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Policy focus shifted to sustainability from stability

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Summary: We believe the market will be surprised by policy changes from China in 2018. President Xi enters his second term. The government will focus more on sustainability than stability. Policy stance will be tightened, particularly fiscal spending and financial regulation. The risks of rate hike and trade war are rising. Growth will likely slow, infrastructure and property cycles may cool off and adversely affect commodity demand, while the government favors new economy and consumption. Macro policies may lead to short term pain but conducive to growth in the long term. We also expect faster progress on some structural reforms such as opening up part of the service sector.

We spent the last week meeting clients in Europe. Most investors are not concerned about China. The trade war issue came up in every meeting, but we doubt investors have generally recognized the other important macro issue -- a change of policy focus in Beijing.

President Xi started his second term. We believe the government focus has shifted to sustainability from stability, for the following reasons.

1. President Xi's policy priority in his first term was political consolidation, which he achieved successfully. He needed economic stability to avoid distraction. To achieve stability, fiscal policy was quite supportive particularly in 2016 and early 2017. Total fiscal spending (including government funds) started to slow in H2 2017, its contribution to nominal GDP growth started to drop to 2.2% from 4.3% in H1 2017 (Figure 1; see our report for more details on fiscal support).
2. The Constitution has been amended. The term limit is gone. President Xi's talk at the 19th Party Congress in Oct focused on China outlook in 2035 and 2050, much longer horizon than the typical "five year plan" his predecessors engaged in. It makes sense to focus on economic issues in his second term, and address risks that may jeopardize the economy in his tenure.
3. President Xi sent clear signals. He assigned his senior advisor Liu He to be Vice Premier in charge of financial sector policies. He talked harshly against local government debt issue and financial risks since mid 2017, and put "containing financial risks" as #1 policy priority in 2018. The government cut fiscal deficit the first time since President Xi took over in 2012. In the National People's Congress, the number of

representatives from the property sector dropped by around 20 people. The "new economy" filled those seats.

This shift of policy priority has important implications for China and the global economy.

1. It is negative for the old economy and commodity. Fiscal spending is constrained, local government officials will likely become cautious in borrowing. Infrastructure investment growth was 19% in 2017. It already dropped to 16% in Jan-Feb. We expect it to drop to around 10% for the whole year of 2018. In the property market, while land sales remained strong, it seems to be more a price effect. New housing starts is only growing at 6% yoy on 3mma basis (Figure 2). As financial regulation tightens, I see the risk of housing starts to the downside.
2. New economy is set to get more policy support. The service sector has provided plenty of job opportunities to keep the labour market tight. It is also less credit and pollution intensive. The government aims to leverage the internet technology to improve service such as education and healthcare. There is also a clear push for automation, which should help to mitigate demographic challenge in the long term.

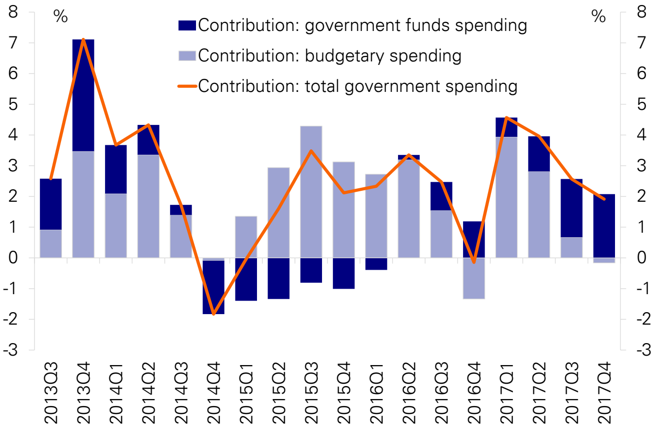
We expect short term pains and long term gains. The new team to manage the economy is strong. Liu He and Yi Gang both have good reputation as reformers. Guo Shuqing, the current head of the bank regulator and another reformer, may continue to head the new agency regulating both banks and insurance companies. This is a strong team to contain financial risks. The excessive leverage buildup and the rampant shadow banking activities will be under close scrutiny. In the short term this will likely lead to slower growth but it is a price worth paying.

The two key questions for China outlook in the next 3-6 months are

- When will land auction slow? Land sales are still running at around 40% yoy on 3mma basis. It helped to offset some of the decline in fiscal spending. When land sales slow, the full impact of fiscal tightening will play out.
- How big an impact will the trade war with the US have on Chinese exports? Our analysis is available in our report the rising risk of a trade war.

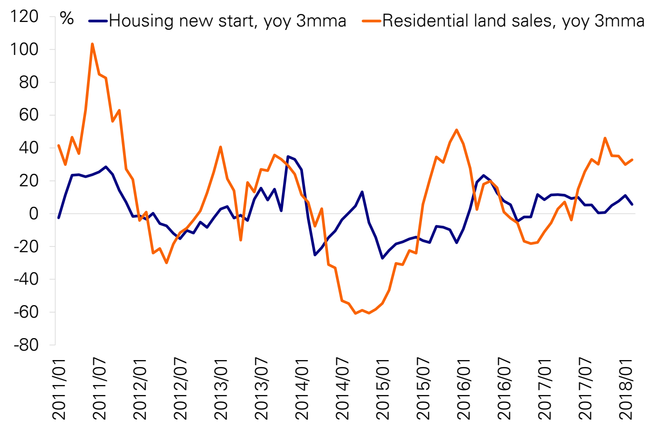
While our baseline case remains that the PBoC will hold the benchmark rates unchanged this year, this has become a close call. PBoC has become stronger, with Governor Yi handpicked by President Xi. Its mandate expanded. NDRC on the other hand weakened. This suggests monetary policy may become less constrained by short term growth target. Nonetheless with the trade war risk rising the government may choose to keep benchmark rates unchanged in March and only move reverse repo rate when the Fed hikes rate, as they did in December.

Figure 1: contribution to nominal GDP growth from fiscal spending



Source: Deutsche Bank, WIND

Figure 2: Housing new start and land sales volume growth



Source: Deutsche Bank, WIND, CREIS

Appendix 1

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