China

Is the worst over?

China's population and its economy were the first to be struck by the coronavirus epidemic. Activity contracted abruptly during the month of February before rebounding thereafter at a very gradual pace. Although the situation on the supply side is expected to return to normal in Q2, the demand shock will persist. Domestic investment and consumption will suffer from the effects of lost household and corporate revenues while world demand is falling. The authorities still have substantial resources to intervene to help restart the economy. Central government finances are not threatened. However, after the shock to GDP growth, the expected upsurge in domestic debt ratios will once again aggravate vulnerabilities in the financial sector.

China, which was the first country to be hit by the coronavirus outbreak, reported a very sharp drop in activity after the population was put in lockdown, from the Chinese New Year celebrations at the end of January through the end of March or early April (rules and dates vary from region to region). The brutal shock was transmitted through numerous channels, ranging from a supply-side shock to a shock on domestic demand and exports, a revenue shock and a confidence shock. Activity has begun to rebound, and the authorities have launched stimulus measures that should help bolster the recovery. Major downside risks persist however. Lost corporate revenues, a deteriorated labour market and uncertainty over the pandemic's future course will hamper domestic demand. At the same time, the export sector is bound to be hit by the repercussions of the sanitary and economic crisis that is spreading worldwide. We expect to see an unprecedented contraction in real GDP in Q1 2020 (-8% year-on-year), followed by a rebound in economic growth starting in Q2. We have just revised down once again our real GDP growth projection for 2020.

An unprecedented shock

After the authorities imposed drastic measures to contain the epidemic, consumption of goods and services collapsed (Figure 2). Retail sales volumes declined by 23% year-on-year (y/y) in the first two months of 2020, with automobile sales entering a free fall (-78% y/y in February). Online retail sales were more resilient, but nonetheless contracted by 3% y/y in January-February due to the decline in sales of services and non-essential goods. Transport networks were paralysed (with passenger traffic down 84% y/y in February). Construction and the real estate sector were also hard hit (property sales were down 40% in the first two months of the year)[1].

The supply-side shock was just as severe since factories were forced to remain shuttered after Chinese New Year and the work force was put in lockdown. Industrial output plunged 13.5% y/y in real terms in the first two months of 2020 (vs. +5.8% in 2019). The shutdown of production lines and transport blockages contributed to the decline in merchandise exports (-17% y/y in January-February and -6% in March). Lastly, falling revenues and uncertainty over future growth prospects led corporates to drastically scale back investment in all major economic sectors. Total fixed-asset investment declined by 25% y/y in the first two months of the year.

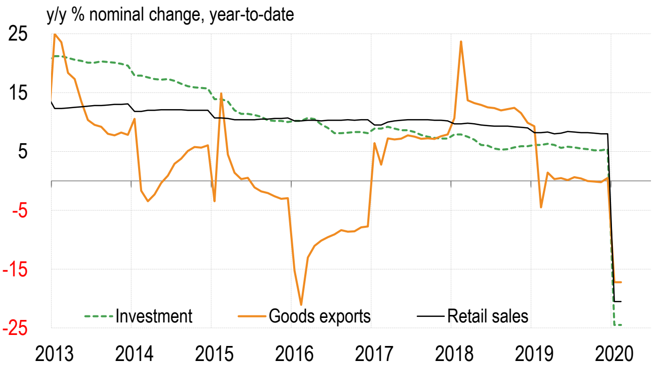
[1] Services account for 54% of GDP, including retail trade (10%), transport (4%) and real estate (7%). The industrial sector accounts for 39% of GDP, including construction (7%).

1-Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	6.6	6.1	1.5	9.5
Inflation (CPI, year average, %)	2.1	2.9	3.1	2.0
Actual fiscal balance / GDP (%)	-4.1	-4.9	-6.5	-5.8
Current account balance / GDP (%)	0.4	1.2	1.0	0.6

e: BNP Paribas Group Economic Research estimates and forecasts

2- Collapse



Source: NBS

The epidemic's spread in China is currently contained and the economy is recovering. Restrictions have been lifted on domestic passenger traffic and merchandise transport (albeit still partially in Hubei) and export activity has started up again. At the end of March, the official work resumption rate was 98% for large industrial enterprises (and 85% in the province of Hubei) and more than 70% for small and medium-sized enterprises (SME). Yet production capacity utilisation rates are still far below pre-crisis levels (it was 77% in the industry in Q4 2019). Production facilities are expected to return to normal by the end of April for industry and by the end of Q2 for services (with the exception of tourism).

However, just as the supply-side shock is winding down, a new demand shock is taking shape. The collapse in world demand will rapidly undermine China's exports. Therefore, their protracted contraction will threaten the recovery in the manufacturing sector (which also continues to be affected by higher US tariffs). This should drive export-oriented corporates to reduce inventories and scale back investment. In addition, both households and corporates have been hit by a revenue shock, which will continue to squeeze domestic demand in the short term. Finally, there has been a severe erosion in confidence due to the pandemic and uncertainty over its future course.

The financial situation of many corporates has weakened and their capacity to invest and repay loans has deteriorated (profits of industrial enterprises declined by 38% y/y in the first two months of 2020, and eight SMEs out of ten reported cash-flow problems in early March). Total domestic debt of the corporate sector is excessively high, at 150% of GDP at year-end 2019 (more than two thirds of which are bank loans). The debt burden reduces corporates' resilience to shocks, and the increasing risk of default on bank loans and in the local bond markets could weaken the financial sector. In contrast, corporates' external debt in foreign currency is small (estimated at 7% of GDP) and is not a source of instability for China's external accounts, even if payment difficulties and refinancing risk increase.

Chinese consumers are expected to remain both constrained by their income loss and very cautious. Job market conditions deteriorated rapidly during the confinement period: the unemployment rate surged to 6.2% in February from 3.6% in December 2019. The shock will also be amplified by household indebtedness. Their debt-to-GDP ratio was 55% of GDP at the end of 2019, which is not excessively high yet. However, it has increased significantly over the past ten years. More importantly, the debt burden is much higher for low-income households, which are also more vulnerable to income shocks. Consequently, there is likely to be an even sharper downward adjustment in private consumption in the short term.

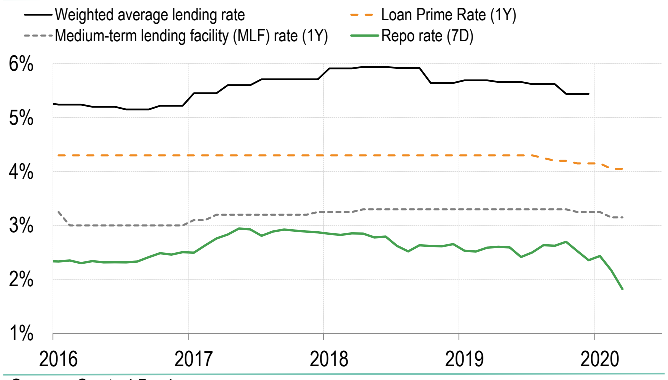
Actions on all fronts

Since February, the government and the central bank have launched a series of measures that aim: 1) to support corporates that have been hard hit by the coronavirus outbreak, help prevent defaults and bankruptcies, limit the risk of financial-sector instability and facilitate the economic recovery, and 2) to offset the decline in revenues and to stimulate investment and consumption. As the external environment deteriorates, Beijing is expected to bolster its stimulus measures in the weeks ahead.

Monetary conditions have been eased gradually since the beginning of the epidemic. The central bank has injected liquidity in the financial sector in order to meet demand (RMB 3 trn in the first two weeks of February). It initially opted for a moderate reduction in policy rates (the rate on medium-term lending facilities was lowered from 3.25% to 3.15% in February and then left unchanged in March), but recently stepped up the easing in interest rates (Figure 3). Special credit programmes have been introduced, such as an expansion of relending facilities (RMB 700 bn) and a special loan program by policy banks to help small firms (RMB 350 bn).

In mid-March, reserve requirement ratios were lowered by between 50 bp and 200 bp (depending on the bank) in order to free up RMB 550 bn for targeted loans. Banks have also been sent directives instructing them to cover the financing needs of corporates hit by the epidemic, refinance loans and reschedule loan

3- Lower interest rates



Source: Central Bank

repayments of clients facing difficulties. Prudential standards have been (moderately) eased for commercial banks, as well as the rules for issuing corporate equity and bonds.

On the fiscal front, the central government has opted for a relatively measured response until now. It has increased spending (notably on healthcare: +RMB 110 bn), exonerated companies from some social welfare contributions (RMB 500 bn) and taxes, reduced electricity rates for corporates by 5%, and announced fiscal incentives to stimulate domestic demand. Local governments also participate actively in stimulus efforts, notably by increasing investment in infrastructure projects (a traditional policy tool in China) and through direct aid for enterprises and households (such as reduced rent for land leases and the distribution of coupons). Beijing has substantially increased the local government bond issuance programme to finance infrastructure projects (RMB 850 bn in addition to the initial quota of RMB 1 trn for 2020).

Public finances can absorb the shock

The authorities' actions will play a key role in restoring economic growth. The central government has comfortable fiscal manoeuvring room and the central bank has ample liquidity cushions to ensure the stabilisation of the financial system. In contrast, the debt excess of the economy is constraining monetary policy as well as the investment capacity of local governments (their total debt already represents about 50% of GDP). Consequently, while it is highly likely that the central bank will continue to ease monetary conditions in the short term and that local governments will further increase investment, the central government will have to give priority to fiscal stimulus measures. Fiscal deficits will rise to historically high levels, but the central government's financing needs will be easily covered and its debt will remain moderate: it represented 16% of GDP at year-end 2019; it is almost entirely in local currency, and more than 90% of which is held by local investors.

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