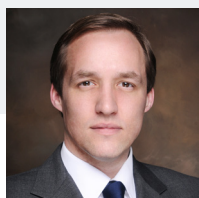




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## Emerging Markets **RETURN TO MEASURED STIMULUS IN CHINA**

### KEY POINTS

- Chinese policymakers are returning to stimulus by using all three policy levers: monetary, fiscal, and regulatory.
- Part of the reason for stimulus is preparation for the potential escalation of a trade war with the U.S.—but this is less important than domestic considerations.
- The move could have knock-on implications for other emerging market (EM) economies—especially in Asia—as investors see a floor under how far Chinese growth can fall.

After the decline in investor sentiment toward emerging markets in the first half of this year and growing anxiety surrounding Turkey's financial crisis, China's recent shift toward policy stimulus is a positive development. Policymakers in China are responding to concerns about growth and signaling clear, if measured, easing through each of the three main policy levers: monetary, fiscal, and regulatory.

But it is important not to overemphasize the point that policymakers have overcome their reluctance to intervene. Over the past decade, Chinese policy has been characterized by periods of tightening to control credit, punctuated by periods of stimulus to support growth—with easing cycles in 2009, 2012, and 2016.

The current actions perhaps represent the start of a new cycle, but we have no expectations that stimulus could reach the levels seen in the aftermath of the financial crisis. Nor is the impact on commodity prices likely to be as bullish as it was in 2009 and 2016.

What we are observing now is an effort to add 0.3–0.5 percentage points to GDP—not to get growth back to prior levels, but to stabilize it around the 6.5% target.

On the monetary side, the central bank has, in recent weeks, shifted to cutting reserve requirement ratios to boost liquidity. And though there is little new fiscal stimulus, local governments are increasingly being encouraged to start borrowing again to fund infrastructure projects. This represents a clear shift in priority: to push infrastructure spending back up to about 10% of GDP. Housing policy, however, has not been loosened.

We believe broader emerging market pessimism about weak Chinese growth has been overplayed. Much of this negative sentiment has, in fact, flowed from concerns about developed markets: the worrying divergence in growth and monetary policy between the U.S. and the rest of the world and increasing U.S. belligerence toward its trading partners.

# As policymakers now move toward stimulus, they are signaling their approval to local investors to take on more risk—not indiscriminately, but with the goal that stable, lower-rated companies should not be cut off from credit.

The potential escalation of a trade war between the U.S. and China is clearly important. For now, the first USD \$50 billion of U.S. tariffs are relatively immaterial. But if the U.S. follows through on its threat to escalate tariffs to USD \$200 billion, the costs will begin to mount. We estimate such a move would subtract 0.3–0.5 percentage points from Chinese GDP. It would start to have an impact on China's ability to meet its growth targets and also shake confidence in its business environment.

The move by Chinese policymakers toward a growth phase seems to be part of their plan to prepare for the imposition of a harsher round of tariffs—and to signal they're capable of resisting U.S. threats. But this needs to be put into perspective. In the

western media, there tends to be a sharp focus on Chinese policymaking as a response to what is happening in the rest of the world. But given the restrictions on moving money in and out of China, this is a much more nuanced situation.

The policy tightening that has taken place until recently was driven predominantly by Chinese domestic considerations. It resulted in some quite remarkable achievements, including the contraction of China's shadow lending outside the formal banking sector—something many observers would not have thought possible just a few years ago. The recent stimulus should now be viewed, we believe, largely as a response to the domestic impact of an overcorrection.

For investors, the first half of this year in the Chinese credit market saw a flight to quality—onshore money rotating out of some of the riskier corporate and local government-issued bonds toward central government and top-rated corporate bonds. As policymakers now move toward stimulus, they are signaling their approval to local investors to take on more risk—not indiscriminately, but with the goal that stable lower-rated companies should not be cut off from credit. We think the trend toward Chinese government bonds and AAA bonds outperforming lower-rated bonds should, therefore, begin to unwind as emerging market jitters abate.

On the currency side, the combination of China loosening monetary policy and the tightening path pursued by the Federal Reserve should, on balance, put depreciation pressure on the renminbi—in spite of the offsetting effect of the stimulus measures. The imposition of tariffs also adds to this pressure, which will likely be managed by the People's Bank of China to contain any disorderly depreciation or speculative pressure on the renminbi.

A final, but important, point: The implications of what is happening in China for external investors are probably more important in other markets, notably in much of the rest of Asia, where China is a major source of demand and export markets. As Chinese policymakers signal the existence of a floor under how far growth can fall, they offer a positive data point to emerging market investors, who have had little cause for optimism so far this year.

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