GLOBAL
ECONOMY

4/18

China’s state-owned enterprises to become yet more influential

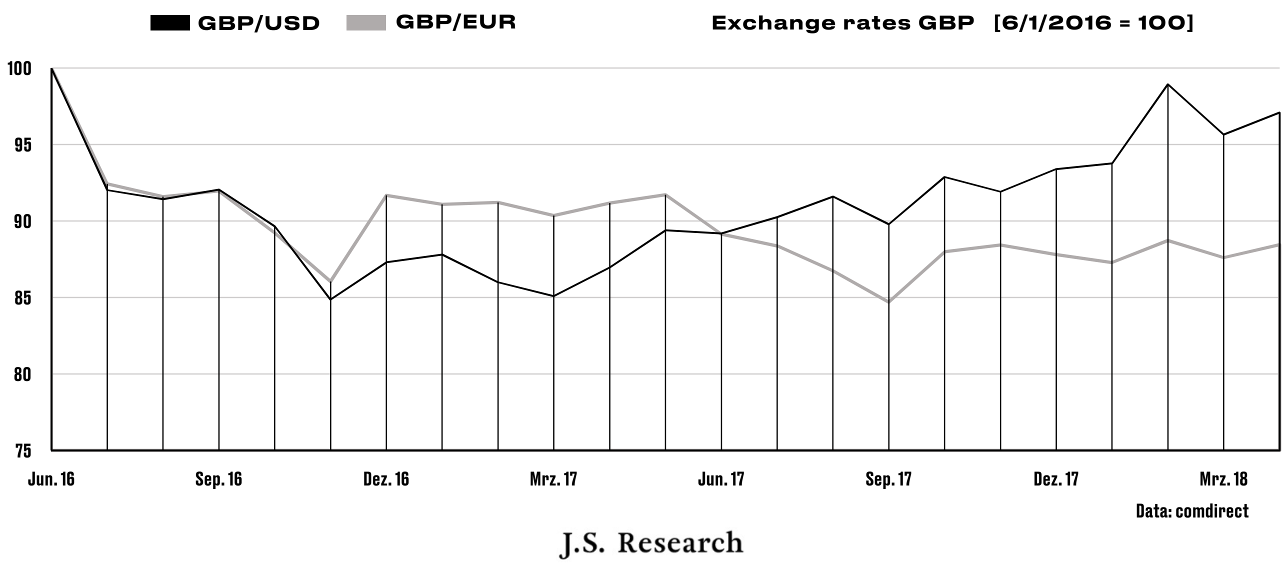
At a fateful junction: The UK’s economy one year ahead of Brexit

J.S. Research

Something smells fishy about transition, Brexiteers say – while banks are told to continue preparing for no-deal

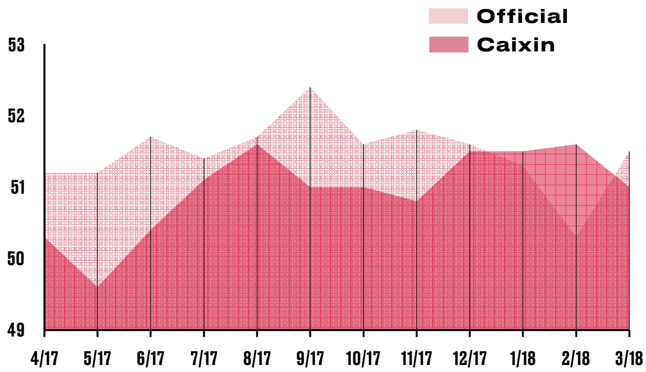
Though its chances to become the word of the year are probably slim, the rather technical term of transition has taken centre stage in recent weeks. Clamoured for by industry as well as employer associations on both sides of the Channel to reduce the uncertainty created by Brexit just a year away by now, a transition deal (or „implementation phase", the term favoured by Theresa May) had been hoped to come just in time for businesses to avoid triggering their contingency plans. Alas, the expected magic fails to work. The most important reason for the muted effect of Britain and the EU27 agreeing on a transition deal is its very own contingent nature: The deal will only come into effect when a comprehensive, overarching Brexit agreement will be struck no later than in the fall: No agreement (for whatever reasons), no transition. What's more, as of yet there is no clarity whether the transition will encompass passporting for the City, too. In effect, the understanding between David Davis and Michel Barnier on the terms of that time span between Brexit-legal and Brexit-actual merely is exactly that: A memorandum of under-standing wholly dependent on their bosses reaching a consensus in October. Uncertainty thus prevails, as pointed out by the eurozone's banking supervisors telling lenders they still ought to prepare for a no deal-Brexit come March next year. This is no real surprise for close observers of the process as well as our clients: By pushing talks on transition in front of negotiations about the terms of future relations between Britain and the EU, Messrs Davis and Barnier turned the EU's original schedule upside-down, talking about an implementation phase without exactly knowing what to implement. Though mitigated somewhat by the specific nature of this „stand still"-transition simply prolonging the status quo until the end of 2020, there remains the inescapable fact that, hence, transition in itself is meaningless until the final deal is struck.

If that weren't enough, Theresa May faces the next rebellion of the Brexiteers against the stand-still character of transition, unchanged fishing quotas for the UK in its domestic waters included. A group of thirteen rebels, led by Jacob Rees-Moog and one of the Parliamentary leaders of the DUP on whose



support Mrs May's government depends, has written to the Prime Minister decrying that continuation of fishing quotas until Brexit-effective. In the letter, the MPs threaten to oppose the transition deal in Parliament should the Prime Minister not cancel it in its present form. Never mind economics: Fishing accounts for less than 0.05 per cent of UK GDP. It is politics all over again making this uprising a real threat to an orderly Brexit, and it is hard to see how Theresa May might backtrack on the transition deal now. Hence, we cannot discern how she might placate the sworn eurosceptics in her parliamentary party and that of her Northern Irish allies enough to stave off defeat in Westminster. An even greater threat to Mrs May's government will become the so-called 'back-stop' solution proposed by the EU27 for the Irish border should a no deal-scenario unfold: In that case, the withdrawal agreement signed on 23 March stipulates that Northern Ireland will remain within the customs union – the very thing the Prime Minister herself had vowed in Parliament that "no Prime Minister of the United Kingdom could ever agree to." Now she has done so all the same, and Brexiteers as much as the DUP are fuming. Rather than calming down the waters, transition has added thrust to the civil war in Parliament – and that is what will decide the fate of Brexit in the end, as we have been stating all along.

Manufacturing PMIs, China



Data: trading economics

China's rust belt provinces demonstrate what to expect next from state-owned enterprises

They were the powerhouses of the Chinese economic miracle, harbouring the coal and ore necessary for the inception of the Middle Empire's industrial rise: the north-eastern provinces constituting China's own rustbelt. And just as much as their heavy industries are a token of the past, their economies are dominated by that peculiar Chinese speciality, the state-owned enterprises (SOEs). According to "The Economist", their share in employment is 40 per cent and 55 per cent for Liaoning and Heilongjiang, respectively. Though that is less than in times of old when SOEs where part and parcel to the first wave of state-controlled economic boom in China, accounting for roughly 80 per cent of output nationwide, SOEs have been remaining steadfast to their main characteristic: they are rarely profitable. Their other prominent feature is, of course, their being a vehicle for centralised industrial policy. And that is where the problem begins. Several of the SOEs are behemoths proper: According to "The Economist" again, in 2015 the 200 biggest of them constituted some 6% of the global car industry's revenues, for example. These gargantuan conglomerates are often called "red zaibatsu", likening them to those Japanese conglomerates known for their relative inertness. From the point of view of economic policy, even more worrisome are their younger cousins, so-called state capital investment and operation companies (SCIOs). It has become clear now that these are not intended to operate like, say, Singapore's well-known Temasek Holdings, administrating state assets to yield a profit. By contrast, SCIOs are an unequivocal instrument to implement the government's "One Belt, One Road" strategy encompassing the whole of East and Central Asia. They are armed with state-backed, cheap funding, and thus are able to break into and disrupt erstwhile dominions of the private sector such as IT and other high-tech industries. Into addition, state-backed private-equity funds have been created, too, pursuing the same objectives. The SOEs' rapid growth, and a foray of mergers and acquisitions, however, have added to their borrowing. They are thus at the core of China's debt problem and part of the government's recent clampdown on selected companies to stop the debt binge from going on: SOEs debt constitutes about half of all commercial credit, which the Bank of International Settlement has estimated at some 160 per cent of GDP at the end of 2017. It would appear that not much has changed since former premier Wen Jiabao stated as early as in 2007 that China's economy was marred by four "uns": In his view, it was unsustainable, uncoordinated, unbalanced, and unstable. Thus, the current clampdown on the

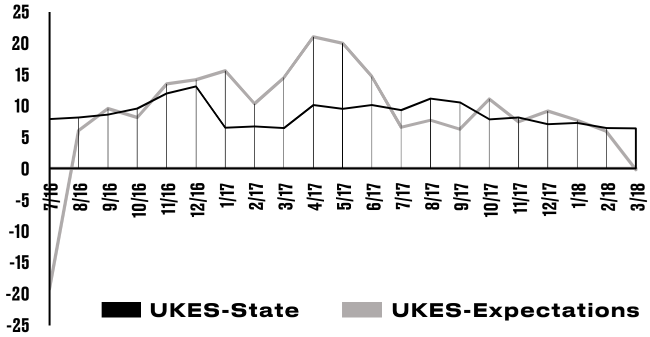
SOEs debt-binge is the first step in the right direction. Yet inevitably, it has left braking marks in the country's growth numbers: In February, the official manufacturing PMI by the National Bureau of Statistics fell the most since 2011 stopping ever so short off the neutral level of 50 points, even if it managed to retrace some of that fall in March; crucially, the statistic's panel is mainly composed of large SOEs. By contrast, the manufacturing PMI by the private data provider Caixing, focussing on private SMEs climbed to a level of 51.6 points by a tiny fraction, but it climbed – only to mirror in March the official statistic's sharp fall one month earlier. China has re-embarked on a decidedly autocratic, centralised way, with President Xi Jinping having been successful in changing the constitution so as to allow him staying in power indefinitely. SOEs are a natural part of this renewed confidence and authority of the state in economic affairs, used to balance the relative slack China's economy has been experiencing in the recent past. Expect the role of SOEs in China's economic policy to expand in the coming years.

At a fateful junction: The UK economy a year prior to Brexit-effective

With one year to go until Brexit (well, Brexit-legal, actually, because thanks to the recently agreed transition, Brexit-effective is still of some two more years), it is time to look at the current state of the British economy, evaluating how it has coped with Brexit-related uncertainty so far and what the perspectives of both consumers and businesses are.

First, the general picture. Our clients and followers know our UKES, a comprehensive indicator on the state of the UK economy, charting expectations against current conditions and combining them into a single indicator (see chart 1) – and the picture the indicator is drawing is not very rosy at all. After its quick recuperation from the aftermath of referendum day, the UKES at first had been precluding the relative rally afterwards, with consumers way more happy to spend than anticipated by most observers, and manufacturing in a positive boom period thanks to weak Sterling as much as an exuberant global economy. Yet around the late summer of last year, the mood has begun to turn sour. Currently, the expectations component hovers between the state

Chart 1: UKES

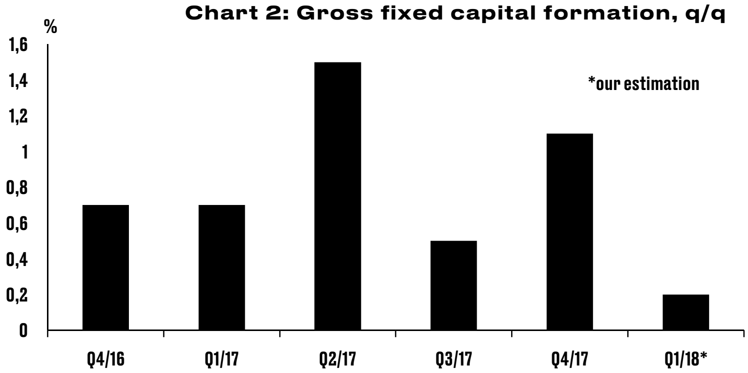


component and the main indicator line, mirroring the wait-and-see mode many businesses and the majority of the public have fallen into until Brexit negotiations come to their critical point in the fall. Yet the risks are clearly tilted to the downside of affairs: Anything other but a benign, mutually appreciative agreement in October will result in anxiety on the part of all too many businesses. The ensuing transition phase will fail to help out of that, because it simply prolongs the period of uncertainty as to what exactly the trade arrangement between the UK and the EU27 will entail. In that situation, we project the expectations component of the UKES to drop through both the state component and the main indicator line, triggering an unequivocal signal for economic trouble in the months following. To support this analysis, let us turn to the details.

Just as we said back in the second half of 2016 when, after referendum day, British consumers went on a veritable shopping spree, that merry spending feast was but a smart anticipation of the coming weakness of the Pound and hence rise of inflation from the winter of 2016 onwards. Primarily, the British people bought discretionary items such as cars, household appliances, kitchens and the like, just to preclude their waning spending power in time. Even more important, they did so largely on credit: Unsecured consumer lending had been rising virtually unchecked right until the end of last year. In the first quarter of this year, however, lenders reduced the availability of unsecured credit drastically after default have begun to rise. Thus, our analysis got finally confirmed at the beginning of this year: After that post-Brexit shopping tour, in 2017 consumer spending fell to its lowest in six years, with real wages thrashed by rising inflation and an inconclusive election in June exacerbating political uncertainty. Simultaneously, house prices appear to begin flatlining after a bout of weakness from mid-2017, endangering the primary source of wealth of the average UK household and thus decreasing consumer spending even further. At least, March brought an upshot when against the odds consumer confidence was lifted on the back of finally rising wages. The latter, however, has brought the Bank of England onto the scene, mulling at least one and potentially two rate raises this year. In turn, that would pressure debt servicing for mortgage holders, pressuring household's spending power yet further. The picture for the UK consumer is hence anything but rosy, and B2C businesses are facing difficult times.

The picture on the part of UK businesses is somewhat better, though not exactly exuberant either. First and foremost, business investment still is relatively resilient, contrary to erstwhile expectations after referendum day (see chart 2).

Chart 2: Gross fixed capital formation, q/q



Data: trading economics

Though there is anecdotic evidence of some investment retrenchment, the general statistic shows otherwise with a healthy growth of 1.1 per cent quarter-on-quarter in Q4 of last year and thus at its long-term average. Second, even the major economic headache of the recent past, faltering productivity has shown some improvement of last: After long stagnation, it has increased by 0.9 and 0.8 per cent in the third and fourth quarter of 2017, respectively, though the jury is still out whether that actually was a break of the trend in past years or simply due to statistical effects. And the manufacturing sector, third, is in an all but exuberant mood all over the past 12 months, buoyed by a global economy in ruddy health and weak Sterling. As recently as in March, the manufacturing PMI displayed a strong print of 55.1, well above the neutral threshold of 50 and at the upper end of its long-term range. Fittingly, other 'soft' indicators such as the Lloyds Bank Business Barometre confirm the current equanimous mood among businesses. Alas, the horizon for manufacturing begins to darken, too: Domestic car sales as well as production have suffered a veritable, double-digit breakdown in 2017, in a severe warning of what to expect from the convulsions Brexit is yet to effect. More than most other sectors, car manufacturers and their suppliers are sensitive to any disruptions to their supply chains; yet even the most comprehensive, liberal trade deal inevitably will bring about more friction to cross-border goods exchange than membership in the Common Market. On the services side of affairs, the City of London is not yet safe. Even though its dominating demand of the past months, transition has been actually agreed, it is still dependent on a deal being struck in October. What's more, European regulators such as the ECB remain wary to issue British financials with those crucial "passporting" rights during transition to sell their services into the Common Market without having to found fully-fledged subsidiaries there or to relocate part of their activities to continental Europe. If those rights were to be denied, the financial services sector of the UK economy stands to suffer heavily; anyway, thanks to the remaining uncertainty banks already prepare for a cliff-edge Brexit in March 2019, thus kick-starting the very disruption in the City transition was meant to stave off.

Taken together, the UK economy is in no bad shape, yet the positive picture of the past twelve months is beginning to falter; recent retails sales as well as manufacturing production numbers have testified to that. Into the addition, the risks are distributed unevenly: Manufacturing has peaked, while consumers are retrenching already. Any additional uncertainty created by a deadlock in the tight timetable for the remainder of the Brexit negotiations or due to a political crisis triggered by a potential Brexiteer rebellion in Westminster (both way more likely than most analysts seem to grasp) will topple this precarious balance. Hence, we project no more than 1.5 per cent growth this year, falling to as low as -0.1 to 0.2 per cent in the worst case scenario of a collapse of the Brexit talks.

Statistical Bulletin

Exports growth (Feb.)

Norway: +4.4% → Norway's exports have continued to display solid if unremarkable growth in February which furthermore were driven by oil and oil derivatives.
Canada: +1.4% ↑ Even though growing less fast on a yearly basis, Canada's, by contrast, have been continuing their upward trend, pulled by the automotive and aerospace sectors.

Credit to the private sector (Feb.)

Sweden: +6.7% ↓ Credit to the private sector in Sweden grew by a healthy rate of late, though apparently decelerating already, certainly not much to the liking of the Riksbank.
Singapore: +3.2% → In Singapore, credit growth has been somewhat stolid, sticking to its sideways trend.

Composite PMI (Mar.)

China: 51.8 → The composite PMI in China has been levelling out on a somewhat subdued level recently. Though still in growth territory, it has been losing steam rather conspicuously, corroborating the evidence of the deflating effect the recent clampdown on the country's most reckless borrowers has had (see related article above).
Ghana: 55.2 ↑ Not so in Ghana: Ever since the peaceful change of government last year, the West African country's economy has been displaying a robust economy, with inflation subsiding and growth hitting new highs within the recent years.

Industrial production (Feb.)

Netherlands: +6.3% ↑ The industrial production in the Netherlands has expanded forcefully in February, driven by pharmaceuticals in particular.
South Korea: -6.4% ↓ Quite the contrasting picture has been displayed by South Korea whose production has taken a heavy blow, even if much of that was due to the effect of the Lunar New Year. Manufacturing, however, has been showing a weak spot lately anyway, so that a new downward trend seems to be in the making.

Int'l comparison: Composite PMI

An international comparison shows that China's figure even ranks among the lower quarter only, whereas Ghana's ranks in the top one. Germany manages to stay in the top third, whereas the UK has slid to the lower one. India is the rear lantern.

Data: trading economics, bloomberg, comdirect, own calculations

Design concept: Firm | www.f-i-r-m.de

Published by J.S. Research KG
represented by Jakob Steffen, owner & managing director
Dohlenweg 10,
D-42115 Wuppertal, Germany