CHINA

MOVING OFF UPHILL

Chinese economic growth has re-accelerated since the end of January, mainly driven by services and household consumption. The recovery in manufacturing activity is more moderate. In the real estate sector, the crisis is lessening. These improvements will continue in the short term. However, constraints on economic growth remain significant; they principally stem from the weakening global demand and geopolitical tensions as well as from financial difficulties for property developers, local governments and their financing vehicles. Beyond this, the question arises of a lasting loss of confidence in the Chinese private sector.

POST-COVID RESTART OF THE ECONOMY

Following the abandonment of the zero-Covid policy in early December, the lifting of all restrictions on mobility and the end of the disruptions caused by the surge in the number of infections in December-January, Chinese economic growth has rebounded since the end of January. The recovery has been primarily driven by services, while the improvement in industry turned out to be more modest (Chart 1).

Activity in the services sector and household consumption have recovered more quickly than expected. After several months of contraction, retail sales volumes increased by around +2% YoY in January-February, despite the decline in car sales due to the end of tax incentives. Consumer price inflation remained low (+1.6% YoY in January-February after reaching +1.8% in Q4 2022).

The crisis in the construction and real estate sectors has eased: new construction, housing sales and real estate investment all continued to contract in January-February YoY, but at much slower rates than in previous months. In addition, the average house price in the 70 main cities rose slightly in February (+0.1% MoM) after falling for 18 months in a row (however, the total house price drop has been limited to -5.2% since July 2021).

In the manufacturing sector, the recovery in activity has been more hesitant, and PMIs fell slightly in March after just two months of improvement. Total automobile production has fallen sharply (but new energy vehicle production has continued to rise strongly) and export-oriented sectors have been affected by the decline in global demand for several months. Exports of goods measured in dollars fell by -6% YoY in January-February 2023, after -6.6% in Q4 2022.

Against this difficult but more reassuring backdrop, the National People's Congress held its annual meeting in Beijing at the beginning of March. The government notably announced its main macroeconomic objectives for 2023. The growth target was set at "around 5%", indicative of the cautious realism of the authorities. This target of 5% should in fact be easily reached thanks to the momentum provided by post-Covid catch-up effects, which will continue in the coming months, particularly in the services sectors.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	2.2	8.4	3.0	5.6	5.3
Inflation, CPI, year average, %	2.5	0.9	2.0	2.7	2.5
Official budget balance / GDP, %	-3.7	-3.1	-2.8	-3.0	-3.2
Official general government debt / GDP, %	45.9	46.9	50.4	51.6	53.0
Current account balance / GDP, %	1.7	1.8	2.3	1.7	1.2
External debt / GDP, %	16.3	15.4	14.4	14.3	14.0
Forex reserves, USD bn	3 217	3 250	3 128	3 050	3 030
Forex reserves, in months of imports	16.2	12.6	11.9	11.0	10.0

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: POST-COVID RECOVERY

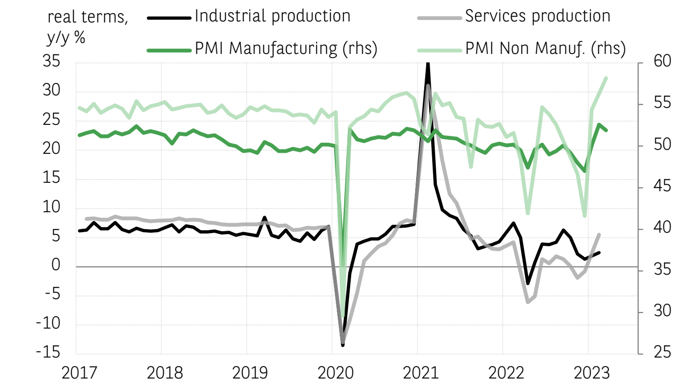

CHART 1

SOURCE: NBS, BNP PARIBAS

OTHER CONSTRAINTS ON GROWTH PERSIST

At the same time, by setting a low growth target for 2023, the authorities are first counting on moderate support from fiscal and monetary policies, and second, recognising the existence of high downside risks.

On the external front, the global economic slowdown will continue to weigh on the performance of the export sector. Furthermore, the geopolitical context, tensions with the United States and the very strict controls imposed by Washington on the sale of electronic components to Chinese companies[1] are clouding the prospects for the expansion of high-tech industries in China – at least in the short and medium term, pending progress in China's search for technological self-sufficiency.

While the international environment becomes more complex, the confidence and demand of private companies could also be durably affected by the increased regulatory risks weighing on the domestic market (lack of visibility, increased control of the State and Communist Party).

1The export controls were drastically strengthened by Washington in October 2022: US semiconductor companies, as well as any foreign company using their components and equipment, must apply for a special licence (with a high risk of refusal) to be able to sell the most advanced chips and equipment to Chinese companies. Under pressure from the US, the Netherlands and Japan recently announced restrictions on exports of semiconductor production equipment.

FRAGILE LOCAL GOVERNMENT FINANCE

The crisis in the property sector remains a threat to short-term growth. Government support measures and the lifting of mobility restrictions should help stop the collapse of activity. Nevertheless, housing sales and new construction projects should remain hindered by the still poor confidence of potential buyers, the persistent financial difficulties of a large number of property developers and the slow pace of their debt restructuring.

The weakness of local government finance is also fuelling growth risks, since it should impose fiscal consolidation efforts, constrain local governments' capacity to resort to debt and therefore weigh on public spending and investment.

Since 2020, public accounts have deteriorated, with local governments being the most affected. They have taken on a large part of the new expenditure linked to the health crisis, and suffered from the weakening of their current revenue (-2% in 2022) resulting from the slowdown in activity and tax support measures. Since mid-2021, they have also suffered from the sharp drop in their land sales proceeds (-23% in 2022). These revenues, resulting from the sale of land to developers, finance "government funds", managed by local governments outside the official general budget and largely dedicated to infrastructure projects[2].

Between the end of 2019 and the end of 2022, the explicitly budgeted debt of local governments increased from 21.6% of GDP to 29%, and that of the central government went from 17% to 21.4% (Chart 2). Taken as a whole, local government debt is not excessively high and benefits from the same favourable conditions as that of the central State. These conditions ensure medium-term debt sustainability (favourable debt profile, moderate interest charge, positive differential between GDP growth rate and interest rate).

However, financial conditions vary widely from region to region and some local governments face excessive debt servicing. In addition, in order to be able to cover all their needs (and in particular to finance infrastructure investments), many local governments have continued to use financing vehicles (LGFV, or local government financing vehicles). The debt of these entities is contracted within a regulatory framework that is sometimes still unclear, outside the official budget, and constitutes an additional indirect debt for the local governments. It is high, mainly made up of bank loans, as well as bonds (around a quarter of the total, mainly issued in domestic markets) and other non-bank financing sources.

According to IMF estimates (Article IV, February 2023), total LGFV debt reached 47% of GDP at the end of 2022, compared to 40% at the end of 2019. The risk of default on this debt is high, especially because the returns on the investments financed are often too late or not sufficient to cover repayments. It is a growing source of vulnerability for local governments, while their capacity for support has deteriorated. The amount of LGFV bond debt falling due will peak in 2023 and remain high in 2024. Liquidity risks are considered very high in some of the least developed provinces. These credit risks should notably weaken certain regional banks, which would be required to cover the liquidity needs of LGFVs through new financing and debt restructuring.

CHINA: DEBT OF CENTRAL AND LOCAL GOVERNMENTS

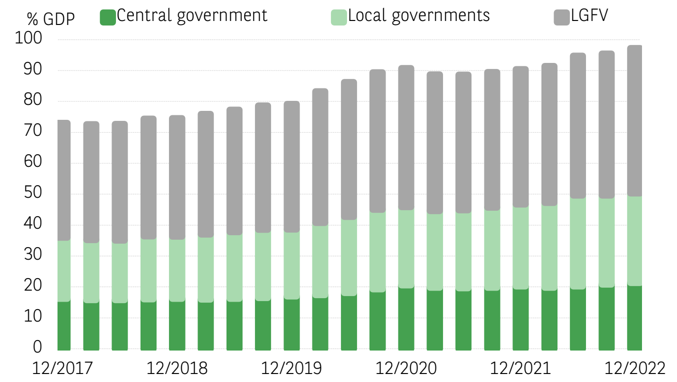

CHART 2

SOURCE: MOF, NBS, IMF, BNP PARIBAS

CAUTIOUS CONSUMERS

Uncertainties remain about Chinese household behaviour during the post-Covid period. Households may remain very cautious, having suffered from lower income growth since 2020 (disposable income per capita increased by +4.4% per year on average in real terms, compared to +6.5% in 2017-2019) and a loss of wealth due to the crisis of the property market (which concentrates around two-thirds of household assets). The consumer confidence index has remained at historically low levels since spring 2022. It has started to improve since December, but its recovery could be slow. As a result, the additional savings accumulated during the pandemic, which were rather moderate, may be only partially spent in the short term[3].

The evolution of household sentiment and demand will largely depend on the recovery of the labour market. However, this could be limited, particularly if the upturn in activity in industry remains moderate and if private business confidence remains fragile. The urban unemployment rate rose slightly in February 2023, reaching 5.6% on average across the country, and 18.1% for the 16-24 age group (compared to 5.2% and 11.9% respectively in 2019).

Structural factors of the economic growth slowdown add to these short-term downside factors, in particular, China's demographic dynamic and the slowdown in productivity growth.

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2 The fiscal slippage is hardly visible in the «official» deficit figures (-2.8% of GDP in 2022), which corresponds to the general government deficit, consolidated and adjusted for transfers between public accounts. More so (but also not covering all government), the consolidated general government deficit, to which is added the «government funds» deficit, is estimated at 7.4% of GDP in 2022, compared to 5.6% in 2019. Analysis of Chinese government accounts remains complicated by the lack of data and numerous transfers and accounting adjustments.

3 The household savings rate is estimated to be 39% of disposable income in 2022, compared to 35% in 2019. The sharp increase in bank deposits in 2022 can be explained in part by the transfer of other financial assets and real estate investments to deposits, which are less risky.