China View

March 2020: Coronavirus raises credit risk

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2020 is an important year for China. It is the year when China has pledged to eliminate poverty and double the economy's size from a decade ago. With the trade war with the US on pause, the year looked promising to begin with. But the coronavirus outbreak is casting a shadow on the growth outlook. We expect activity resumption and government stimuli to stage a strong rebound later this year, but some policy actions are likely to exacerbate the systemic risks in the medium term.

Macro: A substantial impact on growth

Now that the number of new infections with COVID-19 virus is on the decline in China, government officials can direct their focus on mitigating the adverse impacts on the economy. The first conventional data, the PMI surveys, suggests an unprecedented fall in economic activity in Q1. We estimate that the economy will grow by barely 3% y/y in Q1, versus our previous forecast of 6%. Due to an expected rebound in Q2 and Q3, we expect full-year GDP growth at 5%, an all-time low for China. The risk is on the downside, in our view, as the rapid spread of the virus among China's trading partners could have a spill-back effect on Chinese growth.

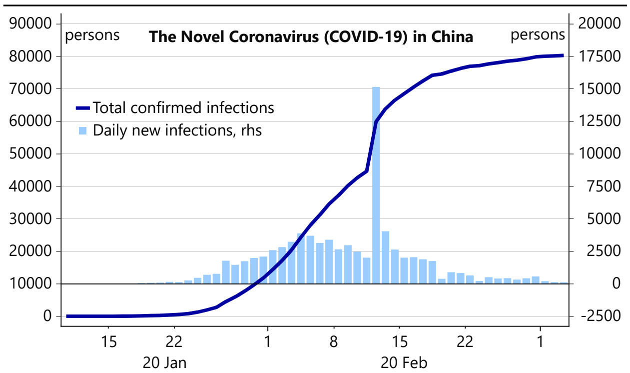
Fiscal stimulus raises credit risk in China

To maintain economic and social stability, Beijing has once again turned to infrastructure investment to support growth. Half of China's provinces have plans to spend a total of CNY 6.6tn (about 6% of GDP) this year on transportation, energy, high-tech sectors and healthcare. Other provinces will likely follow suit. Relying on bank loans and local government bonds as funding will no doubt raise the overall credit risk, as many infrastructure loans have experienced trouble with repayment in the past.

CNY: Waiting for the PBoC

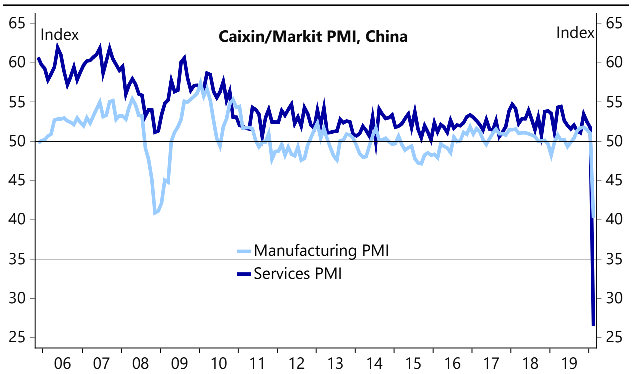
The CNY has appreciated nearly 2% in less than two weeks in anticipation of a rate cut from the Fed. Now it has happened and the ball is back in the PBoC's court. We expect the PBoC to cut the benchmark lending rates to support growth while curbing further upside to the CNY.

DECLINE IN NEW COVID-19 CASES IN CHINA



Source: Nordea and Macrobond

UNPRECEDENTED PLUNGE IN ACTIVITY IN CHINA



Source: Nordea and Macrobond

Macro: Coronavirus raises credit risk

The coronavirus outbreak is hurting Chinese growth this year and jeopardising an important growth target. A large-scale investment package might shore up demand in the short term but will exacerbate the already large credit risk in China.

An important growth target this year

When the Chinese top leaders in 2012 set the ambitious goal of doubling 2010 GDP in real terms by 2020, they probably did not factor in black swan risks such as a fast-spread virus that would cause significant disruption to the economy.

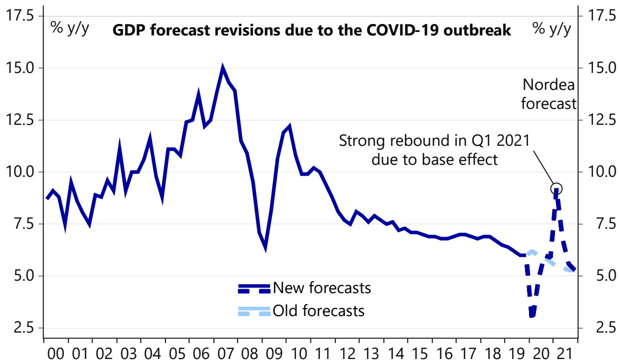
5.6% GDP growth is needed

In fact, given average GDP growth of 7.3% between 2011 and 2019, the rate only needs to be 5.6% this year for the target to be met. That seems achievable, as the phase one trade deal has paused the two year-long trade war between China and the US and improved the growth prospects.

The coronavirus is jeopardising this goal

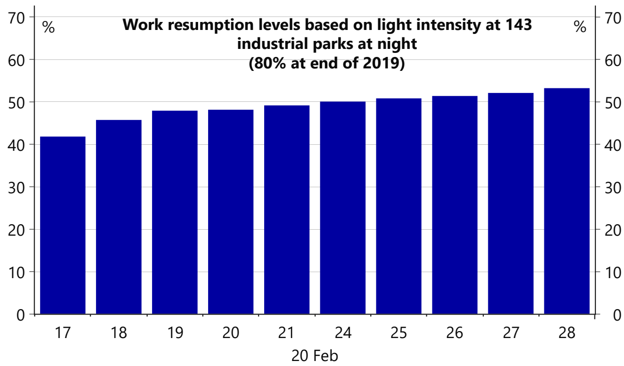
However, the coronavirus is casting a shadow over the near-term outlook. We estimate that the outbreak will halve Chinese growth to around 3% y/y in Q1. Assuming the virus is contained soon and activity returns to normal levels within weeks, we expect a strong rebound in Q2. But the loss to some services, such as travel and restaurant visits, will likely not be compensated for later. Thus, full-year GDP growth could fall to 5%, versus our previous forecast of 5.9%.

GDP GROWTH TO PLUNGE IN Q1 BEFORE REBOUNDING IN Q2



Source: Nordea and Macrobond

ACTIVITY REMAINS 20-30% BELOW NORMAL LEVELS



Source: Nordea and China Merchant Bank

Our estimates of the impact face downside risks...

The risks are tilted to the downside. Unconventional data such as traffic congestion and anecdotal evidence of factory reopenings indicates that activity remains 20-30% below normal. Heavy paperwork and mandatory quarantine before people return to work in some regions could mean that the economy is not back to normal in March, as we assume in our forecasts.

...and large uncertainty

Furthermore, the virus is spreading rapidly outside China and is expected to hurt the economies of its trading partners. The potential spill-back to China makes it difficult to measure the full cost on the Chinese economy.

Government stimulus to the rescue

In response to the potentially strong headwinds, the authorities have rolled out a number of measures to provide liquidity and subsidies, currently estimated to amount to CNY 1tn, about 1% of GDP. As a whole, they should be sufficient to prevent mass lay-offs and therefore the risk of social unrest.

Infrastructure investments to ensure stable growth

However, these measures cannot guarantee the economy will meet China's growth target for the decade. Hence, demand needs to be fired up through infrastructure investments. So far, around half of China's provinces have announced plans to invest a total of CNY 6.6tn (about 6% of GDP) this year in transportation, energy, high-tech sectors and healthcare.

Most of the investments were already planned but have been frontloaded to this year. We estimate that fixed investments will grow by 8-10% this year compared to 5% in the last two years.

CHINA'S STIMULUS MEASURES IN RESPONSE TO THE CORONAVIRUS

For general economy	For corporates	For consumers
Monetary easing (rate and RRR cut)	Issuing loans to affected companies, more than 1000 as of end of February	Extending loans to people with lost income, for up to 1 month
Issuing more local government special bonds	Extending loans to affected loans for up to 1 year and not classify these as NPL	Cutting costs (eg. toll fees)
Frontloading construction projects (infrastructure investment expected to grow by 8-10% y/y)	Cutting corporate tax for affected companies	Subsidies for consumption (eg. car purchase)
Relaxing housing restrictions (eg. downpayment requirement lowered to 20%)	Cutting costs (eg. rent, electricity costs and toll fees)	
	Subsidies for those directly hurt by the lockdown (eg. tourism attractions and catering)	
	Lowering or waiving employers' social insurance contributions for up to 5 months	
	Export credit insuance (in discussion)	

Source: Nordea and Chinese government websites

This increases the already large credit risk

Relying on investment to shore up growth is nothing new in China. It has occurred repeatedly since 2009. As always, the investments will be funded by bank loans and government bonds. Thus, it is safe to assume a surge in credit growth this year, which will exacerbate the already large credit risk.

Special-purpose bonds have become the main funding tool...

It is worth mentioning that local government special-purpose bonds (SPB) will likely account for the lion's share of the local project financing. SPBs were introduced in 2015 and differ from standard government bonds in that they are repaid from the income generated by the specific projects rather than from government revenues.

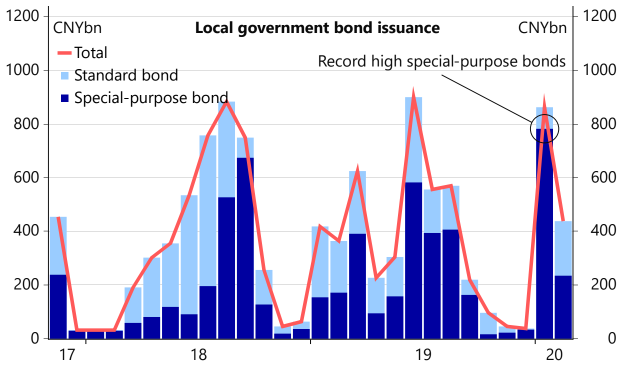
...but are no less risky

The SPBs have become popular among local officials, as they help alleviate the pressure on local government finances. However, they do not carry any less default risk than conventional government bonds, because they are still tied to project rentability.

Bond defaults are expected to rise further this year

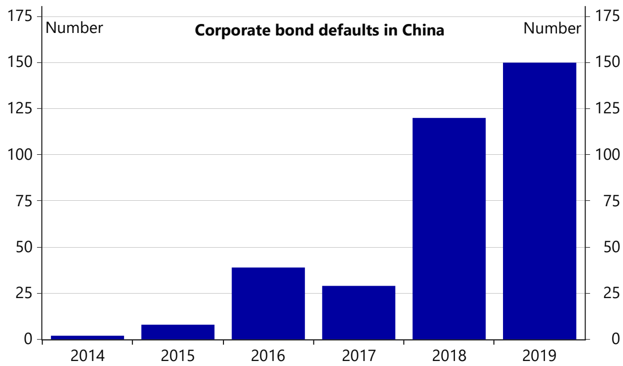
Corporate bond defaults have surged since 2018 and include those by state-owned enterprises backed by local governments. The urge to stimulate demand this year carries the risk that many investment projects are approved hastily. Thus, a new record for bond defaults in 2020 seems more like reality than a risk scenario.

LOCAL BOND ISSUANCE SPIKED IN JANUARY



Source: Nordea and Macrobond

SOARING BOND DEFAULTS IN CHINA



Source: Nordea and Bloomberg

CNY: Waiting for the PBoC

With a murky outlook for domestic and external demand, the PBoC is expected to cut rates to support growth and limit further gains in the CNY. Central bank intervention is also expected, should the yuan face strong sell-off pressure.

Nearly 2% appreciation in the CNY

In a market environment dominated by the coronavirus, it seems counterintuitive that the CNY has strengthened nearly 2% against the USD in less than two weeks.

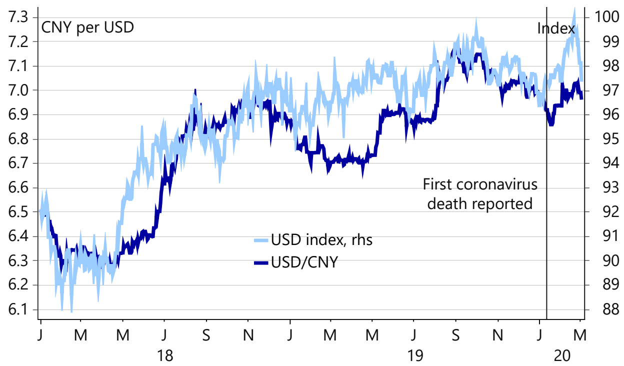
Fed rate cut could strengthen the yuan further if the PBoC does nothing

It was the bet on a Fed rate cut that weakened the dollar and supported the yuan. Now that this has been delivered and another 25 bp rate cut is priced in for March, the policy rate difference between the PBoC and the Fed is once again widening. That could push USD/CNY lower in the near term as yield-hungry flows stream to Chinese assets.

Macro uncertainties are large

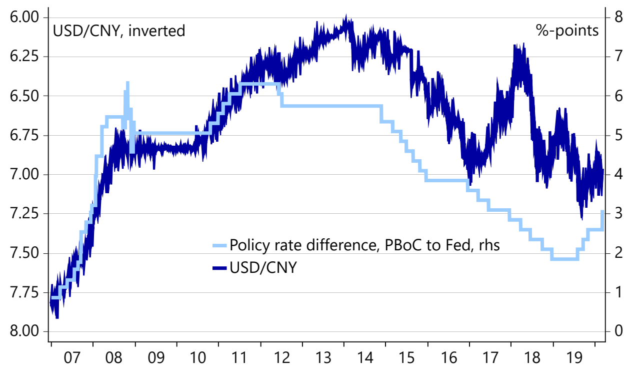
The collapsing PMI indices in February suggest an unprecedented low GDP growth figure for Q1, but the path of recovery remains unclear. We know that workers are returning and businesses restarting, but at a slow pace. The longer it takes for the economy to return to normal operation, the bigger the impact on growth this year.

THE CNY IS SENTIMENT-DRIVEN



Source: Nordea and Macrobond

WIDENING CHINA-US YIELD DIFFERENCE



Source: Nordea and Macrobond

Strong CNY is not optimal for China's current outlook

With an uncertain outlook for domestic demand, Beijing is not interested in a strong yuan that would hurt exports. Many exporters are already struggling as a result of lost revenue and concerns about lower external demand due to the global virus spread.

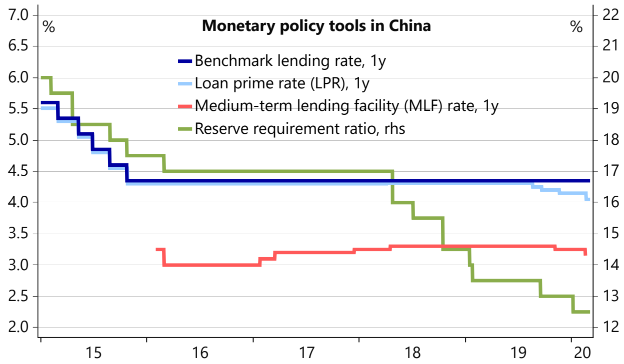
We expect the PBoC to cut rates and the RRR

Thus, the PBoC will likely continue easing monetary policy to stimulate demand and to curb the yuan upside. Specifically, we expect a cut to the benchmark lending rates, as this would have a bigger effect than cutting the loan prime rates (LPR), which apply only to new loans. Liquidity will likely be provided through a cut to the reserve requirement ratio (RRR).

Beijing will not tolerate too much yuan weakening

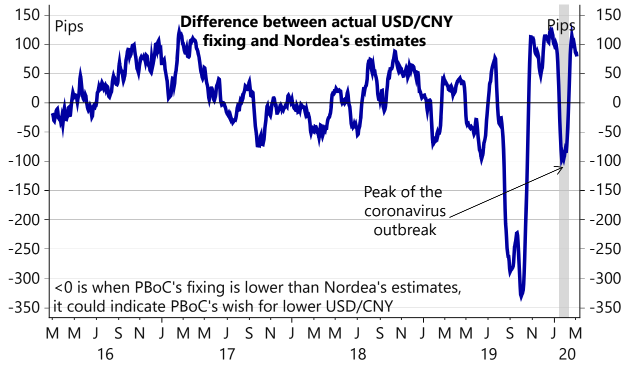
On the other side, capital outflow concerns will likely make the PBoC guard against downside risks to the CNY and stand ready to intervene.

FURTHER MONETARY POLICY EASING ON THE CARDS



Source: Nordea and Macrobond

PBOC WILL INTERVENE SHOULD THE CNY WEAKEN AGAIN



Source: Nordea estimates and Macrobond

Nordea forecasts for China

MACRO FORECASTS FOR CHINA

	2017	2018	2019E	2020E	2021E
Real GDP, % y/y	6.9	6.6	6.1	5.0	6.6
Consumer prices, % y/y	1.6	2.1	2.9	4.8	2.5
Current account, % of GDP	1.6	0.4	1.0	0.9	0.8
Public sector balance, % of GDP	-3.9	-4.8	-6.1	-6.3	-6.3

Source: Nordea estimates and Macrobond

FINANCIAL FORECASTS FOR CHINA

Forecasts	Spot	3M	Mid-2020	End-2020	End-2021
USD/CNY	6.96	7.04	6.95	6.95	7.10
EUR/CNY	7.79	7.67	8.06	8.54	8.16
Policy rate	4.35	4.10	3.60	3.60	3.60

Source: Nordea estimates and Macrobond (spot)

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