# CHINA



## FIRST SIGNS OF CREDIT POLICY TIGHTENING

**Economic growth reached 2.3% in 2020. Activity has rebounded rapidly since March and the recovery has gradually spread from industry to services. Infrastructure and real estate projects continue to drive investment, but it is also beginning to strengthen in the manufacturing sector, encouraged by solid export performance. Private consumption is still lagging, but yet has picked up vigorously since the summer. Whereas fiscal policy should continue to be growth-supportive in the short term, the monetary authorities are expected to adjust their priorities. Credit conditions should be tightened slowly, especially via the introduction of new prudential rules. Corporate defaults are likely to increase alongside efforts to clean up the financial sector.**

China has experienced a V-shaped economic recovery since lockdown restrictions were lifted last March. After contracting 10% between Q4 2019 and Q1 2020, real GDP regained all of the lost ground in just a quarter (+11.6% q/q in Q2). Real GDP then rose by 3% q/q in Q3 and by another 2.6% in Q4. Moreover, the recovery has gradually spread. The rebound was initially driven by industrial production and by investment in public infrastructure and real estate, which were buoyed by policy stimulus measures. Then the rebound in global demand has boosted the export sector. Lastly, the services sector and private consumption have regained strength since the summer. In full-year 2020, real GDP growth reached 2.3%.

However, the crisis triggered by the Covid-19 pandemic has left scars. Private consumption in particular is still far from returning to normal, since households have been hard hit by the downturn in the labour market and in disposable income. Moreover, enterprises have faced increasing financial difficulties while their debt ratios are excessively high. Credit risks are on the rise and we are bound to see an increase in corporate defaults both on bank loans and in the bond market. The authorities have begun to adjust their credit policy to give priority to controlling the risks of instability in the financial sector, albeit without thwarting the turnaround in the economy.

| FORECASTS | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 6.1 | 2.3 | 9.5 | 5.3 |
| Inflation (CPI, year average, %) | 2.9 | 2.5 | 2.3 | 2.8 |
| Official budget balance / GDP (%) | -2.8 | -3.6 | -3.0 | -3.0 |
| Central government debt / GDP (%) | 17.0 | 19.5 | 20.6 | 22.0 |
| Current account balance / GDP (%) | 1.0 | 2.0 | 1.7 | 1.4 |
| Total external debt / GDP (%) | 14.4 | 16.1 | 16.0 | 15.6 |
| Forex reserves (USD bn) | 3 108 | 3 217 | 3 260 | 3 300 |
| Forex reserves, in months of imports | 15.0 | 16.5 | 15.5 | 15.0 |
| Exchange rate USDCNY (year end) | 7.0 | 6.5 | 6.4 | 6.5 |

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

## V-SHAPED RECOVERY IN ECONOMIC ACTIVITY

The economic recovery has been solid over the last months of 2020 (chart 1). On the supply side, industrial production has accelerated continuously since lockdown restrictions were first lifted in March, and reached 7.3% year-on-year (y/y) in December. In 2020, industrial production was 2.8% higher in volume than in 2019 (and about +1%in value terms given the 1.8% decline in producer prices in 2020).

In the services sector, the rebound started much later, but activity has accelerated strongly since September. After plummeting in Q1, growth in the services sector swung from -0.4% y/y in Q2 to +4.3% in Q3. In Q4, it finally caught up with and surpassed the growth of industrial production (+7.7% y/y). although activity in the services sector slightly declined in December, it is expected to resume its role as the main growth engine in 2021.

The acceleration in services has kept pace with the renewed vigour of private consumption. Although online commerce picked up rapidly in Q2, the rebound in retail sales was very hesitant at first and did not strengthen until the end of the summer (it reached +5% y/y in Q4). In 2020, retail sales volumes were still nearly 5% below the 2019 level.

Households are regaining confidence, bolstered by the recent improvement in the labour market and by declining inflation. The urban unemployment rate has fallen since March, and hit 5.2% in November and December, the same level as in December 2019. Consumer price

V-SHAPED REBOUND, RETAIL SALES STILL LAGGING

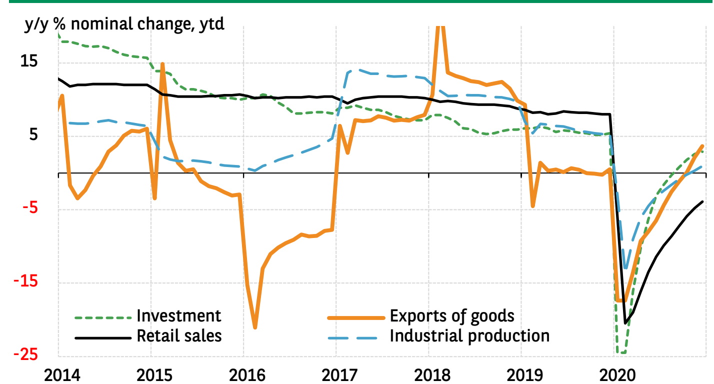
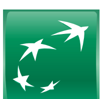



CHART 1 SOURCE: NBS, CEIC

inflation has fallen sharply in 2020, dropping from 5% y/y in Q1 to 0.1% in Q4. This is mainly due to the major slowdown in food prices, which had soared in the last months of 2019 and the first months of 2020. Core inflation is also low, but stable (+0.5% since July, down from an average of 1.6% in 2019).

Household demand should continue to recover, although it is likely to idle somewhat longer given the increase in the number of precarious jobs that accompanied the improvement in the labour market and the mild increase in disposable income in 2020 (+2.1% in real terms, vs. 5.8% in 2019) and persisting uncertainties over the epidemic situation.



At the same time, new measures to stimulate private consumption will probably be adopted next year, since expanding consumption remains a top priority for China's economic strategy. In the new five-year plan presented last fall, the domestic market is clearly specified as one of the pillars of economic growth. The details of the 2021-2025 five-year plan will be released in March.

Domestic investment has strengthened gradually since Q2, growing by 2.9% in full-year 2020. It has been largely fuelled by Infrastructure and real estate projects, even though these have recently started to slow slightly. Investment in the manufacturing sector has shown signs of picking up, bolstered notably by the solid performance of exports.

These exports have rebounded since June and rapidly gained strength, rising from an average of +10% y/y (in current USD) for the period July-October to an average of 20% y/y in the last two months of the year. China has successfully responded to the strong increase in global demand for medical supplies and equipment, technological goods, and more recently, for other consumer goods such as toys. Export prospects are still uncertain, however, since they are dependent on the ongoing turnaround in global demand, which hinges on the spread of the pandemic, and on future trade talks between Washington and Beijing.

## PRUDENT CHANGE IN MONETARY AND CREDIT POLICY

Fiscal policy and public investment are expected to continue to support economic activity. Meanwhile, the authorities have begun to selectively tighten their credit policy. Given the solidity of the economic rebound, the monetary authorities have now some leeway to adjust their goals and give priority to controlling risks in the financial sector. Yet tightening the screws on lending will be no easy task. On the one hand, it must not hamper the ongoing economic turnaround, nor add to deflationary pressures. Beijing probably also wants to avoid accentuating the yuan's appreciation, which has already gained 9% against the USD since the end of May 2020. On the other hand, while encouraging healthy loan practices, the authorities must continue to support otherwise healthy enterprises that are encountering financial difficulties due to the Covid-19 crisis, while limiting the risks of instability and bouts of stress in the financial sector.

The central bank, PBOC (People's Bank of China), should therefore remain prudent. Since April, it has maintained its key policy rate at 2.95% (after a 30 basis point cut earlier in the year) and gradually tightened money market rates until November (the 7-day repo rate rose from an average of 1.5% in April to 2.3% in November). Yet, PBOC has reversed the trend since December (the 7-day repo rate averaged 1.9% in the first two weeks of January 2021). In the very short term, the central bank will probably act to ease any excessive tension in the local monetary and bond markets and maintain liquidity at comfortable levels in the financial sector.

In contrast, the authorities are likely to slowly tighten credit conditions by acting primarily on the prudential framework and by demanding greater discipline from financial players. They have recently introduced rules to put debt limits on real estate developers, and also clearly signalled their determination to supervise internet finance more closely. In early December, they announced tighter prudential standards applicable to banks considered to be too big to fail, and the list of these institutions is expected to get longer, notably to increase supervision of regional banks. Growth in the social financing stock (total domestic credit), which accelerated from 10.7% y/y at year-end 2019 to 13.7% in October, already levelled off during the last two months of 2020.

NEW RISE IN DEBT LEVELS

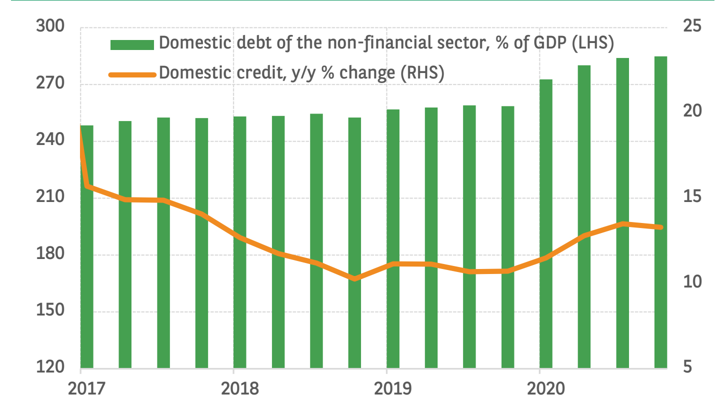



CHART 2 SOURCE: PBOC, BNP PARIBAS

## CORPORATE DEFAULTS ARE EXPECTED TO INCREASE

Corporate defaults are expected to increase in 2021 due to the effects of the Covid-19 crisis and the corollary impact of efforts to clean up the financial sector. The Chinese economy entered the Covid-19 crisis with excessively high levels of debt, estimated at 258% of GDP at the end of 2019 (domestic debt of the non-financial sector). In 2017-2019, measures were implemented to reduce financial risks (including tighter regulations, a decline in shadow banking activities, and the start of corporate debt reduction), but this movement was cut short by the Q1 2020 crisis and the ensuing easing of the monetary and regulatory environment. The debt excess of the economy has only worsened: the debt-to-GDP ratio is estimated to have increased by about 25 percentage points in 2020, after a ten-point increase in the previous three years (chart 2).

Although economic activity has returned to normal in most sectors, many corporates and households are still in fragile positions after the financial losses of the beginning of the year. Domestic credit conditions are starting to be tightened and the weight of debt servicing charges will increase considerably in the months ahead as post-Covid support measures (credit lines, refinancing, rescheduling of debt repayments) wind down. In the banking sector, the official non-performing loan ratio increased slightly to 1.96% in Q3 2020, which is still low but trending slightly upwards. Recent corporate defaults in the local bond market also foreshadow more to come. The number of corporate defaults is expected to rise rapidly in the coming months. More importantly, the share of state-owned enterprises in default is starting to increase, showing proof of a slow decline in implicit state support.

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