China

Difficult policy choices

Since Q2 2018, Beijing has let the yuan depreciate against the dollar each time the US has raised its tariffs on imported goods from China. Yet, exchange rate policy as an instrument to support economic activity is expected to be used moderately in the short term. There is also little room to stimulate credit given the excessively high debt levels of the economy and the authorities' priority on pursuing efforts to clean up the financial system, the public sector and the housing market. Torn between stimulating economic growth and deleveraging, the authorities' dilemma could get worse if recent fiscal stimulus measures do not have the intended impact on domestic demand, or if the external environment were to deteriorate further.

Real GDP growth slowed to 6.2% year-on-year (y/y) in Q2 2019, down from 6.4% in the previous quarter and 6.6% in full-year 2018. Growth should continue to slow in the short term since the support provided by policy stimulus measures will only partially offset the impact of the slump in external demand. The authorities' room for manoeuvre to stimulate growth has narrowed sharply in recent years due to the erosion of external surpluses and rising internal imbalances (excessive debt, need to clean up the public and financial sectors).

Yuan depreciation should continue to be moderate

In the first eight months of 2019, export revenues stagnated compared to the same period in 2018 (-0.05%) because of higher US tariffs and the decline in world trade growth. Thanks to a 4.5% fall in imports, the trade surplus increased by 30% y/y to USD 262 billion over the same period. The export sector's troubles are expected to get worse in the months ahead, and the outlook for 2020 is still very uncertain since it hinges on the outcome of trade talks between Washington and Beijing.

Since Q2 2018, the weighted average tariff imposed by the United States on imported Chinese goods has increased from 6.5% to about 20% at the end of September 2019 (tariffs have so far been raised on more than two thirds of these imports). The weighted average tariff could exceed 25% by the end of the year if the recently renewed trade talks were to collapse and the new tariffs announced by the Trump administration last summer were effectively introduced. It threatened to apply tariffs to all US imports of Chinese goods (totalling USD 550bn). Between the end of March 2018 and the end of August 2019, the yuan lost nearly 13% against the dollar (including 3% in July-August). This decline more than offset the increase in the yuan reported in the previous fifteen months. With each new increase in US tariffs (announced or effective), the Chinese authorities have responded by letting the yuan depreciate to partially offset the impact on exporting companies (chart 2). In September, despite the introduction of new tariffs, the yuan levelled off against the dollar because Beijing and Washington had agreed to restart trade talks.

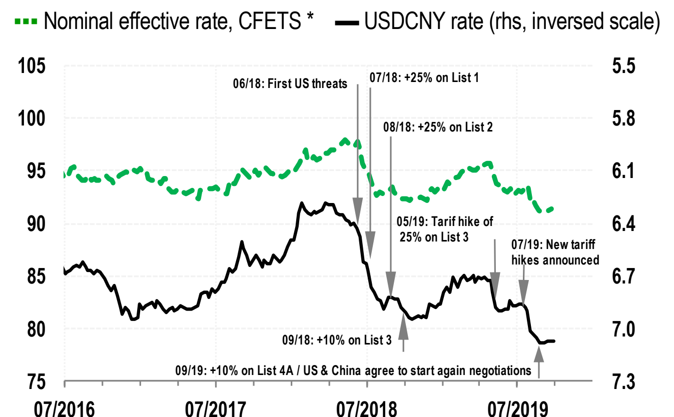
The authorities are expected to resort to the exchange rate policy moderately to stimulate economic activity in the short term. They fear the anticipation of currency depreciation could trigger a vicious circle of new capital outflows and yuan weakening. Yet this risk is limited given the existing controls on resident capital outflows (which have been reinforced since 2016, and then adjusted depending on balance-of-payment pressures). Moreover, the slight improvement in the current account surplus (it stood at 1.3% of GDP in H1 2019 and is projected 1.7% in full-year 2019, compared to 0.4% in 2018) and the expected increase in foreign portfolio investment inflows into China's financial markets (following recent market opening measures) might also help stabilise the exchange rate in the short term.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	6.6	5.9	5.6
Inflation (CPI, year average, %)	1.6	2.1	2.4	2.8
Actual fiscal balance / GDP (%)	-3.7	-4.2	-4.5	-5.0
Central government debt / GDP (%)	16.4	16.6	19.6	22.0
Current account balance / GDP (%)	1.4	0.4	1.7	1.4
Total external debt / GDP (%)	14.4	14.5	14.1	13.5
Forex reserves (USD bn)	3 140	3 073	3 075	2 980
Forex reserves, in months of imports	17.0	14.5	14.9	14.8
Exchange rate USDCNY (year end)	6.5	6.9	7.3	7.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- US tariffs and China's exchange rate policy



Source: China Foreign Exchange Trading Center, BNP Paribas.

** The CFETS index shows the yuan's weighted average exchange rate against the currencies of China's main trading partners.*

*** The lists of Chinese goods imported by the US and affected by tariff hikes are called "List 1" totalling USD 34 bn, "List 2" totalling USD 16 bn, "List 3" totalling USD 200 bn and "List 4A" of USD 125 bn (first slice of list 4).*

Credit is not responding much to monetary easing

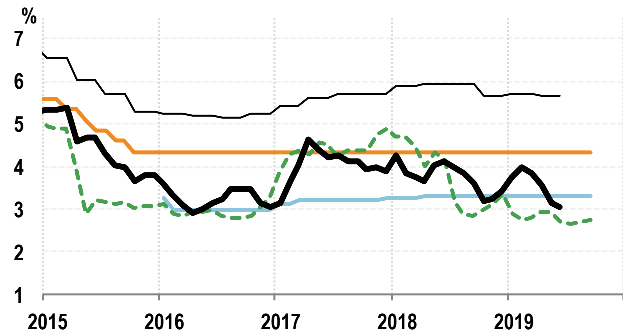
Investment and private consumption growth continued to falter in Q3 2019. In value terms, investment rose by only 5.5% y/y in the first eight months of 2019, compared to 5.8% in H1 2019. Growth in retail sales slowed to 7.5% y/y in July-August, compared to 8.4% in H1 2019. There are several downside factors: the troubles in the manufacturing sector are squeezing corporate profits and affecting the job market; food price inflation has surged (+10% y/y in August), and growth in bank loans to households has slowed (+16% y/y in August compared to +21% at year-end 2017). In this morose environment, it is interesting to note that the housing market has picked up a bit, with transaction volumes increasing slightly again in July-August, while average house price inflation continued to ease (+5.3% y/y in August). In the commercial and office real estate markets, in contrast, sales volumes continued to slump.

Monetary and fiscal policies have become increasingly expansionist since spring 2018 to counter the slowdown in domestic demand growth. Monetary and credit policy has been eased continuously and cautiously. Banks have been encouraged to increase lending to certain corporates, such as SMEs, the healthiest companies and the most buoyant sectors; liquidity conditions have been improved, thanks to successive reductions in reserve requirement ratios (the latest 50bp cut was in mid-September) and bank lending rates have been lowered slightly. To increase the effectiveness of its actions, the central bank announced a new interest rate reform in August 2019: the one-year loan prime rate will no longer be guided by the "benchmark lending rate", but by the "medium-term lending facility (MLF) rate". This change should improve the transmission of monetary policy and encourage the decline in interest rates on loans to the non-financial sector in the short term.

As a matter of fact, the weighted average lending rate on bank loans has not declined much since the beginning of monetary easing. From Q2 2018 to Q2 2019, it narrowed by 28 basis points (bp) in nominal terms and by 120bp in real terms (chart 3). Domestic credit growth has barely picked up. The rebound in bank lending (which accounts for two thirds of "total social financing") proved to be short lived: after accelerating between H2 2018 and Q1 2019, nominal loan growth slowed again from 13.8% y/y in March 2019 to 12.6% in August. Banks have remained very cautious in view of the economic slowdown, the excessively heavy debt burden of borrowers, and high risk of defaults. Credit from non-bank financial institutions (shadow banking) has continued to contract, illustrating the authorities' determination to continue cleaning up the financial sector. Bond issues were the only type of financing that has accelerated gradually over the past year (+11.3% y/y in August).

As a matter of fact, the authorities have little room for manoeuvre to boost credit. Beijing wants to stimulate domestic demand while also continuing to strengthen the financial sector's regulatory framework, encourage deleveraging of both financial institutions and the weakest state-owned companies, and cool the property market in order to improve housing affordability. Excessive debt in the corporate sector (which was estimated at about 135% of GDP at mid-2019, excluding local government financing vehicles) and the already high level of household debt (55% of GDP) are major

3- Interest rates on bank loans do not decline much



Source: PBOC

factors constraining the growth and efficiency of new loans. Interest rates are expected to decline slightly further in the short term, and the authorities could try to ease monetary policy further if economic growth were to deteriorate further. Even so, this risks having only a very mild impact on activity.

The impact of fiscal measures should start to be felt

Growth in public infrastructure investment is beginning to pick up. It should strengthen further in the short term given the recent rebound in bond issuance by local governments for project financing. Yet the authorities have limited room for manoeuvre to boost public investment as local governments and their financing vehicles are also strapped with high debt (estimated at about 50% of GDP).

A series of fiscal stimulus measures have been introduced since 2018. Household tax cuts aim to stimulate consumer spending by providing direct support for disposable income. These measures are geared especially towards low-income households. For example, changes introduced over the past year include raising the income tax brackets for the lowest income earners. The authorities initially estimated that tax cuts would boost total disposable income by as much as RMB 660 bn, which could increase private consumption by a total of 1.2 percentage points. The positive impact on household spending was not visible yet in August's economic indicators. However, the slight improvement in the "new orders" components of the PMIs for both the manufacturing and services sectors in September seems to suggest that a recovery in private consumption growth is possible in the very short term.

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