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CHINA'S SOCIAL CONTRACT HAS CHANGED

...FED NORMALISATION TO TEST THE NEW PARADIGM

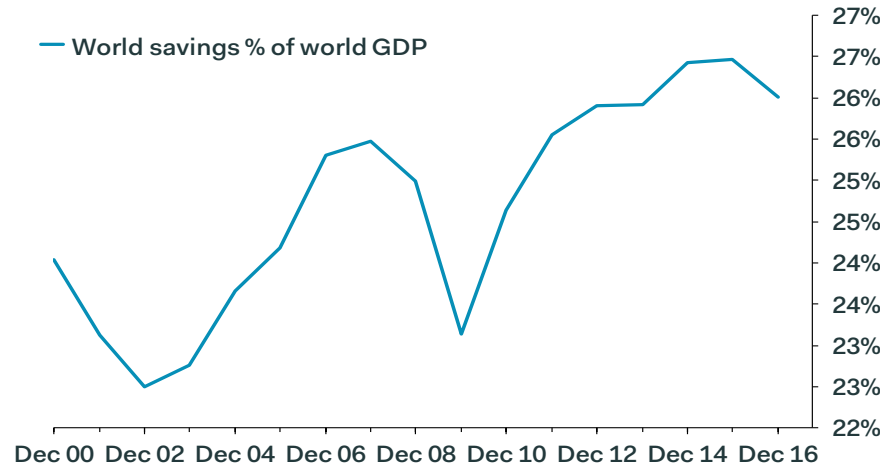
ASIA CHARTBOOK, NOVEMBER 2017

DATA AS AT NOVEMBER 21 | FREYA BEAMISH, CHIEF ASIA ECONOMIST
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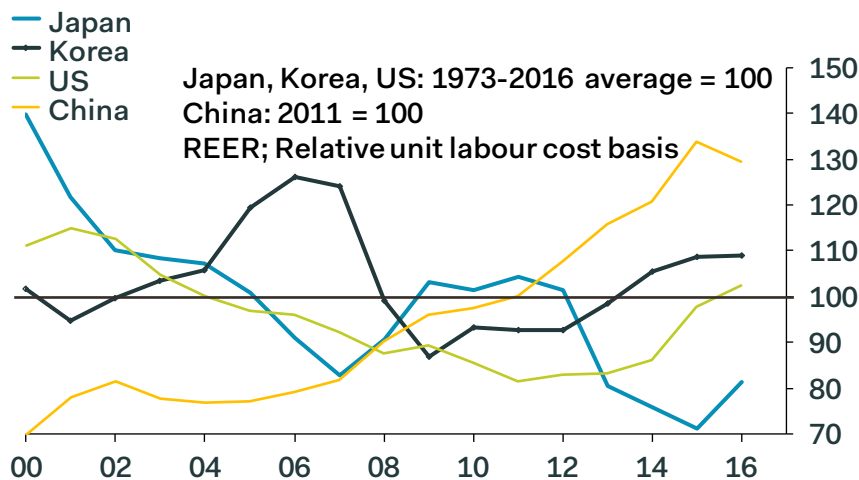
Summary

- **The Chinese Communist Party Congress confirmed that the social contract has changed.** Historically, China's leaders had to deliver fast GDP growth to stay in power. This year marks a paradigm shift in which policymakers switch from GDPism—the obsession with GDP targets—to environmentalism, with wide sweeping environmental targets now a key part of political career progression for local government officials. The implications of the “war on pollution” are real and present, with the authorities struggling to avoid a winter pollution spike; shutdowns of production and construction in the northern cities could push real GDP growth a bit below the 2017 target of around 6.5% year-over-year. The authorities likely will print an above-target figure regardless.
- Quarterly real GDP growth should rebound in Q2 as production and construction come back online. But China is now much more sensitive to interest rates than in the past, and the authorities' reticence to allow significant RMB depreciation will mean domestic rates have further to rise, crimping domestic demand. **China cannot stomach the extent of domestic rate rises necessary to keep the RMB stable, however, and markets are under-appreciating the risks of another step down in the currency.** The property market is particularly exposed.
- **Japanese domestic demand should rebound in Q4, with weakness in Q3 merely correcting unsustainable growth in Q2.** The reversal was evident across the board and the LEIs are looking good for a stabilisation in Q4. Real GDP growth still should slow in Q4, though, as exports face headwinds from weakening demand in China and the lagged effect of the hurricanes in the U.S., while imports should rebound, in line with domestic demand. Growth, nevertheless, will come in around trend, so capacity will remain tight.
- **Korean exports show volumes growth likely is slowing in Q4.** The country sits near the beginning of the global supply chain and publishes early in the calendar so the slowdown could herald softer export growth for Japan as well. The preliminary data are volatile so we wait for further evidence to confirm, but a weakening of exports will give the BoK pause before attempting to follow the Fed up next year. Exports should rebound in the first half but domestic demand is sensitive to the likely rise in long-end yields.

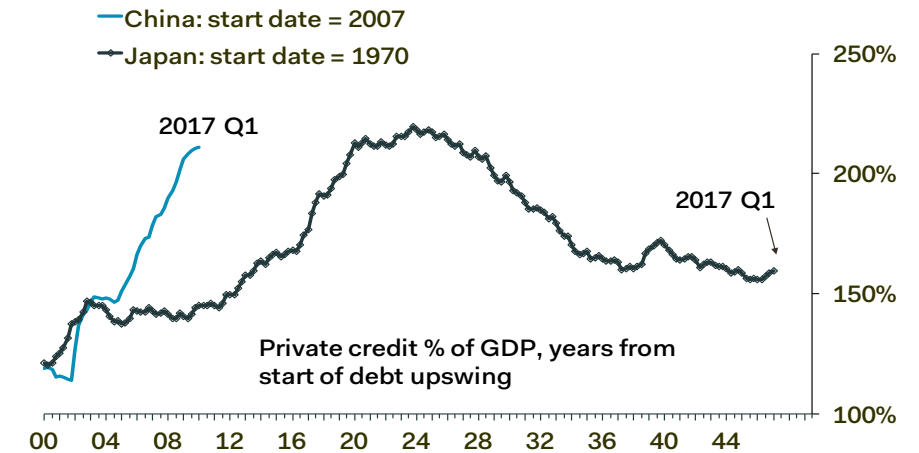
1. EXCESS SAVERS FINALLY FORCED TO BEAR THEIR OWN BURDEN



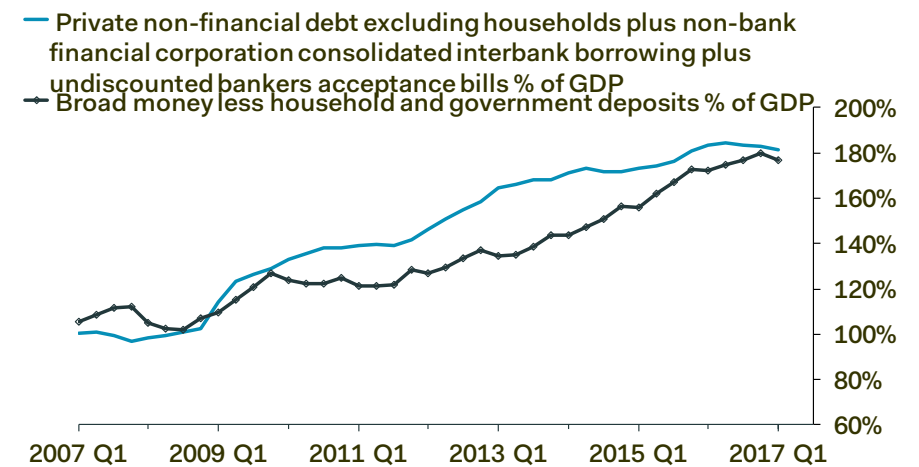
2. THE RMB REMAINS OVERVALUED, RENDERING CHINA UNCOMPETITIVE



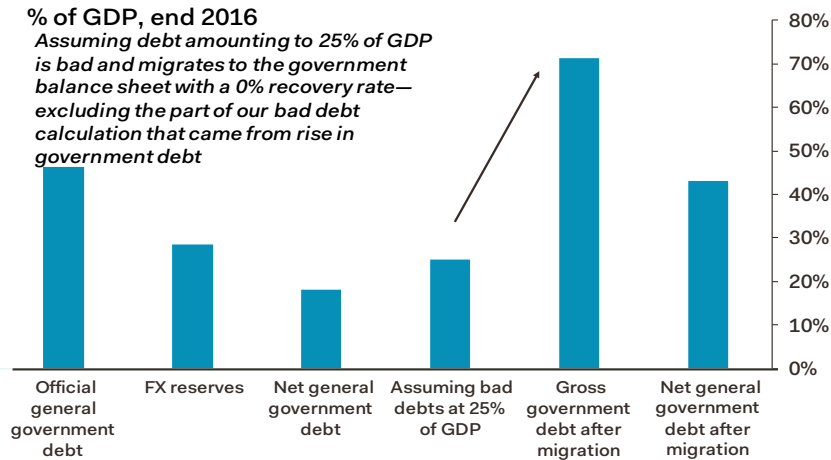
3. CHINA WILL BE HARD-PUSHED TO AVOID THE JAPAN TRAJECTORY



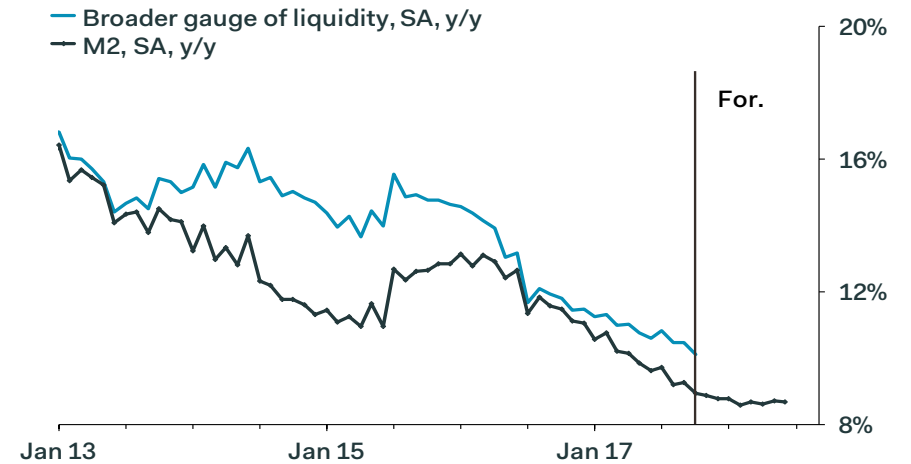
4. CORPORATE/STATE DEBT RATIOS HAVE LEVELLED OFF



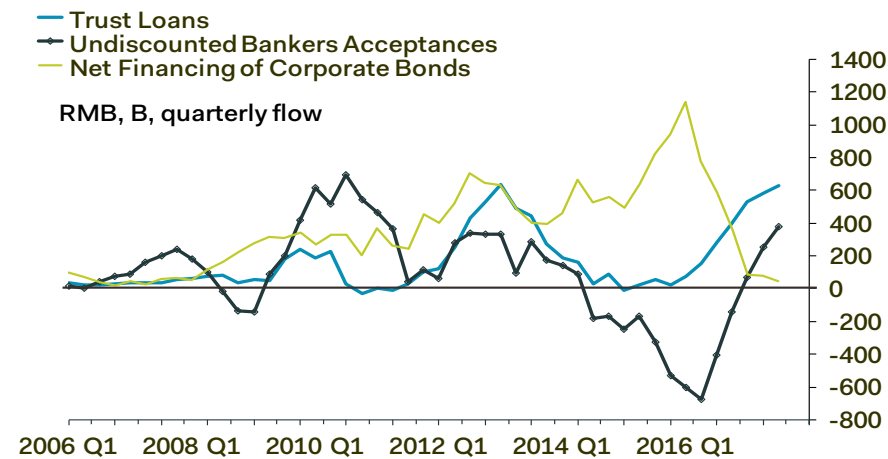
5. THE GOVERNMENT STILL HAS SPACE ON ITS BALANCE SHEET



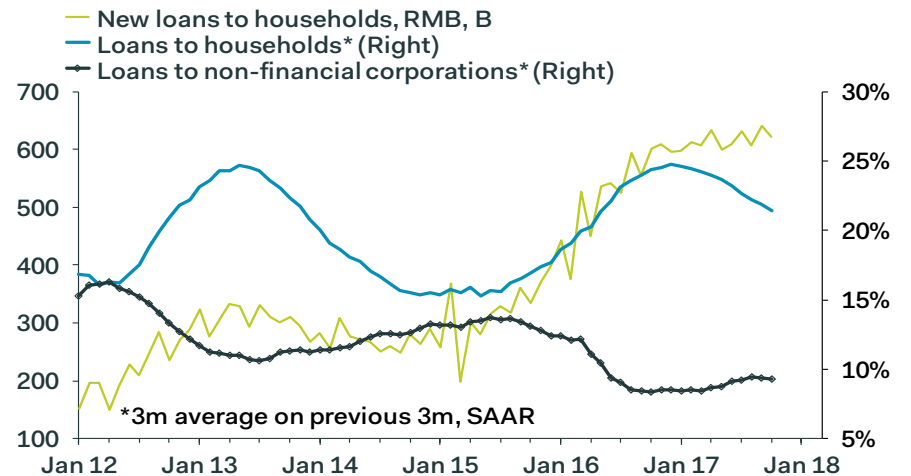
7. MONEY GROWTH IS SLOWING, EVEN INCLUDING SHADOW ACTIVITIES



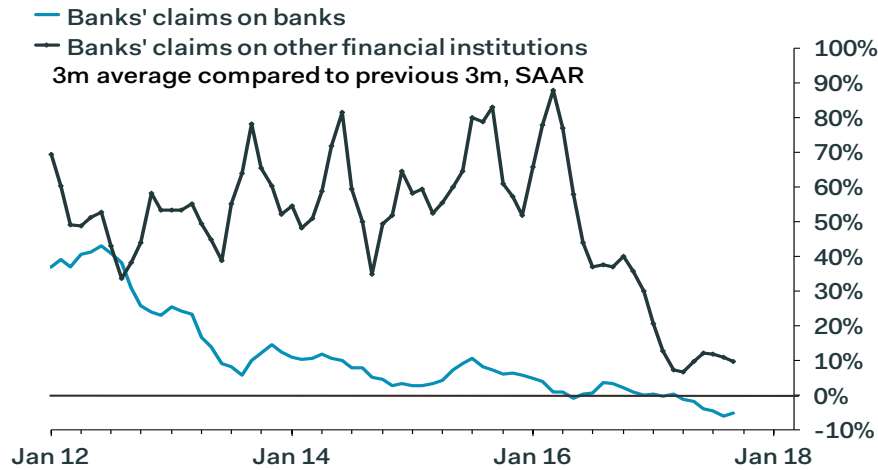
6. SHADOW BANKING IS ON THE RISE AGAIN



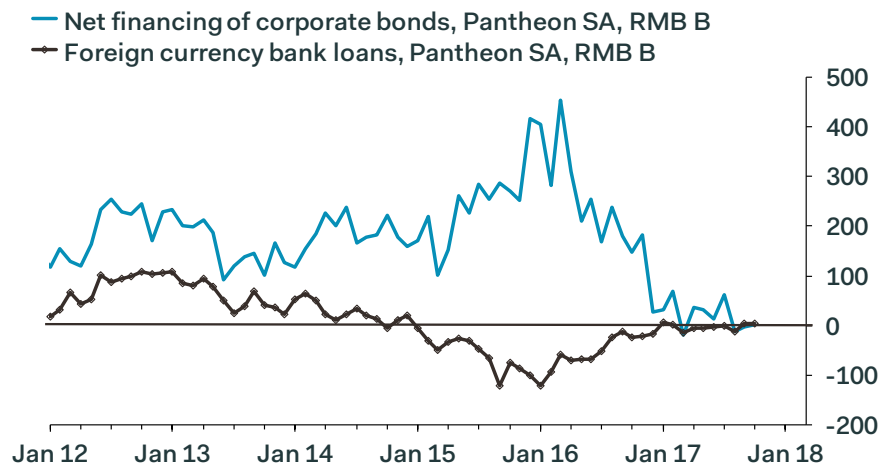
8. HOUSEHOLD DEBT GROWTH IS STILL RAPID, FOR NOW



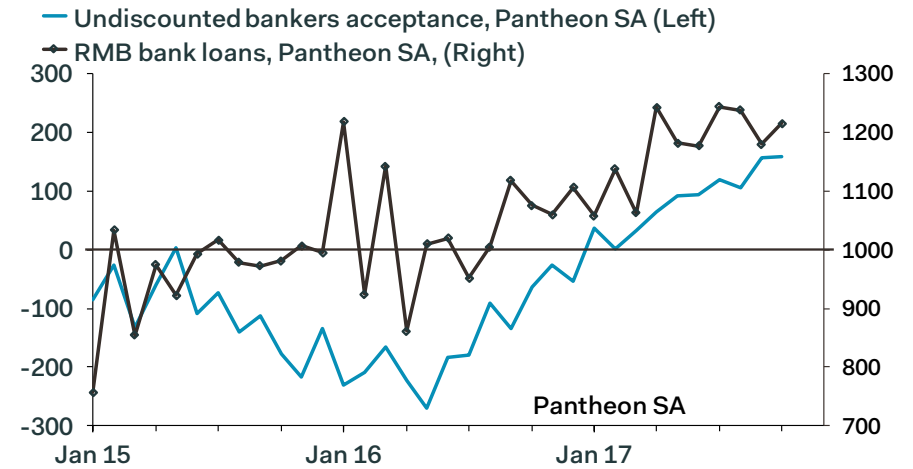
9. NBFIS HAVE STAYED OUT OF THE INTERBANK MARKET SINCE 2016



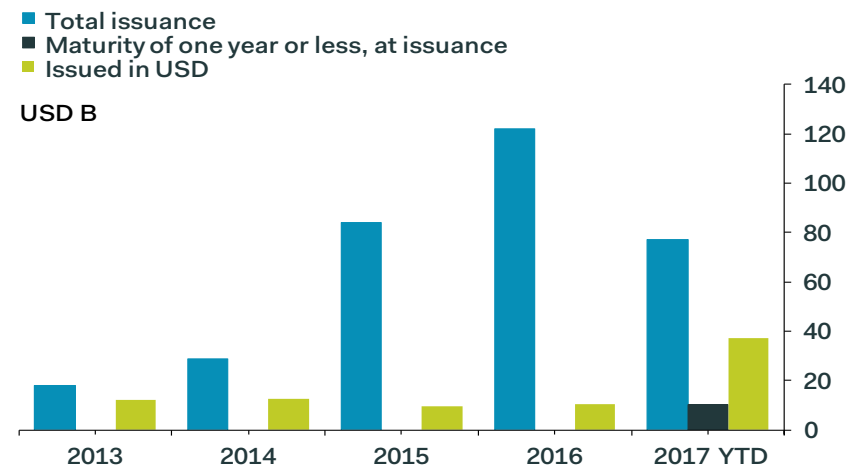
10. THE ONSHORE BOND MARKET IS TIGHTENING...



11. ...NFCs HAVE HAD TO RATCHET UP THEIR OWN BORROWING, AGAIN

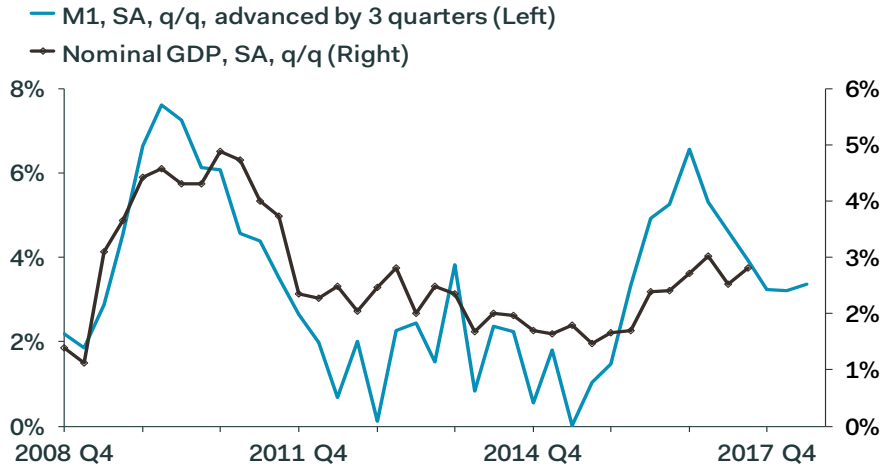


12. ...AND DEVELOPERS HAVE INCREASED OFFSHORE ISSUANCE

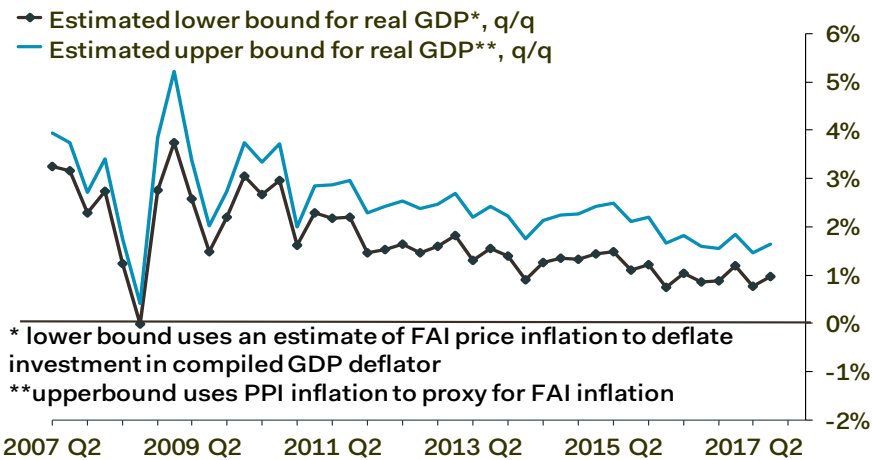




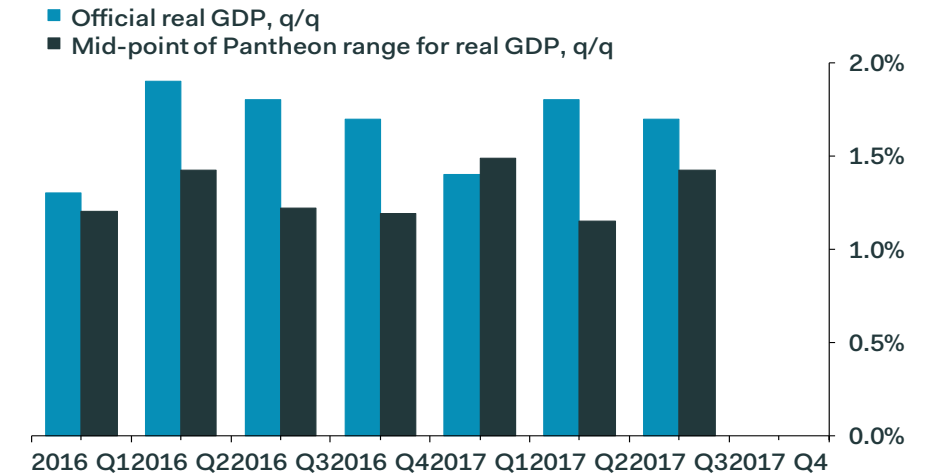
13. NOMINAL GDP GROWTH WILL TREND DOWN



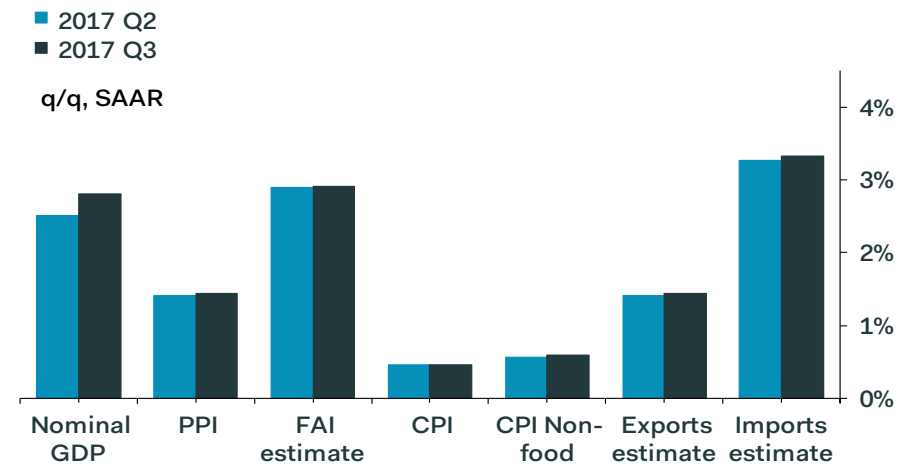
14. CHINA'S STRUCTURAL SLOWDOWN IS CLEAR



15. Q3 REAL GDP GROWTH PICKED UP BUT Q4 WILL BE WEAK AGAIN

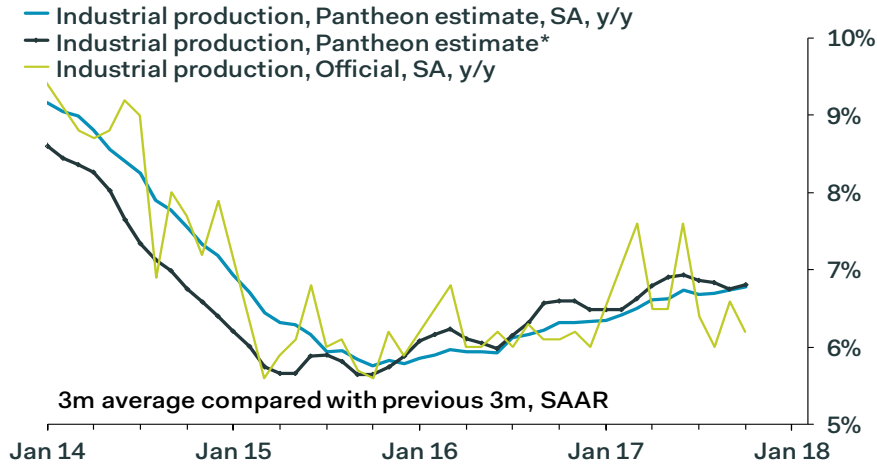


16. PRICE INCREASES MAINTAINED MOMENTUM IN Q3

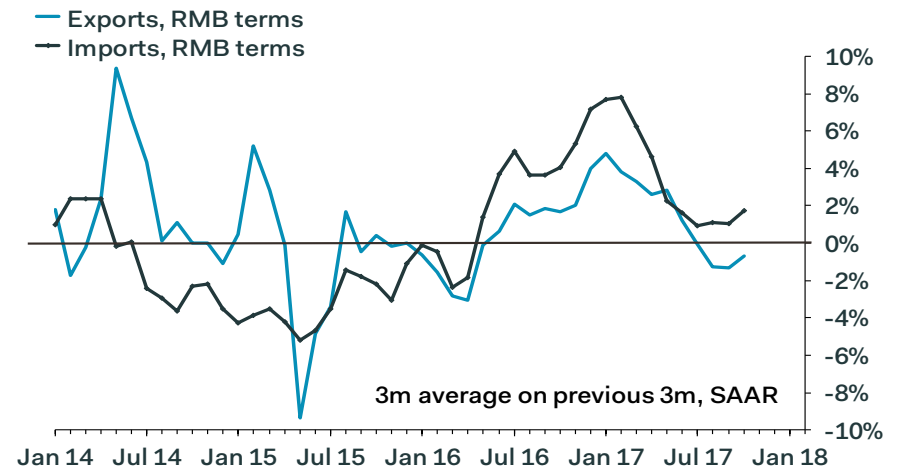




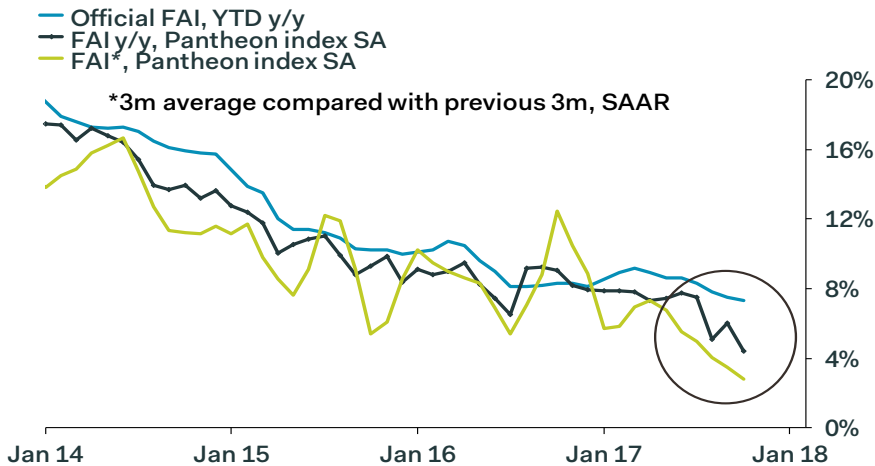
17. PRODUCTION WILL BE DAMAGED BY ANTI-POLLUTION CURBS IN Q4



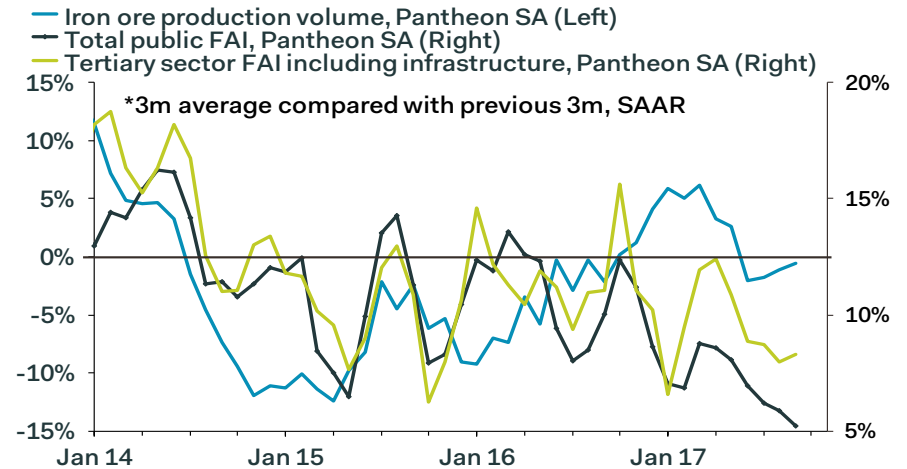
19. EXPORTS HAVE BEEN DAMAGED BY RMB OVERVALUATION



18. FAI GROWTH IS SHOCKINGLY WEAK, BUT THE DATA ARE UNRELIABLE

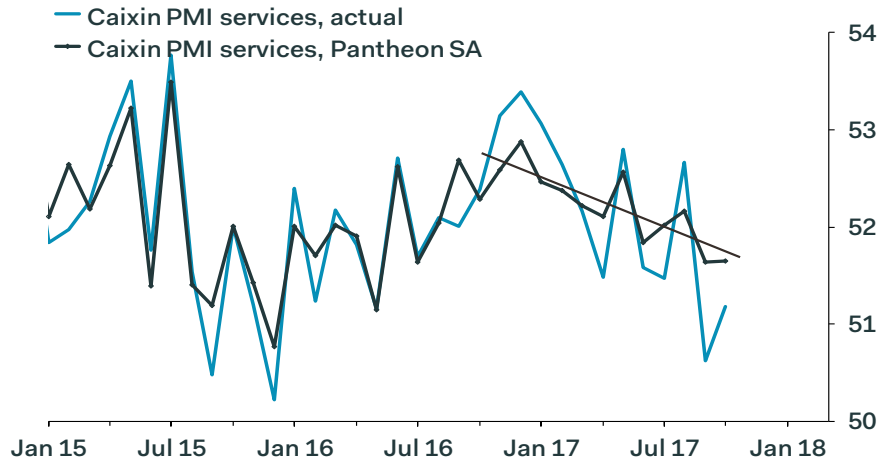


20. OLD-GUARD GOVERNMENT SPENDING HAS SLOWED SINCE Q2

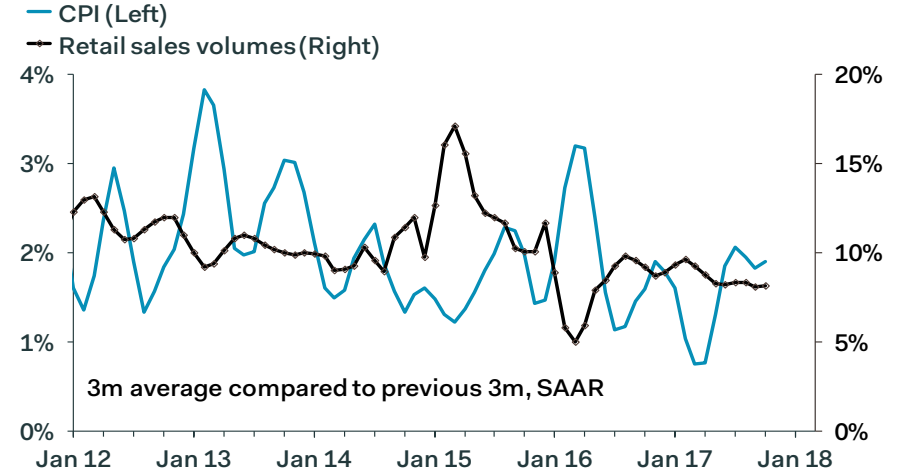




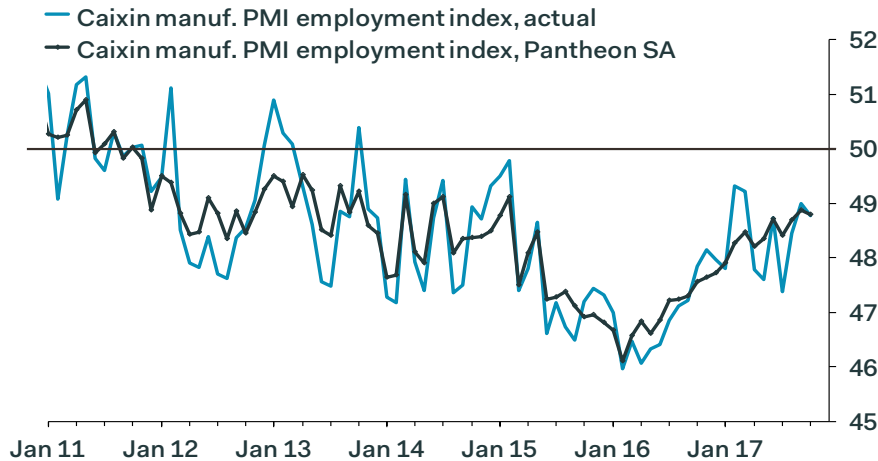
21. SERVICES PMI TICKED UP IN OCTOBER BUT THE DOWNTREND IS CLEAR



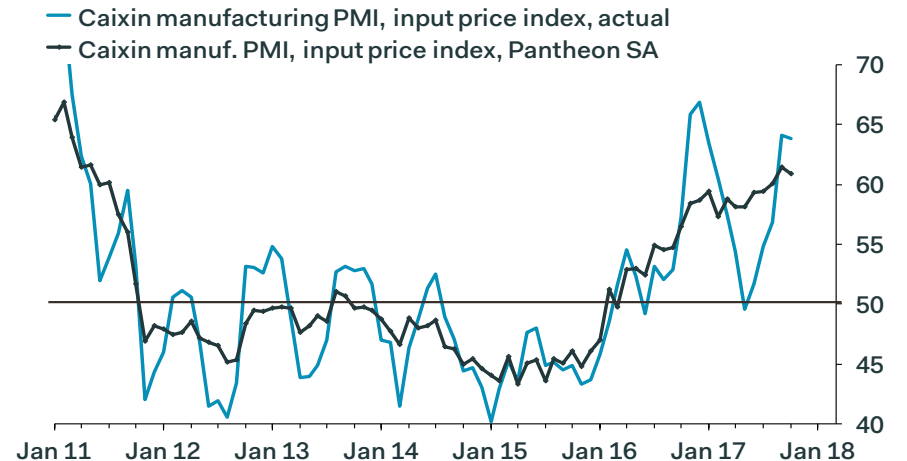
23. RETAIL SALES VOLUMES GROWTH IS HOLDING UP, FOR NOW



22. MANUFACTURING IS ON A PRODUCTIVITY DRIVE

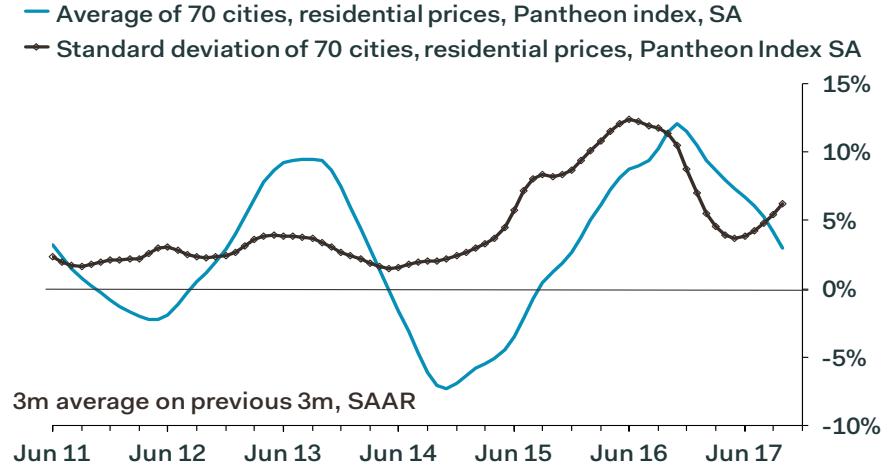


24. INPUT PRICES RISES MEAN LITTLE ROOM FOR FASTER WAGE GAINS

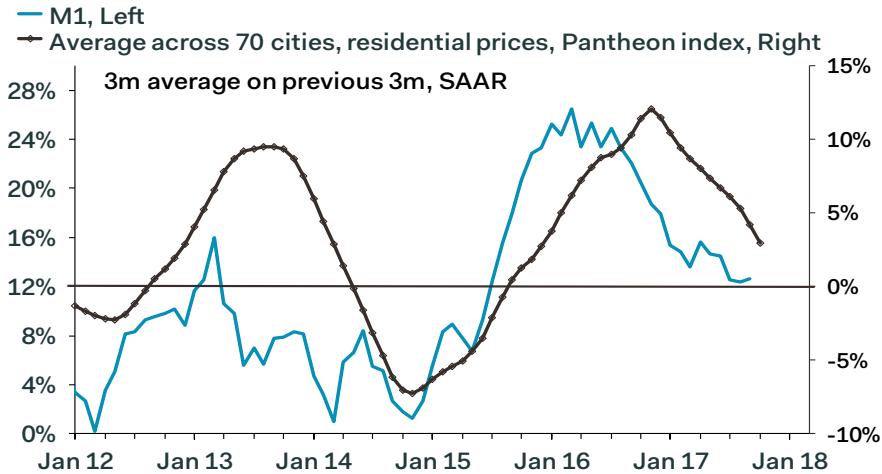




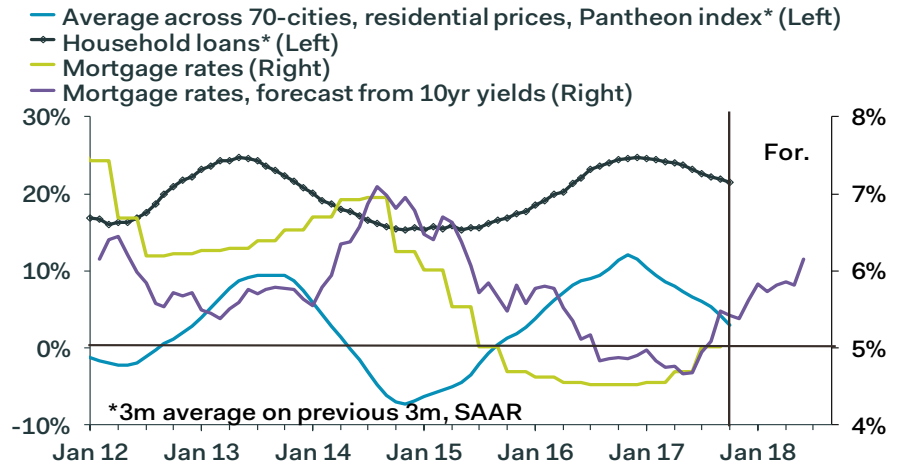
25. DIVERGENT CITIES PRESENT A POLICY CHALLENGE



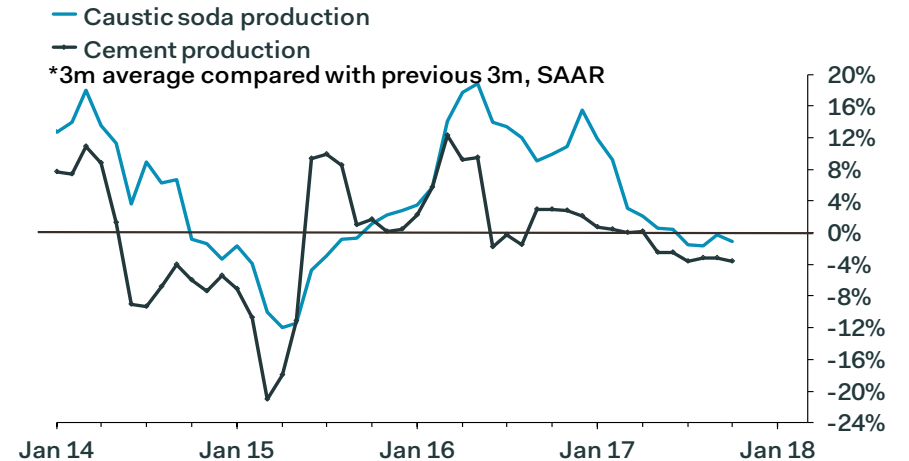
26. MONETARY TIGHTENING MEANS PROPERTY TO SLOW INTO 2018



27. MORTGAGE RATES SET TO RISE SUBSTANTIALLY NEXT YEAR

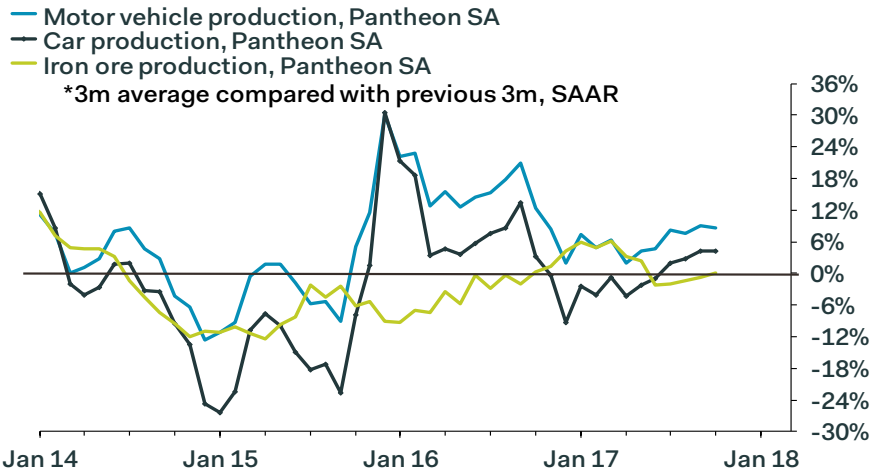


28. ANTI-POLLUTION CURBS WILL DEPRESS CONSTRUCTION ACTIVITY

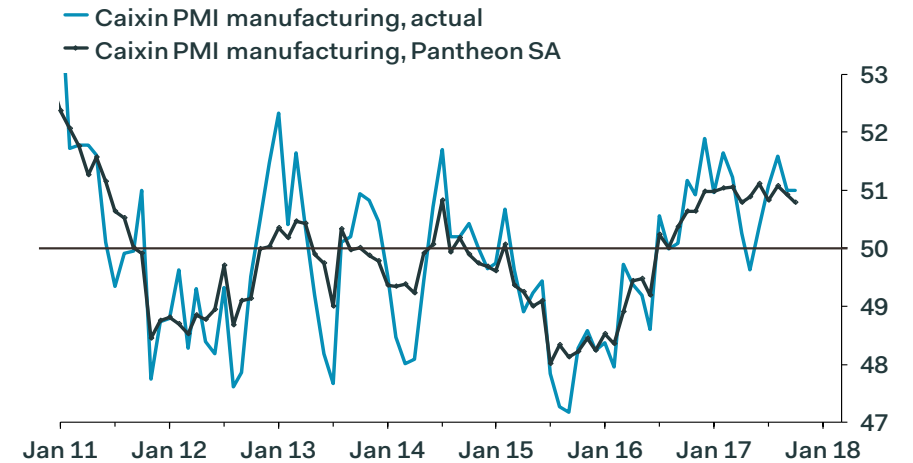




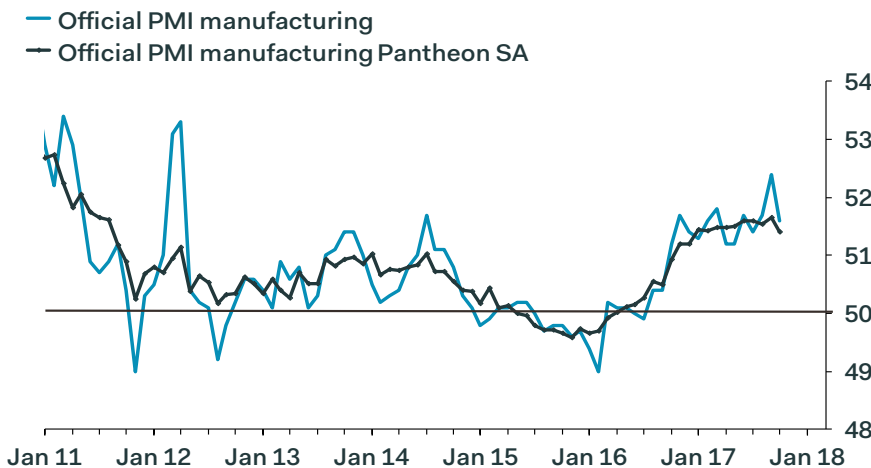
29. VEHICLE PRODUCTION IS PROVING A BASTION OF STRENGTH



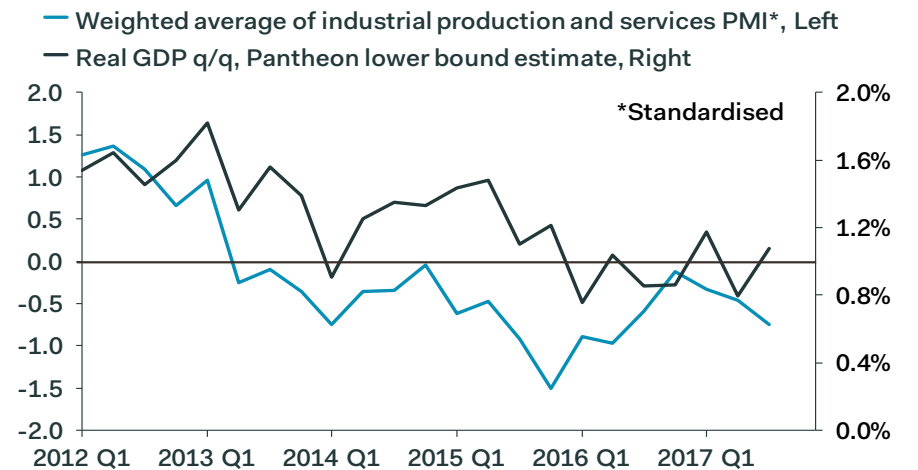
31. ...THOUGH SMALLER FIRMS ARE DOING LESS WELL



30. MANUFACTURING STILL IS ROBUST...

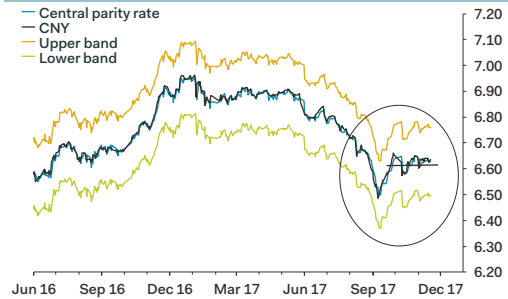


32. BUT INDUSTRY AND SERVICES LOST MOMENTUM OVERALL IN Q3

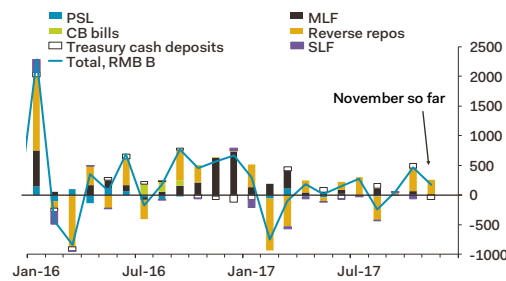


PBOC DASHBOARD

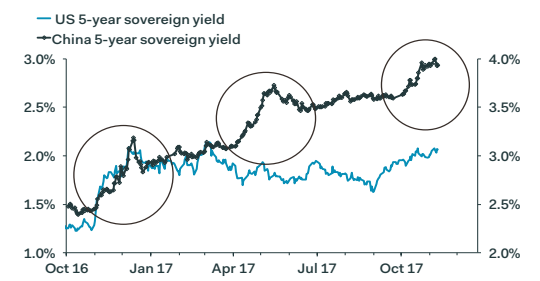
33. PBOC CANNOT MAINTAIN RMB STABILITY



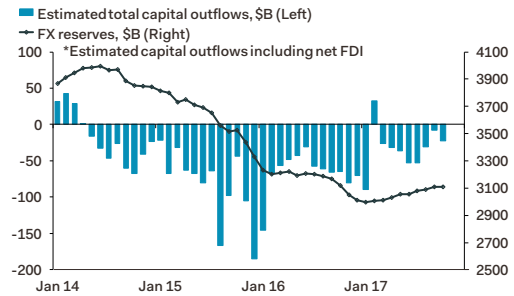
36. THE PBOC HAS A WIDE ARRAY OF TOOLS



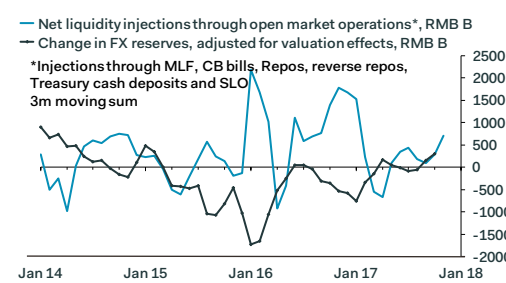
39. PBOC ALLOWS RATES TO RISE AHEAD OF FED



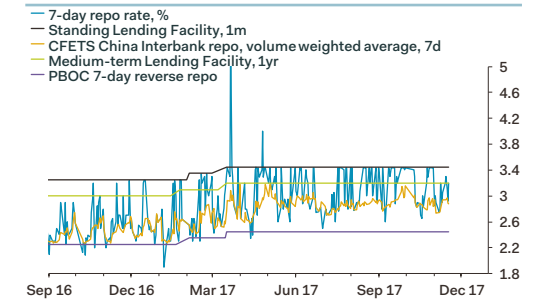
34. FX RESERVES TO START FALLING AGAIN



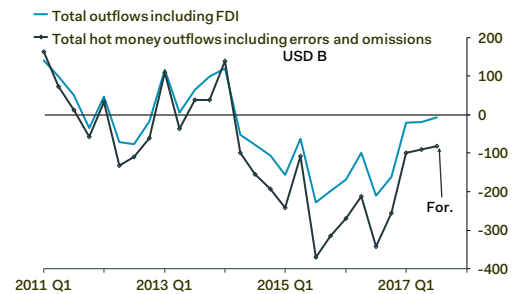
37. LIQUIDITY INJECTIONS IMPLY FALLING FX RESERVES



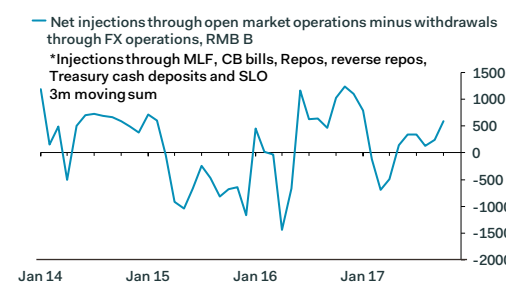
40. PBOC KEEPING INTERBANK RATES DOWN



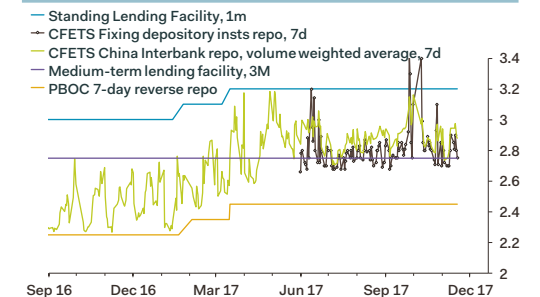
35. CAPITAL OUTFLOWS TO PICK UP AGAIN



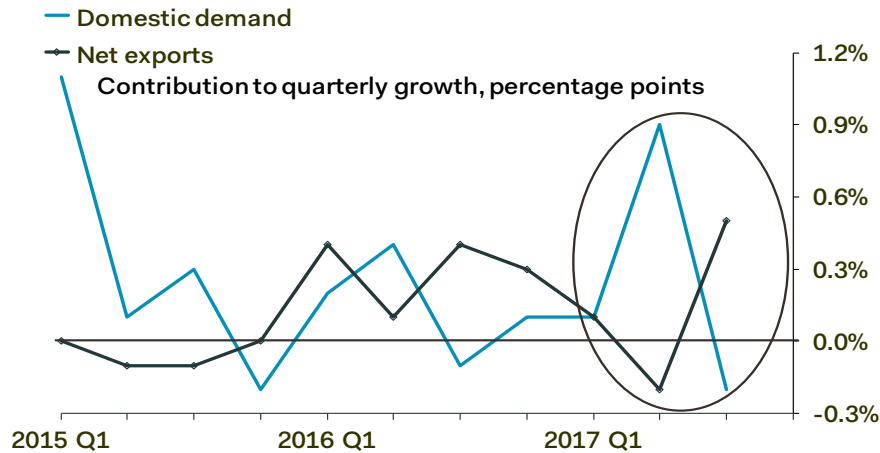
38. OVERALL NET INJECTIONS HAVE PICKED UP



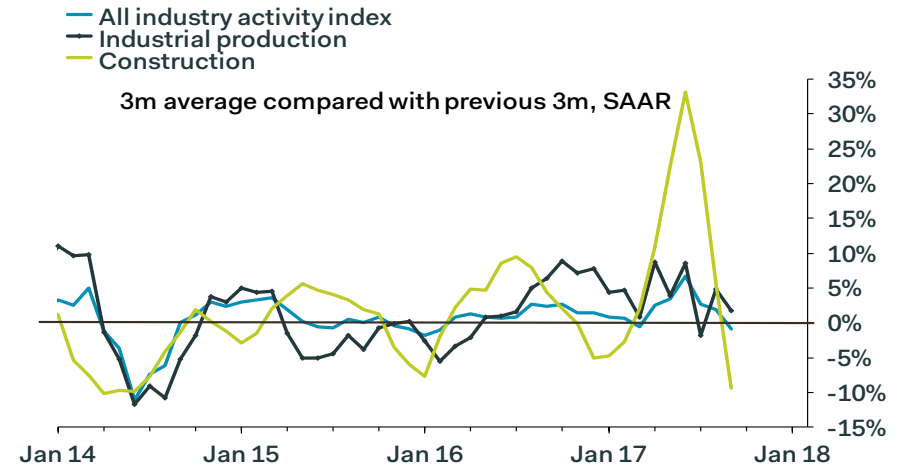
41. ...THOUGH BANKING STRESSES BUBBLE



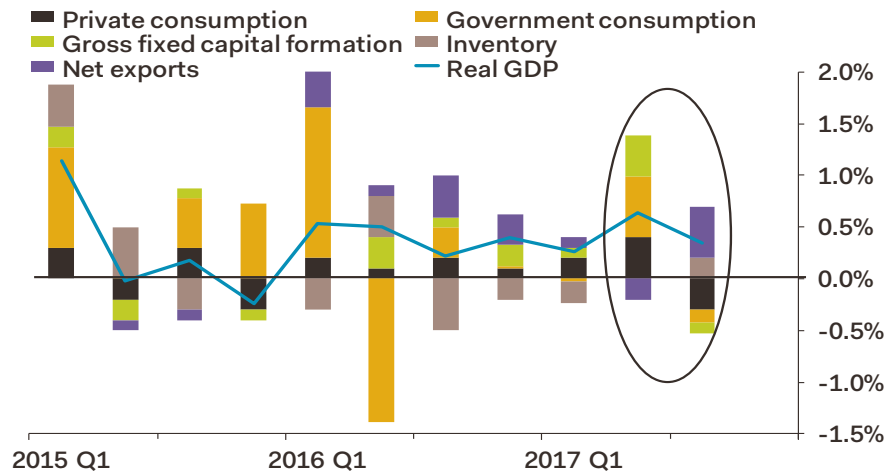
42. SLOWER JAPANESE Q3 GDP GROWTH CORRECTED Q2 OVERSHOOT...



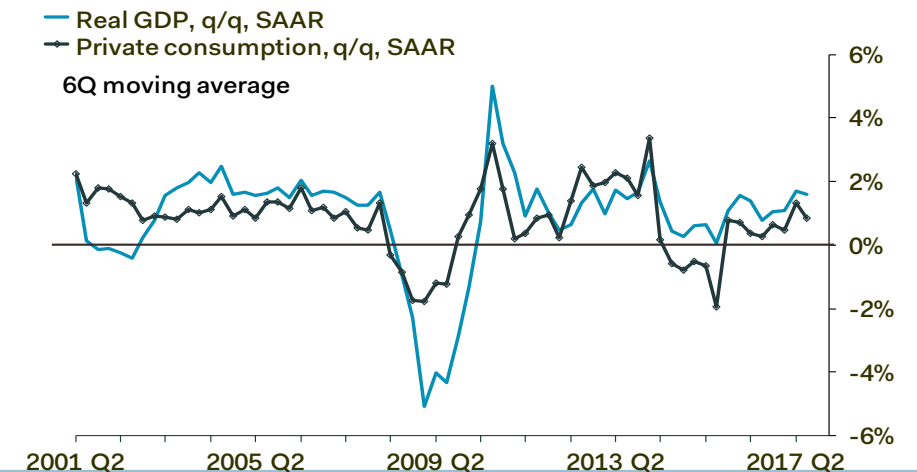
44. CONSTRUCTION ACTIVITY HAS BEEN PARTICULARLY VOLATILE



43. ...WITH THE REVERSAL EVIDENT ACROSS THE COMPONENTS OF GDP

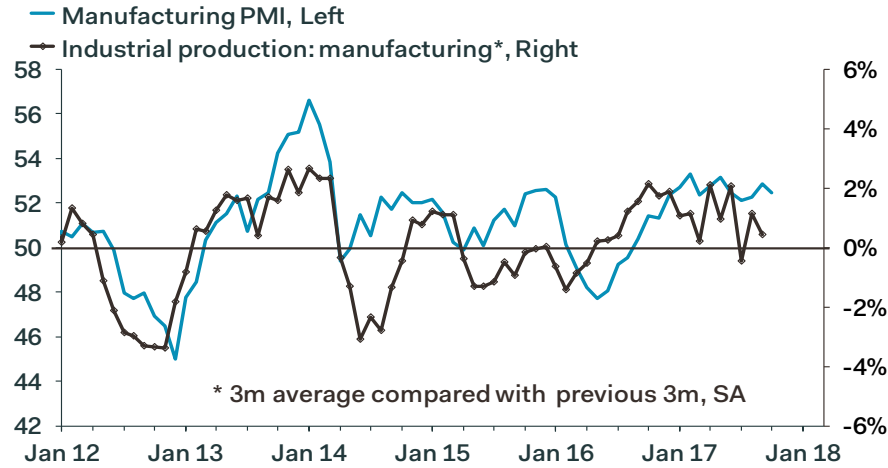


45. PRIVATE CONSUMPTION TREND IS STRONG

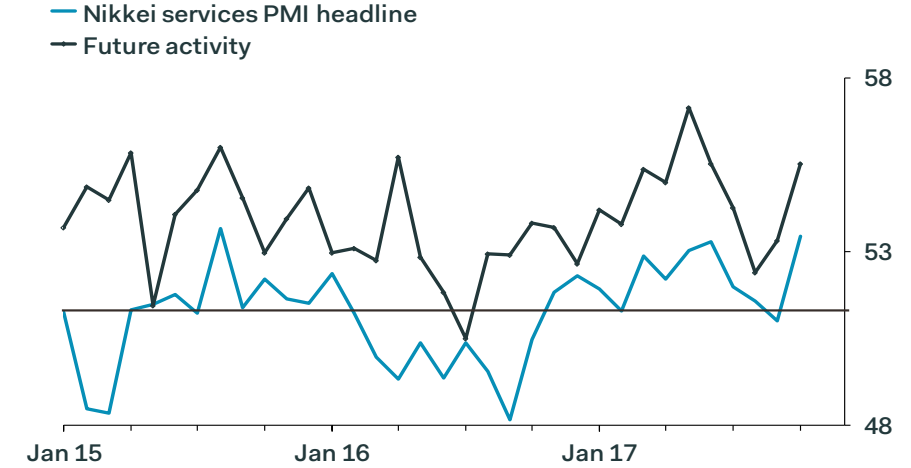




46. THE MANUFACTURING PMI POINTS TO REBOUNDED PRODUCTION



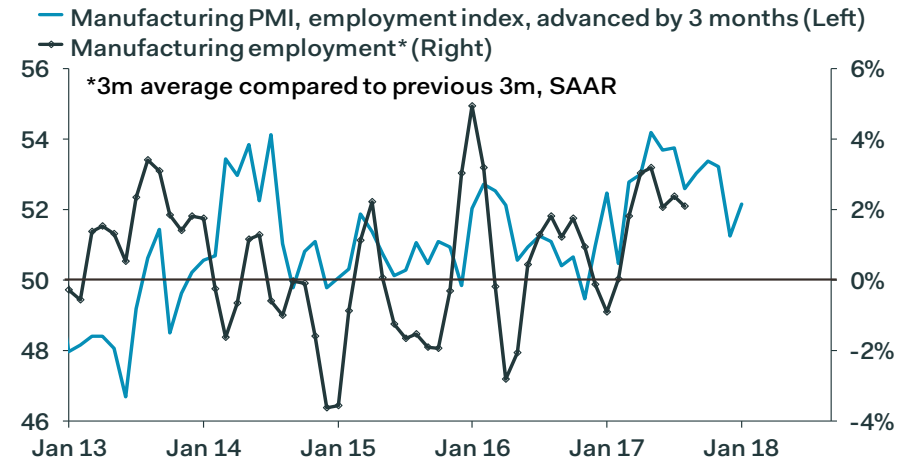
48. SERVICES SHOULD REBOUND IN Q4



47. EXPORTS FACE NEAR-TERM HEADWINDS

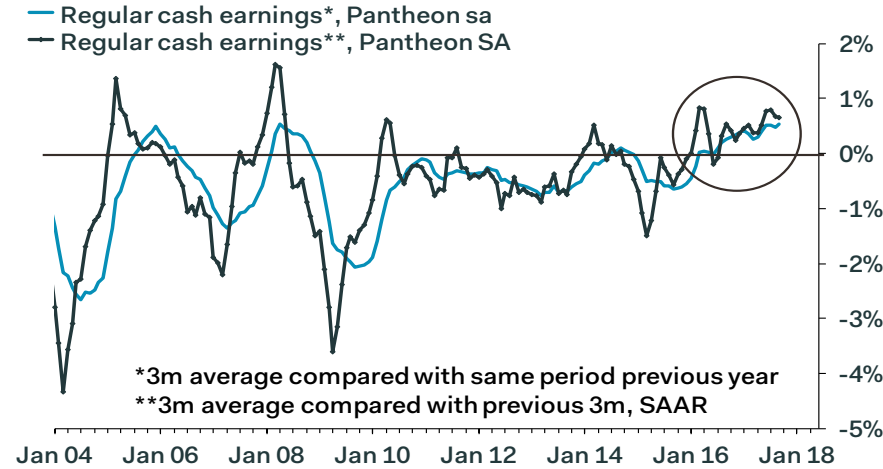


49. EMPLOYMENT GROWTH WILL SOFTEN BUT STILL REMAIN STRONG





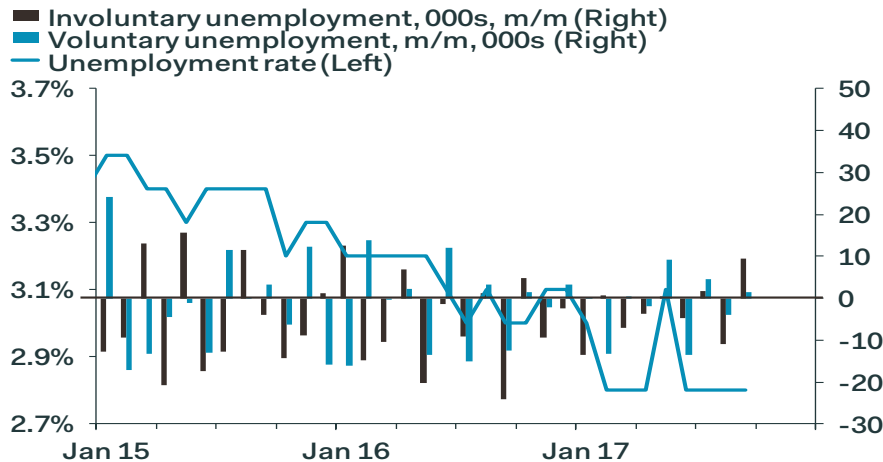
50. REGULAR CASH EARNINGS GROWTH IS RELATIVELY HIGH AND STABLE



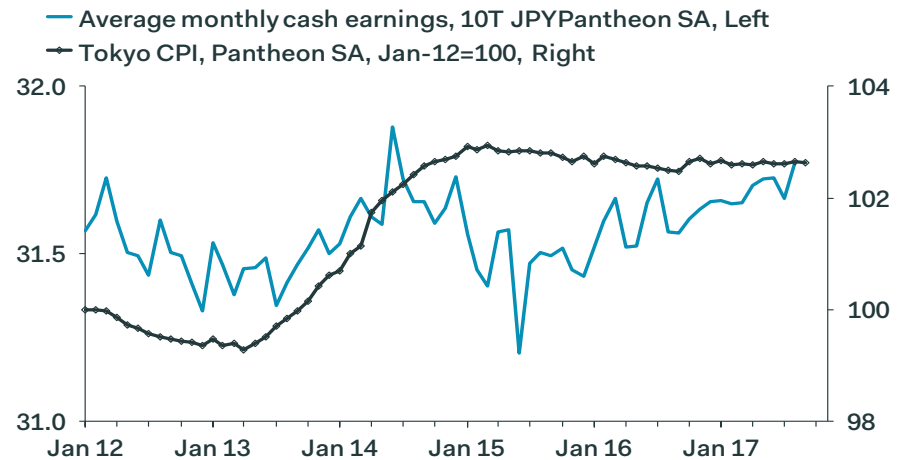
52. FIRMS ARE HAVING TO ENTICE WORKERS TO QUIT JOBS



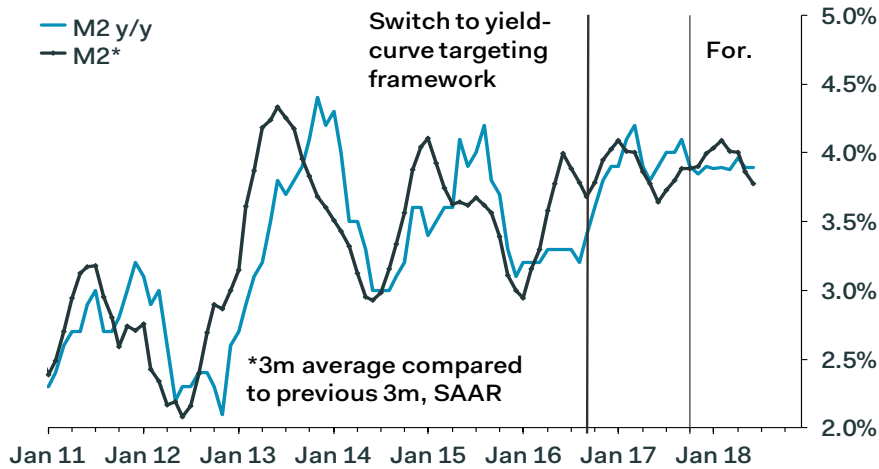
51. EMPLOYMENT GROWTH IS CAPPED WITH UNEMPLOYMENT SO LOW



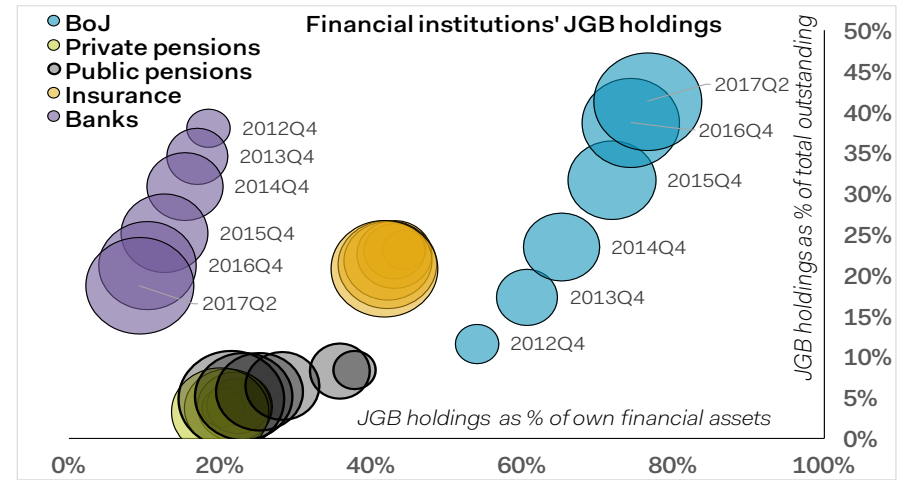
53. NO WAGE PRICE SPIRAL YET, BUT 2018 COULD SEE SOME UPLIFT



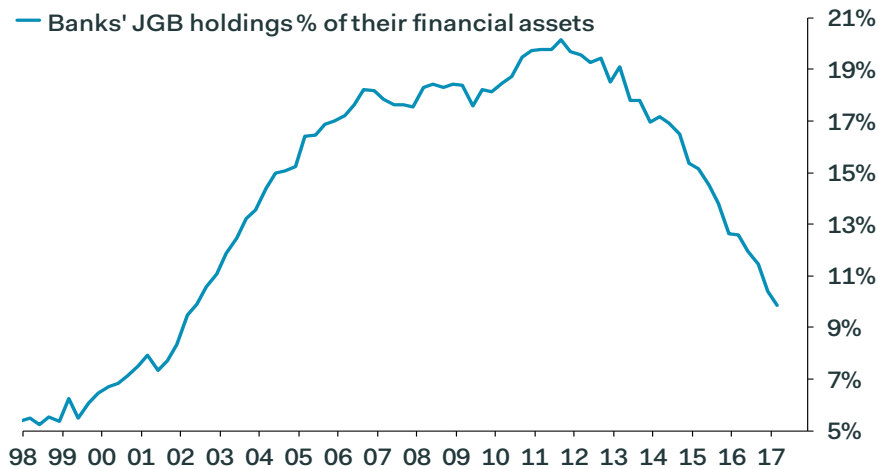
54. MONETARY CONDITIONS REMAIN LOOSE



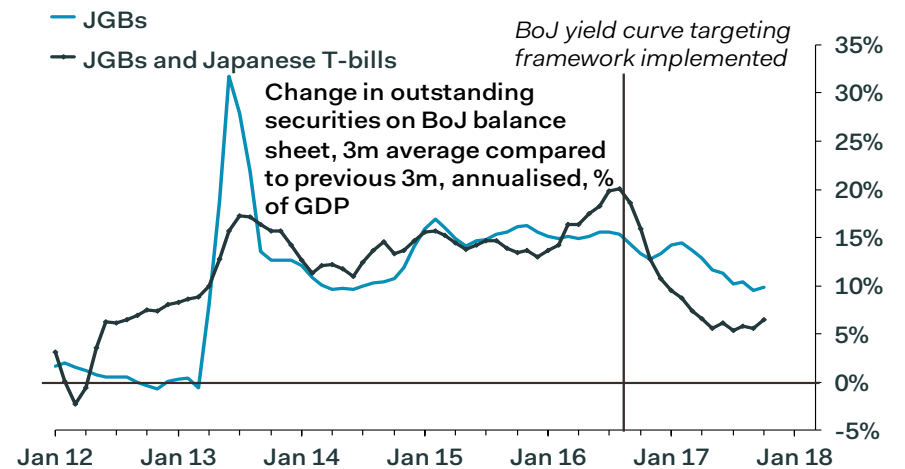
56. FINANCIAL INSTITUTIONS ARE HOBBLLED BY THE BOJ PROGRAMME



55. BANKS RUNNING OUT OF JGBS TO SELL

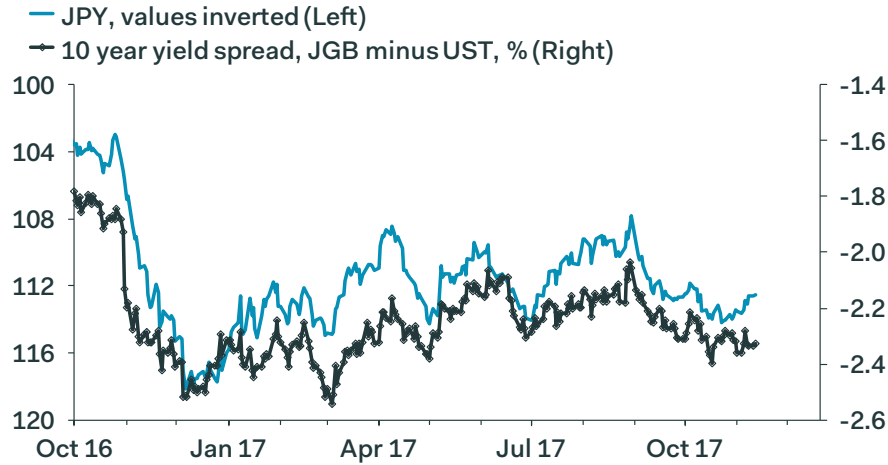


57. BOJ BALANCE SHEET EXPANSION HAS STABILISED FOR NOW

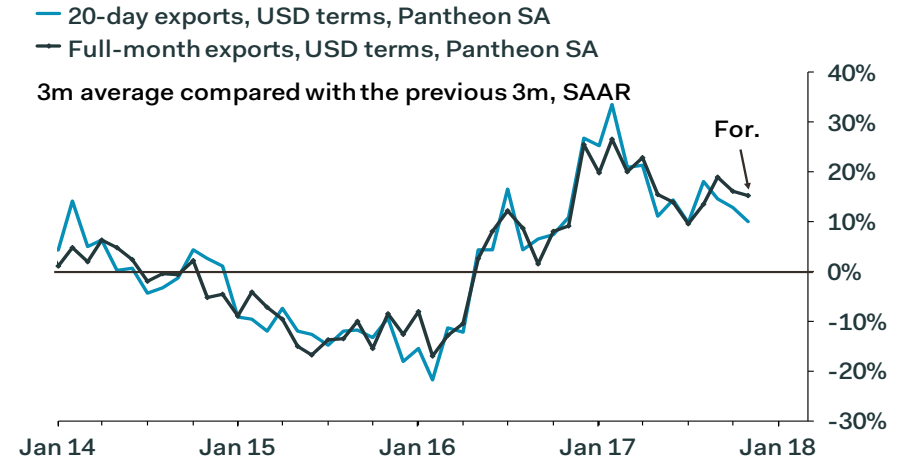




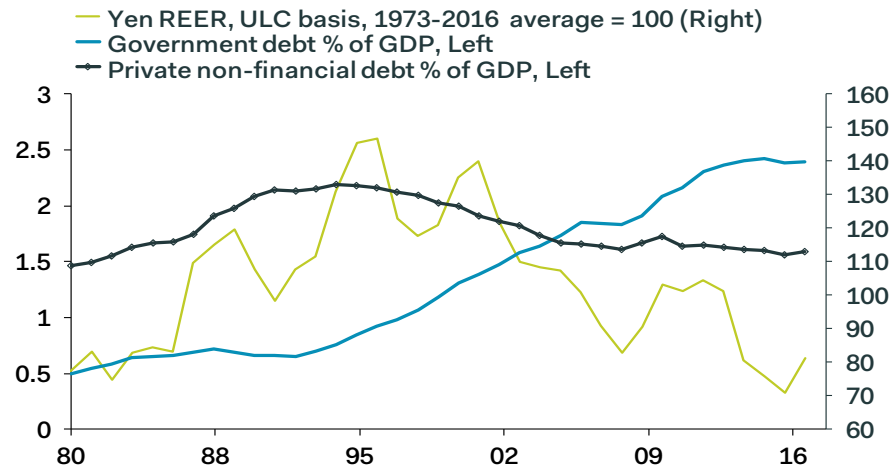
58. RATE DIFFERENTIALS ARE A POWERFUL GRAVITATIONAL FORCE



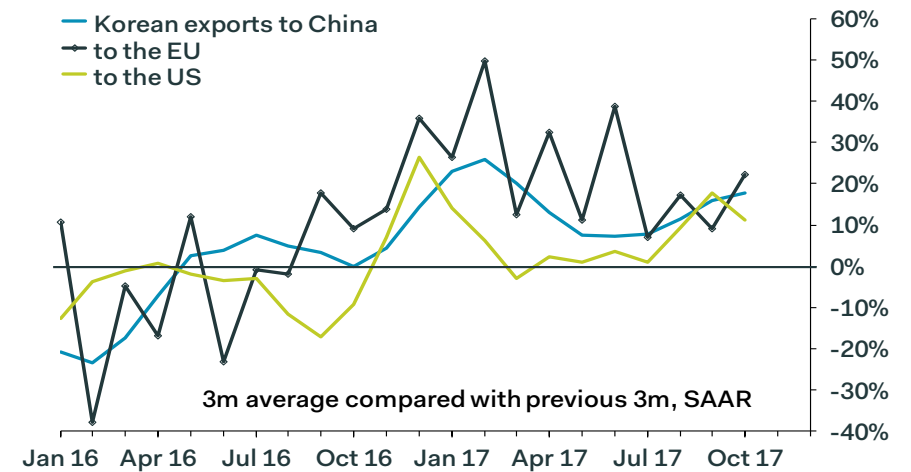
60. KOREAN EXPORTS ARE LOSING MOMENTUM AGAIN



59. JAPAN'S LESSON TO CHINA: HOW NOT TO AVOID A MINSKY MOMENT



61. EXPORTS TO THE U.S. COULD BE DAMAGED BY THE STORMS IN Q4



Economic Activity (y/y%)	2015	2016	2017	2018
China GDP				
Official	6.8	6.8	6.8	6.4
PM estimate	5.3	6.7	6.4	5.1
Japan GDP	1.1	1.7	1.4	0.9
Korea GDP	3.3	2.4	3.6	1.3

Prices

China				
CPI inflation	1.6	2.1	1.8	1.9
CPI excl. food inflation	1.1	2.0	2.4	2.5
PPI inflation	-5.9	5.5	5.7	3.7
Japan				
CPI inflation	0.2	0.3	0.7	1.2
CPI excl. food and energy inflation	0.8	0.0	0.1	1.2
Korea				
CPI inflation	1.1	1.3	1.9	1.6
CPI excl. agriculture and oil inflation	2.4	1.5	1.4	1.3

Monetary Policy and Financial Forecasts

PBoC 1-year Standing Lending Facility rate	3.25	3.25	3.45	3.65
BoJ Policy Balance rate	N/A	-0.10	-0.10	0.10
BoJ 10-year yield target	N/A	0.00	0.00	0.40
BoK base rate	1.50	1.50	1.50	1.50
China 10-year yield	2.85	3.10	4.00	4.50
Japan 10-year yield	0.30	0.05	0.08	0.50
Korea 10-year yield	2.10	2.10	2.60	3.10