China

PBOC is acting to reduce financial risks

■ **Economic growth has picked up slightly over the past two quarters, supported by the authorities' stimulus policy measures. In Q1 2017, the growth acceleration was fuelled by a rebound in industrial activity, lifted by stronger domestic demand and an upturn in exports.**

■ **This cyclical strengthening has enabled the central bank (PBOC) to start to tighten monetary policy cautiously, in response to the continued rise in credit risks and liquidity risks in the financial sector.**

■ **However, downside risks to short-term economic growth prospects remain high, and the authorities' determination to contain financial risks could be tested rapidly in case of another slowdown in economic activity.**

Industrial production growth has accelerated

Economic growth accelerated slightly in Q4 2016 and again in Q1 2017. Real GDP rose by 6.9% year-on-year (y-o-y), compared to 6.8% in the previous quarter and 6.7% for full-year 2016. Of the three main sectors of activity, services continued to report the strongest growth (7.7% y-o-y in Q1 2017, vs. 7.8% in 2016), but the industry was the only sector to report an acceleration (6.4% y-o-y in Q1 2017, vs. 6.1% in 2016), buoyed by brighter export prospects and stronger domestic demand.

After two years of contraction, Chinese exports rose by 4% in Q1 2017 compared to Q1 2016 (in US dollars), in a world environment marked by an upturn in demand, prices and trade volumes. This recovery is likely to consolidate in the very short term, and the yuan's recent depreciation (-6% in real effective terms in 2016) is also likely to help. Yet downside risks are still high, notably due to the persisting uncertainty shrouding world trade growth prospects and the possible rise in trade tensions with the United States.

Domestic demand has been the main factor supporting Chinese economic growth over the past year, and again in Q1 2017. Stimulus policy measures have helped turn around three sectors in particular: i) public infrastructure: investment growth rebounded in H1 2016 and again in early 2017, notably in water conservation and environmental projects; ii) real estate: the market has gradually picked up since year-end 2015 (sales and prices have rebounded in a growing number of cities, then triggering an upturn in investment), in response to monetary policy loosening and to the easing of the government's "property policy" (i.e. the prudential rules applied to real estate transactions and loans); and iii) automobile sales, which rose more than 10% in 2016, stimulated by fiscal incentives. Automobile sales have dropped off since early 2017 after the tax rate on small car purchases increased. Retail sales are currently supported by the need for durable goods that is accompanying the rebound in real estate transactions; however, the continued slowdown in household revenue growth remains an important constraint on the expansion of private consumption.

Investment growth recovery

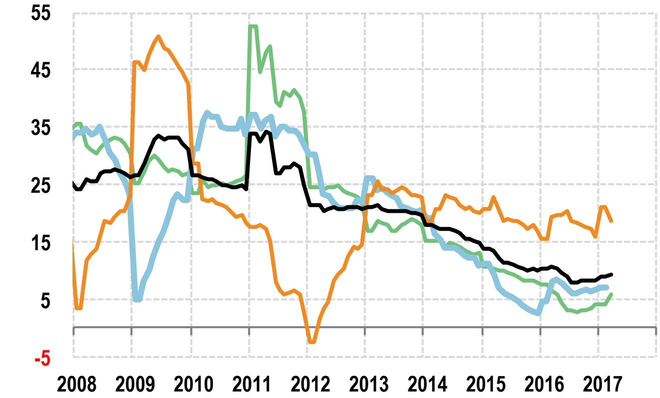

Chart 1 Source: NBS

The rebound in activity in the sectors directly targeted by the stimulus policy measures had only very limited spill over effects on the rest of the economy. Yet, investment in the manufacturing sector has also picked up since last fall, buoyed by the upturn in producer price inflation (which swung back into positive territory in September and reached 7.6% y-o-y in March 2017) and the growth rebound in profits of industrial enterprises (+9% in 2016, and +32% y-o-y in the first two months of 2017). The recovery in private investment growth in early 2017 also seems to have been fuelled by the development of infrastructure projects financed through public-private partnerships.

Monetary policy is turning less growth-supportive

Infrastructure investment will remain a key growth engine in the quarters ahead. The expansionist fiscal policy could also take the form of new tax measures in favour of companies and households, if private demand were to slump again. In contrast, monetary policy has recently become less accommodative, and is likely to remain very cautious in the short term. The "property policy" has also become more restrictive in recent months (and still differentiated from one city to another), as home purchase restrictions and rules applied to mortgage loans have begun to be tightened in more than 30 cities where house prices have increased excessively fast.

PBOC (People's Bank Of China) has numerous objectives (it must guarantee price stability, support economic growth and the job market, promote financial reforms, etc.). Two main goals were given priority for 2016 and 2017: supporting economic growth and financial stability. The first priority led the monetary authorities to pursue an expansionist policy through Q3 2016, in response to the rapid slowdown in industrial growth. The second priority justifies recent monetary policy tightening actions. As a matter of fact, credit risks, risks of liquidity tensions in the financial sector and risks of asset market bubbles are elevated and have only increased further over the past year. With the recent improvement in real GDP growth rates and industrial performance and the upturn in producer price inflation, the authorities have been able to rank their priorities somewhat differently.

PBOC has announced a "prudent and neutral" monetary policy for 2017, and set a target for growth in total social financing (+12%) that is slightly lower than the 2016 target (+12.8%). In fact, the authorities have already taken actions to tighten monetary conditions.

The central bank uses a series of liquidity management instruments, such as reserve requirement ratios but, most importantly, it has also resorted increasingly to open-market operations and to "liquidity facilities", which enable to provide liquidity to certain well-targeted institutions. Interest rates on these liquidity facilities and repo rates have in fact become the main determinants of interbank market rates. Repo rates have been increased gradually since Q4 2016 and the rates on the liquidity facilities have been increased since early 2017.

PBOC still has recourse to its "benchmark interest rates on loans and deposits". Although there are no longer any interest rate controls since October 2015, commercial banks continue to monitor these benchmark rates to determine the rates they offer customers. These benchmark interest rates, which were cut six consecutive times between year-end 2014 and year-end 2015, have been held steady ever since.

These actions illustrate the cautious approach of the monetary authorities. They want to avoid raising too much the cost of borrowing for households and corporates in order not to weigh on activity or aggravate debt servicing charges, but at the same time, they tighten monetary rates in order to discourage the use of interbank financing. Interbank financing has indeed increased steadily in the recent past and is largely used by small banks and non-bank financial institutions (shadow banking). The problem is that excessive reliance on interbank financing aggravates the risks of financial instability, by increasing the volatility of the creditors' sources of financing, balance-sheet transformation risks and contagion risks in case of a liquidity squeeze on certain institutions. These risks only add to the already high level of credit risks resulting from the debt excess of the Chinese economy (debt of the non-financial sector reached an estimated 213% of GDP at the end of Q1 2017), from the lack of supervision and weak governance of financial institutions.

New macro-prudential measures were introduced in recent months to address this later point, aimed at strengthening risk management by both the authorities and the financial institutions.

Repo rates trending up (%)

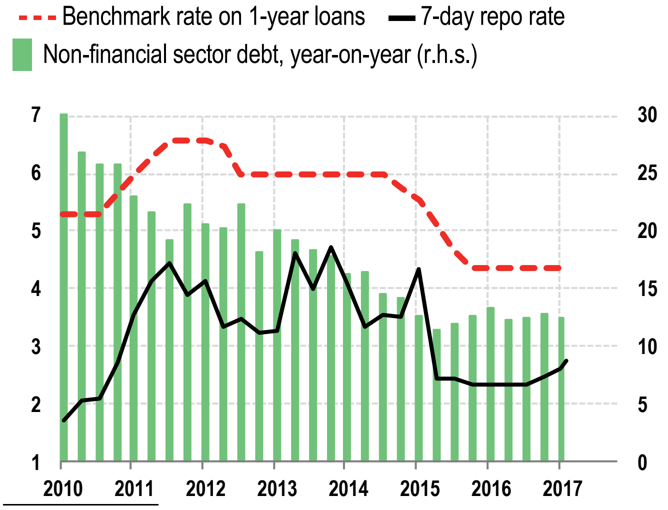

Chart 2 Sources: PBOC, BNPParibas

Prudent monetary policy tightening, a more restrictive property policy in cities with overheating housing markets, and a tighter regulatory framework for the financial sector are positive steps, which might not enable to reverse, but at least could help stabilize the dynamic of worsening credit risks registered in the last decade. However, to achieve this would mean maintaining a "cautious policy tightening" stance. Yet this policy could be rapidly called into question if economic growth were to slow down excessively, due to the very impact of the recent tightening of monetary conditions, for example. Stable economic growth will indeed remain Beijing's top priority, at least until the 19th Congress of the Communist Party in fall 2017.