CHINA ECONOMIC UPDATE FEBRUARY 2020

China's economy faces a host of challenges in the Year of the Rat

NAB Group Economics

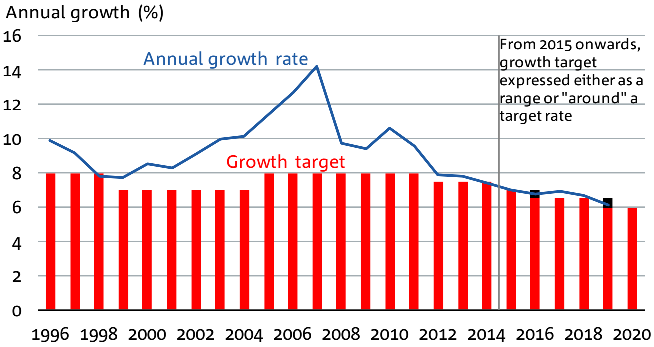
China enters the Year of the Rat having recorded its weakest rate of growth in almost three decades in 2019. Some of this reflected the gradual slowing trend as China's economy matures, however it has also faced some external pressures as well. While the recently signed "Phase One" trade deal with the United States provides a more positive outlook than was the case in mid-2019, China's economy will continue to face some significant challenges.

CHINA'S GROWTH TO TREND LOWER

According to the latest national accounts data, China's economy grew by 6.1% in 2019, the slowest rate of growth since 1990. China's growth has been trending lower for a number of years, having peaked at 14.2% in 2007. This slowing was expected, as earlier stronger rates were not sustainable in the long term, having largely closed the technology gap to advanced economies, developed sufficient capital stock (with oversupply in some industrial sectors) and reached the end of the demographic dividend (where the relative size of the workforce to the overall population was expanding).

CHINA'S SLOWING GROWTH TREND

Lower target likely for 2020



Source: Bloomberg, CEIC, NAB Economics

We expect the slowing trend to continue – apparently in line with official expectations. According to reports, China will lower its official growth target from 6%-6.5% in 2019 to "around 6%" at the National People's Congress in March. We forecast growth at 5.9% in 2020 – a rate we believe is close enough to the growth target to satisfy policy makers.

That said, we are currently reviewing our growth forecast due to the economic disruption caused by the coronavirus.

THE UNCERTAIN IMPACT OF THE CORONAVIRUS ON CHINA'S ECONOMY

In early 2020, there are significant concerns around the spread of a disease known as 2019-nCoV, or more simply coronavirus. The outbreak started in Wuhan, a city of around 11 million people in Hubei province and a regional transport hub. The timing of the outbreak is problematic – due to mass movement of Chinese residents across the country during Chinese New Year, there is greater scope for the disease to spread rapidly. While authorities are attempting to limit transport to and from Wuhan and surrounding cities, the disease has already spread beyond this region (including isolated cases identified internationally).

It is too early to quantify the impact of the disease, however parallels have been drawn to the SARS outbreak in 2003. While official Chinese data showed little economic impact from this disease, alternative measures suggested a rapid downturn in Q2 2003, particularly in retail spending and other services, as residents avoided contact with each other to prevent catching the disease. However, activity recovered relatively quickly in Q3 2003, once the worst of the outbreak had passed.

A similar trend is thought to be the most likely – that said, the size of any downturn and subsequent recovery depends on the spread of the coronavirus and its impact on consumer confidence, along with

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government policy responses. Should authorities successfully contain and treat the outbreak, then the economic impact would be negligible this year, however the disease presents downside risk to our forecasts.

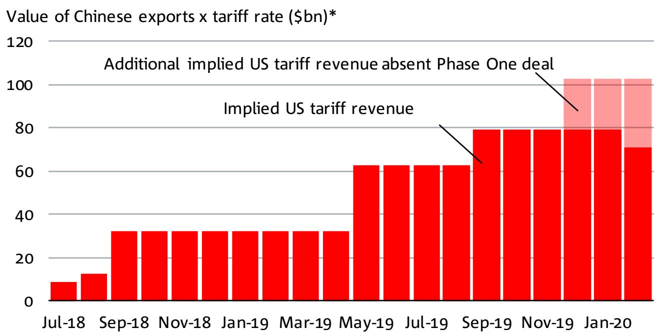
There is broader uncertainty as to the impact on China's near neighbours. China is the largest source of tourists for a range of Asian economies and constraints on travel could have a negative impact on economic growth in this region.

THE TRADE ENVIRONMENT REMAINS UNCERTAIN

China and the United States signed the "Phase One" trade deal on 15 January. The deal included a partial roll back of tariffs introduced by both countries, albeit the majority of these trade measures remain in place. China committed to greater protection and enforcement of intellectual property rights, along with an agreement to increase purchases of US goods and services.

TRADE POST-PHASE ONE DEAL

Bulk of tariffs remain in place



Source: NAB Economics. * Based on estimated import values at the time tariffs announced. Assumes deal formally signed in January, with 15% tariff on $110b reduced to 7.5% in Feb.

This deal is akin to a ceasefire in the trade war, rather than a conclusion to it. US trade policy sits in the hands of the President, who could immediately escalate trade tensions should China fail to satisfy the deal's requirements to the Administration's standards.

The prospect of a broader "Phase Two" agreement, encompassing the full range of intellectual property and industrial policy reforms demanded by the US government, appears remote at present, with little progress likely ahead of the US Presidential Election in November.

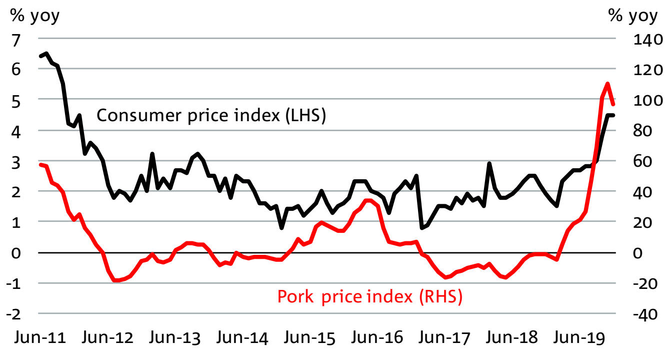
Beyond the US-China relationship, there is uncertainty around the relationship between the US and European Union – raising the prospect of a fresh trade war that could damage both parties. This could negatively impact demand for Chinese imports due to lower national incomes.

HIGH INFLATION RATES LIKELY TO PERSIST

China confirmed its first case of African Swine Fever in August 2019, and the disease has spread rapidly around the country. While humans are not susceptible to the disease, it is highly contagious and fatal for pigs – with the pig stock down around 41% yoy in October 2019, and the breeding stock down by over one-third. There have been estimates that it could take five years for the industry to fully recover from the outbreak.

PORK PRICES DRIVING INFLATION

Supply constraints will keep them elevated



Source: Refinitiv, NAB Economics

Pork has a major role in the Chinese diet – accounting for over 60% of animal protein consumption. African Swine Fever has dramatically impacted pork supply, which has driven prices higher (more than doubling year-on-year in Q4 2019). With China the world's largest pork producer and limited sources of alternative supply, pork prices will remain elevated – flowing through into relatively high consumer price inflation for some time.

CORPORATE DEFAULTS ON THE RISE

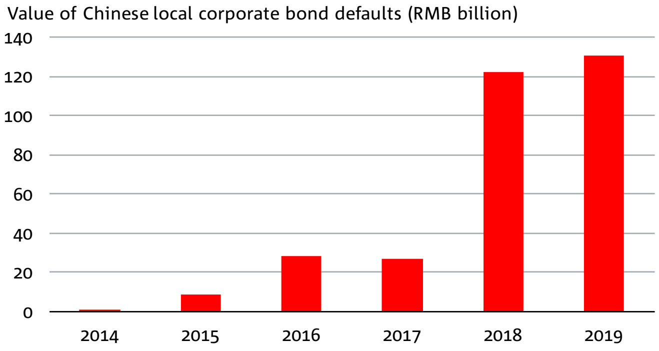
Slower domestic economic growth, and a more challenging trading environment, has had a negative impact on China's corporate sector. Debt levels are already high within this space and the efforts to control the growth of China's shadow banking industry have placed additional stress on corporates – particularly for private sector firms who face challenges accessing traditional finance.

Corporate bonds have become an increasingly important source of funding for Chinese firms – increasing from around 5% of total social financing at the end 2009 to around 10% in December 2019. That said, it is worth noting that the share fell a little during the period of deleveraging across 2017 and 2018, before increasing once again in 2019.

Recent years have also seen an increase in corporate bond defaults. In part, this has been intentional – with Chinese authorities attempting to impose some discipline on state-owned firms, breaking the earlier implicit guarantee of bailout that encouraged poor business practices. However, this trend also reflects the slowing economy and restrictions on shadow banking (which restricted firms access to short term funding to avoid default).

CORPORATE BOND DEFAULTS RISING

Greater uncertainty for lenders



Source: Bloomberg, NAB Economics

While the longer term impact of policies allowing defaults to occur will likely be positive – in encouraging financial discipline on China's corporate sector – the short term impact could be negative. Greater uncertainty around the credit worthiness of bond issuers adds risk across the bond market, potentially driving up lending costs for firms through this channel at the same time that authorities are attempting to lower them in other financial markets.

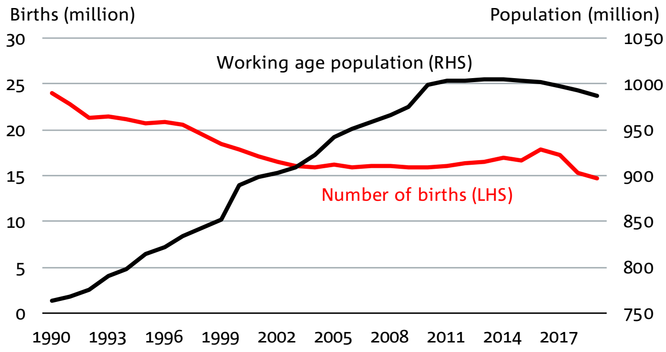
DEMOGRAPHIC CONSTRAINTS ARE ACCELERATING

From the mid-1990s through to around 2010, China's economy benefited from the demographic dividend, as the working age share of the country's total population expanded. In part this reflected the impact of the One Child Policy – which added to an already slowing birth rate that gradually reduced the younger population share over time.

The timeframe of such an economic boost is limited. China's working age population peaked in 2013 and has declined each year since – with fewer new entrants to the workforce each year than those reaching retirement age.

DEMOGRAPHIC CONSTRAINTS GROWING

Looser policy not leading to more births



Source: CEIC, NAB Economics

Despite loosening family planning policies in January 2016, permitting families to have two children, birth rates have continued to trend lower (despite a short term uptick in 2016 following the policy change). This suggests that the trend is likely to continue in coming years, providing a demographic constraint to China's overall growth in the longer term.

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