CHINA

PERSISTENT PESSIMISM

The post-Covid recovery in China's economic activity was not as strong as expected in 2023. The property sector crisis deepened further at the end of the year, the demand for housing did not pick up again, and weak household confidence continues to weigh on household consumption. Conversely, the export-oriented manufacturing sector performed better than expected in the last quarter, in contrast with the performances of domestically oriented sectors. The authorities are maintaining an accommodative policy. However, the weak financial situation of local governments is constraining public investment, and the People's Bank Of China has little room for manoeuvre to revive credit growth. The banking sector is facing an increase in credit risk, but this is seemingly still under control.

Chinese economic growth stood at 5.2% in 2023, up from 3% in 2022. This recovery was largely due to the post-Covid normalisation of domestic demand and base effects. It has also been supported by cautious and gradual monetary and fiscal policy easing since last summer. However, the Chinese economy continues to deal with a large number of fragilities that are likely to persist in the short term.

DOMESTIC DEMAND IS LACKING MOMENTUM

These fragilities are concentrated in domestically oriented sectors and weigh on investment and private consumption. In particular, the property sector is still in the depths of a major crisis, which further intensified in late 2023 (Chart 1).

Property investment contracted by around 8% in value in 2023, just as it did in 2022. Property transaction volumes fell by 23% y/y in December and by 18% over 2023 as a whole, and the apparent recovery in housing starts seen in November (after falling for 31 consecutive months) was seemingly a false dawn. Only the number of completed projects has continued to improve (+16% in 2023, after a drop of 15% in 2022) thanks to the measures implemented by the authorities to finance the completion of unfinished projects. Conversely, the measures introduced to rekindle demand for housing have not made a difference. For the first time, total mortgages outstanding shrank in 2023 (-1.8% y/y). Unsold housing stocks are still excessively high, while property developers continue to face enormous financial difficulties. Access to loans for the financially healthiest developers improved slightly in 2022 and H1 2023, but has deteriorated again in recent months. Growth in total bank loans to developers accelerated from +1.5% y/y in June 2022 to +4.9% y/y in June 2023 (vs. +15% per year on average in 2015-2019), but it slowed down in Q4 2023.

Property prices have continued to fall. In December, the average drop in housing prices in China's 70 largest cities stood at -4.1% year-on-year and -0.8% month-on-month, which are the biggest falls since the correction in the property sector began in 2021. However, the overall fall in prices since the crisis began is relatively moderate: at the end of 2023, housing prices were estimated to be around 9% below their mid-2021 level on average.

The loss of confidence among households, private investors and lenders has significantly contributed to the property sector crisis not abating. Weak household confidence is also at the root of the weaker than expected recovery in private consumption in 2023, despite the effects resulting from the end of mobility restrictions. Retail sales volumes were up 7%, after contracting by around 2% in 2022.

At the same time, deflationary pressures emerged over the course of the year, as a result of not only weak domestic demand, but also falling food prices (-3% y/y on average in H2 2023, after rising 2.5% in H1), the correction in residential property prices and lower energy prices (fuel prices declined 5.1% in 2023). Consumer price inflation eased from +0.7% y/y in H1 2023 to -0.2% in H2. Core inflation stabilised at +0.6% y/y in Q4 2023, compared to +0.7% over the previous six months, which is low compared to the pre-Covid years (core inflation was 1.6% on average in 2019).

However, the increase in household purchasing power remained moderate in 2023. Disposable income per capita grew by +6.1% in real terms on average in China, and by +4.8% in urban areas (vs. +5.7% per year in 2017-2019). Unemployment is still high among young people, and employment prospects are uncertain, particularly in service sectors where the regulatory framework has become more stringent. All of these factors adversely affect consumer confidence and spending.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	8.4	3.0	5.2	4.5	4.3
Inflation, CPI, year average, %	0.9	2.0	0.2	1.5	1.7
Official budget balance / GDP, %	-3.1	-2.8	-3.8	-3.2	-3.5
Official general government debt / GDP, %	46.8	50.6	55.0	57.1	58.6
Current account balance / GDP, %	2.0	2.2	1.8	1.3	1.0
External debt / GDP, %	15.4	13.7	13.4	12.4	11.6
Forex reserves, USD bn	3 250	3 128	3 238	3 190	3 140
Forex reserves, in months of imports	12.6	12.0	12.5	11.7	11.0

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: DEEPENING CRISIS IN THE PROPERTY SECTOR

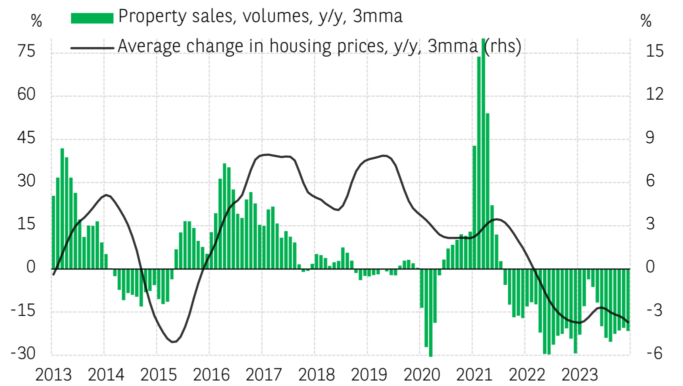

CHART 1 SOURCE: NBS, BNP PARIBAS

They are also compounded by the negative wealth effects of falling property prices and plummeting stock prices since 2021. The CSI 300 Index (a weighted index of 300 A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges) fell 35% between June 2021 and December 2023.

THE EXPORT INDUSTRY IS PICKING UP STEAM AGAIN

The recovery in service-sector activity weakened in late 2023, because of the sluggishness of household demand and lower base effects. Services growth stood at +8.5% y/y in real terms in December, bringing an end to four consecutive months where it accelerated gradually. It is estimated to be +8% over 2023 as a whole (vs. -0.1% in 2022). By contrast, the performance of the manufacturing and export sectors has recently strengthened. Growth in industrial production further accelerated slightly in December (+6.8% y/y), with improvements seen in a large number of sectors, particularly in the automobile and renewable energy sectors. Over 2023 as a whole, industrial production increased by +4.6% (up from +3.6% in 2022). Meanwhile, manufacturing investment growth recovered slightly in Q4 2023 after falling for more than a year (it increased by 6.5% in value over the year as a whole).

Activity in the manufacturing sector is largely driven by exports, which ultimately performed better than expected in 2023, despite a lacklustre international environment. Goods exports stabilised in November and rose up again in December (+2.3% y/y in current USD), following six months of decline. Most notably, export volumes have strongly recovered in recent months, boosted by the reduced prices offered by Chinese companies in order to strengthen their market shares. China's share in total world goods exports grew again to 15.2% in Q3 2023 (vs. 14.7% in 2022 and 14.5% in H1 2023), which is a higher share than during the pre-Covid years (it stood at 13.3% in 2019). As a matter of fact, China has managed to develop its product range (from low value-added consumer goods to green technology products), gain a foothold on the electric vehicle market, and diversify its markets in an attempt to offset the drop in sales in the United States and the European Union.

BANKS ARE FACING AN INCREASE IN CREDIT RISKS

Since the summer, the authorities have been trying to boost activity, without giving up the needed adjustments in the property sector (deleveraging of developers, moderation of housing costs) and by taking into account strong constraints (downward pressures on the yuan, weak finances of local governments and, more generally, the high level of debt in the economy). Monetary and fiscal easing measures have mainly aimed to stimulate supply (manufacturing and construction) and investment (particularly in public infrastructure), and much less household consumption. So far, they have had very limited effects on private-sector demand, which is still plagued by a crisis of confidence.

In addition, the difficulties faced by Chinese financial institutions have both restricted the central bank's room for manoeuvre and weakened the transmission of monetary policy to credit activity. Between June and December 2023, growth in bank loans in local currency slowed from +11.6% y/y to +10.9% y/y in nominal terms and remained more or less stable in real terms. Growth in total outstanding social financing accelerated slightly (from +9.3% y/y to +9.8% y/y in nominal terms), thanks in particular to the increase in bond issues (Chart 2).

Since June 2023, there have been only small cuts to key policy rates (with the 1-year MLF rate decreasing from 2.75% to 2.5% and the 1-year Loan Prime Rate decreasing from 3.65% to 3.45%, for example). Reserve requirement ratios (RRRs) have also been reduced only slightly, but further cuts have just been announced (the weighted average RRR for the banking sector fell from 7.6% to 7.4% at the end of 2023, and to 7% at the start of February 2024).

CHINA: TENTATIVE REBOUND IN DOMESTIC CREDIT GROWTH

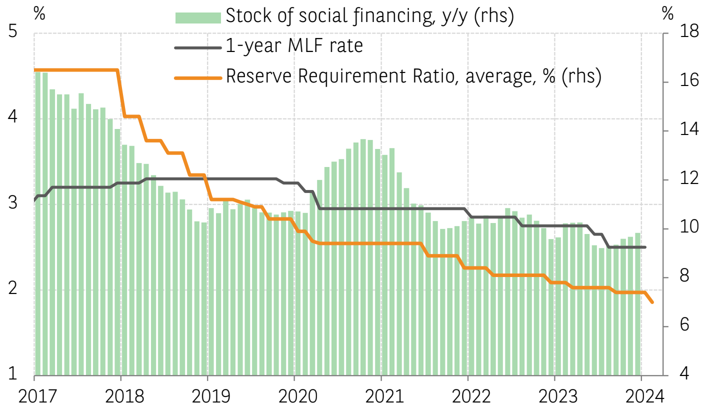

CHART 2 SOURCE: PBOC, BNP PARIBAS

The corresponding liquidity injection must help support the acceleration of central government and local government bond issues. In the short term, further monetary easing measures are expected, with the use of a wider range of instruments and more targeted credit measures.

The average quality of financial-sector assets has deteriorated over the past four years, due to the pandemic, the weak economic recovery last year, the property sector crisis and the financial difficulties of local governments. This deterioration is not large enough to trigger systemic instability. In particular, credit risks have affected non-bank financial institutions, small banks and bond markets more, while the asset quality deterioration of major commercial banks has been much more moderate. In addition, the liquidity risks faced by local governments and their financing vehicles in the short term have been reduced by the support measures recently implemented (including a programme to refinance debt of some financing vehicles with bonds issued directly by local governments, and a transfer of central government funds to local governments in Q4 2023).

In the banking sector, the average non-performing loan (NPL) ratio has remained low, standing at 1.6% in Q3 2023 (compared to 1.9% at the end of 2019). First and foremost, banks managed to contain the rise in NPL ratios thanks to large disposals of non-performing assets (which accounted for 0.5% of total loans over the Q1-Q3 2023 period). Secondly, risks on property loans are still manageable, even though these loans constitute a very large share of total outstanding bank loans (mortgage loans: 16.9% of the total in 2023, compared to 21.9% in 2019; loans to developers: 5.5% in 2023, compared to 7.4% in 2019). At the end of 2023, the NPL ratio on loans to developers was estimated to stand at 4% (by the Institute of International Finance), but the NPL ratio on mortgage loans was below 0.5% (compared to 0.3% in 2019), thanks in particular to the low loan-to-value ratios enforced by prudential regulations and to the moderate correction in housing prices.

Commercial banks are also facing deteriorating profits caused by lower net interest margins (which fell from an average of 2.22% at the end of 2019 to a historic low of 1.73% at the end of September 2023). While some small banks could see their capitalisation ratios dangerously weakened by the decline in their profits and asset quality deterioration, large nationwide banks are strong enough to ride out the difficulties and support the authorities, albeit cautiously, in their efforts to boost economic growth.

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