CHINA

THE TIGHTENING IN CREDIT CONDITIONS IS A DELICATE EXERCISE

Economic activity has rebounded rapidly since March and has gradually spread from industry to services. Infrastructure and real estate projects continue to drive investment, but it has also begun to strengthen in the manufacturing sector as well, encouraged by solid export performance. Lastly, 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 and return their focus on controlling financial risks. 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 (+11.7% q/q in Q2). Real GDP then rose by 2.7% in Q3 and is expected to gain another 2% in Q4. Moreover, the recovery has gradually spread and strengthened. 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 is expected to reach 2% (chart 1).

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 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.

V-SHAPED RECOVERY CONFIRMED

The economic recovery has been solid over the last months of 2020 (chart 2). On the supply side, industrial production has accelerated continuously since lockdown restrictions were first lifted in March, and reached 6.9% year-on-year (y/y) in September and October. In the first ten months of the year, industrial production was 1.8% higher in volume than the 2019 figure. In value terms, it has remained virtually flat given the nearly 2% 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% in Q3. In October, it finally caught up with and surpassed the growth of industrial production (+7.4%). These sector dynamics are expected to continue in the short term, and services will resume their role as the main growth engine in 2021.

The acceleration in services 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 consolidate until the end of the summer (+4.6% y/y in October). In the first ten months of the year, retail sales volumes were still nearly 8% 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 5.3% in October, the same level as at the beginning of the year. Consumer price inflation has

GROWTH AND INFLATION (%)

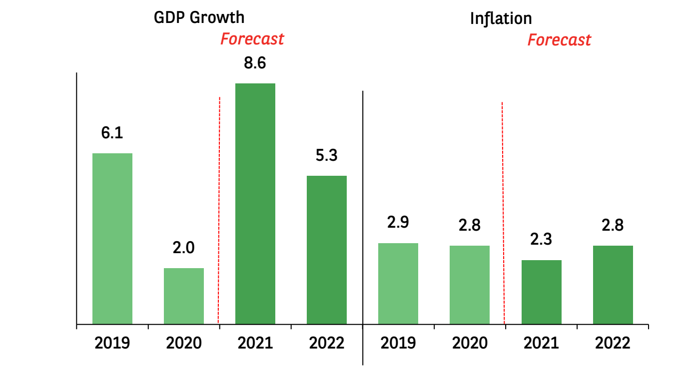

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

ECONOMIC ACTIVITY NORMALISES, BUT RETAIL SALES STILL LAG

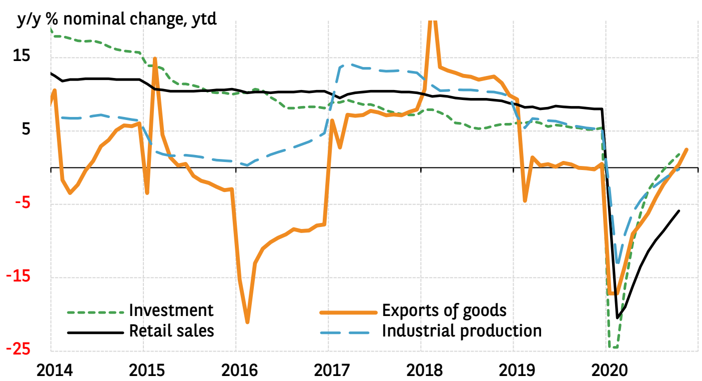

CHART 2 SOURCE: NBS, CEIC

fallen sharply since July, dropping from 2.7% y/y to a negative 0.5% in November. This is mainly due to the major slowdown in food prices, which had soared in Q4 2019 and in the first months of 2020. Core inflation is also low, but stable (+0.5% since July, down from a 2019 average of 1.6%).

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 still mild increase in disposable income (+0.6% y/y in real terms in the first nine months of 2020). 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 also strengthened in October (+1.8% y/y in the first ten months of 2020), largely fuelled by Infrastructure and real estate projects. Investment in the manufacturing sector is still weak, although it has shown signs of picking up, bolstered notably by the solid performance of exports. They 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 21% in November. 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.

THE AUTHORITIES READJUST THE CREDIT POLICY

Investment in infrastructure projects is expected to remain dynamic in the short term while real estate investment could lose some momentum, in response to economic policy adjustments. Fiscal policy and public investment are indeed 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 7% against the USD over the past six months. 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.

Since April, the central bank has maintained its key policy rate at 2.95% (after a 30bp cut earlier in the year), but has gradually tightened money market rates (the 7-day repo rate rose from an average of 1.5% in April to 2.3% in November). Even so, the central bank will probably limit the rise in domestic interest rates and also 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. Last month they already introduced rules to put debt limits on real estate developers. They have 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.

DEBT SWELLS AGAIN

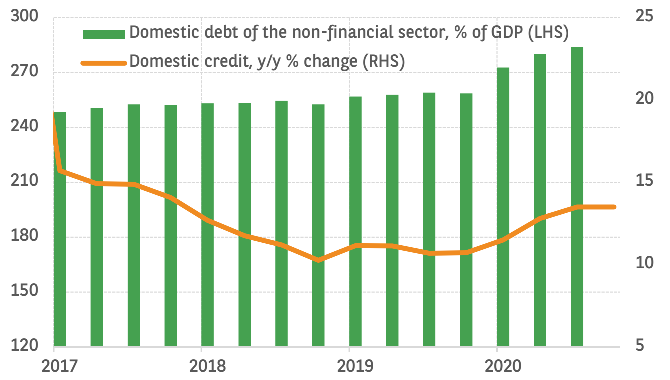

CHART 3 SOURCE: PBOC, BNP PARIBAS

CORPORATE DEFAULTS ARE EXPECTED TO INCREASE

Corporate defaults are expected to increase in 2021 due to the impact 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 debt, estimated at 258% of GDP (domestic debt of the non-financial sector at year-end 2019). In 2017-2019, measures were implemented to reduce financial risks (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 increase in the social financing stock (total credit) accelerated from 10.7% y/y at year-end 2019 to 13.7% in October (it is expected to level off during the last months of the year). The debt-to-GDP ratio is projected to increase by about 25 percentage points in 2020, after a ten-point increase in the previous three years (chart 3).

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. 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 could rapidly exceed the 2018-2019 levels. More importantly, the share of state-owned companies in default seems to be increasing, showing proof of a slow decline in implicit state support.

Completed on 14 December 2020

Christine Peltier
christine.peltier@bnpparibas.com