7 March 2016

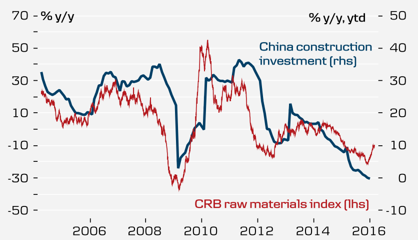
Flash Comment

China: growth target confirmed, capital outflows ease

New Five-Year Plan confirms growth target of 6.5-7% in 2016

- The draft of the new Five-Year Plan presented at the National People's Congress confirms that the **growth target for 2016 will be 6.5-7%** – down from the 7% target for 2015.
- The draft did not provide many surprises as it was in line with the one presented in October 2015 (see *Flash Comment: China to upgrade to version to Version 2020*, 30 October 2015).
- China's focus over the next five years will be on (a) a **rebalancing** towards the consumer and service sector and more high-tech industries, (b) **cutting overcapacity** in the old industries such as the steel and cement sector, (c) focus on **innovation** and **entrepreneurship**, (d) continuing the drive towards **energy efficiency** and greener growth, (e) accelerating **urbanisation** to deal with the oversupply of houses, (f) continuing **internationalisation** of financial markets and opening of the capital account, (g) continuing the **reform of State-Owned Enterprises** to make them more efficient.
- The **fiscal deficit will be allowed to increase** from 2.3% of GDP in 2015 to 3.0% and a tax reform will cut taxes on businesses in exchange for VAT tax on consumers.
- A **fund of CNY100bn will be established to assist those that are made redundant** as a result of closing zombie companies and reducing overcapacity.
- The **markets have generally received the plan positively**, and especially commodity markets have been encouraged by the aim to reduce overcapacity in the steel and cement industries. **Iron ore prices and industrial metals have added to the rise seen recently and look to be trending higher** on optimism that the worst is behind us in terms of lacklustre demand and oversupply.
- China reiterated over the weekend that the **FX policy is to keep the CNY stable** against a basket of currencies. Therefore, China repeated that there is no scope for a devaluation.
- **Our take:** *the measures are broadly as we expected and do not change our outlook for 6.7% growth this year (on official numbers) for China. We continue to expect a gradual recovery in the construction and industrial sector to drive an improvement in the Chinese economy over the next one-two years while service sector growth continues at a robust pace. Especially the increase in construction activity – albeit moderate – should be positive for raw material prices and iron ore as supply cuts are taking place at the same time.*

Bottom in Chinese construction and supply cuts push commodities higher

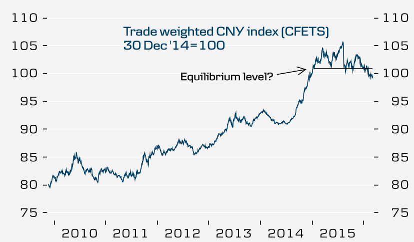


Source: Macrobond Financial

Pessimism around China is easing

Source: Macrobond Financial

China aims for stable CNY vs basket



Source: Macrobond Financial

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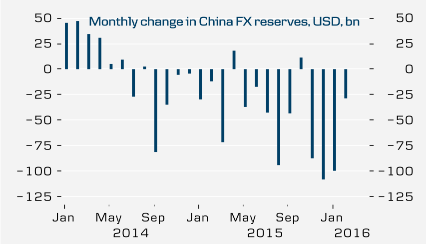
Capital outflows ease – pressure on CNY calming down

Chinese currency reserve data for February confirmed that Chinese capital outflows have eased considerably. Reserves fell only USD28.6bn in February (broadly similar in valuation-adjusted terms as currencies did not move much). This follows an average outflow of close to USD100bn in the previous three months. Hence, China has managed to calm down outflows. The line in the sand was drawn when China forced up offshore money market rates by intervening and draining liquidity, which made it very expensive to speculate against the CNY through the CNH market. Since then markets have calmed down completely and the outflow in February was very small.

A gauge of how much selling pressure is on the CNY is the CNH-CNY spread, as the CNH market can be traded freely and most of the hedging and speculative bets are done in this market. At its worst point, the CNH was 2% weaker than the CNY. But this spread is now down to around zero, showing no selling pressure in the offshore market.

The new calm **suggests that the devaluation fears in the market have eased** and we do not expect a Chinese devaluation. Nevertheless, we look for a further weakening of the CNY versus the USD over the course of the next year, mainly because we expect a divergence between US monetary policy (the Fed raising rates further) and Chinese monetary policy (further rate cuts and reduction in the Reserve Requirement Ratio). In addition, we do not think China will be concerned about a moderate weakening of the currency as long as it is happening in an orderly way and not fuelling significant outflows. We look for CNY to weaken around 6-7% against the USD from current levels to 7.00. With our forecast of a higher EUR/USD at the same time, this translates into a depreciation of the CNY versus EUR of more than 10%. This is much more than is priced in by the market and **we continue to recommend corporates to hedge CNY receivables. The recent decline in the CNH value and lower money market rates has made it cheaper recently to hedge.**

Very limited outflows in February



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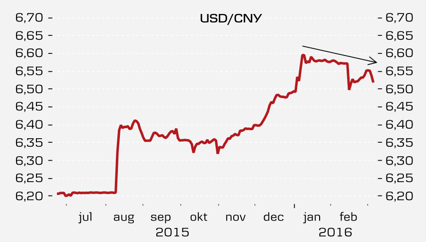
CNY stronger vs the USD since January panic



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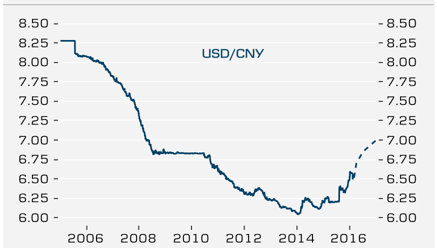
We look for a gradual weakening vs the USD but no great devaluation



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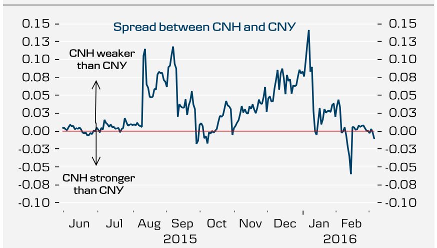
The panic gauge – CNH-CNY spread – has also normalised again



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