CHINA Insights

How to make progress while maintain stability in 2018?

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Highlights:

- **China deleted the phrase "appropriately expand aggregate demand", implying a less simulative economic policy in 2018.**
- **We see three reasons why the word "leverage" is not mentioned in 2017 statement (it was mentioned five times in 2016 statement).**
- **We expect China to step up its de-leverage campaign in four areas in 2018 including local government debt, control of money supply, deal with zombie companies, long term mechanism for property market.**
- **The wording about money supply has been changed from "adjusting money supply" to "controlling the floodgate of money supply", implying a tighter bias.**
- **Currency reform is likely to take a backseat in 2018 after deleting the phrase "increase RMB flexibility".**
- **The latest statement from the Central Economic Working Conference clearly specifies that China is ready to lead the next phase of globalization via boosting import and further openness.**

China concluded its three-day Annual Central Economic Work Conference on 20 December and set the tone for 2018. Clearly, China has shifted its focus from quantity of growth to quality of growth. One of the key changes in this year's statement is that China **deleted phrase "appropriately expand aggregate demand".** This shows that China's economic policy in 2018 is likely to be less simulative, implying a higher tolerance for slower growth.

Surprisingly, **the word "leverage" is not mentioned in 2017** statement (it was mentioned five times in 2016 statement). We think the omission of the word is probably due to three reasons.

First, it shows the Chinese leaders are comfortable with the current progress of de-leverage. Chinese leaders including PBoC Governor Zhou Xiaochuan have mentioned publically in the past few months that China's total leverage ratio started to decline.

Second, it also shows that China has different opinion on how to calculate the leverage ratio. China has argued a number of times that the common way of using debt to GDP ratio is not the best way to gauge China's leverage level. As such, China may try to avoid the use of leverage ratio before developing a better monitoring system.

Corporate FX & Structured Products
Tel: 6349-1888 / 1881

Fixed Income & Structured Products
Tel: 6349-1810

Investments & Structured Product
Tel: 6349-1886

Interest Rate Derivatives
Tel: 6349-1899

Treasury Research & Strategy
Tel: 6530-4887

Tommy Xie Dongming
+(65) 6530 7256

Third and most important, **China has broken the conceptual "de-leverage" into details in 2017 statements.** We expect China to step up its de-leverage campaign in four areas in 2018 including local government debt, control of money supply, deal with zombie companies, long term mechanism for property market.

Table: Key takeaways from the Central Economic Working Conference

Key areas	**2017 Statement change**	**Implications**
Economic growth	Deleted phrase "Appropriately expand the aggregate demand"	China's economic policy in 2018 is likely to be less simulative.
De-leverage	No mention of the word "leverage", which appeared five times in 2016 statements	China has broken the conceptual "de-leverage" into details. China will step up its de-leverage in four areas in 2018.
Fiscal policy	Added concrete measures will be taken to strengthen the regulation of local government debt	China is ready for failure of some high risk local government debt.
Monetary policy	The wording about money supply has been changed from "adjusting money supply" to "controlling the floodgate of money supply".	Monetary policy could be tighter in 2018. China may adjust its money market rate higher further in 2018 following the Fed rate hike.
Property	China will development its housing rental market with long term leases.	China's housing market may enter into a new stage of slower price appreciation with still solid construction activities.
Currency	Deleted phrase "increase RMB flexibility"	Currency reform is likely to take a backseat in 2018. Low probability of self-engineered RMB volatility in 2018.

Four battlegrounds for de-leverage

On fiscal front, as compared to 2016 statement, it is first mentioned in 2017 statement that concrete measures will be taken to strengthen the regulation of local government debt. This shows that China is ready for failure of some high risk local government debt.

On monetary policy front, although China reiterated to maintain its prudent monetary policy intact, the wording about **money supply has been changed from "adjusting money supply" to "controlling the floodgate of money supply".** This suggests monetary policy could be tighter in 2018. We expect to adjust its money market rate higher further in 2018 following the Fed rate hike.

On structural reform, China will move more aggressively to break ineffective supply and deal with "zombie companies". This means that default rate is likely to go higher next year.

On property, China will work towards building a long term mechanism via ensuring supply through multiple channels such as German model (rental market) and Singapore model (economic housing). China will development its housing rental market with long term leases and support the development of professional and institutional house rental enterprises. The development of rental market is likely to help contain the rapid growth of household debt. We think China's housing market may enter into a new stage of slower price appreciation with still solid construction activities as the building of rental house may continue to support the real estate investment though it will cap the price appreciation. On the positive note, there is no mention of property tax reform in the statement. As such, we think the chance for China to roll out property tax is likely to be low in 2018.

Currency reform is likely to take a backseat in 2018

One of The other notable changes in 2017 statement is that **China deleted phrase "increase RMB flexibility".** This shows that China's policy makers are comfortable with the narrow trading range for USDCNY and stable RMB index in the past few months. As China will focus on balancing between de-leverage and containing financial risk in 2018, the currency reform is likely to take a backseat. As such, we expect low probability of self-engineered RMB volatility in 2018 and China may continue to keep RMB index stable around current range from 94 to 96.

How will the world benefit from China's economic policy in 2018?

Although it is too early to conclude that China will fill the gap from the retreat of US from global leadership, the latest statement from the Central Economic Working Conference clearly specifies that China is ready to lead the next phase of globalization via boosting consumption and further openness.

Consumption is expected to play a more important role in China's growth story. The increasing share of consumption in GDP helped China build buffer to counter external shocks. Boosting import is clearly one of the key initiatives for this consumption story. President Xi has mentioned in May that China will host its first import exhibition in November 2018 to attract more foreign companies to sell their products to vast Chinese market. Meanwhile, China's Ministry of Finance also just announced to lower import tariff on 187 consumer goods, effective from 1 Dec. This should be good news for regional economies supports the global business cycle going into 2018.

Meanwhile, China also mentions that it will lower the barriers significantly for foreign investors to enter China's market. The openness accelerated after 19th Party Congress. In early November, China's People's Daily published an article written by Vice Premier Wang Yang, who is expected to take a bigger role next year, to advocate further opening.

In addition, China also announced to gradually remove cap for foreign investment in China's financial sector.

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