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China 2019 outlook: Testing resilience

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GS MACRO OUTLOOK 2019

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- As headwinds to growth and confidence gather, Chinese policymakers have been flexible in easing policy to buffer the slowdown. But a big uncertainty that the market is grappling with concerns the economic roadmap farther out. Worries about a possible comeback of the debt-driven growth model, and/or a diminished economic role of private enterprises, weigh heavily on investors' minds.
- For 2019, we expect the government to lower the GDP growth target modestly to "6.0-6.5%" (vs. "around 6.5%" this year), and eventually achieve 6.2% full-year GDP growth. This will not be an easy task, as policymakers need to strike a fine balance between averting a sharp slide in growth and preventing a fast debt buildup.
- Broad fiscal policy will likely be the preferred tool to stabilize growth (with off-budget fiscal deficit ramping up as needed). As consumption and export growth is likely to slow, we expect fixed investment—especially infrastructure—to accelerate on policy support and be a key leader in growth.
- CPI inflation will likely increase, but remain within the PBOC's tolerance zone. This should allow scope for the dovish monetary policy stance to extend and push market rates moderately lower. We expect CNY to weaken in a managed way and ultimately breach 7.0 against the USD in the coming months, barring major positive developments on the US-China trade relationship.
- Further ahead, however, policy focus needs to shift from cyclical stimulus to deeper structural reforms to ensure sustainable growth. For instance, augmenting the social safety net would be key to bolstering consumption in the long run. Tackling the financial system's structural inefficiencies such as the continued large presence of zombie state-related enterprises would be more effective than targeted micro assistance in protecting financing supply to the private sector. On the external side, laying a stronger foundation for capital account liberalization (e.g., with a more market-oriented CNY) would provide a big boost to the global status of China's capital markets. Although these reforms

may take time to show their economic benefits, concrete policy actions would likely be received favorably by the market.

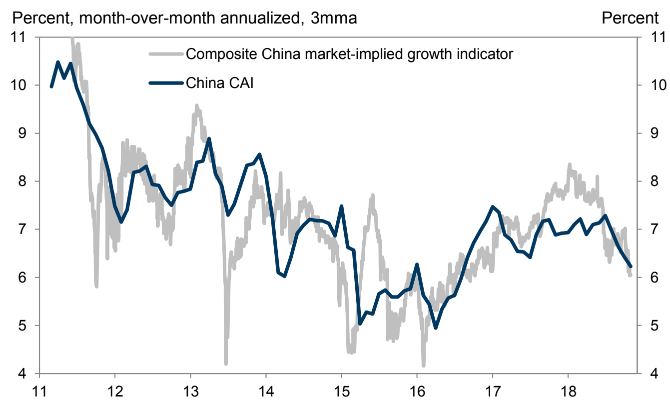
1. Top Themes: beyond growth

2018: year of two halves

The year 2018 has been truly a year of two halves. The robust economic momentum and strong market sentiment from 2017 carried through early this year. Our China current activity indicator (CAI) surpassed reported GDP growth, reaching 7.1% in the first half of the year. Markets appeared to price in even more favorable growth prospects (Exhibit 1). With the two-term constitutional limit to the presidency abolished and President Xi's power more fully consolidated, hopes for a faster pace of structural economic reforms were raised.

Then the news flow and shortly afterward data started to turn. The effects of 2016-17 policy tightening to contain financial risks began to be more clearly felt with a lag, putting especially smaller corporates under greater financial stress and default worries rose. The escalation of trade tension with the US has further clouded the outlook. While Chinese policymakers have been largely flexible in easing policy to buffer the slowdown, a big uncertainty that the market is grappling with concerns the economic roadmap farther out. The credit-centric and investment-driven growth model looked to be receding early this year, but worries about its possible comeback are weighing on investors' minds. Similarly, the extent to which private enterprises and market forces will have a role in driving the economy forward has come under the spotlight.

Exhibit 1: Markets' early-2018 growth optimism has faded rapidly



Source: Goldman Sachs Global Investment Research, Bloomberg

2019: uncertainties and hopes

Questions abound as we step into 2019. Beyond growth and cyclical policy, the top issues that we will watch closely as signposts for the Chinese economy's path ahead are:

US-China trade tension—deal or no deal. Hopes for a positive dialog between the two leaders at the G20 meetings at end-November have increased. Given the apparently wide gap between the two countries' "bid-ask", it still seems unlikely that a comprehensive agreement can be ironed out any time soon, if at all. Uncertainty is high, and as a baseline we expect the trade tension to stay or possibly even escalate in 2019, although with the probability of a "deal" increasing over time. For the Chinese economy, while we believe the direct growth impact of US tariffs is manageable, it carries immense implications for confidence in both the real economy and financial markets (*see our growth and CNY outlooks in sections **2** and **6***).

"**Policy put" on growth—where the strike is**. The typical "Catch-22**"** situation that Chinese policymakers faced during previous economic downswings is how to avert a sharp growth slowdown without exacerbating the debt buildup. It is a tricky balancing act, with both extremes—another 2009-style massive stimulus package or severe labor market strains—clearly unpalatable. The shrinking workforce and the increasing importance of the labor-intensive services sector suggest that the government could let GDP growth slow meaningfully while keeping unemployment contained. However, we believe Chinese leaders' usual gradualist approach will continue, leading them to lower the growth target only slightly to 6.0-6.5% for 2019 (vs. "around 6.5%" for this year). Correspondingly, we set our 2019 growth forecast at 6.2%, with policy-driven infrastructure investment being a key growth support (*see our expectation of growth composition and policy outlooks in sections **3**-**5***).

Structural reforms—unfinished business. The best way to ease the Catch-22 situation and ensure sustainable solid growth is via deeper structural reforms. One area that has been in recent focus is potential corporate tax cuts. In our view, a meaningful tax cut would be positive for confidence but may not imply a strong growth impulse given the binding constraint of the on-budget fiscal deficit target (*see our fiscal policy outlook in section **4***). More broadly, some important long-standing reform needs are yet to be fully addressed (Exhibit 2). For instance, to boost consumption in the long run, additional steps towards reforming and increasing the social safety net would be key, in our view. To bolster support for private enterprises' financing—a recent pledge by President Xi —tackling the structural inefficiencies of the financial system such as the "crowding out" effects due to the continued presence of zombie enterprises would be more effective, compared to targeted micro assistance which could introduce distortions in the system. Although these reforms may take time to show their economic benefits, concrete steps on those fronts would likely be received favorably by the market.

External liberalization—setting the stage. The FX reform kick-started in August 2015 initially caused a lot of CNY anxiety and outflow pressure, but in the last 18 months it has begun to bear fruit in that CNY has become a more flexible currency. In the last couple of months, the process has paused as the authorities have turned more hands-on in managing the currency as USD/CNY approaches 7.0. We believe such resistance is only temporary, and do not expect an effective "re-pegging" of CNY to USD at below 7.0. To set a more robust stage for capital account opening up, CNY would need to be more free-floating and market-oriented first, according to a theory of proper sequencing of external reforms (e.g., IMF, 2011). As such, in addition to the prospective inclusion of domestic bond market in Bloomberg-Barclays index and increases in MSCI's inclusion factor assigned to the A-share market, key to assessing the potential of capital account liberalization is how importantly market forces will be allowed to drive the CNY (*see our CNY outlook in section **6***). For the rest of Asia, how China's policy easing is balanced between domestic demand stimulus and CNY depreciation implies very different economic impacts.

Exhibit 2: Reform agenda: progress and unfinished business

Category	Element	Description; Main examples	Progress so far*
Financial reforms			*darker shading: more progress*
	Strengthen "macro-prudential" + "monetary policy" twin pillar policy framework	Establish cross-agency regulatory committee, reinforce PBOC's MPA	
	Regulate local govt finances	Curb irregular PPP funding/local govts' implicit guarantee, expand asset-backed muni bond program	
	Restrain shadow banking/financial leverage	Tighten financial institutions' leverage & reliance on short-term funding, curb non-standard credit assets	
	Tackling zombie enterprises	Allow more defaults and restructuring, promote "market-based" debt-to-equity swap	
	Liberalize CNY exchange rate	Reduce CNY intervention and increase market-orientation	
	Ease market access by foreigner businesses	Reduce negative list for foreign investment in China; concrete implementation of proposed liberalization	
	Increase capital account convertibility	Promote bond and equity inflows, ease x-border RMB flows; but large-scale outflow relaxation less likely	
	Promote capital market development	Strengthen IPO approvals; increase bondtrading liquidity; facilitate hedging through financial derivatives	
Environmental protection			
	Anti-pollution measures	Limit production of pollution-heavy industries; promote green investment	
	Promote new energy	Encourage development of solar/wind/nuclear energy production, incentives for electric vehicles	
Safety net, new urbanization, fiscal			
	Promote home rental and share-ownership	Partial substitutes for home purchases in private market	
	Tax reforms	Prepare for introduction of property tax, lower effective tax burden on SMEs	
	Improve fiscal responsibility division b/w central vs. local govts	More efficient allocation of fiscal resources and spending control	
	Poverty reduction	As part of top-level goal to reduce income disparity	
	Rural land reform	Allow easier cashing out by households of their rural land rights	
	Hukou relaxation	Strengthen social safety net for migrant workers especially in lower-tier cities	
	Pension reform	Expand coverage, professionalize pension investment, fill pension gaps	
	Healthcare reform	More differentiated medical pricing	
	Expand education coverage	Increase enrolment ratio for kindergartens and higher education, esp for migrant workers' children	
Anticorruption and administrative reform			
	Expand state's anticorruption powers	National Supervisory Commission launched in early 2018	
	Streamline govt admin processes	Reduce administrative burden on license processing, business approval, etc.	
SOE reforms			
	Mixed ownership	Introduce co-ownership of enterprises by social and private capital	
	Create fair environment for private capital	Allow non-SOEs to enter authorized/strategically important business areas	
	Strengthen corporate governance focus	Enhance transparency/disclosure and market based operations	
Manufacturing upgrading			
	Promote R&D, increase automation	Targeted state support for initial phases, while letting private sector drive the development process	

** Progress so far is GS's subjective assessment*

Source: Goldman Sachs Global Investment Research

2. Key Macro Forecasts: another balancing act

Growth

We expect the government to lower the GDP growth target to a range target of 6.0% to 6.5%, from this year's "around 6.5%". This target will not be set until December at the politburo meeting ahead of the Central Economic Working Conference, and will not be formally announced until the National People's Congress next March. Various policy comments have indicated a willingness to allow growth to slow gradually in the coming years because of (1) demographic headwinds, (2) clear weakness in the economy over the past 6 months even before actual export growth showed any slowdown at all amid the trade dispute, and (3) other growth constraints such as environmental, leverage and property price issues.

While policymakers are likely to accept a mild deceleration, we do not expect the government to tolerate much slower GDP growth of 6.0% or below, for several reasons: (1) the previous administration's goal of doubling income by 2020 (from 2010 level) requires around 6.1% GDP growth in 2019 and 2020, and this is an important goal which is effectively binding, (2) given 2018 growth is likely to be 6.6% or 6.5%, policy makers do not want to see too much slowdown in one year and prefer to make it gradual, and (3) a growth rate above 6.0% is achievable from a potential growth point of view. Judging from the changes in inflation and unemployment, potential growth is not too far from the current actual level.

Exhibit 3: Our forecasts on GDP by expenditure and FAI by industry in detail

		2017	2018F	2019F	2020F
GDP by expenditure	**% yoy**	**6.9**	**6.6**	**6.2**	**6.1**
Domestic demand	% yoy	6.4	7.2	6.8	6.3
Consumption	% yoy	8.3	9.1	7.8	7.9
Household	% yoy	7.5	8.0	7.0	7.5
Government	% yoy	10.5	12.0	10.0	9.0
Gross capital formation	% yoy	4.1	5.0	5.7	4.2
Fixed investment	% yoy	3.4	5.0	5.9	4.4
Inventory	PPT	0.4	0.1	0.0	0.0
Net exports	PPT	0.6	-0.5	-0.7	-0.2
Exports	% yoy	8.6	5.0	3.0	3.0
Imports	% yoy	6.3	7.0	6.5	4.0
Contribution (percentage points)		**2017**	**2018F**	**2019F**	**2020F**
GDP by expenditure	**PPT**	**6.9**	**6.6**	**6.2**	**6.1**
Domestic demand	PPT	6.3	7.1	6.8	6.3
Consumption	PPT	4.5	4.9	4.3	4.4
Gross capital formation	PPT	1.8	2.2	2.6	1.9
Fixed investment	PPT	1.5	2.1	2.5	1.9
Net exports	PPT	0.6	-0.5	-0.7	-0.2
FAI forecasts		**2017**	**2018F**	**2019F**	**2020F**
Headline FAI	% yoy	7.2	5.0	6.0	5.8
Manufacturing	% yoy	4.8	7.0	6.0	6.0
Infrastructure	% yoy	15.1	4.0	10.0	9.0
Real estate	% yoy	7.0	7.0	5.0	5.0
Others	% yoy	-1.1	2.0	0.0	0.0

Source: Goldman Sachs Global Investment Research

Main risks to our growth view

The biggest risks to this baseline are mainly from the trade dispute. If there is a surprise comprehensive resolution involving unwinding of tariffs and other sanctions the US has imposed on China, growth could surprise on the upside because:

1. Export sectors will be facing less pressure in 2019, though export growth is still likely to slow over the next few months because it has been distorted by frontloading;

2. The removal of uncertainties can lead to stronger domestic investment and consumption which have been suspended as many adopt a "wait and see" strategy. This demand can be thought of as pent-up demand, which is different from straightforward worsening of expectations as it can easily go in either direction depending on the outcome of the trade dispute.

3. Better sentiment is likely to boost financial market performance. More importantly for the long term, any deal will inevitably involve structural reforms such as greater openness, lower barriers, better IPR protection, less direct government intervention in terms of fiscal subsidies and non-economic interventions, which are mostly positive for the long term growth potential of the economy. Contrary to many elements of the domestic reform agenda, these reforms are much more likely to be carried out because they involve international agreements.

While the policy loosening stance will surely become less aggressive in the event of a deal, it probably would be dialed back less than proportionately, with growth ending up in the upper half of the target range.

Another potential source of surprise is the magnitude of loosening especially after the recent meeting President Xi held with entrepreneurs. Ministries have been in a competition mode to roll out policies supporting private companies. While some loosening will be effectively at the expense of SOEs, this competition dynamic could lead to a loosening of the overall policy stance. The response of entrepreneurs is highly uncertain, though likely incrementally positive. To feel truly secure to invest and consume, institutional reforms are needed and these remain to be seen.

On the downside, if the trade talk doesn't go well, additional US sanctions may be imposed. In this case, growth may test the lower bound even given the government will come up with additional loosening measures.

Overall we see risks to our 6.2% GDP growth forecast largely balanced with a slight bias on the upside in terms of reported GDP data. This is much less true in terms of non-official measures of growth such as our own Current Activity Indicator (CAI). We expect next year's growth to be in the 5-6% range in terms of our CAI, down from the recent level of around 6%.

Inflation

We expect CPI to be broadly stable around the current level of 2.5% yoy, though this will be higher than 2018 average of around 2.2%. There are three considerations behind this call:

- The cautious bias in policy loosening will likely limit the risks of high inflation. On the other hand the determination to keep growth above 6.0% means there are limited deflationary pressures;
- There was a period of time around mid-2018 when observers were very concerned about rising food prices from of disruptions to food supply. These included meat (pig virus), vegetables (typhoons and floods), and grains (lower level of harvest). By now the only remaining concern is pig virus; this is still around but the worse period is likely behind us as the disease tends to be more active in the summer, especially when temperature is higher than usual.
- Other non-food price changes are generally positive with less pressure from (1) oil and gas, (2) rent (property market is cooling down), and (3) lack of large one off reforms to government controlled prices such as the adjustment to medical services and medicine last year.

PPI inflation is expected to be broadly stable at current level of around 3.3%, modestly below the 2018 average which is close to 4%. Slower growth in China is generally associated with lower upstream inflation. Equally importantly, we expect a rotation of growth drivers towards investment-led growth. As exports are much less commodity intensive than investment activities, the commodity intensity of the overall economy is likely to increase, supporting upstream inflation amid slower headline growth. Contrary to CPI, China's PPI is highly affected by oil prices. A moderate level of oil prices is another factor which put downward pressures on PPI. Apart from the trade talk and corresponding cyclical policy responses, uncertainties related to PPI come from supply side shocks to control pollution and ensure work safety. In the recent meeting with entrepreneurs President Xi requested authorities avoid "across the board"-style of work safety and pollution control inspections. This effectively will lead to an incremental loosening.

Exhibit 4: We forecast CPI inflation to edge a bit higher, while nominal GDP growth decelerate materially

		2017	2018F	2019F	2020F
CPI inflation	% yoy	1.6	2.2	2.5	2.3
PPI inflation	% yoy	6.3	3.9	3.3	2.7
GDP deflator	% yoy	4.1	2.9	2.1	1.7
Nominal GDP growth (in RMB)	% yoy	11.2	9.7	8.4	7.9

Source: Goldman Sachs Global Investment Research

Nominal GDP growth

Nominal GDP growth is expected to slow a bit more than real GDP, as the GDP deflator is expected to fall modestly. While CPI is likely to be higher on an annual basis, this is likely more than fully offset by the fall in PPIn inflation (combining these two measures is a crude proxy for the GDP deflator). Other nominal indicators such as corporate profit will likely slow more than nominal GDP growth, while components such as wages and depreciation are typically more stable.

3. Growth Composition: a rotation towards fixed investment

What's more noteworthy towards the end of this year is the early signs of a rebound in fixed investment activity. We believe this trend will likely continue going into next year. On the other hand, consumption continues to face multiple headwinds and export growth looks set to weaken from the current level.

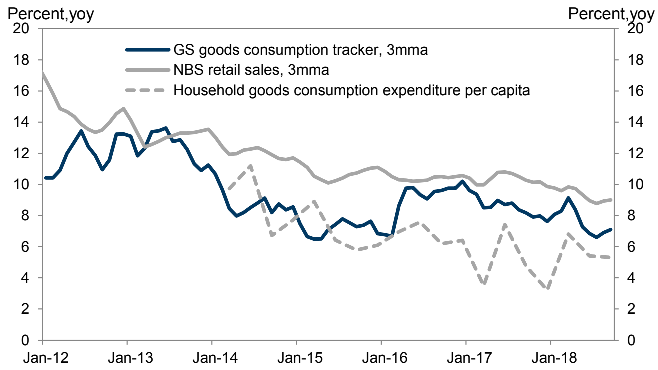
Consumption headwinds

Consumption continues to face a few headwinds next year, including fading credit impulse, slower moving-in related consumption, dampened consumer sentiment and the abating support from shantytown redevelopment plan due to a lower cash compensation ratio. Goods consumption growth has weakened meaningfully starting from Q2 this year (Exhibit 5). As we analyzed before, fading credit impulse from slower consumer credit growth on the back of regulation tightening on consumers' irregular borrowing suggest that consumer credit may remain a drag on goods consumption growth next year.

Besides credit, housing transactions may continue to decelerate next year and less furnishing need from households implies weaker moving-in related consumption. This could have particularly negative impact on home appliance and furniture consumption. Somewhat related to these two negative factors, auto sales have slowed to a decade low level in recent months. Besides credit and moving-in related drags, the expiration of previous tax cut policy also shaved auto sales growth. Given automobile demand was potentially front-loaded in 2016 and 2017 when purchase taxes were lowered, auto sales may remain weak next year.

Moreover, the recently dampened consumer sentiment could weigh on consumption growth. Possibly due to the fall in equity market and lower property price inflation (as a large portion of Chinese households' wealth is stored in the property market), recent surveys from NBS and PBOC suggest consumers' confidence level fell and the portion of urban depositors willing to consume has also fallen. Last, the government's pledge to reduce the cash compensation ratio in the shantytown redevelopment plan could imply lower transfer income to households in the program, and by our estimate could shave consumption growth next year.

Exhibit 5: Goods consumption growth has slowed this year



Source: Goldman Sachs Global Investment Research, NBS

Upside risks to our consumption view include the still-solid labor market and steady wage growth. Surveyed unemployment rates fell marginally this year compared with last year, based on NBS data. Our GS wage tracker suggest nominal wage growth stabilized at around 7.2% yoy level this year, after moderating for three to four years since 2013. This should offset some of the downward pressures discussed above, but overall, we still see more headwinds than tailwinds to consumption growth next year.

Export drag

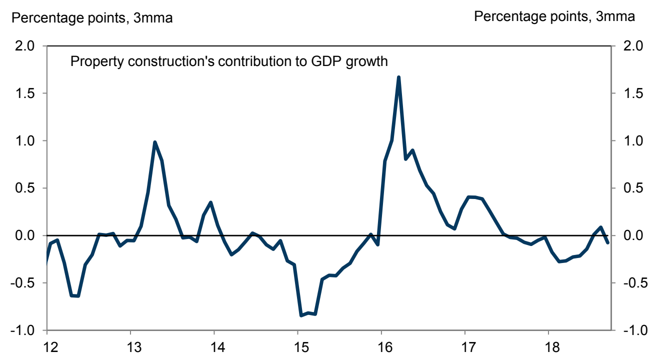
Besides consumption, export growth is also set to slow on the payback from "front-loading" of exports ahead of US tariffs, as those higher tariffs come into effect and encourage a shift in demand to other suppliers, and as global growth moderates next year. Export growth stayed strong in recent months despite higher tariffs. Our analysis suggests that front-loading might have contributed to the resilience in recent export data. With the recent positive news and the G20 meeting where two presidents are scheduled to talk, the chance of reaching a deal between these two sides has increased. Nevertheless, further escalation of trade tension in the near future is still the most likely outcome in our view. Our rough estimate is that front-loading will boost second-half 2018 sequential GDP growth by 0.2pp annualized. An offsetting "payback" to Chinese exports is set to occur beginning in December or January and be a corresponding drag on Chinese GDP growth during H1 2019. Higher tariffs could also reduce Chinese exports' price competitiveness. Besides headwinds related to trade tensions, our global team expects global growth to slow next year (from 3.0% to 2.8% excluding China). Currency depreciation would mitigate some downward pressures to growth, especially if the US and China do not reach a deal.

Fixed investment support

Against the backdrop of a weaker exports and consumption growth, we expect fixed investment growth to pick up, primarily reflecting the government's efforts to push infrastructure investment to stabilize growth (for details of investment outlook, see our recent report). But we are relatively less upbeat for property investment and manufacturing investment. We expect the headwinds that have led to sluggish manufacturing investment to remain largely in place, although we see some forces that may limit further deceleration in property investment.

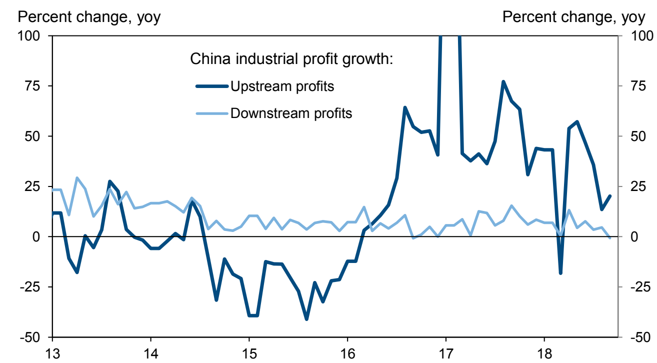
- **Infrastructure investment** slowed significantly after several years of rapid growth, as a cost of the government's efforts to maintain financial stability through regulatory policy in several areas, including local government debt risks, shadow banking sector and housing sector. These measures have weighed on infrastructure investment through reducing financing available for investment and damping local governments' incentives. However, with the government becoming more concerned about growth stability, a series of measures have been taken or announced recently to boost infrastructure investment.
- **Property investment** growth has been strong this year in official headline FAI data, but this has been significantly inflated by high growth in land purchase costs. "Underlying" property investment has been decelerating markedly since mid-2016, according to both the "construction and installation" part of property FAI and our property construction indicator (Exhibit 6), reflecting the government's regulations in housing sector. A significant increase in the cash compensation share of the shantytown redevelopment program has also contributed. For next year, some degree of relaxation in regulations in some cities and a likely lower share of cash compensation may halt further deceleration in property investment. We do not expect a significant pickup in property investment growth, as a full relaxation of property restrictions would risk undermining the credibility of the government's push against housing speculation.
- **Manufacturing investment** should be least policy-driven, and is primarily determined by profit/sales expectations, financing availability, uncertainty, and also by the government's capacity restrictions. Considering these factors, it's difficult to see strong reasons for firms to ramp up manufacturing investment next year. For instance, profitability continued to diverge between mid-/downstream sectors and upstream sectors, with profit growth for the former (accounting for the majority of manufacturing investment) still weak (Exhibit 7). Although the government has been trying to improve private firms' financing availability, it is not very likely to see a notable increase of lending to those firms without underlying institutional reform. VAT and corporate income tax cuts represent potential upside risks, but the impacts on investment may be not significant, according to empirical research.

Exhibit 6: Property construction has slowed significantly since mid-2016



Source: Goldman Sachs Global Investment Research

Exhibit 7: Divergence in profit growth across up- vs. mid-/downstream industries has continued



Source: CEIC, Goldman Sachs Global Investment Research

4. Fiscal Policy: more proactive

Broad fiscal policy, including both on-budget policy and quasi-fiscal policy, has been a major swing factor for growth so far in 2018 (Exhibit 8). In order to stop growth from slowing much further, the government called for fiscal policy to be "more proactive" in July, and fiscal policy stance turned supportive again in Q3, particularly on sharp acceleration in issuance of local government special bonds in Q3. This more proactive stance started to take effect recently, with a meaningful pickup in infrastructure investment growth in October.

For 2019, we expect broad fiscal policy to continue to be the major tool to stabilize growth, with key elements of fiscal stimulus as follows (using a framework we laid out early this year).

Size: From a short-term cyclical perspective, we expect the government to implement fiscal stimulus as needed to stabilize growth within its acceptable range. This would be through both a slightly higher on-budget fiscal deficit and stronger quasi-fiscal support. We expect the official on-budget fiscal deficit target to adjust back to 3% in 2019 after a downward adjustment to 2.6% in 2018. The effective deficit could be higher than this, with the gap reflecting other sources that the government can employ for on-budget spending, including fiscal deposits and transfer of revenue from other fiscal accounts.

Financing: From the financing side, in addition to general government bonds and tax revenue, fiscal stimulus is largely financed by local government special bonds, LGFV bonds, policy bank support, shadow banking lending, and land sale revenue. We expect the quota for special bonds would likely increase further from this year's RMB 1.35 tn (Exhibit 9). LGFV bonds issuance is heavily affected by liquidity conditions in the interbank market and the market perception of credit risks. Shadow banking lending is largely affected by the regulatory policy and risk appetite currently.

Coordination among fiscal policy, regulatory policy and monetary policy is key to successfully finance and deliver stimulus. For instance, in Q2 we saw an example of lack of coordination, with LGFV bonds issuance down significantly and contraction of shadow banking lending accelerating further due to regulations and rising default. Since Q3, we have seen an improvement in coordination, with tweaks in regulations and more accommodative monetary policy to facilitate bonds issuance through RRR cuts and also some other targeted supports.

Policy bank support is the most flexible part among those major quasi-fiscal financing channels, and could serve as the last resort to stabilize growth, based on experience in previous years. For instance, during the economic slowdown around 2015, the government established a special construction fund through China Development Bank, which played a major role in supporting infrastructure investment then, though this has been suspended since 2017. We believe this kind of tool could reappear, if needed.

From an incentive perspective, local government debt regulation could be the most important factor affecting local officials' will to spend. However, we think the central government is less likely to tighten the regulation significantly when the downward growth pressure persists.

Composition: The package will likely include two major aspects. The first is tax cuts, including potentially VAT, corporate income tax and other tax rebates (e.g., for car purchase), while personal income tax cuts have already been announced this year and will be effective next year.[1] These measures, if all implemented, may potentially reduce tax revenue by at least 1% of GDP, although this revenue shortfall would need to be filled by tightening tax and fee collection elsewhere unless on-budget fiscal deficit target is raised considerably (which we do not expect, as discussed above).

The second aspect of the package would be focused on infrastructure investment. Recently the government has taken measures to ensure a pickup in infrastructure investment, by guaranteeing financing and accelerating project starts. The major areas that the government focuses on include poverty relief, railway, road, airport, water, energy, rural infrastructure, and environment.

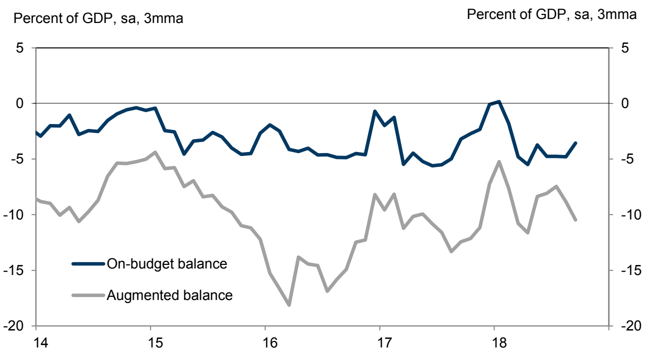
Risks: The market has been concerned that fiscal stimulus may lead to a reemergence of structural issues, for instance higher leverage due to both worsening of capital allocation and high credit growth.

Another main cost of fiscal stimulus is its negative impact on debt sustainability, given that the fiscal space of the government is much more limited than before. If taking implicit debt into account, the debt to GDP ratio in China could be as high as around 70% according to our estimation (Exhibit 10), much higher than the official number (37%). From a debt sustainability perspective, if the augmented fiscal deficit is maintained at the current level (about 10% of GDP), the government's debt-to-GDP level

[1] On personal income tax, we see limited impact on household consumption. A very simple estimation suggests personal income tax cut may raise disposable income by around 0.4pp of GDP. And also most of those benefits should be enjoyed by people in top income deciles, who should have lower consumption propensity. On potential tax rebates for car purchases, these may help, but the impact should be much smaller than the last two rounds (2009 and 2016). More importantly, with a modest increase in on-budget deficit target, tax cuts could be offset by cutbacks in spending. So net impacts on growth could be even smaller.

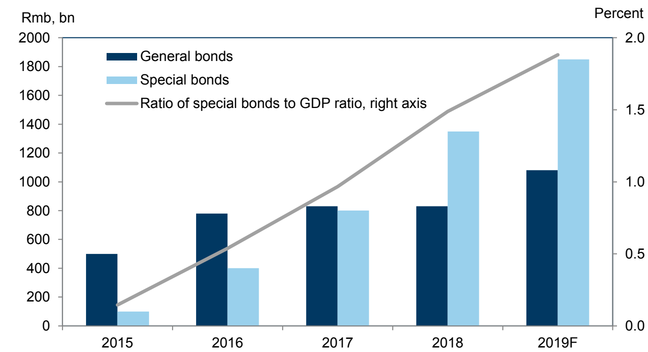
would only stabilize at a high 140% in the long run, which would stretch fiscal sustainability.

Exhibit 8: Fiscal policy has been a major policy swing factor so far in 2018



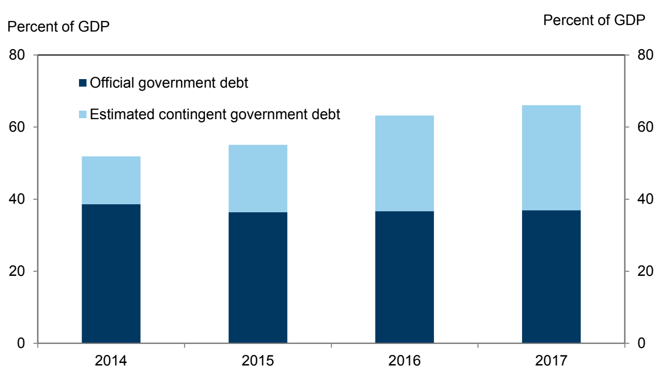
Source: Goldman Sachs Global Investment Research, Wind

Exhibit 9: We expect the quota for special muni bonds to increase further in 2019



Source: Goldman Sachs Global Investment Research, Ministry of Finance

Exhibit 10: Maintaining the augmented fiscal deficit at high level would stretch fiscal sustainability



Source: Goldman Sachs Global Investment Research, Ministry of Finance

5. Monetary Policy: dovish stance to extend

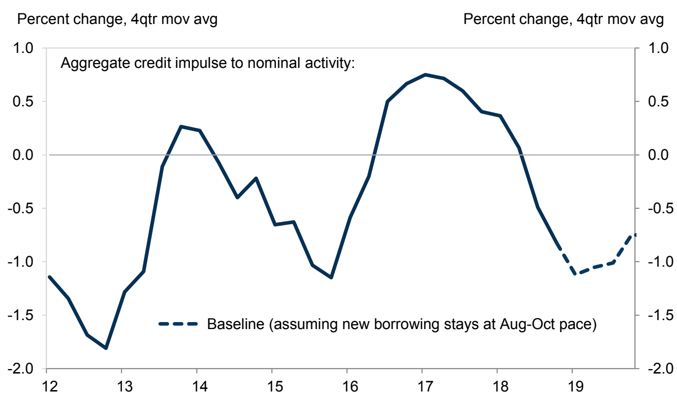
While fiscal measures are likely to be the main policy lever, monetary policy should stay accommodative as well. We expect the 7-day repo rate to drift lower in the first half of 2019 to 2.25%, before moving modestly higher in the second half to 2.5%.

As discussed above, activity growth faces increased downward pressure in Q1 2019 and we expect interbank rates to be managed lower to help growth recover. Despite the recent monetary easing, effective lending rates still went up in Q3 2018, suggesting insufficient transmission to the real economy. The credit impulse would remain a drag on growth next year based on our analysis (Exhibit 11) and lower interbank rates could mitigate this. More liquidity and lower rates could also facilitate the smooth issuance of local government bonds, especially given our expectation that the quota could be increased further from this year's level. The typical side-effects of lower rates now seem to be much smaller given the regulatory controls amid the government's commitment to contain financial risks. This should leave the authority more room to lower interest rates.

Another potential hurdle for lowering interest rates is higher FX outflows and associated higher depreciation pressures on the currency. The Fed is likely to continue hiking rates next year based on our US team's forecasts and lower rates in China could imply unfavourable interest rate differentials, risks of acceleration in outflows, and thus more depreciation pressure on the currency. Having said that, we do not expect exchange rate pressure to be an insurmountable barrier to lowering rates, especially if domestic growth is soft. Capital control measures put in place since late 2015 have been effective in curbing outflows, and even when the CNY was under heavy pressure in 2015-16, the authorities chose to keep interest rates low to support the domestic economy.

We do not view higher inflation as a major constraint to lowering interest rates. CPI inflation could briefly approach the 3% ceiling in Q2 2019 based on our estimate, but we expect it to moderate in the second half and the full year average of CPI inflation to be around 2.5%yoy—higher than this year but still acceptable.

Exhibit 11: Fading credit impulse would continue to shave growth next year



Source: Goldman Sachs Global Investment Research

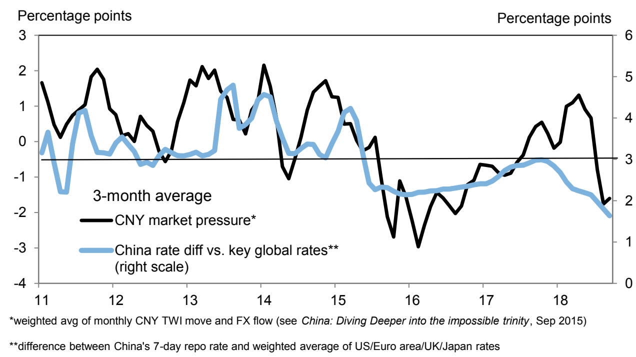
6. CNY Regime: tug of war

Reasons for weakening

Both cyclical and structural economic forces make a compelling case for further CNY weakening, in our view. First, the decoupling of China's interest rate cycle vs. the rest of the world has squeezed the interest rate differential to a multi-year low (Exhibit 12). This has naturally given rise to depreciation pressure. The ongoing trade tension with the US has also added to the market's bearish mood towards the currency.

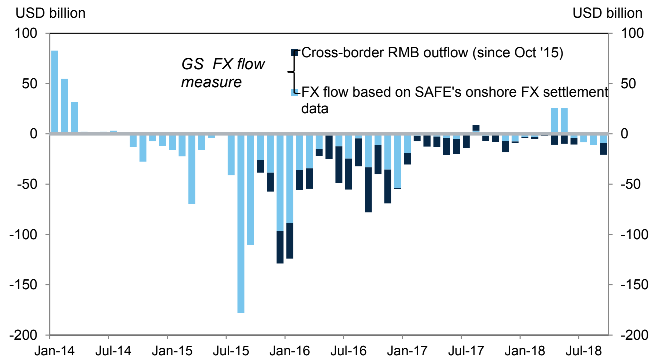
Second, due to both more effective capital account controls and policymakers' more refined CNY expectations management, FX outflow pressure has remained contained despite significant depreciation this year (Exhibit 13). Whereas CNY depreciation in 2015-16 led to a large amount of capital leaving the country and gave rise to financial stability risks, the authorities have greater scope nowadays to let the exchange rate weaken without incurring similar fragility.

Exhibit 12: Narrower interest rate differential puts pressure on CNY



Source: Goldman Sachs Global Investment Research

Exhibit 13: FX outflow has remained contained in recent months

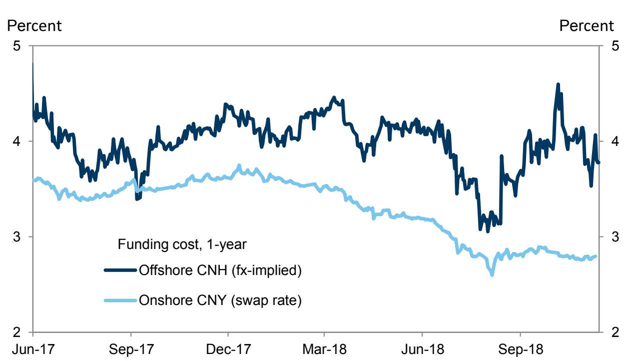


Source: Goldman Sachs Global Investment Research, SAFE

Third, the argument for allowing a weaker CNY to support exports is particularly appealing against the backdrop of the "deleveraging" policy objective. Compared to fixed investment and to some extent household consumption, exports are a much less credit-intensive growth driver.

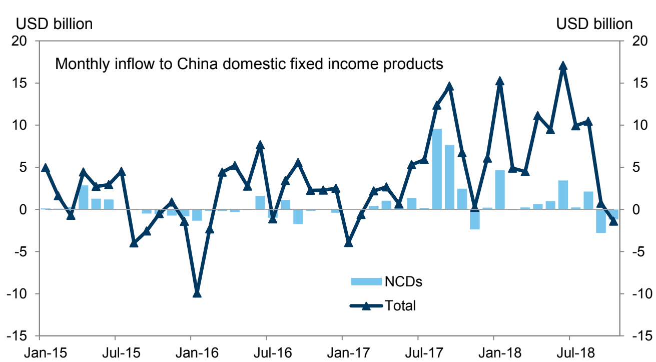
Fourth, a more market-oriented CNY would be a key building block for a sustained capital account opening-up. One example of how a yet-to-be liberalized CNY curtails free cross-border capital flows is the wide funding cost spreads between onshore (CNY) and offshore (CNH) markets (Exhibit 14). That is partly a result of the steps taken to segregate the two markets, such that CNY can be largely insulated from global market pressures. In turn, the higher CNH funding cost does not bode well for inflows to China's bond market, because many foreign bond investors do FX-hedging only in the offshore market (where the high funding cost implies a high hedging cost). Bond inflows were slow in recent months, after the earlier possible one-off inflow drivers subsided (Exhibit 15).

Exhibit 14: Funding costs of offshore CNH and onshore CNY markets have diverged



Source: Goldman Sachs Global Investment Research

Exhibit 15: Bond inflows were slow in the last couple of months



Source: Goldman Sachs Global Investment Research

We see China's bond market as a great draw for foreign investment over time, and in the near term the prospective inclusion in the Bloomberg-Barclays index in April 2019 could attract meaningful inflows. Beyond that, the pace at which its full potential will materialize partly depends on the speed of external liberalization, including a more market-oriented CNY.

Efforts to stabilize

Tugging the CNY in the opposite direction to the economic forces are political and sentiment factors. The White House's annoyance at past CNY weakening has likely contributed to Chinese policymakers' reluctance to let the currency depreciate by much more, lest it exacerbate the already complicated bilateral trade relationship. Moreover, a continued fall in the CNY could further damage equity market sentiment and possibly also wider EM market performance (similar to what happened in June-July), which could in turn tighten financial conditions and drag on growth. An "internalization" of such costs would argue for keeping the CNY steady.

Given the particularly high uncertainty about the US-China trade relationship, we cast our CNY views according to three stylistic scenarios, and weigh the likely market and policy forces in each of those (Exhibit 16). The three scenarios are: i) "deal", i.e., a formal resolution that involves a rollback of US tariffs; ii) "pause", i.e., status quo with no new tariffs and continued willingness to talk; and iii) "escalation", i.e., a step-up in tariffs and/or other non-trade restrictions.

In the short term, we see "escalation" as still the most likely of the three scenarios. In this case the economic need and market pressure for depreciation would be so large that policymakers would likely accommodate further meaningful CNY weakening. A "pause" is a realistic—though not yet baseline—possibility following the Trump-Xi meeting, and we think it becomes more likely over time (and in fact is the most likely scenario at some point in 2019). In this state of the world, downward pressure on exports and sentiment lingers, but Chinese policymakers resist further depreciation to try to preserve room for reaching a deal in the future and not to risk compounding the negative sentiment. And in the "deal" scenario, the currency rallies, but only modestly given the still-negative interest rate differential.

Exhibit 16: Our CNY views by different trade scenarios

		CNY in event of			Event probabilities			
		deal	**pause**	**escalation**	**deal**	**pause**	**escalation**	**E(CNY)**
3m	**Q1**	6.8	6.95	7.1	10%	40%	50%	7.0
6m	**Q2**	6.75	6.95	7.35	25%	35%	40%	7.1
12m	**Q4**	6.7	6.90	7.3	30%	50%	20%	6.9

Source: Goldman Sachs Global Investment Research

7. Market Implications

Rates

We expect the dovish monetary policy stance to extend, in light of growth headwinds, the continued tight financing conditions and muted credit supply (*more detailed discussion in section **5** above*). Monetary policy transmission has become less effective given banks' stronger focus on their capital buffers and diminished risk appetite. This, in our view, argues for even more easing in rates, rather than less. In particular, looser market liquidity should still be clearly beneficial to corporate bond issuance. We expect a RRR cut of 50bp during the rest of 2018, and then quarterly cuts of 50bp each through 2019H1. We continue to expect PBOC support to come mostly from greater injections in the interbank market which lower market rates. We do not expect reductions in benchmark lending rates at this point, but the likelihood of such a move would increase should bank lending rates remain high and market confidence fall further.

We forecast the 7-day repo rate to edge lower to 2.25% at end-Q2 2019, but rise slightly thereafter as growth regains momentum. Similarly, we expect the 5-year swap rate to ease to 2.9% in the coming quarters. While we also expect the 10-year CGB yield to fall in sync, the decline is likely to be smaller given substitution effects due to an expected rise in local government bond issuance. Exhibit 17 summarizes our rates outlook.

Exhibit 17: We expect a moderate decline in rates relative to current levels

End of period, %	spot	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4
7-day repo rate, R007	2.65	2.50	2.25	2.25	2.50	2.50
Swap rate 5y	3.15	3.00	2.90	2.90	2.90	2.90
CGB yield 10y	3.50	3.40	3.30	3.30	3.30	3.30

Currency

We frame our CNY views according to how the US-China trade tension may evolve, given the high uncertainty surrounding the bilateral relationship. Our USD/CNY forecasts represent the probability-weighted expected value across different trade scenarios (*more detailed discussion in section **6** above*). Overall, we see moderate CNY depreciation, and do not expect a sharp move in either direction. Domestic headwinds from tight financing conditions and soft consumption would continue to curb any large CNY rally, while the authorities' typically gradualist approach should limit any discontinuous weakening moves. Our 3/6/12-month USD/CNY forecasts are 7.00/7.10/6.90 (*more detailed probabilistic CNY forecasts in Exhibit 16 above*).

Equities

Chinese equities (proxied by MSCI China) have dropped close to 20% year-to-date. This is against the backdrop that corporate earnings growth momentum has still been largely robust. As such, valuations (at 10-11x 12-month forward earnings) are at cycle lows. In our equity strategy team's view, the equity market has already discounted a more bearish macro environment than our expectations. Our colleagues also estimate that while RMB 5tn worth of shares have been involved in stock pledged loans, only a more manageable RMB 1tn of the loans are at risk of margin calls. The recent policy assistance introduced to buffer the risk should ease systemic concerns. Overall, our equity strategy team keeps China at "overweight" in their regional equity allocation.

Credit

To us, tackling excess credit growth from the shadow banking sector and allowing over-levered entities to default and restructure their indebtedness have longer-term positive implications, but are uncomfortable in the near term. One consequence has been the record pace of domestic corporate bond defaults.

Looking ahead, our credit strategy team does not expect the appetite for riskier credit to return in the near term, and expects credit differentiation to continue. Escalating defaults make lenders and bond investors cautious towards providing credit to the riskier corporates, especially within a system that, over recent years, had been reliant on implicit government support (which now appears to be waning). Developing a "credit culture", whereby credit assessment and pricing decisions are based more on underlying credit fundamentals rather than on government or banking sector support, will take time. So while we believe that systemic risk concerns are unlikely to arise and that tackling excess credit growth is positive over the long run, China onshore investor sentiment will likely remain challenged in the near term. We would avoid the riskiest China high yield credits, though we do see value in some of the more defensive areas.

Disclosure Appendix

Reg AC

We, MK Tang, Yu Song, Zhennan Li, Maggie Wei and Andrew Tilton, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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