

FOCAL POINT

China: fiscal stimulus will avoid severe global repercussions

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Our Focal Point series explores topical issues on macro, markets and investment

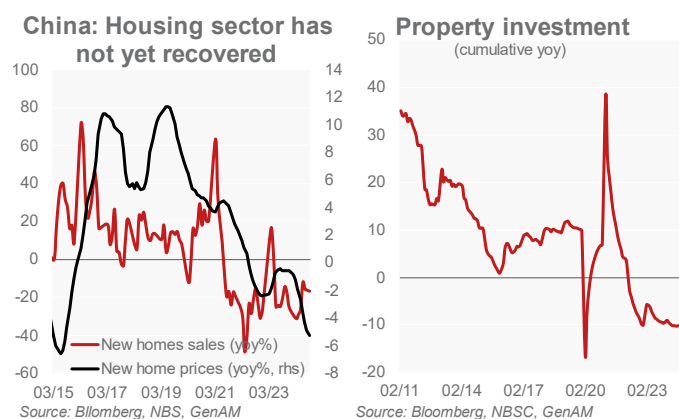
- The prolonged slowdown and deflationary environment in the Chinese economy has raised concerns about the potentially significant global impact. Punitive US tariffs in case of a Trump victory are adding to the risks.
- Stronger and coordinated policy support are on the way, but the scars of the property crisis still have a structurally dampening effect. A focus on downside risks is therefore useful. Similarly, the promise of significant fiscal support has led to high expectations.
- We simulate the impact of a deep domestic downturn, with Chinese GDP lower by 1.5% than the baseline next year, which the government tries to counter by cutting export prices and another one in which, by raising public investment significantly, the government boost GDP by 1%. We measure the impact on GDP and inflation for the largest economies and EMs.
- The reaction of EM assets will be heterogeneous in both scenarios. In a negative scenario, EM FX would be the most vulnerable, with LatAm commodity exporters and open economies in Asia on a back foot. In a positive scenario, local and external debt should benefit equally, while EM FX in the most open economies would outperform.

China has faced growing concerns about slowing growth and the risk of deflation. After a piecemeal approach, the Chinese authorities have made a U-turn by unveiling a coordinated monetary and fiscal stimulus. Details on the size and form of the fiscal support are still awaited to gauge the chances of success. Expectations are high and so is the risk of disappointment. In this Focal Point, we attempt to size the downside risks for the Chinese and global economy and the possible impact of a fiscal boost and its impact on GDP and inflation in the largest economies and emerging markets: a downside scenario in which growth and inflation continue to fall and an upside scenario in which the stimulus is large. In a second step, we identify the investment opportunities in the EM fixed income complex.

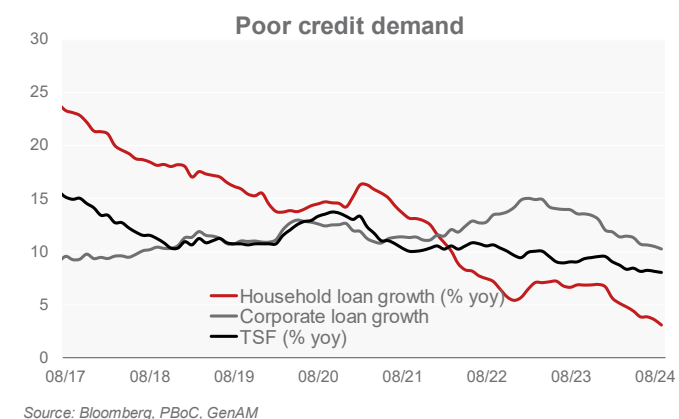
Deflation and economic risks require a new approach

The change in approach by the Chinese authorities has been triggered by the ongoing slowdown in economic activity, and particularly in consumer demand, which is putting the 5% growth target at risk. Indeed, the just released Q3 GDP data showed that growth slowed to 4.6% yoy, from 4.7% in Q2. The latest batch of September data confirms a partial improvement, but from a low base. Retail sales growth rebounded, showing the positive fiscal impact of subsidies for consumer goods such as home appliances and electric vehicles. Early anecdotal evidence from the Golden Week holiday points to an improvement in consumption. Property indicators have also picked up slightly but remain in deep

negative territory. Construction remains a major drag on fixed asset investment, which is down 9.4% year-on-year.



In contrast, credit growth remains problematic, contributing to a deflationary environment. The Q3 GDP figure suggests that GDP deflator growth was negative again. CPI inflation fell further to 0.4% yoy, while PPI inflation came in below expectations. There is still limited credit demand, with household credit growth remaining at lows, as is the case with total social financing (TSF) growth and M2. There has been some marginal improvement, and we hope to see a pick-up in growth following the easing by the PBoC and MoF. However, it should be modest as the supply side is not problematic, but a rebound in consumer confidence is needed to revive credit demand.

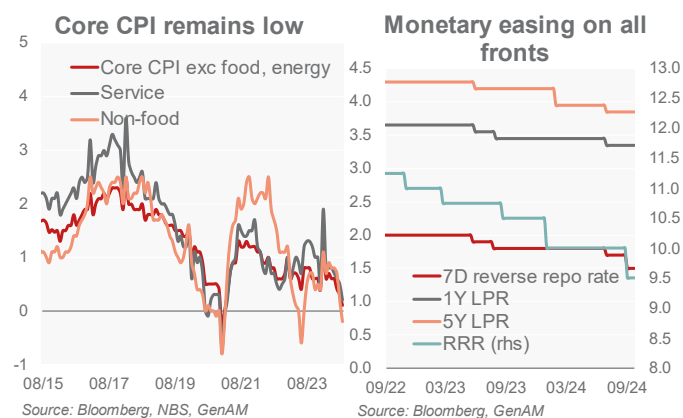


New stimulus: will it be enough?

The Chinese authorities have recently switched to coordinating their various policy tools after months of a piecemeal approach to address slowing growth, the property slump and low inflation. The idea is to create a boost to confidence and domestic demand.

The approach has essentially been fourfold, focusing on monetary and fiscal easing. First, the PBoC has cut the reserve requirement ratio by 50 bp to 10.0%, accompanied by a 20 bp cut in the 7D repo rate to 1.50%. This is the first coordinated cut since 2015. Rates on existing mortgages were cut by an average of 50 bp. Surprisingly, the 1Y and 5Y

lending rates, the rate at which banks lend, were cut by 25 bp, more than the PBoC benchmarks would have suggested, due to amplify monetary support. More important is the commitment to provide further easing if needed. PBoC Governor Pan Gongsheng and the Politburo have indicated the strong possibility of a further cut in the Loan prime rate (LPR) (20-25bp) in Q4, probably the RRR (25-50bp) and the deposit rate by the end of the year.



Second, a program to support the stock market was announced. The PBoC's relending facility (with a first quota of RMB300bn) has started, with a total of RMB11bn used for share buybacks of A-share companies, thereby boosting risk sentiment.

Thirdly, a commitment was made to fix the housing market, along with the prospect of fiscal support to boost consumer demand and ease local government debt pressures. These last two points are the most controversial as details are lacking and expectations are high. There is a recognition that a change is needed, but the size and, more importantly, how the fiscal stimulus will be used will take time to discuss. More details of the fiscal easing package are still to be released, likely during or after the NPC Standing Committee meets from 4 November. There should also be more clarity on the issuance of the new bond quota. Early indications point to the use of the remaining RMB 800 bn bond quota in 2024 and possibly an extension of RMB 1-2 trn in 2025 (0.8-1.6% of GDP) While the measures announced so far may not be enough to trigger a sharp turnaround in growth, they should at least put a floor under the growth slowdown and limit downside risks. However, there are concerns that they may not be sufficient to restore the efficiency of credit transmission, which is still burdened by debt and possibly shaky balance sheets. This could drastically reduce the impact on demand. If fully implemented, these fiscal and monetary policy measures will allow a growth pickup in the next months, but a full impact will be seen in 2025. So, our growth forecast remains intact at 4.8% in 2024. We maintain our growth forecast of 4.5% in 2025, waiting for all the details on the future fiscal stimulus but risks are skewed for a stronger figure.

Two scenarios and their global impact

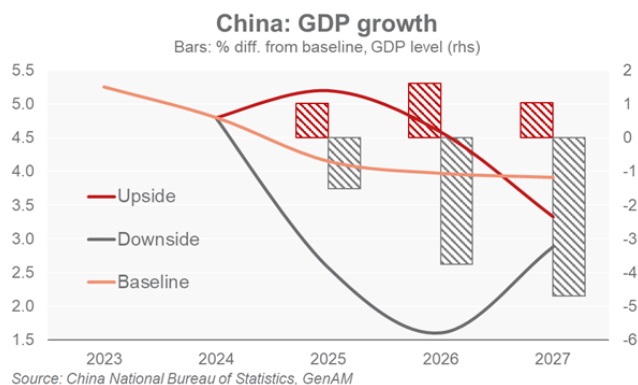
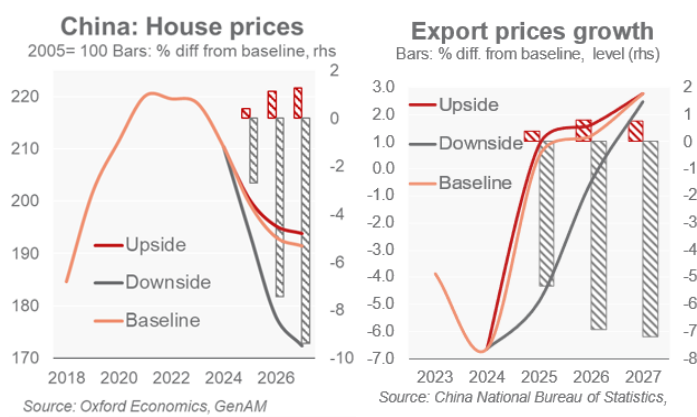
Given the high level of uncertainty about both the state of the Chinese economy and the government's willingness and ability to implement sufficiently large fiscal and monetary policies, we simulate two polar scenarios and assess the global impact using a large-scale econometric model¹. Beyond the numbers, such an exercise is also useful for ranking countries in terms of their vulnerability to a slowdown in the Chinese economy.

We consider:

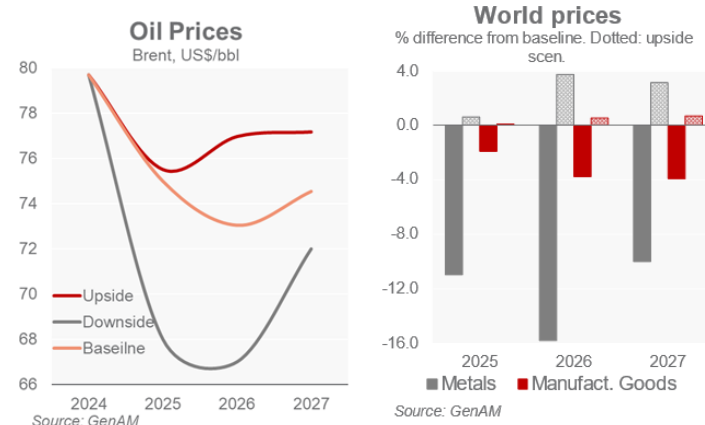
- A tail downside scenario in which house prices take a further hit, bringing them back to 2017 levels by 2026. The government response is consistent with what we have seen so far: a mix of timid monetary stimulus that fails to unfreeze credit, and downward pressure on export prices that limits the damage. The economic turmoil leads to capital outflows and pushes the stock market, with a negative impact on domestic demand (wealth effect) and global repercussions on risk assets. In this extreme downside scenario, Chinese GDP growth collapses to 1.6% in 2026, and the following year the level of activity is still almost 5% below our baseline.

- An upside scenario in which the construction sector finds back on its feet, keeping growth in line with our baseline, but the government, to bring growth back to the 5% target, adds to monetary easing a fiscal response by the authorities to boost domestic investment. The size of the intervention, as % of GDP is calibrated to the response to previous slowdowns (2008, 2016, 2020). In the upside scenario, the boost from public investment turns out to be a "sugar high" that lifts growth above 5% in 2025 but proves unsustainable as unresolved balance sheet issues dampen domestic demand growth thereafter.

The outcome of the US election, and the possibility of hefty tariffs is another clear downside risk.



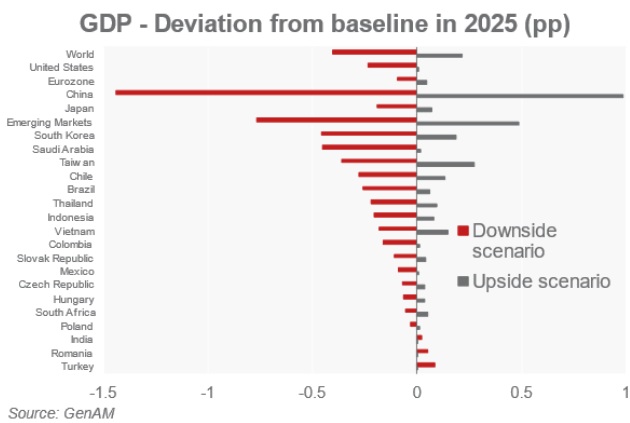
The global impact of the downside scenario is substantial, especially as far as commodity prices are concerned. Oil prices fall, and only a 3% supply cut by OPEC+ manages to limit the price contraction. Weak industrial and construction demand pushes down global metals prices, and dumping exerts significant downward pressure on global finished goods prices.



The negative shock would propagate to emerging markets. Industrialised Asian countries with tight trade links with China would suffer a trade induced negative shock, which, according to the model would be particularly strong for countries like Taiwan, South Korea and Vietnam, where exports to China account for 5% to 10% of GDP. In the upside scenario, the outcome would not be perfectly symmetrical, as the benefits from close trade relationship with China would be offset to a different extent by higher imported inflation.

On the commodities side, the Chinese growth slowdown would create winners and losers. Big net commodity exporters such as Saudi Arabia, Brazil and Chile would face a severe drag on activity, while low commodity prices would benefit net importers with weak trade links with China (first and foremost India).

¹ The Global Economic Model built and maintained by Oxford Economics



EM opportunities: FX looks vulnerable

The reaction of EM markets to the Chinese slowdown and the recently announced stimulus measures has been heterogeneous across regions and asset classes. We expect divergent reactions in the EM complex to our two scenarios.

Downside scenario: EM FXs under pressure

In our downside scenario, there are clear differences between energy exporters/importers and between North Asia and the rest of the world. EM FXs will likely be the most sensitive asset class:

- Latin American commodity exporters such as Chile and, to a lesser extent, Colombia and Brazil are the most vulnerable. Chile, through copper exports to China, is the most sensitive and has reacted strongly to changes in Chinese sentiment in the past.
- North Asian currencies will be under pressure following the CNY depreciation. However, the Chinese authorities have been reluctant to let the CNY depreciate in H2 and so the move can be gradual. KRW should underperform in the region.
- In Europe, the CZK would underperform given its trade openness and exposure to the automotive sector.
- The TRY is likely to be one of the few beneficiaries, thanks to a shrinking current account deficit via lower oil prices, as the energy balance accounts for almost 2/3 of the trade deficit.

For EM external debt, the impact is more indirect. More global deflation may put downward pressure on global interest rates and thus on the duration of EM external debt, supporting returns in this asset class. At the spread level, the short-term impact is likely to be less pronounced than on FX. For sure, hopes around the Chinese stimulus launched in September have supported the spread rally. That said, spreads were also able to compress meaningfully in H124 without the help of China. In the long term, a persistent negative narrative on China will be more problematic. It will continue to discourage

investors from investing in the EM universe, limiting the inflows into the asset class that have been scarce over the past two years.

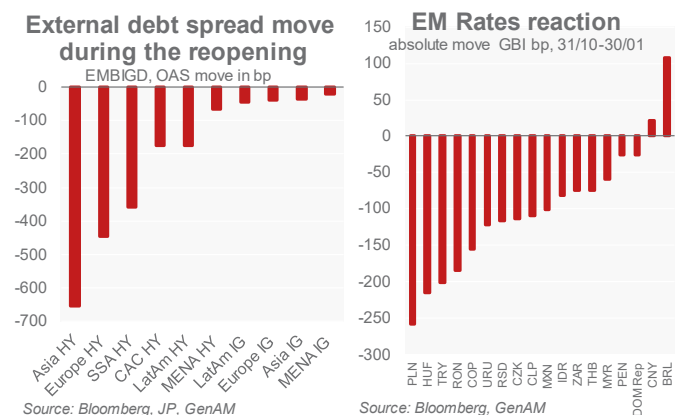
At a country level, the impact on country spread is manageable. LatAm and, to a lesser extent, Asia will underperform. Indeed, local dynamics will continue to trump the Chinese slowdown and Asian countries have already high ratings and tight spreads, leaving them less vulnerable. The impact on Saudi Arabia could be more significant if oil prices fall further. The Saudi Arabian complex (KSA and PIF) has been the largest issuer so far this year, and questions remain about the effectiveness of the Vision 2030 program. Other energy exporters such as Qatar will not be completely immune, but the level of debt supply is much less important and so the impact.

For local debt, we would expect the front-end rates to decline and the local curve to steepen. Chinese slowdown provides more room for further easing, while EM central banks are nearing the end of their easing cycle. Asian central banks are behind in the monetary cycle, the recent Fed move has provided a buffer and a further Chinese slowdown will prompt them to ease. However, FX weakness will incite them to be cautious, especially South Korea and Indonesia.

In LatAm, the Brazilian BCB should not be deterred from tightening further. It is in the process of building credibility. In Mexico, the Banxico is unlikely to be sensitive and some risk premium in rates is needed given the political transition and the new US president. In CEEMEA, the impact is more limited, and we would prefer the South African curve given its steepness, high real yield, exposure to China via metal exports and the start of the easing cycle.

Upside scenario: more broad-based positive effects

In the upside scenario, globally, we would expect a little less differentiation as the better Chinese and global EM narrative would support inflows into the whole EM asset class. It should also help global risk appetite, so we would expect the riskiest part of the EM spectrum to outperform.



If history is a guide, a comparable template would be the reopening period in late 2022 when the Chinese equity market bottomed out (low on 30 October 2022, high on 30 January 2023).

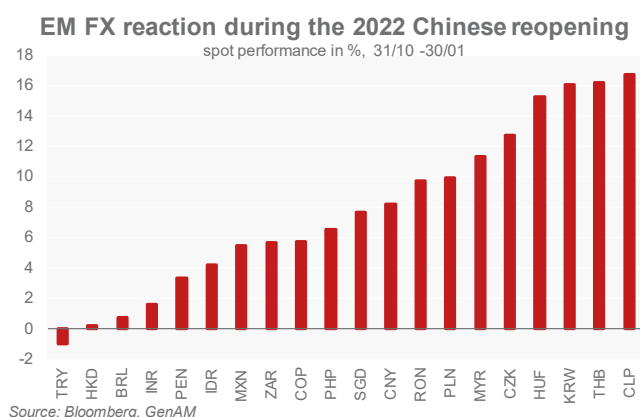
At the asset class level, external debt and local debt performed almost identically. Within external debt, the HY portion outperformed, in particular Asia HY and Europe HY. MENA and oil exporters were not the best performers, even though spreads tightened. Sure, better oil prospects in an upside scenario would lead to less fiscal pressure, but the question is more about long-term diversification.

For local debt, EM rates surprisingly fell on average, but they benefited from the first drop in inflation and hopes of a Fed pivot at that time. EM central banks are now well advanced in their easing cycle, and we would rather expect rates to rise again, especially in Asia. Indeed, Asian central banks have maintained a cautious approach and would have less incentive to tighten.

As in the downside scenario, EM FX would be the most sensitive and should rebound strongly. During the Chinese reopening, the most open economies such as the CZK, HUF and KRW benefited the most. High yielders such as the ZAR, MXN and BRL underperformed. Surprisingly, the CLP did not rally as much as the copper price move would have suggested. The current environment is somewhat different. This time, we would focus on the Asian open economies, CEE, CLP and ZAR (positive political narrative) to benefit from better risk appetite. BRL and MXN should remain on the back foot due to their own local dynamics.

Conclusion

After a prolonged slowdown, the Chinese authorities have promised bolder initiatives. These have mostly materialized on the monetary side, On the fiscal side, the ministry of the economy has detailed the list of measures, which include infrastructure investment, bank recapitalisation and support to the housing market, but has so far stopped short of quantifying the size .To quantify the downside risks associated with the lack of sufficient action, we have simulated a tail scenario in which a further deterioration hits global prices, especially oil and industrial commodities. In such a scenario, EM FX would be under pressure, and we would stay away from countries more integrated with China and oil producers. External debt spreads widening should generally be contained, though. We have also simulated the impact of a generous fiscal stimulus and show that the impact on Chinese GDP could be short-lived, while globally the benefit of close integration with China is often offset by the inflationary hit from higher commodity prices. Local and external debt should perform strongly, with less differentiation than in an adverse scenario. EM HY spreads will continue to tighten, and EM rates will rebound, especially on the front end. EM FX will remain the most sensitive, with open economies benefiting the most.



 **Imprint**

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