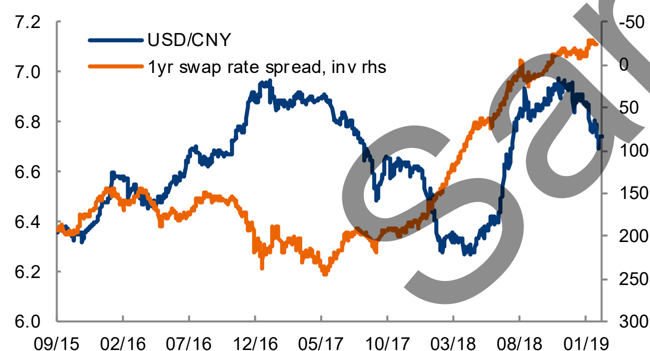
The trade truce temporarily favours the exchange rate

The USD/CNY exchange rate after trading in the 6.90-6.96 range between October and November appreciated once again up to 6.74 at the end of January. The nominal effective exchange rate had a similar trend. The exchange rate movement started **on the announcement of the trade truce** between China and the United States reached at the end of the G20 at the end of November, but it also benefited from the **strong downward revision of expectations on Fed interest rate hikes.** The market expects only one hike in 2019 with a probability of around 25% and a cut between the end of 2019 and the beginning of 2020 with a tiny probability. Our main scenario on US monetary policy sees at least one rise in 2019 with a possible reversal of the monetary policy towards the end of 2020.

In autumn, the Authorities reiterated that **China is not interested in a competitive devaluation** and it is able to keep the exchange rate stable at a "reasonable" level of balance. Despite this, we believe that a correction of market expectations more in line with our scenario and the further easing of monetary conditions expected in China should **bring the exchange rate back down in the 6.90-6.95 range.** A stalemate in trade relations with the US and macroeconomic data that signal the slowdown in the Chinese economy are further factors of a **downside risk on the exchange rate.** We maintain a forecast of **re-appreciation of the renminbi in the second half of 2019,** in line with the stabilisation of economic growth and the support provided by the increase in foreign portfolio investment flows expected after **the inclusion of government and bank securities in the Bloomberg Barclays Global Aggregate Index expected since April 2019.** According to some estimates (Morgan Stanley, CIB Research), considering fund assets and liabilities, China could see about 60-80 billion dollars of fund inflows in the debt market in 2019.

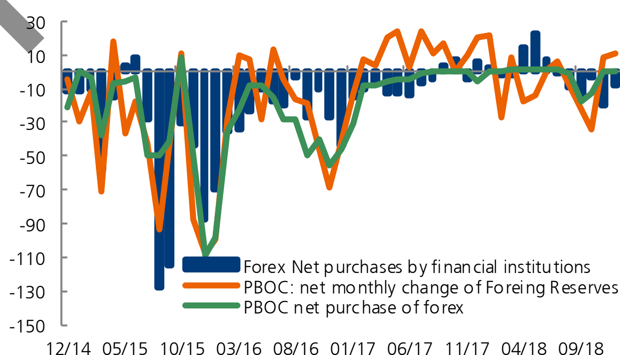
Sample

Exchange rate and rate spreads



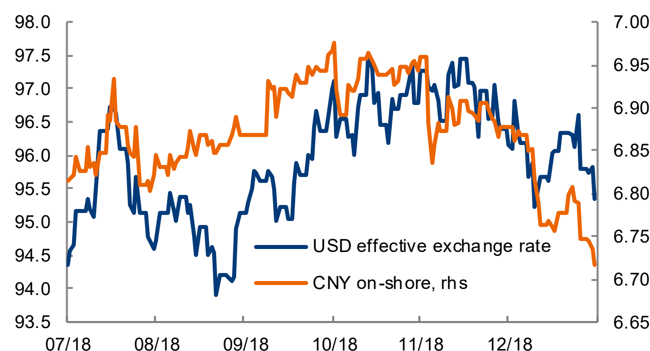
Source: Bloomberg

The PBOC intervenes on the exchange rate



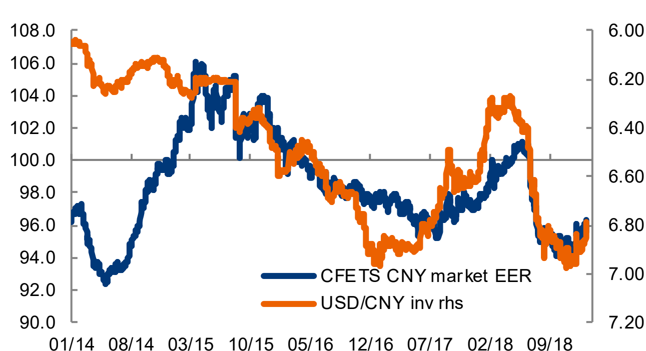
Note: Negative purchase = sale of foreign currency. Source: CEIC, Bloomberg

CNY and USD effective exchange rate



Source: Bloomberg

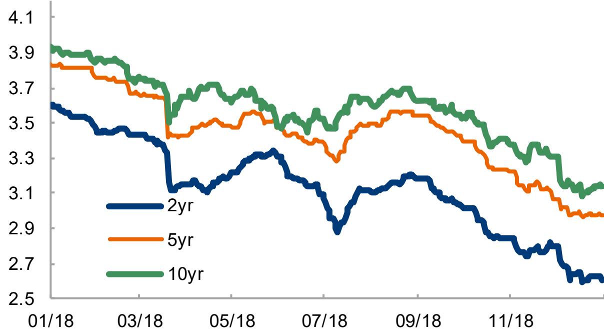
CNY and effective exchange rate



Source: Bloomberg and ISP calculations

Financial markets

Government bond yields(%)

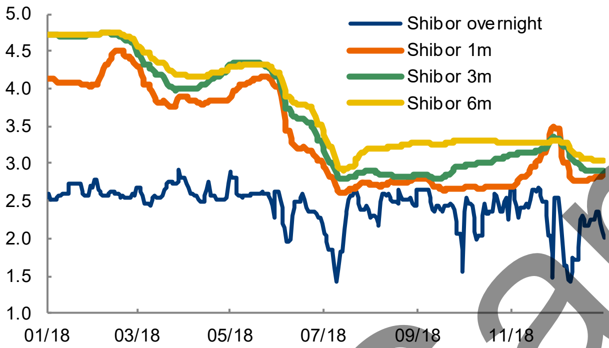


Source: Bloomberg

Government bonds curve slope (bps)

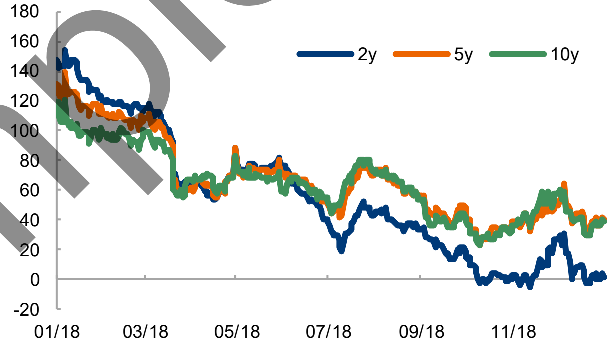
Source: Bloomberg

Money market rates (%)



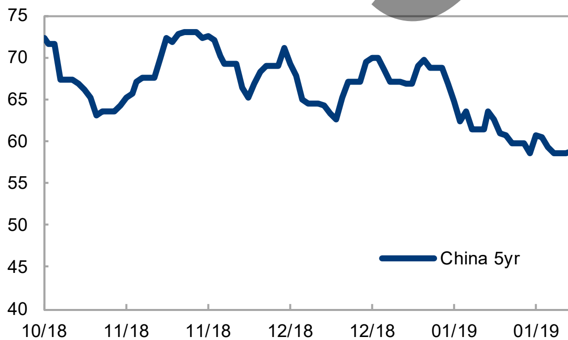
Source: Bloomberg

Government bonds in local currency: spread over US Treasury (bps)



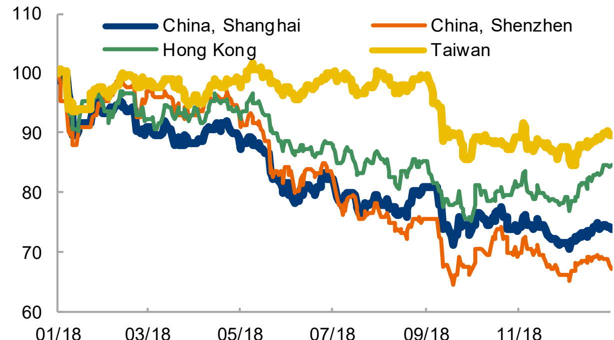
Source: Bloomberg

5-year CDS in USD (bps)



Prices as at 30/01/2019. Source: Bloomberg

Stock exchange: indices rebased at 30/01/2018=100



Source: Bloomberg

Sample

Macroeconomic indicators

Real Econony	2000 2005	2006 2010	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Population (mln)	1283.2	1318.8	1334.0	1339.0	1344.0	1350.0	1355.0	1361.0	1366.0	1372.0	1378.0	1385.0
GDP per head ($ at PPP)	3897	7662	9300	10360	11420	12470	13600	14770	15710	16670	17900	19280
GDP (% real change pa)	9.6	11.3	10.6	9.5	7.9	7.8	7.3	6.9	6.7	6.9	6.6	6.3
Private consumption (% real change pa)	8.5	9.4	9.2	11.1	8.1	6.7	7.9	7.2	8.1	6.9	6.6	6.4
Government consumption (% real change pa)	8.4	10.3	8.8	12.0	8.2	7.0	4.0	9.7	8.3	9.4	9.0	9.4
Gross fixed investment (% real change pa)	12.6	14.2	12.6	8.7	8.9	9.2	6.8	6.6	6.1	4.0	4.4	4.6
Exports of G&S (% real change pa)	18.3	8.0	5.6	14.0	7.9	11.9	8.2	1.8	5.9	9.0	7.3	4.0
Imports of G&S (% real change pa)	20.5	9.6	9.3	15.9	7.1	11.8	7.2	2.0	7.1	7.0	5.7	3.2
Consumer prices (% change pa; av)	1.2	3.0	3.2	5.5	2.6	2.6	2.1	1.5	2.1	1.5	2.0	2.8
Public debt (% of GDP)	24.8	17.1	16.4	14.8	14.3	14.5	14.8	15.2	16.1	16.6	18.8	21.8
Budget balance (% of GDP)	-2.0	-0.9	-1.6	-1.1	-1.6	-1.8	-1.8	-3.4	-3.8	-3.8	-3.5	-4.4
Money market interest rate (%)	3.1	3.0	2.7	5.3	4.6	5.0	5.1	4.1	3.2	4.8	4.4	3.5
Exchange rate LCU:US$ (av)	8.26	7.23	6.77	6.46	6.31	6.20	6.14	6.23	6.64	6.76	6.62	7.10
Real effective exchange rate (CPI-based)	97.5	103.3	109.3	112.6	118.8	126.3	130.2	143.3	135.3	131.9	133.0	125.3

Current Account Balance	2000 2005	2006 2010	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Current account balance (USD bln)	53.0	300.9	237.8	136.1	215.4	148.2	236.0	304.2	202.2	164.9	30.1	22.9
Current account balance / GDP (%)	2.9	7.3	3.9	1.8	2.5	1.5	2.2	2.7	1.8	1.4	0.2	0.2
Trade balance (USD bln)	58.4	278.1	246.4	228.7	311.6	359.0	435.0	576.2	488.9	476.1	410.6	441.9
Services: balance (USD bln)	-7.4	-16.3	-23.4	-46.8	-79.7	-123.6	-213.7	-218.3	-233.1	-265.4	-315.9	-348.3
Income: balance (USD bln)	-13.4	2.6	-25.9	-70.3	-19.9	-78.4	13.3	-41.1	-44.0	-34.4	-50.8	-55.4
Current transfers: balance (USD bln)	15.3	36.6	40.7	24.5	3.4	-8.7	1.4	-12.6	-9.5	-11.4	-13.8	-15.2

External Debt	2000 2005	2006 2010	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Total debt / GDP (%)	12.6	10.2	12.1	13.9	13.3	15.3	16.8	11.8	12.6	14.2	14.5	15.4
Debt-service ratio, paid (%)	6.6	2.5	3.0	2.9	3.1	3.0	3.0	4.8	6.7	7.5	6.4	7.5
Short term external debt/Total External Debt (%)	39.0	58.3	69.8	73.9	69.6	73.2	70.0	62.0	56.6	60.3	59.4	58.8
Short term external debt / Forex reserves (%)	19.3	13.4	17.9	24.1	23.8	28.1	32.1	24.6	26.4	32.6	37.1	41.0
Import cover (months)	11.0	20.6	25.0	21.1	20.6	21.8	20.7	20.4	19.1	17.6	14.8	13.4

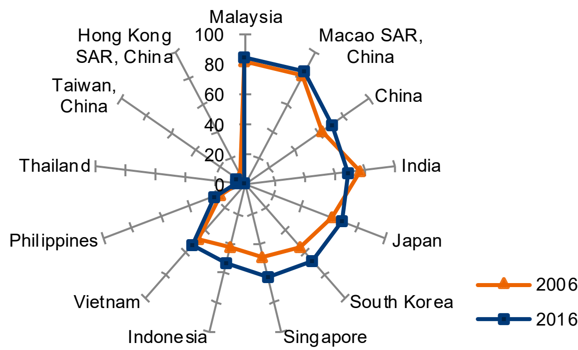
External financing requirement backing (USD bln)	2000 2005	2006 2010	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
External Financig Requirement [1] (plus sign=surplus)	-27.5	87.4	-21.5	-401.2	-585.8	-680.6	-879.2	-1019.2	-749.2	-779.3	-1122.4	-1275.8
Current account Balance	53.0	300.9	237.8	136.1	215.4	148.2	236.0	304.2	202.2	164.9	30.1	22.9
Medium and Long term debt expiring	-21.4	-22.9	-18.8	-24.9	-29.8	-36.7	-38.2	-83.9	-129.1	-142.8	-121.9	-145.4
Short term Debt expiring	-59.0	-190.6	-240.5	-512.3	-771.4	-792.1	-1077.0	-1239.5	-822.2	-801.4	-1030.6	-1153.2
Financial Backing:												
Medium and Long term loans of which	21.9	32.8	38.6	78.6	80.3	79.9	136.8	108.6	170.0	228.2	227.0	212.9
Commercial banks loans	13.6	24.6	26.7	27.0	27.7	29.5	57.9	61.0	113.7	114.9	160.7	121.5
Officially guaranteed loans (ODA)	5.7	7.1	11.8	23.4	15.3	20.1	17.5	13.7	19.2	18.9	16.7	12.0
International bond issues	2.6	1.0	0.0	28.2	37.3	30.3	61.4	33.9	37.1	94.4	49.6	79.3
Short term loans	81.2	263.4	512.3	771.4	792.1	1077.0	1239.5	822.2	801.4	1030.6	1153.2	1219.3
Net direct investment flows	53.6	122.0	185.7	231.7	176.3	218.0	145.0	68.1	-41.7	66.3	101.1	43.0
Net portfolio investment flows (net of fc bond issues)	-2.9	8.9	25.5	-5.4	12.1	24.4	28.5	-75.2	-74.5	-74.7	48.7	-27.1
Other net capital flows [2]	-15.1	-104.4	-290.6	-338.4	-346.7	-210.3	-651.0	-367.3	-414.3	-333.2	-468.3	-308.5
Change in international reserves (minus sign=increase)	-111.2	-410.1	-450.0	-336.7	-128.3	-508.4	-19.6	462.9	308.3	-138.1	60.7	136.2

Notes: (1) Gross financing requirement = current account balance - short-term debt - long-term debt maturing during the year; (2) Other capital flows, assessment changes, errors and omissions.
Source: EIU, e=estimates, f=forecasts as at the last available date: 20-Dec-18

Sample

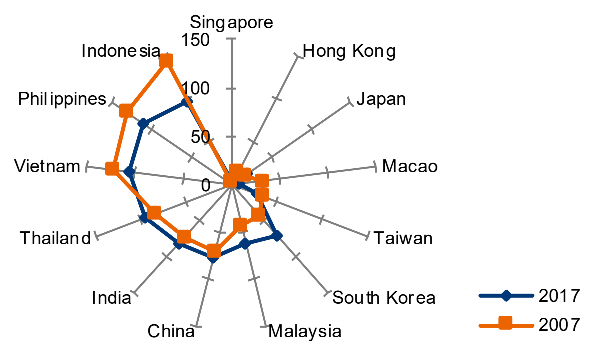
Socio-political indicators

Economic Governance



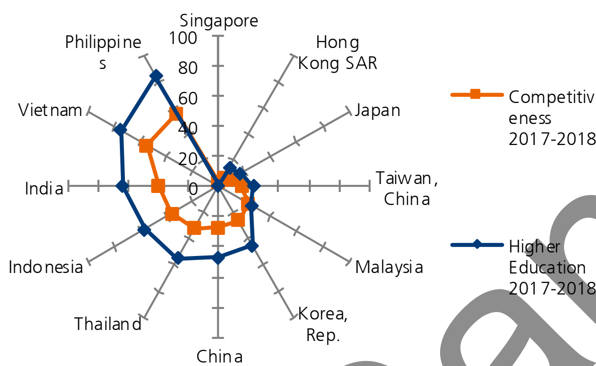
Source: World Bank, rank

Corruption perception index



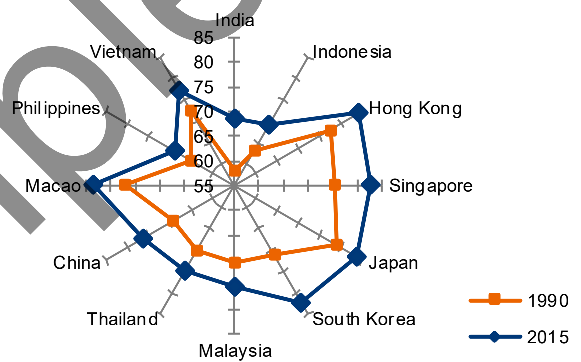
Source: Transparency, rank

Business Competitiveness and Higher Education Index



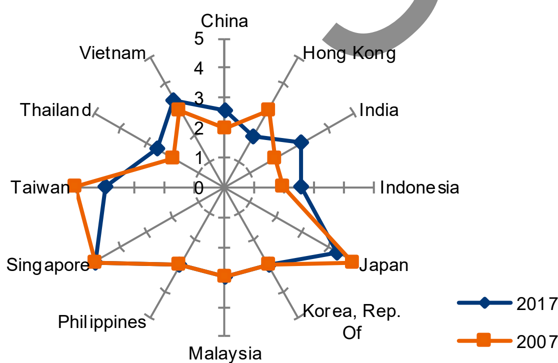
Source: World Economic Forum, rank

Life Expectancy (years)



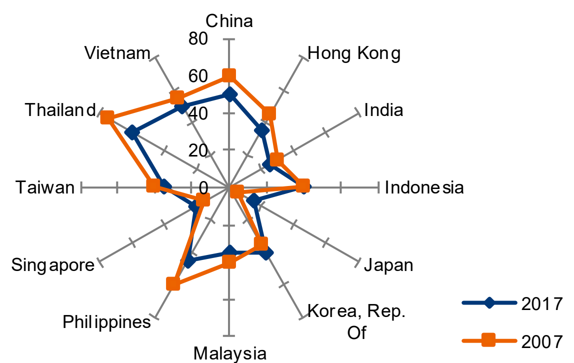
Source: World Bank

Risk of social unrest



Source: EIU, 5= lowest 1=highest

Risk of Political Instability

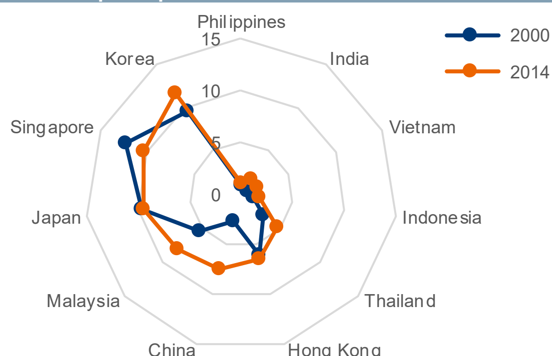


Source: EIU, 100=highest

Sample

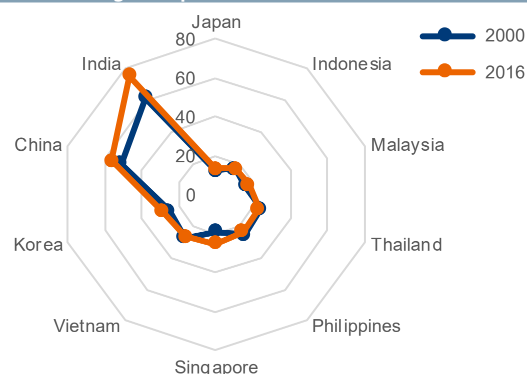
Environmental and energy indicators

CO_2 emissions (per capita metric tons)



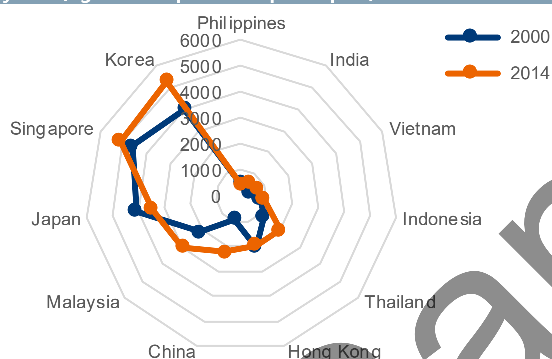
Source: World Bank

PM2.5 levels (micrograms per m³)



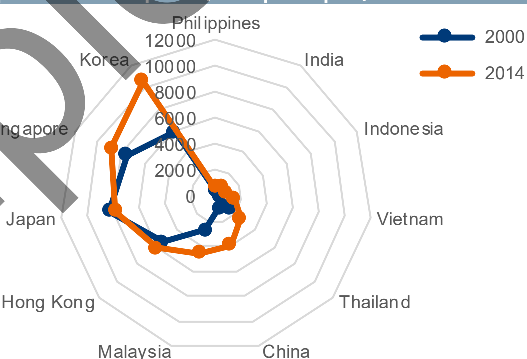
Source: World Bank; Hong Kong data not available

Energy use (kg of oil equivalent per capita)



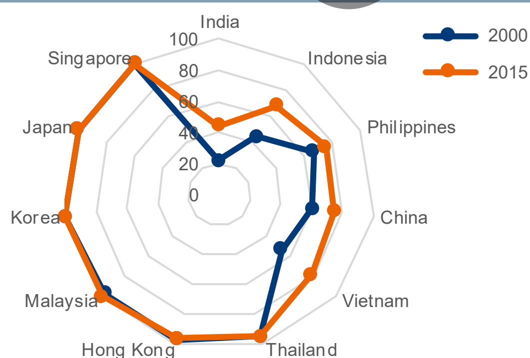
Source: World Bank

Electric power consumption (kWh per capita)



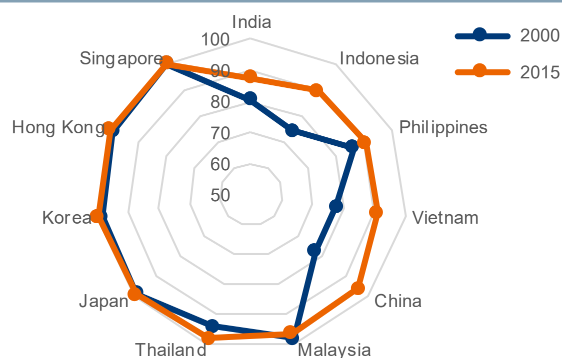
Source: World Bank

People Using At Least Basic Sanitation Services: % of Population



Source: World Bank

People Using At Least Basic Drinking Water Services: % of Population



Source: World Bank

Sample

Intesa Sanpaolo Research Department – Head of Department Gregorio De Felice		
Tel 02 8021 + (3) Tel 02 879 + (6)		
International Research Network - Head Gianluca Salsecci	35608	gianluca.salsecci@intesasanpaolo.com
Economist – Latin America, CSI and MENA Giancarlo Frigoli	32287	giancarlo.frigoli@intesasanpaolo.com
Economist – Emerging Asia Silvia Guizzo	62109	silvia.guizzo@intesasanpaolo.com
Economist – CEE and SEE Antonio Pesce	62137	antonio.pesce@intesasanpaolo.com
Economist – Trade and industry Wilma Vergi	62039	wilma.vergi@intesasanpaolo.com
Economist – Banks and markets Davidia Zucchelli	32290	davidia.zucchelli@intesasanpaolo.com

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Sample