CHINA

THE ECONOMIC RECOVERY IS STILL MIXED

Economic growth rebounded very rapidly following the Covid-19 shock, but this rebound has also been characterised by mixed performances between sectors and between demand components. Growth of industrial production and exports accelerated vigorously until early 2021 and is now gradually returning to normal. Meanwhile, the services sector and private consumption were slower to rebound, and their recovery still proved to be fragile in Q2 2021. Consequently, the authorities are likely to be increasingly cautious about tightening economic policy. Even so, they should still give priority to slowing down domestic credit growth and adjusting the fiscal deficits.

Economic activity rebounded rapidly following the Covid-19 shock of early 2020, with real GDP returning to its pre-crisis level by the end of Q2 2020. The recovery reached a peak early this year, and real GDP growth rates should return to more normal levels in the quarters ahead. China's economic rebound has also been characterised by very mixed performances between sectors and between demand components. These imbalances were still visible in Q2 2021. Consequently, many corporates are still fragile , especially small enterprises in the services sector, and the labour market has not fully recovered yet, which in turn is hampering the recovery in household demand.

MIXED PERFORMANCES

Industrial activity rebounded rapidly in spring 2020, which enabled China to respond to the surge in world demand for manufactured goods and to win market share. Industrial production and export growth accelerated vigorously until early 2021. Since March, base effects have dissipated, growth rates have been normalizing, and supply shortages in some inputs have started to constrain activity. Industrial production growth averaged (a still robust) 9.3% year-on-year (y/y) in April-May, compared to 24.5% in Q1 2021. Industrial growth did not slow as much in value terms due to the acceleration in producer price inflation, which rose from 1.7% y/y in February to a record high of 9% in May. Meanwhile, merchandise exports increased by 30% y/y in April-May (in value terms), compared to 70% in Q1. Growth in the industrial sector and exports should continue to ease gradually in the months ahead.

In the services sector, activity contracted just as much as it did in industry during the lockdown of January-February 2020, but the rebound started later and has been less vigorous. Even so, since March 2021, the growth rate in services production has surpassed that of industrial production (+15.4% y/y in April-May).

Meanwhile, private consumption growth continues to recover, but it has slacked off in recent months. The performance of retail sales fell short of expectations in April-May, increasing by 13% y/y in volume terms (compared to 33.5% in Q1).

RISING INEQUALITIES WITHIN URBAN AREAS

Changes in household savings illustrate how cautious individuals are. According to our estimates, the household savings rate increased from 34.6% of disposable income in 2019 to 37.7% in 2020, and these extra savings have been only partially absorbed so far.

Firstly, private consumption remains hampered by persisting health risks. Although the pandemic is largely under control in China, temporary and localised restrictions on mobility are still regularly introduced in case of the emergence of new Covid-19 cases. This risk should diminish with the ongoing acceleration of the vaccination campaign. On June 10th, 43% of the population had received at least one dose of the vaccine, and 16% were fully vaccinated (source: ourworldindata.org).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	6.1	2.3	8.7	5.3
Inflation (CPI, year average, %)	2.9	2.5	1.7	2.8
Official budget balance / GDP (%)	-2.8	-3.7	-3.2	-3.0
Central government debt / GDP (%)	17.0	20.6	22.0	23.4
Current account balance / GDP (%)	0.7	2.0	2.1	1.7
Total external debt / GDP (%)	14.5	16.3	15.1	15.8
Forex reserves (USD bn)	3 108	3 217	3 272	3 312
Forex reserves, in months of imports	15.0	16.3	15.2	14.5

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DIFFERENTIATED REBOUNDS

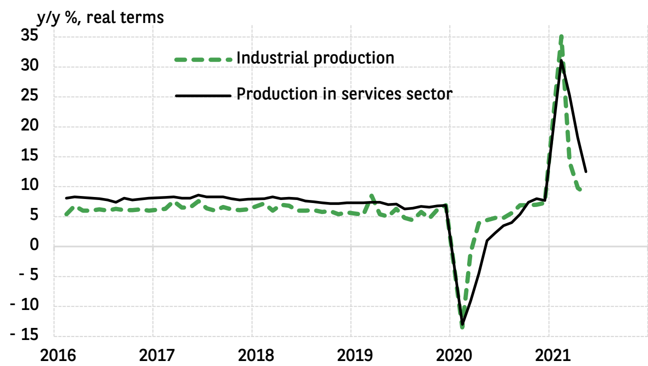

CHART 1 SOURCE: NBS

Although official unemployment rates continue to decline (the urban unemployment rate based on surveys fell to 5% in May, the same level as in May 2019), the labour market has yet to return to its pre-crisis situation. Job insecurity and underemployment have increased; youth unemployment rates remain particularly high (13.8% in May 2021 vs. 10.5% in May 2019); and job creation has been less dynamic (in Q1 2021, job creations were 8% below the Q1 2019 level). All of this has constrained the rebound in household income. This is especially true for low-income households, the category that ran up the biggest losses during the lockdown and accumulated fewer savings in 2020.

In urban areas, disposable income per capita declined by 2.2% in real terms for low-income households (after increasing 5.2% in 2019), whereas it rose by 2.3% for high-income households (compared to

+5.1% in 2019). Average real income of migrant workers stagnated in 2020. Rising inequalities and the difficulties of low-income households are contributing to delaying the turnaround in private consumption. Meanwhile, income inequalities between urban and rural areas have narrowed during the health crisis. In 2020, average disposable income per capita increased by 1.2% in real terms in the cities and by 3.8% in rural areas. The ratio between the two has declined slowly for several years, reaching 2.6 in 2020, and fell further in Q1 2021.

Consumer price inflation is still very mild and is unlikely to strain household spending, even though it has been accelerating over the past three months (to +1.3% in May from -0.2% y/y in February) after slowing throughout 2020 and early 2021. Food price inflation (+0.3% in May) is expected to remain low at least until fall, after flaring up in H2 2019 and H1 2020, and the increase in producer prices is having a limited impact on consumer prices. Core inflation has accelerated slightly (+0.9% in May), but remains lower than pre-crisis levels (it averaged 1.6% in 2019).

DOMESTIC INVESTMENT IS DICTATED BY ECONOMIC POLICY

After collapsing in Q1 2020 (-16% y/y in value), investment rebounded rapidly and rose by 3% in full-year 2020. Investment growth hit record highs in January-February 2021 (+35% y/y) due to large base effects, but it has since fallen back rapidly (to +5% y/y in May). Last year, the rebound in investment was mainly driven by real estate and public infrastructure projects, which were encouraged by policy stimulus measures. Therefore, the recent growth slowdown in investment in both sectors was largely expected given the gradual tightening in domestic credit conditions since Q3 2020 and the moderation in public spending.

In contrast, manufacturing investment picked up later in 2020 and is expected to continue to recover in 2021. It should be stimulated by the strong momentum in exports and industrial activity, very high industrial capacity utilisation rates, and the improvement in corporate profits. Despite a rather disappointing performance recently, we still expect manufacturing investment to strengthen in the short term.

INCREASINGLY CAUTIOUS WITHDRAWAL OF SUPPORT MEASURES

The authorities have shifted their priorities in recent months. Given the economy's strong performance after the Covid-19 shock, support measures have been withdrawn gradually. However, the authorities also admit that the economic recovery's foundations have remained "unstable", so they will probably be increasingly cautious when tightening economic policy.

Regarding monetary and credit conditions, the top priority is to slow debt growth and to combat financial-instability risks, primarily through prudential measures. Growth in total credit (social financing) slowed from 13.7% y/y in October 2020 to 11% in May 2021, driven by a slight decline in bank loan growth (60% of the total), a sharp slowdown in bond financing growth and the continued contraction in shadow banking credit. Total credit growth should continue to slow in the short term. In particular, property policy could be tightened further (with stricter rules for transactions, financing of developers or mortgage loans). At the same time, key policy rates are expected to stay stable,

DECELERATION IN DOMESTIC CREDIT GROWTH

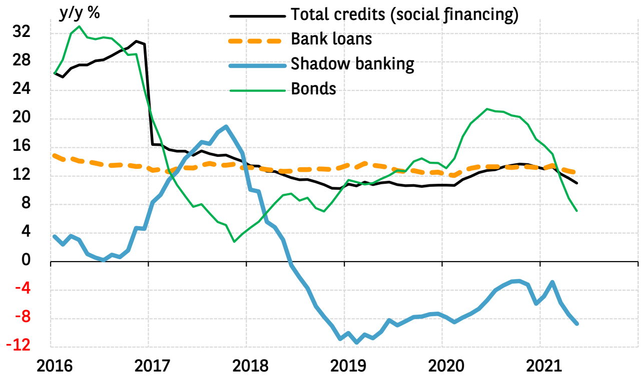

CHART 2

SOURCE: PBOC

and domestic liquidity will be maintained at sufficient levels to support manufacturing investment, boost the recovery of SMEs and the services sector, and avoid aggravating credit risks. The absence of strong inflationary tensions and appreciation pressure on the yuan should also provide incentives for the authorities to keep key interest rates unchanged.

On the fiscal policy front, priority will be given to adjusting the public accounts while continuing to provide support to the most vulnerable enterprises. Fiscal deficits swelled considerably in 2020: while the "official" deficit only increased to 3.7% of GDP from 2.8% in 2019, the consolidated deficit of the entire general government doubled last year. According to our estimates, it rose from RMB 4,600 bn in 2019, or 4.6% of GDP, to RMB 9,200 bn in 2020, or 9% of GDP.

Moreover, total government debt is moderate (it rose from 17% of GDP at year-end 2019 to 21% at year-end 2020 for the central government, and from 21.6% to 25.3% for local governments), but the debt load is unequally distributed. Above all, local governments are exposed to high contingent risks associated with the debt of their financing vehicles and other enterprises they own (according to the IMF estimates, the debt of financing vehicles was 38% of GDP at year-end 2020).

Signalling a cautious policy tightening move, the official deficit target for 2021 was lowered to 3.2% of GDP and the consolidated deficit of the entire general government should decline slightly to 7.5%. Deferrals/exemptions from taxes and social security contributions are unwound gradually, except for small enterprises. Public spending is moderated, in particular with a sharp slowdown in infrastructure investment growth – which contributes to both fiscal adjustment and domestic debt reduction efforts. As a matter of fact, new bond issues by local governments to finance infrastructure projects were cut back sharply in the first months of 2021.

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