China: private consumption, a fragile growth engine

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Private consumption has played a greater role in the Chinese economy in recent years, but this growth engine remains fragile. At a time when the export sector is hurt by US protectionist measures and weak global demand, China is seeking other solid sources of growth. Yet private consumption growth is slowing and is likely to be disappointing in the short and medium terms. A catching-up dynamic should continue, supported by urbanization, an ageing population and action of the government, which strives to reduce income inequality, improve housing affordability and further strengthen the social protection system. However, these structural changes will take time. Moreover, although certain sectors show potential for major productivity gains, wage growth is likely to be hampered by the troubles of the industry, where production growth is slowed and the move upmarket is hampered by rivalries with the United States. Lastly, household debt has swelled rapidly in recent years and could now start to place a damper on consumption.

The Chinese economy has slowly pursued its transition towards a more moderate, more balanced growth model since 2011. The transition has been fostered by the growth slowdown in exports and investment while private consumption has definitely increased its role as a growth engine. There has been a far-reaching change in consumer behavior, especially among China's wealthiest households. Yet private consumption is not a solid growth engine, and its growth has weakened in recent months. At a time when manufacturing exports are affected by US tariff hikes and the debt excess of corporates is restricting their ability to increase investment, household consumption is struggling to pick up the slack.

In the short and medium terms, the catching-up dynamic of private consumption will remain very gradual. Much will depend on wage growth, which could get a boost from the expected productivity gains in certain sectors, notably services, but will also be hurt by the difficulties of the industrial sector. Government action is also expected to play a key role by helping lower the household savings rate and reduce income inequality (which should trigger a catching-up dynamic of the consumer behavior of low-income households). The necessary reforms have been clearly identified by the authorities, integrated in their development strategy and gradually implemented in recent years. However, the process of change remains slow. Moreover, credit to households has become another key factor behind consumer spending, but after a period of rapid growth, debt servicing charges could begin to squeeze private consumption.

A slow transition

China's economic growth slowed from 10.6% in 2010 to 6.2% in H1 2019. This slowdown is essentially due to structural factors. The effects have been exacerbated over the past two years, first by tighter credit conditions – needed for reducing financial-instability risks – and then by weaker global demand and US trade barriers. To address the deterioration in the performance of both exports and domestic demand, the authorities have gradually shifted their economic policy stance. Monetary policy has been cautiously eased since Q2 2018, and a series of fiscal stimulus measures have been launched. At a time when trade tensions between Washington and Beijing have made export prospects very uncertain, this accommodating economic policy should support domestic demand and help the economy to continue its soft landing in the short term.

Structural economic slowdown since 2011

The decline in China's potential growth rate illustrates the structural nature of the slowdown. We estimate potential GDP growth slowed from 11.5% in 2006-2007 (the strongest growth in the 2000s) to 6.2% in 2018. All GDP growth factors –capital accumulation, labor and total factor productivity– have weakened in the period following the 2008-2009 global shock, often for interdependent reasons (Chart 1).

China's demographic dividend continues to diminish. Growth in the working-age population slowed sharply after the introduction of the one-child policy in the early 1980s. It was already less than 1% a year in the 2000s (compared to 3% in 1980), and has now dropped into negative territory (since 2012 if the working-age population is the 15-59 age group). At the same time, there has been a slowdown in the migration of labor from the countryside to urban areas. The urban labor force continues to increase, but the number of new job creations remain relatively stable (13.6 million new jobs in 2018). These trends have led, first, to the decline in the contribution of labor to GDP growth (which has been slightly negative since 2017 according to our estimates) and, second, to wage pressures. At the same time, factor productivity growth has slowed over the past ten years, following a period of very strong gains in 2003-2007. This moderation has been mainly due to the deterioration in capital allocation (reflecting a very high investment rate over a long period of time), the erosion of the beneficial effects of China's integration in global supply chains, and the economy's sector transformations. In fact, China has completed the process of reallocating labor from agriculture to industry, which enjoys higher productivity gains. Since 2013, job creations in the services sector have helped absorb the decline in employment in the primary and secondary sectors (Chart 2).

The smaller increase in labor productivity has squeezed wage growth, but this effect has been partially offset by upward pressure from demographics. In the end, real wage growth has slowed between 2009 and 2017, albeit to a lesser extent than productivity growth. This has constrained the increase in household revenues and, at the same time, contributed to China's loss of cost-competitiveness (Chart 3).

Real GDP

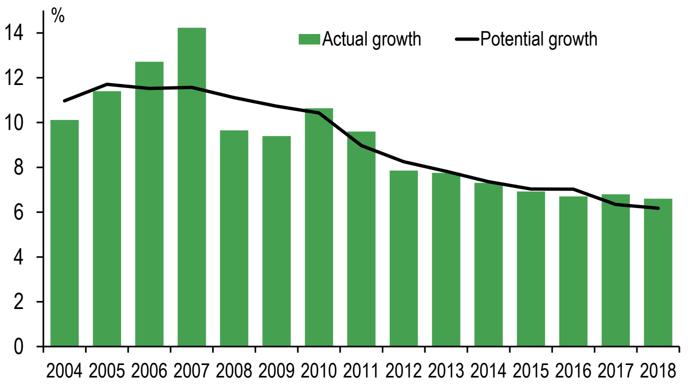

Chart 1 Source: NBS, BNP Paribas

Exports and investment

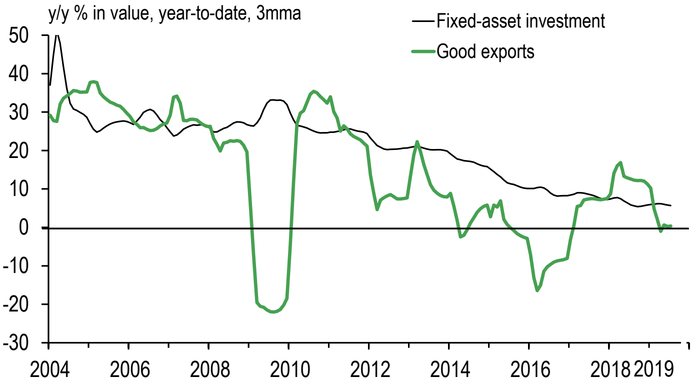

Chart 4 Source: NBS, General Adm. of Customs

Employment by sector

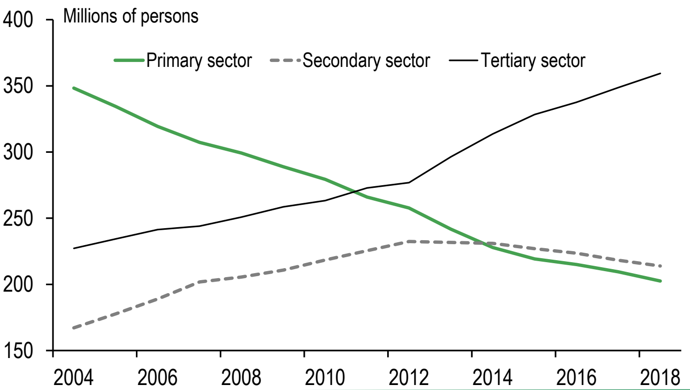

Chart 2 Source: NBS

Real GDP growth components

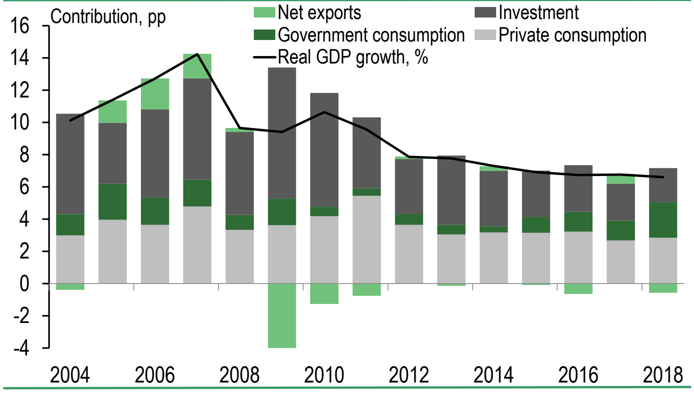

Chart 5 Source: NBS, World Bank, BNP Paribas

Wages and productivity

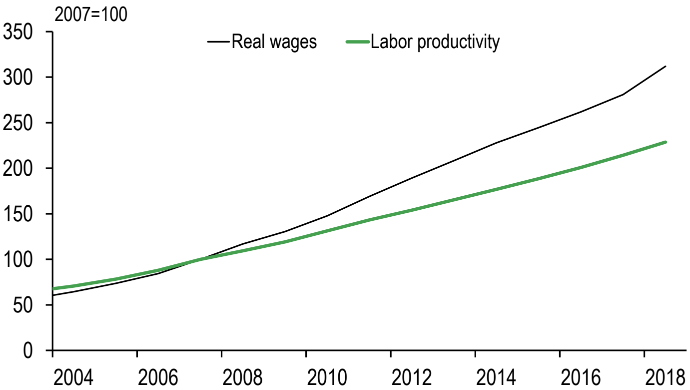

Chart 3 Source: NBS, BNP Paribas

Contribution share to nominal GDP by sector

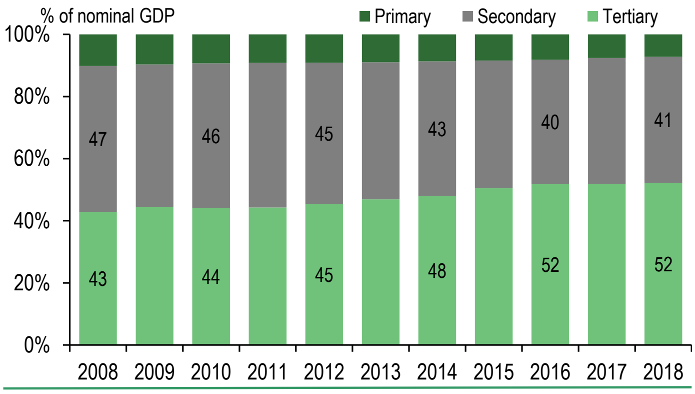

Chart 6 Source : NBS

Therefore, China has suffered from the exhaustion of its traditional growth engines, first exports and then investment. Merchandise export growth has declined sharply since the 2008-2009 shock, dropping from an average annual rate of 26% in volume in 2003-2007 to 5% in 2011-2018. The export manufacturing sector has been hurt by a loss of competitiveness (not only cost-competitiveness, but also the impact of a stronger yuan), slowing external demand and a lasting weakening of global supply chains. Exports rebounded in 2017, but the situation worsened again in 2018 due to another slowdown in world trade and US protectionist measures. Meanwhile, investment growth has decelerated in the majority of sectors, especially in manufacturing, mining and real estate. Following the 2008-2009 trade shock, the authorities launched a vast stimulus plan that helped boost public investment, but also accelerated the deterioration in capital allocation and aggravated economic imbalances (such as excess production capacity in the industry, real estate market distortions and debt excess of state-owned enterprises). As of 2011, the authorities took measures to reduce these imbalances (see below). This added to the slowdown in exports and led to a downturn in investment growth (Chart 4).

Having reached the limits of its old growth model, the Chinese economy has slowly pursued its transition towards a “new” growth regime. This regime aims to be more moderate, more inclusive and better balanced, i.e. less dependent on investment and credit, industry and exports of manufacturing goods. Instead it must rely more heavily on private consumption and services. China’s economic transition has made progress since 2011, especially thanks to structural reforms, but it still has a long way to go. Domestic consumption is not solid enough yet to step in for investment and exports as the main growth engine.

A still fragile rebalancing

The breakdown of GDP gives an idea of the extent of the rebalancing that has accompanied the growth slowdown since 2011. First, the role of investment and industry has diminished, but it is still important. Second, household consumption and services have made an increasingly large contribution to GDP growth. Nonetheless, certain factors underlying these transformations are still fragile.

Between 2011 and 2018, investment shrank as a share of nominal GDP from 47.8% to 44.1%, which is still very high. Over the same period, the share of household consumption increased from 36.2% of GDP to 38.7%. Private consumption has been the biggest contributor to real GDP growth since 2015 (Chart 5). Moreover, the national savings rate declined slightly from 49.6% of GDP in 2011 to 44.4% in 2018. The current account surplus has also eroded (0.4% of GDP in 2018). From a sector perspective, industry’s contribution to nominal GDP dropped from 46.5% in 2011 to 40.7% in 2018 (with construction accounting for 7%), while the contribution of services increased from 44.3% to 52.2% over the same period (Chart 6).

These transformations can be attributed to divergences in real growth rates as well as to price effects linked to a long period of industrial deflation from 2012 to 2016. The adjustment in industry and investment has been triggered by the weakening in world demand after years of over-investment and credit boom. In recent years, it has also gone hand in hand with structural changes encouraged by the authorities, and this should help make the rebalancing process more sustainable. Industry scaled back its excess production capacity (in nearly 20 sectors, and in the coal, steel, cement and flat glass sectors in particular), and shut down some of the most heavily polluting factories. Efforts to streamline state-owned enterprises have also been accompanied by a tighter credit policy since late 2016, which helped curb corporate debt growth in 2017-2018. Yet industrial restructuring and corporate deleveraging are far from over. Corporate debt is still excessively high, and industrial production capacity utilization rates are still low (76% at year-end 2018). It will be hard to pursue this process in the short term given the deterioration in the international environment. The authorities have redefined their economic policy stance in recent months, and are giving priority to contra-cyclical measures in the short term. The reduction in corporate debt ratios are likely to be interrupted in 2019.

The expansion of the services sector and private consumption has also been supported by structural changes that should contribute to the continued rebalancing process going forward. Fiscal measures and the elimination of entrance barriers in certain sectors have stimulated growth in services, while the strengthening of the social protection system, for instance, has helped stimulate household consumption (see below). Yet growth in services was driven not only by the retail trade sector, but also by finance and real estate (the three sectors accounted for 9.4%, 7.7% and 6.7% of GDP, respectively in 2018). Expansion of the financial sector was not sustainable because it was accompanied by a sharp rise in instability risks and, since 2016, its expansion has slowed and its share in total GDP has declined. The authorities have also tightened property policy, in order to cap housing price inflation and improve home affordability for households. Most importantly, private consumption growth, which is a key determinant of the development of services, has slowed.

Household consumption has lost momentum

The role of private consumption as a growth engine has increased over the past decade, as demonstrated by its higher contribution to GDP. Consumer behavior has changed profoundly in China, notably in urban areas and among the wealthiest households. As a result, discretionary spending (transport & communication, education & leisure and luxury goods, etc.) has increased over the past decade as a share of total household consumption spending while the average share of spending on basic necessities has decreased. Yet it is still high and should decline further (food and clothing still account for 35% of the average household budget in 2018, while another 23% is allocated to residence expenses). Moreover, there are still very large regional disparities and differences between revenue categories, which are bound to diminish (Chart 7).

Nonetheless, private consumption is not a very solid growth engine. It still accounts for less than 40% of nominal GDP, and its growth has slowed since it peaked at 15% in 2011. Real growth in private consumption fell to an average annual rate of 8% in 2013-2016 and then to 7% in 2017-2018 (estimates based on NBS and World Bank data). The recent worsening in the slowdown is even more alarming.

Growth in retail sales volumes slowed from 12% in 2011 to a low of 6.7% year-on-year (y/y) in H1 2019 (Chart 8). Automobile sales contracted by 3% in 2018 and by another 12% y/y in H1 2019, which heavily strained the overall performance (automobiles account for about 10% of total retail sales). This contraction was caused by a structural slowdown in the sector and by the end of fiscal incentives on car purchases implemented between year-end 2015 and early 2018. Sales also slowed in other sectors, notably durable goods (in line with the moderation in house sales) and the cultural and leisure sectors. Online sales growth has eased somewhat but remains buoyant (+22% y/y in H1 2019), and the consumption of services has followed similar trends (they currently account for nearly half of total consumer spending).

Several factors explain the recent consumption growth slowdown: the impact of industrial troubles on the labor market and household confidence; a slight upturn in inflation, driven by food prices (Chart 9); and more moderate consumer credit growth after the regulatory framework was tightened in the financial sector and the authorities cracked down on P2P (peer-to-peer) lending platforms between individuals. At the same time, the increase in household debt in recent years has begun to strain consumer spending (see below). Finally, real estate activity is another key factor, but its effects are mixed: the decline in property transactions over the past year has curbed durable goods purchases while the rapid rise in house prices since 2016 has increased incentives for household savings, but also triggered a positive wealth effect that favors consumption (Chart 10).

Increasing incomes and reducing savings are complex challenges

The recent slowdown in private consumption growth is also explained by strong structural constraints. On the one hand, real revenue growth has been trending downwards since 2011, although it levelled off in 2017-2018. On the other, households continue to save a high portion of their revenues. The household savings rate was still 36% of disposable income in 2018[1]. In the short and medium terms, the authorities must take action to boost household revenues and increase their propensity to consume.

The multifarious dynamics of productivity gains

Since 2011, disposable income per capita has increased at an average annual rate of nearly 8% in real terms. However, it has gradually lost steam, slowing to 6.5% in 2018 (Chart 11). Real wage growth, the main component of household disposable income, has slowed along with the easing of productivity gains and the downturn in the industry's activity and profits. Wage growth slowed from about 9% a year in 2010-2012 to 6% in 2016-2018. In the end, wages as a share of GDP have not increased much, rising from 57% in 2011 to 59% in 2018. Consumer price inflation has trended slightly upwards since 2016: it is no longer contributing to the improvement in household purchasing power but remains mild at an average annual rate of 2%.

In the short term, real wage growth is likely to be constrained by the difficulties of the manufacturing sector, which has been hit by sluggish external demand and the surge in US protectionist measures. Productivity gains could be curtailed by the impact of the US-China trade war and the dispute over technology, which could hamper the development of the sectors that are most propitious for a rapid upmarket shift. In addition, since 2013, there has been a tendency to reallocate production factors from industry to services, and this transition is bound to continue[2], placing further downside pressure on the economy's average level of productivity.

Public policies have a vital role to play. In general, renewed structural reforms should foster an improvement in the allocation of factors, stronger innovation and an ongoing increase in the skills level of the labor force, which is necessary for productivity gains to accelerate. This should help facilitate the development of high-skilled, high value-added sectors and offset the loss of competitiveness in labor-intensive sectors, which would thus prevent China from falling into a "middle income trap". The authorities have integrated these goals into their development strategy[3], but they are being implemented gradually and risk being disrupted by the deterioration in the external environment in the short to medium term.

Yet major intra-sector productivity gains are still expected, which should help offset the negative effects of inter-sector changes. Each sector should indeed be able to report specific productivity gains. In the industry, these gains will be facilitated by the deployment of the "Made in China 2025" plan, even though the quantitative targets are bound to be scaled back due to trade tensions with the United States. Launched in 2015, the plan aims to accelerate technological progress in ten strategic sectors[4], thanks to government support to finance renovation and innovation. China is to become the world leader in each of these sectors. It is accompanied by upstream spending efforts in research and development (R&D spending should rise to 2.5% of GDP in 2020, from 2.1% of GDP in 2015, which is higher than the OECD average of 2.3%).

In the services sector, productivity gains have been supported by recent structural reforms (deregulation, opening to private companies). They have been more particularly driven by high value-added sectors such as information and communications technology (ICT). These trends are expected to keep pace with the development of services (digitalization of traditional services, emergence of new high value-added sectors…)[5].

[1] Households account for half of total national savings. The household savings rate is exceptionally high at 45% of GDP. This compares with an average savings-to-GDP rate of 31% in the ASEAN countries, 36% in South Korea, 29% in India and 20% in Poland.

[2] Services are expected to account for 48% of employment in 2020, up from 46% in 2018 and 42% in 2015.

[3] The objectives of the economic development strategy were notably defined in the 13th five-year plan adopted by the People's National Assembly in March 2016 for the period 2016-2020.

[4] Computers, robotics, aerospace, clean vehicles, electrical equipment, farm machinery, new materials, naval engineering, rail equipment and biotechnology.

[5] The ICT sector accounted for 6% of Chinese GDP in 2017 and the "digital economy" in the broad sense of the term, about 30%. This figure could rise as high as 50% by 2025. See IMF: "*China's digital economy: opportunities and risks*", Working Paper, Jan. 2019.

Consumption patterns

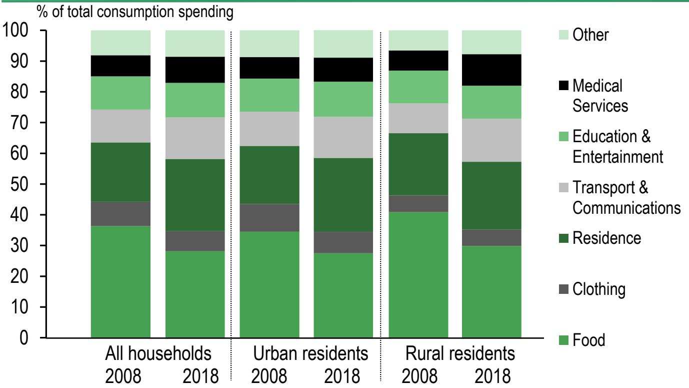

Chart 7 Source: NBS

Retail sales and e-commerce

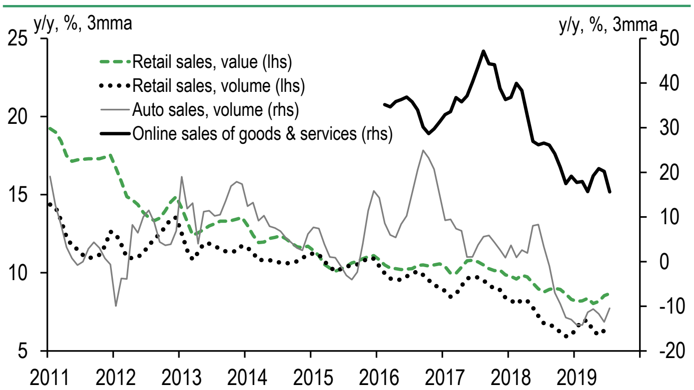

Chart 8 Source: NBS

Inflation

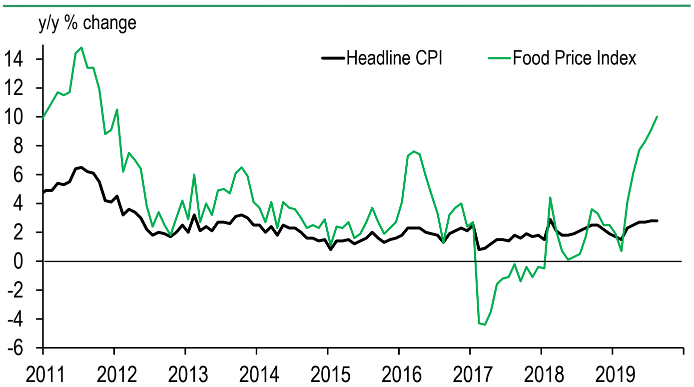

Chart 9 Source: NBS

Property market

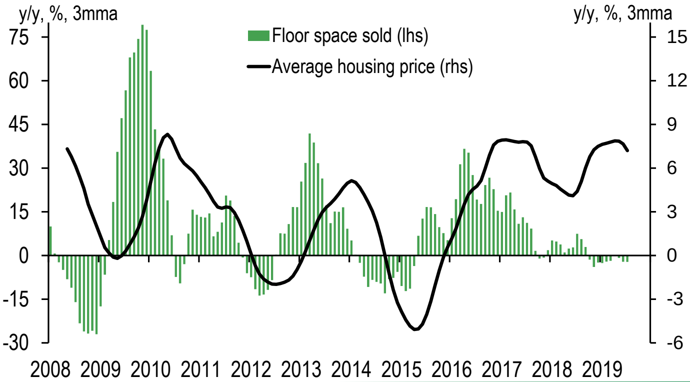

Chart 10 Source: NBS, BNP Paribas

Disposable income per capita

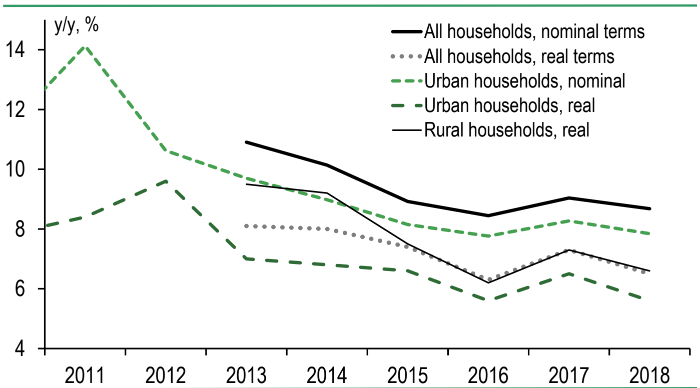

Chart 11 Source: NBS

Average wage growth, estimates by sector

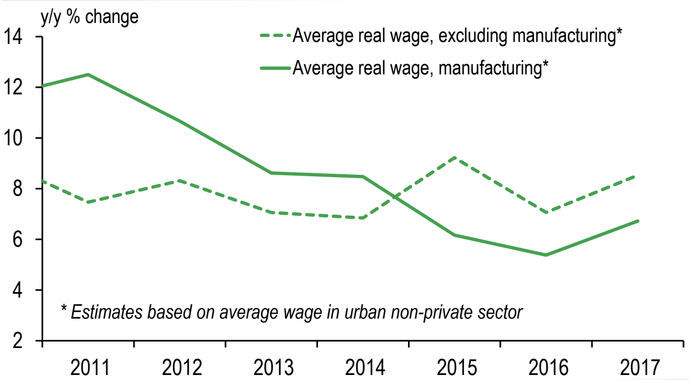

Chart 12 Source : NBS, Min. of Human Ressources and Social Security, BNP Paribas

These intra-sector dynamics explain why the slowdown in labor productivity gains in the economy as a whole managed to level off in 2017-2018 (at an estimated rate of 6.7%, compared to about 9% in 2011). We estimate labor productivity gains have improved in the services sector since 2015, and real wage growth appears to have picked up in this sector, exceeding that of the manufacturing sector (Chart 12).

Consequently, our central medium-term scenario calls for a gentle slowdown in productivity gains. This should help contain the deceleration in real wage growth, which should nonetheless continue to slow. Moreover, given the difficulties that lie ahead in the short term, our forecasts are exposed to major downside risks linked to possible delays in the structural reform process and to the trade tensions with the United States. In the end, real wage growth is likely to make only a moderate contribution to the expansion of private consumption in the short to medium term.

The reduction in the savings rate and income inequality: a slow but far-reaching process

To boost private consumption at a time when real wage growth is slowing, it is essential to lower the savings rate and reduce income inequality so that the consumer behavior of low-income households can catch up with that of the wealthiest households. Once again, the authorities have clearly identified the necessary reforms, which they have been gradually implementing over the past several years. These reforms include favoring more inclusive growth by strengthening the social protection system, reducing income inequality between rural residents, migrants and urban residents, and improving home affordability.

Households' savings rate seems to have stabilized recently

China's household savings are largely precautionary due to the high costs of retirement, healthcare, education and housing (house prices are high and rental markets are poorly developed). There has been some progress over the past decade to lower these costs as a whole. Reforms have helped expand access to public services (healthcare, education) and to the health insurance and old-age pension systems for urban and rural residents. Financial deregulation has also helped reduce the need for household savings by allowing better returns on savings products (elimination of the ceiling on deposit rates, larger savings options in the non-banking sector) and by easing household credit conditions.

The demographic dynamics of an ageing population and the reduction in the labor force have also played a preponderant role. The increase in the dependency rate, which began to rise in China in 2011, is a structural factor behind the decline in the average savings ratio. The increase in private consumption as a share of GDP is highly correlated with that of the dependency ratio[6], in keeping with the life cycle theory, and this demographic factor is expected to persist in the medium term. Yet the link between these two variables loosened in 2017-2018, illustrating the powerful brakes that have emerged to curb consumption (Chart 13 page 9).

The decline in China's savings rate has been a very slow process that seems to have come to a halt recently. The household savings rate diminished from 41% of disposable income in 2011 to 36.1% in 2016, before levelling off around this level in 2017-2018, according to our estimates (Chart 14).

Income inequality is still very high

The social safety net is still insufficient in China (for instance, social welfare benefits account for only about 10% of GDP), and income inequality remains very high[7] despite measures taken by the authorities to boost the revenues of rural and migrant workers and to increase the minimum wage (by 14% a year on average in 2012-2018 vs a 9% increase in the national nominal wage). The ratio between the disposable income per capita of urban households and that of rural households has declined slightly over the past decade, but is still high (2.7 in 2018, down from 3.3 in 2008). Similarly, inequalities in the distribution of wealth and revenues barely stabilized between 2011 and 2015: adults earning the highest 10% of revenues absorbed 42.9% of national revenues before taxes in 2015, compared to 41.4% in 2011, while the share of the lowest 50% of revenues was 14.8% in 2015, compared to 14.5% in 2011[8]. The concentration of revenues even seems to have accentuated since 2016, with the average income of the wealthiest households increasing faster than that of the poorest households. This trend might be explained by upmarket technological shifts in certain sectors, which amplify the revenue gap between workers in zones that benefit the least from those in the most advanced sectors and regions.

The disparities in consumer behavior are particularly wide in China. Discretionary spending as a share of household consumption is high for the wealthiest households but still very modest for low-income households; and the markets for certain goods and services are limited to major cities in the most developed regions[9]. As a result, the development of private consumption and the emergence of new markets in the least advanced regions depend largely on reducing income inequality and boosting consumer spending by low-income households.

Improving access to public services and social welfare protection remains a slow but vital process

Urbanization and, most importantly, the easing of the *hukou* resident registration system could have a significant impact on income inequality and the quality of social welfare protection. Urban residents have better access to public services and better social protections than rural residents and "migrants" (workers in urban areas with rural resident status), and can spend more in consumption of goods and services. For the period 2016-2020, the authorities plan to raise the urbanization ratio from 56.1% of the population to 60% (it was already 59.6% in 2018), to grant urban resident status to 100 million additional migrants and to

[6] Number of individuals under age 15 and over age 64 as a percentage of the working-age population.

[7] The Gini coefficient is very high, at 0.467 in 2017.

[8] Source: World Inequality Database

[9] For example, 40 cities account for more than half of retail sales, and online purchases are concentrated in these cities (source: the Conference Board).

transfer 100 million individuals from rural areas into the cities. According to an OECD study[10], these last two measures could increase consumer spending by as much as 11%. Most importantly, changing the resident status of migrant workers would have a bigger impact than transferring rural workers into urban areas, which illustrates the importance of improving access to public services and the social welfare system. Changes in the *hukou* system have been limited so far, notably due to the barriers raised by certain major cities on new resident applications (by adding restrictive criteria in terms of education or professional experience, for example). It is in the authorities' interest, however, to accelerate the reform process and to continue actively improving public services and providing social welfare protections to the entire population.

Fiscal policy must play a bigger role, credit policy no longer has much leeway

With ongoing structural reforms and an ageing population, the average household savings rate should continue to decline in the medium term, but it will be a slow process. To stimulate private consumption in the short term, the authorities are relying on fiscal policy. The fiscal system has not been very effective at reducing inequalities over the past decade, and there still seems to be a lot of potential to increase its distributive role and boost household consumption in the medium term.

Various fiscal stimulus measures were launched in 2018-2019. Those dedicated to households aim to stimulate consumer spending by directly boosting disposable income, and benefit the most to low/moderate-income households, which have a higher marginal propensity to consume. For example, fiscal measures introduced last year included raising the lowest income tax brackets[11]. According to the authorities, tax relief measures will boost total disposable income by as much as RMB660 billion. This should boost total private consumption by 1.2 percentage points. Moreover, by reducing income inequality, the reforms could have a positive impact on household demand beyond the short term.

The maneuvering room of credit policy is much less limited. First, the increase in household debt needs to be checked (see next section). Second, the authorities are determined to prevent speculative transactions in the property market and guarantee reasonable house price inflation. Numerous programs have been launched to renovate shanty towns and to build low-rent housing in recent years. Prudential regulations governing real-estate loans and transactions have been gradually tightened since mid-2016. Even so, average house price inflation remains high (6.6% y/y on average for the 70 biggest cities since mid-2016, compared to 0.8% in the three previous years), and the home affordability index deteriorated between 2016 and 2018[12] after several years of improvement (Chart 10 page 6). Efforts to contain house price inflation should be maintained, and the authorities have maintained a very cautious property policy despite the easing bias of the monetary and credit policy adopted since mid-2018. Yet this attitude could become harder to maintain if there is an extended slowdown in economic growth in the months ahead.

Credit-driven consumption growth: signs of fragility are already emerging

Household debt has increased rapidly over the past decade, and reached 55% of GDP in mid-2019. Domestic credit has in fact expanded strongly to all economic players, and the debt excess and high credit risks are concentrated in the corporate sector. However, they are also beginning to spread to households[13]. Above all, the rise in household debt, which has driven private spending in recent years, could start to place an additional restriction on the expansion of private consumption in the medium term.

Rapid credit growth has stimulated household spending…

Household debt rose from 17.9% of GDP in 2008 to 52.6% in 2018 and 54.6% in mid-2019. Debt outstanding has increased at an average annual rate of 20% since 2011 (to RMB51,000 billion at the end of June 2019). The household debt ratio was initially in a catching-up phase, and is presently not particularly high as a percentage of GDP. Moreover, it is now considered to be only slightly higher than the ratio that would be in line with China's level of development (Chart 15). However, the weight of household debt is heavier when measured as a share of disposable income: we estimate it at about 90% in 2018, compared to 31% in 2008 (closer to that of countries with higher per capita income). Moreover, official household debt ratios are slightly underestimated since they exclude shadow banking loans (which are still small, even though they have increased rapidly over the past five years).

The increase in household debt has been mainly driven by housing loans, which accounted for nearly 60% of debt in 2018. Yet consumer loans have also increased sharply. Credit card loans outstanding, which first emerged ten years ago, have increased at an average annual rate of 57% between 2011 and 2015 and then by 27% a year since 2016. They accounted for 15% of household debt in 2018. Automobile loans accounted for 3% of debt (Chart 16).

Consumer spending has been stimulated by the direct impact of consumer loans on spending and indirectly via the support of mortgage loans in the real estate market. The direct impact seems to have been big, and even increased in 2017: consumer loan growth accelerated, and new loans accounted for nearly 8% of total private consumption, whereas their share had held around 4% in previous years (Chart 17).

[10] Molnar M., Chalaux T. and Ren Q.: *Urbanisation and household consumption in China*, OECD Working Paper 1434, Nov. 2017.

[11] The tax bracket was raised from monthly income of [RMB0-1500] to [RMB0-3000] for the 3% tax rate, from [RMB1500-4500] to [RMB3000-12000] for the 10% tax rate and from [RMB4500-9000] to [RMB12000-25000] for the 20% tax rate.

[12] In 2017, the purchase of a 100 m^2 apartment represented 20 years of disposable income for a household earning the average national income. Source: OECD, *Economic Surveys: China 2019* (April 2019).

[13] Total debt of China's non-financial sector was estimated at about 250% of GDP at year-end 2018, of which 130% was held by corporates, 50% by local governments and their financing vehicles, 17% by the central government and 53% by households.

Population ageing and private consumption

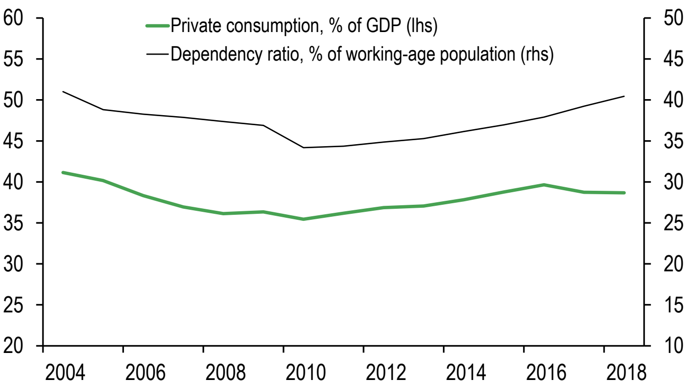

Chart 13 Source : NBS, BNP Paribas

Household debt dynamics

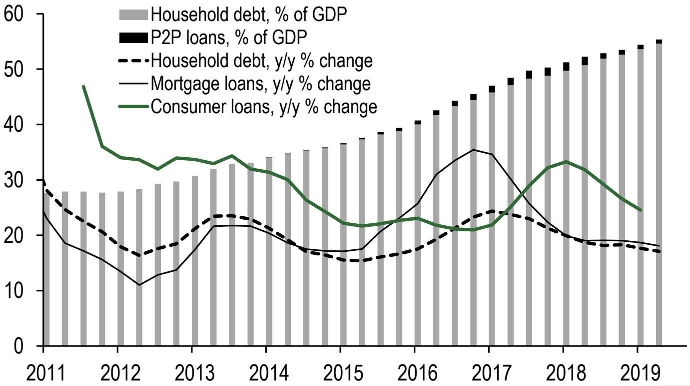

Chart 16 Source : PBOC, Wang dai Zhi Jia, BNP Paribas

Household saving rate

Chart 14 Source: NBS, BNP Paribas

Household consumption and credit

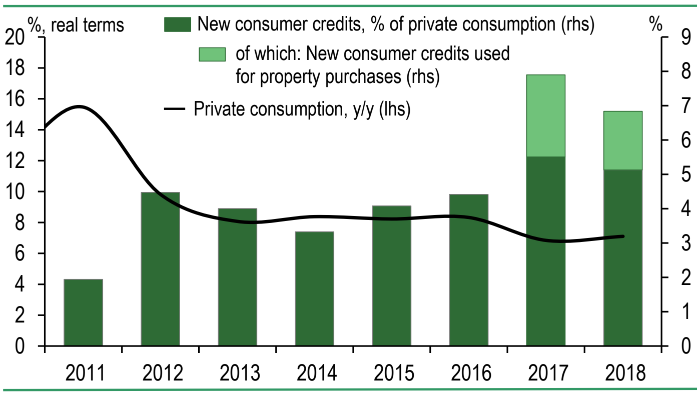

Chart 17 Source: PBOC, World Bank,Conference Board, BNP Paribas

Household debt and GDP per capita

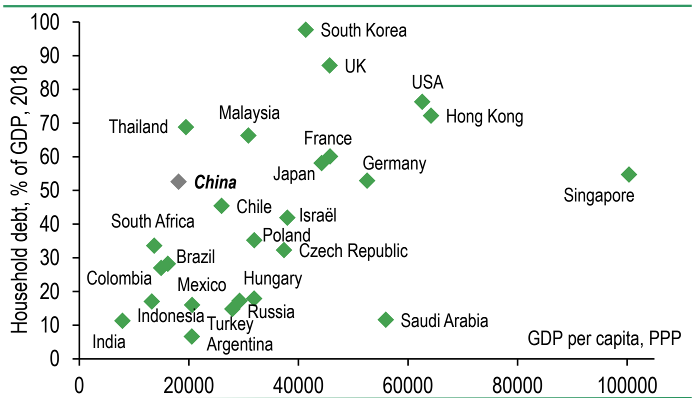

Chart 15 Source : NBS, BNP Paribas

Rebalancing will remain slow

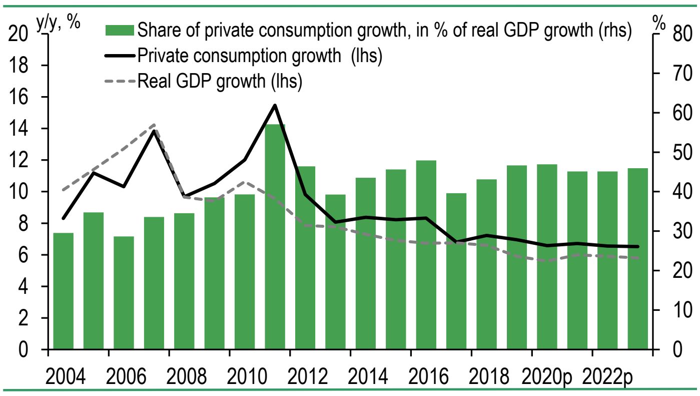

Chart 18 Source : NBS, World Bank, BNP Paribas

Yet private consumption growth slowed in 2017. First, the direct impact of new loans was largely offset by downside factors already mentioned; second, it was also attenuated by the fact that a portion of the new consumer loans were actually used for purchasing real estate assets. In China, there is often a fuzzy line between the different types of lending. This phenomenon was probably amplified in 2017 to get around the tighter restrictions on mortgage loans. Excluding this portion of loans, based on estimates of the Conference Board[14], new loans dedicated exclusively to consumer goods purchases accounted for 5% to 6% of total private consumption in 2017 – which is still high. In 2018, the contribution of consumer credit began to decline, which had an impact on certain types of household purchases (cars and other durable goods in particular).

...but the dynamics are being reversed

The tightening of prudential regulations has been extended to include consumer credit activities since 2018; as a result, growth in credit card loans outstanding slowed from 37% y/y at year-end 2017 to 16% in mid-2019. In fact, the authorities have been gradually addressing the problem of mounting credit risks tied to the rise in household debt.

So far, the quality of mortgage loan portfolios held by commercial banks is satisfactory, thanks notably to relatively conservative prudential rules. In contrast, the rapid increase in consumer loans has been accompanied by less rigorous risk management and a higher default rate (albeit still low). In 2017, the non-performing loan ratio was 0.3% for mortgage loans and 1.6% for credit card loans. Moreover, households, like corporates, have benefited from the expansion of shadow banking activities over the past decade. Bank and non-bank financial institutions have proposed new savings and financing products in order to bypass existing regulations. As a result, the loose regulatory environment has been encouraging risk taking. P2P lending platforms developed rapidly between 2014 and 2017, with the creation of more than 6600 platforms. Total loans outstanding in this category represented only a small portion of household debt (3% at the peak in early 2018), but P2P practices were often fraudulent with high default rates.

Household debt growth slowed from 24% y/y in nominal terms in Q2 2017 to 17% in Q2 2019. The deceleration has resulted from monetary tightening measures implemented between late 2016 and Q2 2018, a tight property policy maintained over the past three years[15], and a series of measures aiming to reduce P2P financing and other shadow banking activities. The vast majority of P2P platforms were brought under supervision or shut down, and P2P loans outstanding have fallen rapidly since July 2018 to reach RMB 687 billion at mid-2019, accounting for 1.3% of household debt (Chart 16 page 9).

The slowdown in household credit, which has helped contain credit risks in the financial sector, clearly constrained consumption growth in 2018 and H1 2019. Moreover, households should also begin to feel the burden of debt servicing payments.

[14] The Conference Board: *Rising household debt, Implications for Chinese consumption*, August 2018.

[15] The average rate on home loans rose from 4.5% at end 2017 to 5.7% at end 2018, a bigger increase than the average rate for all loans (which rose from 5.2% at end 2016 to 5.9% in Sept. 2018, before falling back to 5.6% at end 2018).

Household debt: a new threat

Household debt servicing has increased sharply since 2016. In addition to the direct negative impact on consumption, high debt servicing makes households more sensitive to increases in interest rates and credit tightening measures, and also limits their capacity to take on more debt in the medium term.

According to the Conference Board[14], household debt servicing charges (home loans + consumer loans) accounted for between 8% and 11% of disposable income in 2017, up from 6% to 8% in 2015 (and 5% to 7% in 2011). The most recent estimates by the IIF place debt servicing at 11% of disposable income in 2018, compared to 8% in 2015[16]. These ratios are considered to be moderately high, and the average financial situation of households is still satisfactory, thanks notably to a solid savings rate, with savings invested in real estate and financial assets (bank deposits and other financial assets account for more than two times household debt outstanding).

Yet the situation between households is very mixed. The share of total debt held by over-indebted households (i.e. debt exceeding 4 years of revenues) already increased from about 25% in 2010 to nearly 50% in 2016, according to IMF estimates[17]. As a share of revenues, the debt burden has worsened much faster for low-income households. Income inequality aggravates the impact of credit tightening on consumption: the poorest households, which have the highest debt burden and the lowest savings, are also the most vulnerable to income shocks: they will cutback consumption more sharply of new credit is reduced. Inversely, the easing of household lending conditions should have an even more limited impact on consumption since debt servicing is already significant, and unequally distributed between the different revenue categories.

Consequently, the favorable impact of credit on household spending tends to taper off over time and as debt builds up. According to a BIS study[18], an increase in household debt has a positive impact on private consumption and GDP growth in the short term (1-year horizon), but the impact becomes negative in the medium term, notably because households must allocate a growing share of their revenues to debt servicing. When the debt ratio exceeds the threshold of 60% of GDP, it has a significantly negative impact on consumption in the medium term. China has not reached this threshold yet, but it is approaching it rapidly (in our central scenario, it will cross the 60% threshold in 2020).

The expected adjustments in the housing market (more balanced expansion, lower house price inflation, measures to combat speculation) could lead to a growth slowdown in mortgage loans to households, which would leave a little more room for consumer credit. Even so, there is very little space for lending to boost consumption.

In the short term, the authorities could ease their household lending policy again to stimulate domestic demand and counter the effects of

[16] Institute of International Finance: *Household debt no longer a growth stimulus*, August 2019.

[17] IMF Global Financial Stability Report, Oct. 2017 & IMF Selected Issues, *People's Republic of China*, August 2019.

[18] Lombardi M., Mohanty M. and Shim I.: *The real effects of household debt in the short and long run*, BIS Working Paper 607, Jan. 2017.

sluggish exports. However, even in a healthier regulatory environment, the positive impact of higher debt dynamics is likely to be limited in the short term, and it could have major negative effects on private consumption in the medium term (heavier debt servicing and higher credit risks for banks). Moreover, households now have less capacity to take on more debt. Consequently, we should not expect to see a credit-driven consumer boom in the years ahead.

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Rebalancing China's economic growth engines remains a complicated process. Household consumption growth has slowed down and could continue to be disappointing in the short to medium term. Our central scenario calls for household consumption growth to hold near 7% in 2019 (notably stimulated by recent tax measures) and then gradually slow to 6.5% by 2023. The role of private consumption as a growth engine will only increase slowly: its contribution should rise from about 40% of real GDP growth in 2017-2018 to an average of 46% in 2019-2023 (Chart 18).

Private consumption will continue to grow thanks to structural changes (ageing population, urbanization, reforms) and the decline in the household savings rate (to 33% of disposable income in 2023 in our central scenario). Structural reforms aimed at boosting productivity gains, improving home affordability, reinforcing the social protection system and reducing income inequality are a vital role to play. However, the process of change is likely to remain slow, especially since the deterioration in the external environment has damaged the authorities' capacity to execute reforms in the short term. Moreover, the consequences of US-China trade tensions on manufacturing exports and the labor market are likely to be additional constraints on private consumption growth. Lastly, the increase in household debt, which has supported consumption in recent years, is now becoming a source of risks and rising debt servicing payments are expected to weigh on household spending going forward. In response to the current economic slowdown, the authorities should not encourage household credit, but on the contrary moderate its growth, and instead focus more on fiscal measures to stimulate disposable income, especially for low-income households.

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