CHINA

DUAL CIRCULATION STILL DIFFICULT

In China, manufacturing activity remains dynamic, but rising tensions with most of its trading partners and an increase in protectionist measures are now weighing on export prospects. At the same time, domestic demand continues to be held back by the crisis in the property sector, and credit growth is slowing despite monetary easing measures. Therefore, the authorities are expected to continue to ease cautiously their economic policy in the coming months. The financial difficulties of local governments and, more generally, the deterioration in public finances have reduced the fiscal room for manoeuvre. The central government is being pressed to take a more direct role in support measures.

PROTECTIONIST THREAT

The various components of Chinese economic growth have exhibited varying trajectories since the beginning of 2024. Overall performance is somewhat lacklustre. Following a rebound to +1.6% q/q in Q1 2024, growth is expected to slow in Q2.

In recent months, economic activity has been largely driven by the momentum seen in the export-oriented manufacturing sector, which itself has been supported by the Chinese authorities' very ambitious industrial policy. Although slowing slightly in May, growth in industrial production reached +6.2% year-on-year (y/y) over the first five months of 2024 (compared to +5.2% in H2 2023). This growth rate is close to rates posted in pre-Covid years (*Chart 1*). Meanwhile, investment in the manufacturing sector has increased at a steady pace since the beginning of the year (+9.6% y/y compared to +6.5% in 2023).

Growth in the industrial sector has been largely driven by the production of goods for export in the high-tech and green-technology sectors. For example, chip production and electric vehicle (EV) production jumped by more than +30% y/y over the first five months of 2024. Exports valued in current dollars recorded a modest increase over the first four months of 2024 (+2% y/y), and then rebounded by +7.6% y/y in May. It is worth noting that volumes of exports reached record levels (+10% y/y in Q1 2024), with Chinese companies gaining global market share thanks to lower sale prices.

These strategies have led to heightened tensions between China and most of its trading partners. Consequently, while the export outlook remains positive in the very short term, it could be quickly dampened by the surge in protectionism. In fact, various protectionist barriers have been implemented or are being considered: i) the European Union will be imposing tariffs on imports of Chinese EVs from July 2024, ranging from 17.4% to 38.1% depending on the automaker; ii) the United States has recently increased its tariffs on a range of Chinese goods such as EVs, semiconductors and medical devices (and presidential candidate Donald Trump is even threatening to apply, if elected, a significant increase in US tariffs on all Chinese goods); and iii) a growing number of emerging countries are following suit. Turkey, for example, has just announced additional tariffs on imports of Chinese vehicles, and a number of governments have launched investigations into Chinese subsidies (including Brazil in the steel sector and Vietnam in the wind power sector).

NEVER-ENDING CRISIS IN THE PROPERTY SECTOR

In the services sector, activity strengthened in May and increased by +5% y/y over the first five months of 2024 – compared to average growth of +7.6% over the three years preceding the pandemic.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	8.4	3.0	5.2	5.2	4.3
Inflation, CPI, year average, %	0.9	2.0	0.2	-0.1	1.2
Official budget balance / GDP, %	-3.1	-2.8	-3.9	-3.8	-3.6
Official general government debt / GDP, %	46.8	50.6	56.1	59.0	62.0
Current account balance / GDP, %	2.0	2.5	1.4	1.4	1.2
External debt / GDP, %	15.4	13.7	13.8	13.2	12.8
Forex reserves, USD bn	3 250	3 128	3 238	3 233	3 203
Forex reserves, in months of imports	12.6	11.9	12.4	11.8	11.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: DIVERGENCES BETWEEN SECTORS

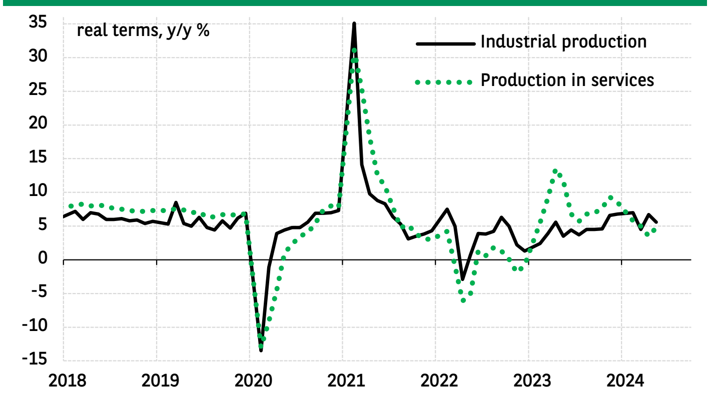

CHART 1 SOURCE: NBS, BNP PARIBAS

The services sectors benefited in May from the strengthening in retail sales growth, which nevertheless remained modest (+3.7% y/y in value). Inflation has accelerated slightly but remains very low; the consumer price index rose by +0.3% y/y in April and May, after 0% in Q1 2024 and -0.3% y/y in Q4 2023.

Above all, the main obstacle to domestic demand growth remains powerful, as the property crisis shows no signs of improvement. Housing sales volumes continued to contract (-24% y/y over the first five months of 2024), as did property starts (-25%).

Real estate investment continued to fall (around -10% y/y over the first five months of 2024). In addition, the decline in property prices worsened (-7.5% y/y on average in May for second-hand homes in the 70 main cities, compared to -4.1% y/y in December 2023). The package of new support measures announced by the authorities in May has not yet been able to have a positive effect on activity in the property sector. These measures include a further easing of mortgage lending conditions (with a lowering in the minimum down payment requirement and measures aimed at reducing interest rates) and a programme for local governments to buy unsold homes, aimed at reducing developers' stocks of unsold homes and increasing stocks of social housing.

LOWER CREDIT GROWTH

More generally, growth in total domestic credit has slowed since the start of the year, despite the accommodative monetary policy stance (*Chart 2*). Total outstanding Aggregate Financing (TAF) rose by 8.4% y/y in May 2024 compared to +9.8% in December 2023, and total bank loans in local currency (representing 64% of TAF) rose by +8.9% y/y in May, compared to +10.9% in December. Conversely, central government and local government bond issues have increased at a slightly steadier pace since Q4 2023, in order to support the rise in public spending (in particular investment in infrastructure, environmental projects and social housing).

Given the persistence of the property crisis, the lack of vigorous activity in services and the emergence of new risks weighing on export prospects, the authorities are expected to ease their fiscal and monetary policies further in the coming months. Their approach will remain cautious. Firstly, the central bank's action is currently hampered by capital outflows and depreciation pressure on the yuan – which are expected to ease once the US Federal Reserve starts its rate cut cycle, i.e. in Q4 2024, according to our forecasts. Secondly, the authorities' room for manoeuvre to stimulate credit is still significantly constrained by the excessive level of corporate and local government debt. The central bank governor recently stated that support for economic activity should involve better credit allocation rather than a faster increase in total outstanding credit.

PUBLIC FINANCES NOT AS STRONG AS BEFORE THE PANDEMIC

The financial difficulties of local governments and, more generally, the gradual deterioration in public finances are also increasingly limiting the authorities' fiscal room for manoeuvre.

In fact, fiscal balances and government debt have deteriorated sharply in recent years. Based on IMF estimates, the total general government deficit increased from 3.9% of GDP on average over the years 2015-2019 to over 7.5% since 2020. This increase can be explained by the rise in public spending, linked in particular to the health crisis, by the weakening of tax revenues, and by the fall in local governments' land sales proceeds. Meanwhile, the "official" budget deficit increased from an average of 2.7% of GDP in 2015-2019 to 3.9% in 2023. But this deficit does not accurately reflect the situation of the public accounts as a whole, since it represents the general government balance adjusted for various transfers from other public accounts, on which the available data remains incomplete.

CHINA: MONETARY LOOSENING

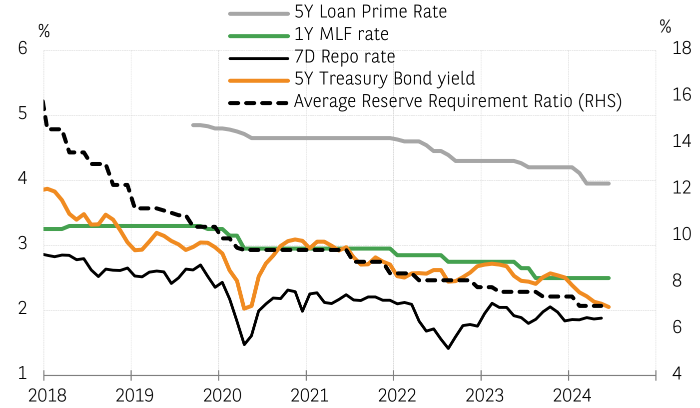

CHART 2 SOURCE: PBOC, NIFC, BNP PARIBAS

Between 2018 and 2023, the total official debt of the general government increased from 36.4% to 56.1% of GDP. This is budgeted debt, consisting of bonds issued by central government (23.8% of GDP in 2023) and local governments (32.3% of GDP). Central government bond debt alone is still at a moderate level and faces no refinancing risk. Its profile is very favourable, since it consists mainly of securities in local currency (98.9% of the total), issued at low interest rates and held by local financial institutions. Foreign investors held 8.7% of central government bonds at the end of 2023 (compared with a peak of 11.9% at the end of 2021).

As far as local governments are concerned, bond debt is at a higher level, and is becoming less and less sustainable for some provinces and municipalities. But above all, this "official" debt is aggravated by an indirect debt contracted by local government financing vehicles (LGFVs). LGFV debt rose from 38% of GDP in 2018 to 53% in 2023, according to IMF estimates, and is excessively high. The risk of default by LGFVs has risen sharply over the past two years. As a result, since last year Beijing has authorised certain local governments to issue new bonds to refinance the most fragile LGFVs and thus reduce short-term liquidity risk. However, these measures are modest in scale (debt swaps in 2023 represented just 1.2% of GDP). In addition, the liabilities of local governments are increasing, so the medium-term solvency risk remains. The authorities have also asked banks to restructure some of their loans to LGFVs (by extending maturities and/or reducing interest rates). But this solution also has its limits, as it weighs on the performance of the banking sector.

In addition, the central government is increasing its direct role in fiscal stimulus policy and support for local governments. In mid-May, for example, it launched a programme to issue very long-term bonds (20 to 50 years), worth RMB 1,000 billion for 2024 (0.8% of GDP). Half of this amount is to be used to cover the financial needs of the central government, and the other half is to be transferred to local governments. In the short to medium term, general government debt is expected to continue to rise, mainly due to the persistence of high fiscal deficits against a backdrop of structurally slower economic growth. At the same time, the central government's share of total outstanding debt is likely to increase gradually.

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