IHS Markit

Economic commentary

10/08/2018

Week Ahead Asia-Pacific Economic Preview

- **China industrial production, retail sales and investment data**
- **Bank Indonesia policy meeting**
- **UK labour market update, including employee earnings**
- **US industrial production and retail sales**
- **Eurozone GDP**

The week ahead sees important official data updates to the health of the US and Chinese economies at the start of the third quarter, as well as UK labour market data and an update to Eurozone GDP. From a policymaking perspective, the spotlight rests in Indonesia, where the central bank meets to set interest rates in a climate of increasing pressure on emerging market currencies.

Our special focus this week takes a look at the extent to which the recent rise in SME lending poses risks to China's banking sector.

China economy in focus

In Asia, the main focus of the week rests with China, where official data relating to industrial production, retail sales and investment are published. The July data are expected to show little change on growth rates seen in June, with retail sales increasing 9.0% annually, outpacing industrial production growth, which looks set to pick up only modestly from the 6.0% rate seen in June. Urban investment growth looks set to hold steady at 6.0%.

As such, the data will add to signs that the Chinese economy is rebalancing away from industry and exports towards more domestic-consumption driven growth. The data come on the heels of the Caixin PMI surveys, which showed that the economy lost some momentum in July, with falling export orders leading the slowdown. The underlying PMI data pointed to a potential further slowing in growth over the coming months amid rising trade tensions and growing internal challenges.

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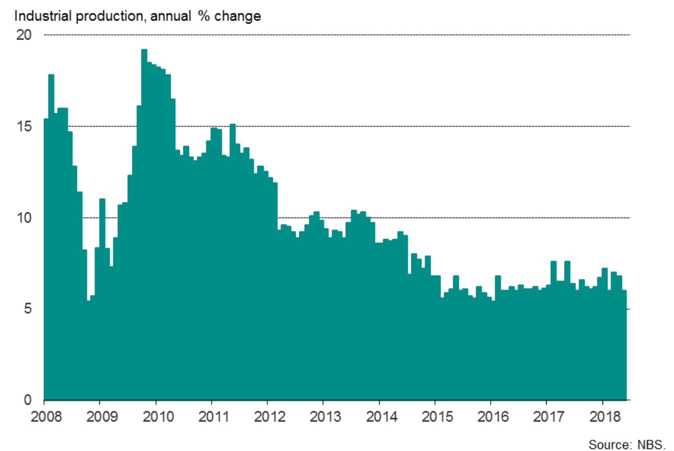
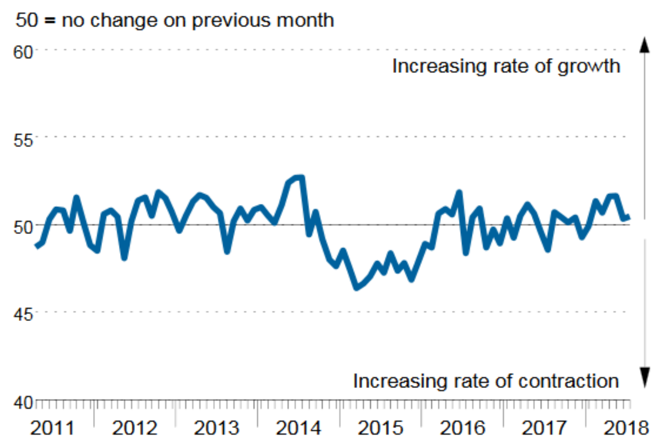
China industrial production growth



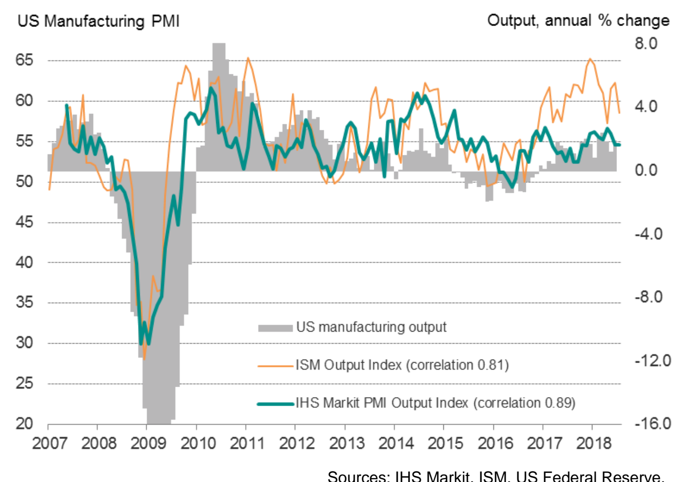
Source: NBS.

Nikkei Indonesia PMI



Sources: IHS Markit, Nikkei.

US manufacturing surveys and official data



Sources: IHS Markit, ISM, US Federal Reserve.

Indonesia policy meeting

Other key releases and events in the Asia Pacific region will be second quarter GDP data for Singapore, Australian employment, unemployment and wage data, as well as the Bank Indonesia policy meeting.

The Indonesian central bank left rates on hold at its last meeting after three prior hikes which had been implemented to stem the falling currency, which had dropped 6% against the US dollar in the first half of the year. The rupiah has since shown signs of stabilising but still looks prone to weakness, keeping the prospect of further rate hikes on the table despite signs of a weakening economy.

Insights into US's start to third quarter

Data on industrial production, retail sales and housing starts will provide the first official insights into how the US economy started the third quarter. US economic growth accelerated in the second quarter, with GDP rising at an annualised rate of 4.1%, up from 2.2% in the first three months of the year.

The acceleration had been foretold by the IHS Markit PMI, which averaged 55.9 in Q2 against 54.6 in Q1. With the composite PMI dipping to 55.7 in July, the pace of expansion cooled slightly at the start of Q3, but the PMI remains consistent with the economy growing at a rate approaching 3%. Manufacturing and services continued to register robust (albeit slower) growth in July, the former held back by a second successive monthly dip in exports. Growth may weaken further in August, however, with future business expectations down to a six-month low and concerns mounting in relation to tariffs and trade wars.

UK labour market data and Eurozone GDP

In Europe, UK labour market data including employee earnings, employment and unemployment will be eyed for signs that the Bank of England judged correctly when hiking interest rates at its August meeting. Policymakers are expecting wage inflation to rise, justifying tighter policy.

Meanwhile, after flash data showed a 0.3% GDP rise in the Eurozone, the next 'preliminary' estimate of GDP may register slightly faster growth. In recent years, initial estimates of GDP have been revised higher by 0.2% on average, bringing the official data into line with the PMI surveys.

Monday 13 August

Singapore GDP, final estimate (Q2)
Netherlands retail sales (Jun)
Italy consumer price inflation, final (Jul)
India consumer price inflation (Jul)

Tuesday 14 August

China industrial production, retail sales & investment (Jul)
France unemployment rate (Q2)
Germany GDP, flash (Q2)
Germany consumer price inflation, final (Jul)
India wholesale price inflation (Jul)
France consumer price inflation, final (Jul)
Spain consumer price inflation, final (Jul)
Czech Republic GDP, prelim (Q2)
Poland GDP, prelim (Q2)
Netherlands GDP, prelim (Q2)
UK labour market report incl. earnings, employment, unemployment, vacancies, (Jun)
Portugal GDP, prelim (Q2)
Eurozone GDP, 2nd estimate (Q2)
India trade balance (Jul)
US import and export prices (Jul)

Wednesday 15 August

Australia consumer sentiment (Aug)
China house prices (Jul)
Australia wage growth (Q2)
UK consumer and producer price inflation (Jul)
US MBA mortgage applications (week 6 Aug)
South Africa retail sales (Jun)
US New York Fed manufacturing survey (Aug)
US labour costs & productivity (Q2)
US retail sales (Jul)
Russia industrial production (Jul)
US industrial production & business inventories (Jul)

Thursday 16 August

Australia employment and unemployment (Jul)
UK retail sales (Jul)
Eurozone trade balance (Jul)
US jobless claims
US housing starts & building permits (Jul)
US Philadelphia Fed survey (Aug)

Friday 17 August

Japan trade data (Jul)
Eurozone current account (Jun)
Eurozone consumer price inflation, final (Jul)
Canada consumer price inflation (Jul)
Indonesia central bank policy meeting
US University of Michigan survey prelim (Aug)
US Baker Hughes rig count

Special Focus

China’s Banking Sector: Is SME lending the next big risk?

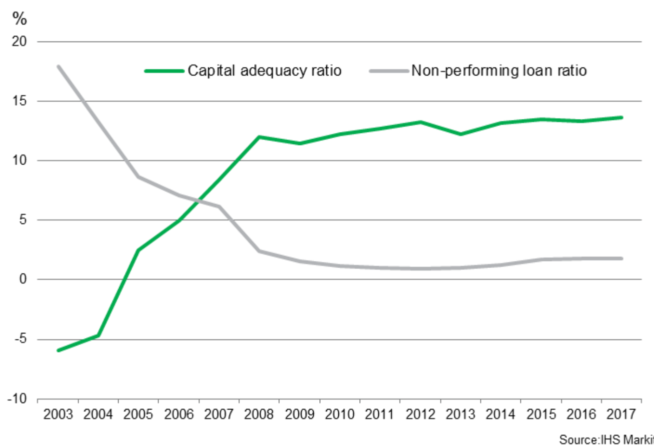
By Angus Lam, Senior Economist, IHS Markit Banking Risk Service

China's Banking Sector

China’s banking sector has grown rapidly over the last decade, with total assets growing by around 87% between 2012 and 2017. China’s banking sector assets reached 250 trillion yuan by the end of 2017, equivalent to around three times China’s GDP. Bank credit provision has increased far faster than economic growth, rising from around 100% of GDP to 152% of GDP over the 10-year period to 2017. Industrial and Commercial Bank of China (ICBC)'s assets alone are roughly equal in size to the total assets of South Korea's banking sector in 2017.

Despite the fast credit growth and rapid asset expansion, the Chinese banking sector has shown remarkable strength, at least on paper, with a rising Basel III capital adequacy ratio (13.7% in 2017) and a falling non-performing loan ratio (1.7% in 2017). However, due to the large shadow-banking sector which has been mostly unregulated until recently and the relaxed impairment classification that has been tightened only in the past few months, the banking sector´s true condition is far less favourable in reality than shown by its regulatory reports.

Strengthening financial position on paper



Source:IHS Markit

Recent developments points to abandonment of sector deleveraging

The Chinese authorities had encouraged de-risking and deleveraging of the banking sector and wider corporate sector until as late as the third quarter of 2017. This was evidenced by instructions directing banks to stop lending to international conglomerates such as Dalian Wanda. Whilst the prior focus to reduce bank exposure to the real estate sector, including mortgages, and to overseas focussed corporates still appears to be continuing, the authorities have recently taken clear measures which encourage banks to expand credit provision to small and medium enterprises (SMEs) and corporates.

The drive to increase lending to SMEs started at least six months before the mutual tariff enactments between China and the USA, although the escalating trade war has resulted in further measures by the Chinese government to improve liquidity conditions for SMEs. Recent changes represented the third instance since 2014 in which the Chinese authorities had lowered the reserve requirement ratio to drive lending to small firms. However, this time appears more aggressive, given the speed and magnitude of incentives to drive expansion in SME and corporate lending.

In early-June 2018, the People's Bank of China (PBoC) suddenly announced the broadening of collateral deemed eligible to obtain medium-term lending facilities from the central bank. The inclusion of SME bonds within such collateral is a clear indication of support for this type of instrument. Such incentives encourage the development of debt instruments for SMEs and bank investment in these bonds, which boost SME liquidity with equal economic impact to a loan, but through a different funding mechanism.

The collateral change was followed quickly both by Premier Li Keqiang giving verbal support for lending to SMEs and by a proposal from the State Council to cut targeted reserve requirements once again to drive further lending to this sector. This has been coupled with the China Banking and Insurance Regulatory Commission's direction to banks to cut loan interest rates for SMEs in late July and the 2018 loan cap expansion for selected banks that lend extensively to SMEs.

Since late July, the PBoC has been looking to incentivise banks further to lend and invest in corporate bonds through a further liquidity boost, but to-date, no detail has been disclosed on what this entails.

These highlighted policies were all specifically targeting lending to SMEs and corporates. Additionally, there have been expansionary policies which are not specific to SMEs and corporates, but which we judge to encourage expanded lending to these sectors as well. The additional cut of 1 percentage point from the total reserve requirement ratio in April 2018, easier than expected rules on wealth management products, which encourage more regulated but higher inflows of funds, and the more recent lowering in July 2018 of what we believe to be the countercyclical capital buffers of certain banks are all also likely to drive lending towards SMEs and corporates.

Return of policy-driven credit risks

Whilst China does not provide specific loan data for SMEs (only specifying lending to small enterprises and by our calculations, the aggregate corporate sector), the latest loan surrey published for first half of 2018 by the PBoC shows that loans for small enterprises had increased 12.2% year-on-year, whilst medium enterprise loans had increased by 9.7%. In this source, no data on loans outstanding is provided for medium enterprises. Although the credit growth rate has remained largely similar for medium enterprises versus the same time last year (9.5%), lending to small enterprises slowed substantially versus the 17.2% recorded then. Nonetheless, the credit growth for small enterprises still exceeded headline credit growth rate of 12.7% in 2017 Q2 and 12.1% in 2018 Q2 respectively. By our calculations, the total loans outstanding extended to small, medium and large corporates totalled around CNY78.6 trillion (USD11.5 trillion) in the first half of 2018, or around 58% of total loans outstanding in China, a figure largely unchanged from 2017 H1.

More specifically, loans to small enterprises account for around 19% of total loans outstanding in China. Although China is still going through a period of rebalancing to local consumption from exports, and small enterprises contribute around 60% of GDP according to the State Administration for Industry and Commerce, the proportion of loans to small enterprises still points to a concentration of credit risks due to their inherently unstable nature.

There is a tendency in China for heavy-handed policies that lead to distortions in the credit market, evidenced by the increase in loans to poorly-performing state-owned heavy manufacturing companies in the past. The large amount of new lending to and growing incentives for lending to SMEs and corporates have the potential, in our view, to drive corporate credit growth to well above the aggregate expansion of credit thus extending their share of outstanding loans to beyond the already elevated 58% of total loans. The PBoC is aware of such risk and as the chair of PBoC, Yi Gang, noted in a speech at the end of June, SMEs have an average lifespan of only approximately three years and have a higher reported non-performing loan ratio (NPL) of 2.75% versus 1.7% for large corporates.

Non-performing loan ratio is likely to rise with heavy-handed regulations to follow

As with the large-scale and rapid push to expand credit, official heavy-handedness also extends to regulatory oversight. When a risk is detected and becomes an area for politburo focus, regulatory bodies then tend to stifle developments in that segment and abruptly reduce credit risk exposures. This has been evidenced by reactions to the stock market crash in China a few years ago, previous virtual elimination of credit to "zombie" companies and clampdowns on the shadow banking sector.

Such abrupt changes are undesirable and if there were to be potential future sudden but steep reduction in SME liquidity as a result of policy moves to curtail lending to the sector, this could pose a significant risk to the survival of many SMEs. In the absence of any new policy changes, we continue to expect non-performing loans (NPL) to increase due to the inherently higher risks of exposure to SMEs and their shorter lifespan, as highlighted by the PBoC chair. The higher NPL ratio is likely to come from natural causes, such as poor management and genuinely bad loans, but also from the recent moves to realign NPL classification standards to meet international norms.

The effect of rising NPLs would weaken bank profitability and their capital positions. Extended losses on corporate loans threaten to reduce banks' capital adequacy ratios and tier-1 capital ratio significantly from the 13.6% and 11.3% respectively as of end-March 2018. Some small regional Chinese banks already face below-required levels of capital, and recent SME-friendly policies are likely to exacerbate and spread such pressures.

In our view, large Chinese banks are better positioned to weather rising NPLs but smaller banks could be faced with existential risk, owing to their already weaker capital buffers and liquidity strains (such as relying on interbank depository certificates). Such problems are unlikely to be avoided, unless there is regulatory forbearance on NPL classification or further easing, or abandonment of internationally-recognised capital requirements. However, these are highly undesirable outcomes that would threaten the international credibility of the Chinese banking sector. Accordingly, regulatory intervention to force sector consolidation through mergers and with larger banks absorbing smaller and weaker ones is likely in the two-year outlook.

For further information:

Contact for further APAC commentary:
Rajiv.Biswas@ihsmarkit.com or
Bernard.Aw@ihsmarkit.com.

Contact for European and US PMI commentary:
chris.williamson@ihsmarkit.com

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