

# Chi Time

## TRUMP AND CHINA AND THE POTENTIAL SURPRISES

*I certainly agree that putting everything into little genres is counterproductive. You're not going to get too many surprises if you only focus on the stuff that fits inside the box that you know.*

*David Byrne*

From an Asian perspective, there are three new US policy directions (under President Trump) that are relevant to China's growth, policy and reform outlook this year: Trade restrictions against China, protectionism, isolationism.

China's possible reaction (I): Allowing the renminbi to drop sharply as retaliation is unlikely, in my view. At this stage, Beijing's overriding policy objective is stability. The PBoC's policy is to keep a stable trade-weighted exchange rate, not large currency devaluation. A sharp drop in the RMB would give the wrong signal to structural reform. It would also create international chaos, leading to a "lose-lose" situation.

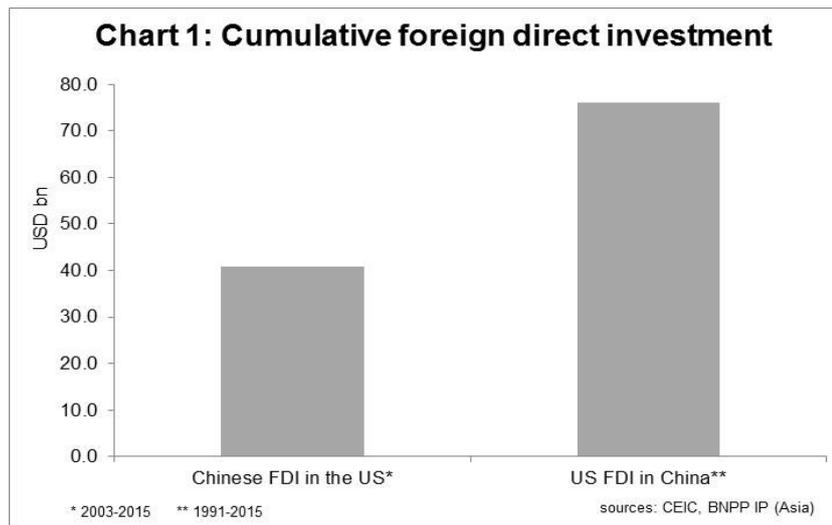
China's possible reaction (II): Dumping US Treasury bonds are also unlikely because such an action could trigger selling by other players, many of whom are already starting to question the outlook of the US's twin deficits. Massive selling of US Treasuries would hurt Chinese reserves valuation significantly.

China's possible reaction (III): Trade retaliation is very likely. It would also likely stretch the trade war with the US by hitting US FDI in China. The US has significantly more FDI in China than China has in the US (Chart 1). Chinese overseas FDI has likely peaked in 2016 in the short-term due to increasing capital control. So the FDI gap between US and China will remain large. This means that the US would be hurt more by China's retaliation than it could hurt China. This also implies that the US does not have much leverage over China in a trade war.



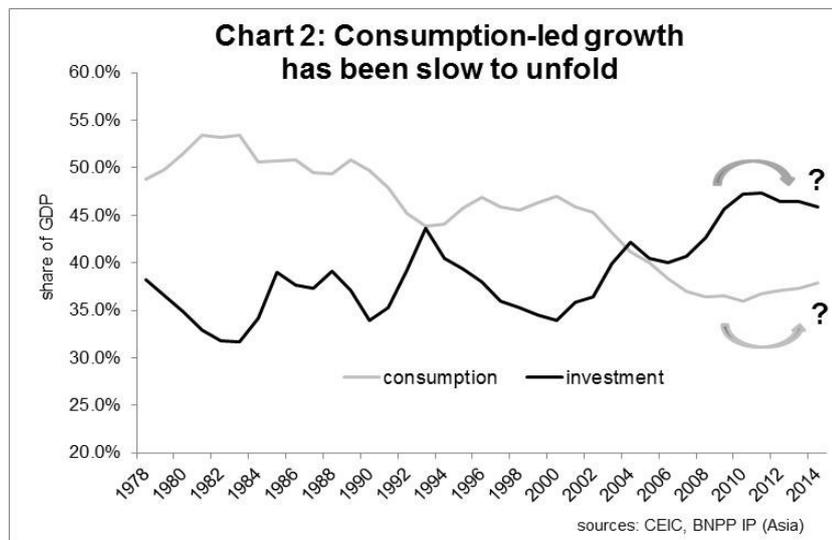
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### The bad impact of Trump's protectionism on China

In addition to hurting RMB sentiment and Chinese growth, a more far-reaching impact of US trade protectionism would be on China's economic rebalancing process (Chart 2). Consumption-led growth is struggling to gain traction. The private-sector has lost its "animal spirits", leading to sharp decline in private investment growth. Further weakening of the external sector implies that state-led investment will have to rise sharply to sustain China's growth. This will delay China's structural rebalancing.



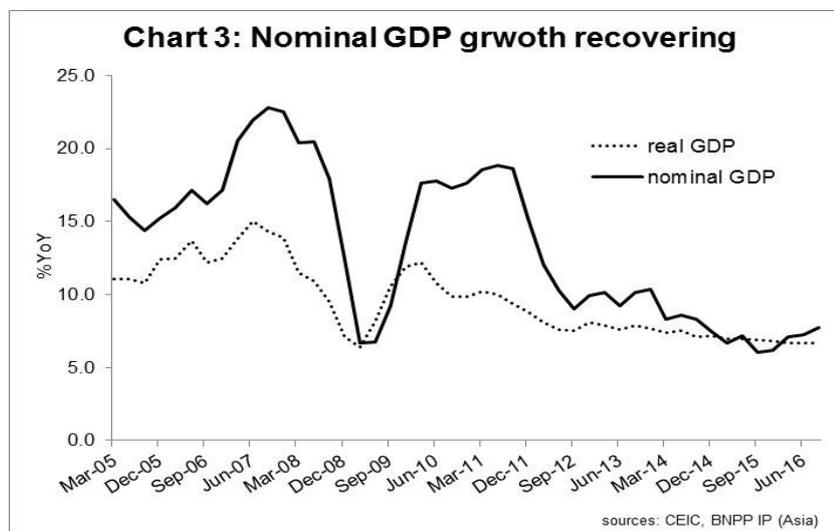
### The good impact of Trump's isolationism on China

Trump's plans to withdraw from the international free trade engagements and potential change in the US's Asia strategy will give space for China to expand. In particular, this isolationism of the US is potentially conducive for Beijing's implementation of the Belt & Road (BAR) plans, esp. in SE Asia. Our research<sup>1</sup> has shown that China is likely to focus first on SE Asia (esp. ASEAN mainland) for expanding its economic and investment influence under the BAR initiatives. A reduction in American influence in the South China Sea is music to China's ears.

### Chinese growth and reform outlook

<sup>1</sup> See "Chi on China: Mega Trends of China (3) – The Belt and Road Strategic Plan", 13 January 2016,

A growth rate of 6.5% this year is achievable, in my view, due to a neutral monetary policy on the back of an expansionary fiscal policy. Nominal GDP growth is already recovering on the revival of PPI inflation (Chart 3). The nominal recovery is positive for corporate profit growth, which should lead to stronger wage and consumption growth.



Due to the sensitivity of the political transition this year that involves many senior personnel changes, Beijing is striving for stability at all cost. The priority of structural reforms, including capital account liberalisation, has been downgraded since early 2016. So do not expect any bold moves on structural reforms this year.

The inclusion of 11 emerging market (presumably volatile) currencies in the renminbi's CFETS basket by the PBoC in December 2016 will lead to more FX volatility, but it does not change its broad renminbi policy. The CNY-USD cross-rate will remain the adjustment factor for the PBoC to keep the trade-weighted renminbi exchange rate stable. Expect more capital controls to augment FX market intervention to keep the renminbi's depreciation against the USD at a measured pace.

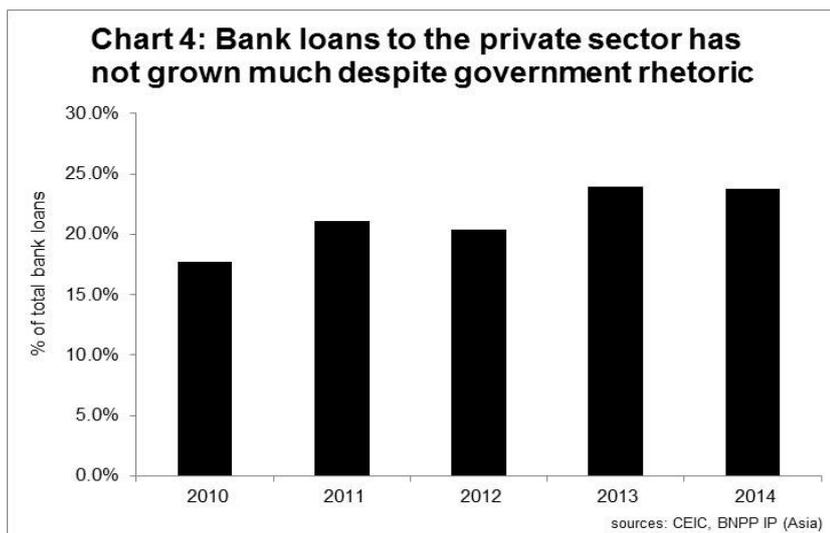
### Growth challenges

Foreign trade friction is the number 1 uncertainty facing China.

Pockets of property bubble pose a macro policy challenge and prevent monetary policy from easing, despite weak growth momentum. Chinese bond yields have risen sharply, hurting corporate funding.

Domestic pricing power remains weak. Revival of PPI inflation boosts profits of upstream industries but squeezes downstream industries. Transmission of higher PPI to CPI is still weak, due to weak aggregate demand, supply response to higher PPI etc.

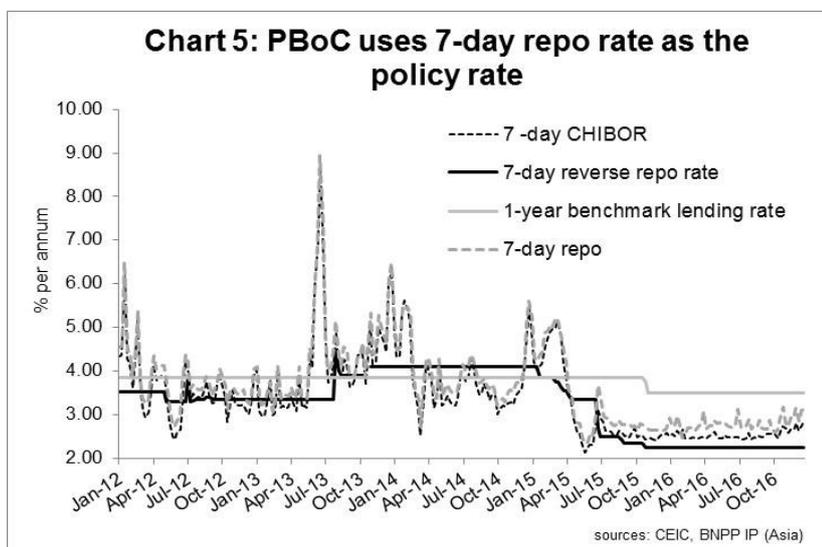
Animal spirits remains weak; private sector is still starved of credit (Chart 4).

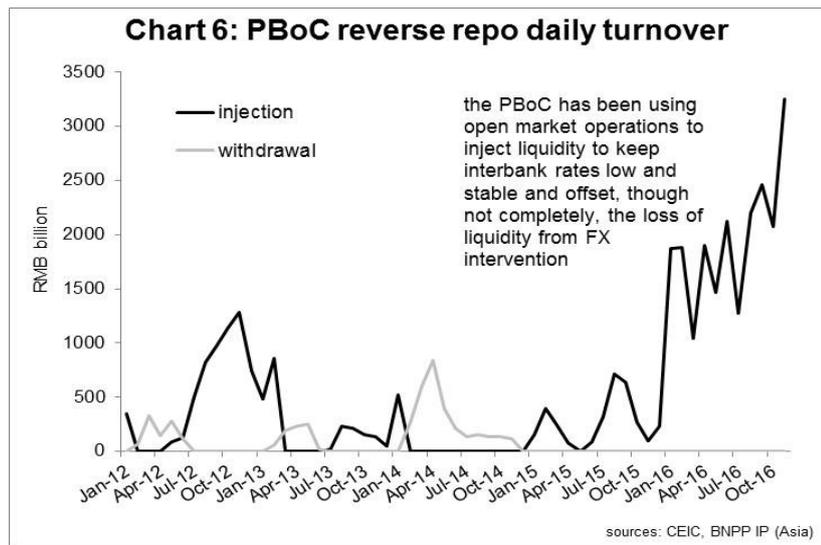


### A monetary policy dilemma

The PBoC is facing a policy dilemma under this complicated environment: It wants ample liquidity to sustain growth at the government's 6.5%-7.0% range. It also wants to prevent the renminbi from falling too much, and this implies FX intervention leading to passive liquidity tightening.

Monetary policy has indeed turned neutral since early 2016 due to concerns about excessive leverage in the property market. However, there is no policy intention to tighten up (Chart 5, note the flat trend of the reverse repo rate which emits policy signals, despite volatility in the money market rates, and Chart 6) due to the growth stability objective. *Ceteris paribus*, we can expect more capital controls, not sharp RMB devaluation and not interest rate hikes, this year.





Nevertheless, a rising USD will put more downward pressure on the renminbi, leading to more FX intervention and passive liquidity squeeze. A lot depends on capital outflows from China. If they fade, that would help alleviate the PBoC's policy headache by reversing the depreciation pressure on the renminbi and, thus, the need for FX intervention.

#### Potential surprises that the markets have not priced in

A full-blown trade war with the US and rising geopolitical risk might prompt China to pursue irrational policy responses. If capital outflows remain intense on the back of these factors, the PBoC might break its stable RMB policy.

Higher inflation (due to slow supply response, higher commodity prices etc.) might lead to sharp monetary tightening by the PBoC. This would, in turn, aggravate the liquidity squeeze due to capital outflows and lead to financial failures, especially by the shadow banks which have relied more on wholesale funding than the big banks<sup>2</sup>.

Sharp correction in China's property market due to hawkish policy stance might erode corporate cash flows, debt-service ability and, thus, GDP growth.

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5 January 2017

<sup>2</sup> See "Chi on China: Where Does China's Financial Risk Lie?" 23 November 2016.

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