China

The year starts with a reprieve

In 2019, economic growth slowed to 6.1%. Total exports contracted and domestic demand continued to weaken. The year 2020 is getting off to a better start as activity shows a few signs of recovering and a preliminary trade agreement was just signed with the United States. Yet economic growth prospects are still looking downbeat in 2020. The rebalancing of China's growth sources is proving to be a long and hard process, and economic policy is increasingly complex to manage. Faced with this situation, Beijing might decide to give new impetus to the structural reform process, the only solution that will maintain the newfound optimism and boost economic prospects in the medium term.

Real GDP growth slowed to 6.1% in 2019 from 6.6% in 2018. This slowdown can be attributed to both declining exports and sluggish domestic demand (charts 1 and 2). Although the most recent activity indicators and the first trade agreement signed between the US and China provide some ground for optimism as the year gets underway, economic growth should continue to slow in 2020.

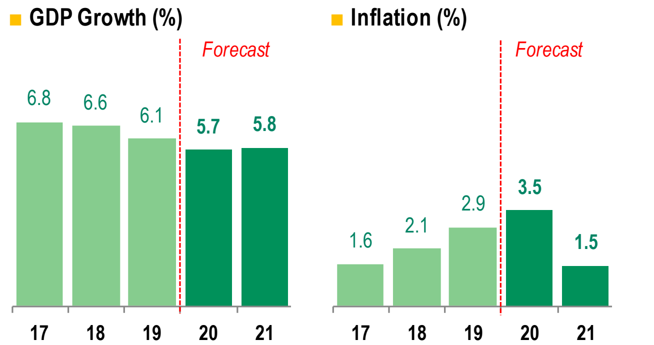
While economic policy has become increasingly accommodative over the past two years, the authorities have remained very prudent. They have very little manoeuvring room given the economy's debt excess and the need for ongoing efforts to clean up the financial system, state-owned enterprises and the housing market. In response to deteriorating economic growth prospects and the increasing difficulties of basing a stimulus policy on credit, the authorities have resorted to fiscal measures to support corporates and households. Might trade tensions with the US and the difficult process of rebalancing the sources of growth also encourage the authorities to give priority to structural reforms?

2019: external shock and the difficult transformation of China's growth model

Chinese exports were hard hit by higher US tariffs and the decline in global demand in 2019. Merchandise exports to the United States plunged by 12.9% (in USD value terms) compared to 2018, while total exports remained virtually flat (-0.1%). Although foreign trade made a positive contribution to GDP growth in full-year 2019, the export sector's troubles have had a big impact on the rest of the economy. Investment in the manufacturing sector rose only 3.1% in value terms in 2019: the investment growth slowdown sharpened due to worsening prospects for sales and weakening earnings. Meanwhile, private consumption has been hit by the industrial slowdown's impact on the job market and confidence. Average real household income slowed to 5.8% in 2019 from 6.5% in 2018, especially since consumer price inflation accelerated (reaching 4.3% y/y in Q4 2019). Inflationary pressures mainly reflected the surge in pork prices, which doubled between Q4 2018 and Q4 2019, driving up food price inflation (+17.3% over the same period). In contrast, core inflation eased from 1.8% y/y in Q4 2018 to only 1.4% in Q4 2019, a sign of sluggish domestic demand.

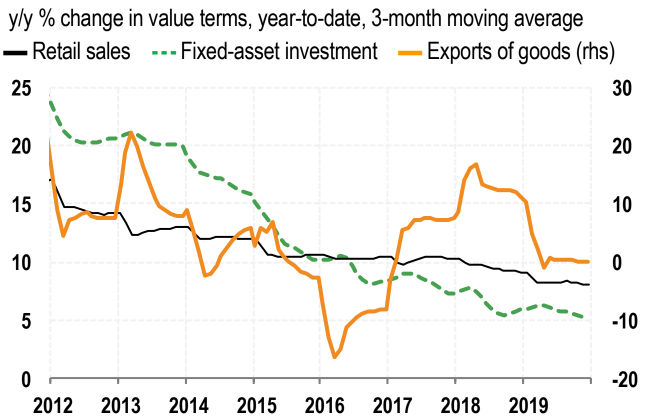
Households were also hit by tighter credit conditions, at a time when debt servicing charges are placing an increasingly heavy burden on their budgets (this reflects the steady increase in household debt, which rose from 28% of GDP at year-end 2011 to 55% at year-end 2019).

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Economic growth slowdown is broad-based



Source: NBS, General Administration of Customs

The accumulation of these negative factors explain why household spending growth has not picked up much in recent months despite fiscal stimulus measures. As a result, growth in retail sales volumes and online sales of goods and services barely levelled off in November-December 2019 (at 4.9% y/y and 12%, respectively). Automobile sales, which account for about 10% of total retail sales, have continued to decline albeit at a slower pace than at the beginning of the year (-2.5% y/y in Q4 2019, vs. -12.5% in H1).

Truce in the trade war

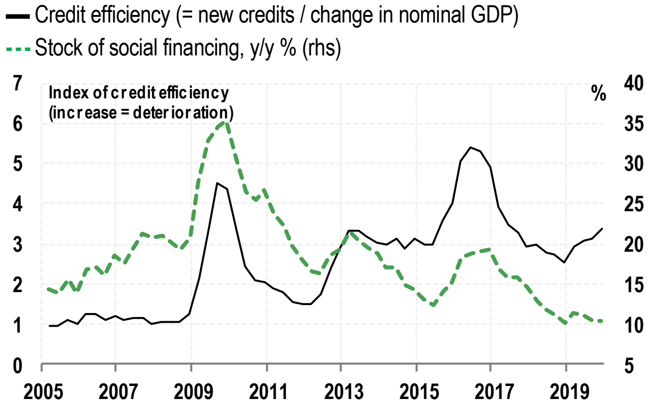
Yet China's economic performance seems to have improved slightly in recent weeks. Industrial production growth accelerated to 6.2% y/y in November 2019 and 6.9% in December, vs 4.9% in July-October. This timid recovery is in keeping with the rebound in exports, which rose by 7.4% y/y in December after several months of decline. The economy should remain somewhat more dynamic in the short term. China's National Bureau of Statistics (NBS) reported an uptick in manufacturing PMI (from 49.3 in October to 50.2 in November and December), which was largely driven by the rebound in the "export orders" component (which rose from 47 in October to 50.3 in December).

The United States and China have called a truce in their trade war since December and signing a preliminary trade agreement on January 15th. This contributed to the better industrial growth performance and renewed confidence of corporates and the markets. The fundamental problems behind US-China trade tensions are still in place and the next rounds of negotiations promise to be very complicated. Nevertheless, the "phase 1" agreement signed mid-January considerably reduces the risk of another increase in US tariffs in 2020. Under the phase 1 agreement, China has to increase its imports of US goods and services by USD 200 bn over the next two years (compared to 2017 purchases of USD 186 bn), including USD 78 bn in manufacturing, USD 52 bn in energy, USD 32 bn in agriculture and USD 38 bn in services. China also seems to be ready to make some concessions in terms of intellectual property rights and the access of foreign enterprises to its domestic market (looser regulations on technology transfers, and opening of the financial sector, for example). In exchange, the United States simply renounced the introduction of new tariffs, and reduced by half the amount of the last tariff increase, in effect since September 2019 (from 15% to 7.5% on about USD 120 bn in imports). The other tariffs introduced over the past two years will be maintained. As a result, the weighted average tariff imposed by the US on imports of Chinese goods will decline only slightly, from 21% at year-end 2019 to about 19% (vs 3% before the outbreak of the trade war). Tariffs will continue to be levied on two thirds of these imports.

Greater impetus for reforms?

Since 2018, the authorities have loosened their monetary and fiscal policies in order to stimulate activity. At the same time, they have remained cautious, and still pursued efforts to strengthen financial-sector regulations, contain the increase in household debt and try to reduce the debt of the most fragile corporates. Last year, in a particularly unfavourable international environment coupled with disappointingly sluggish domestic demand and growing corporate financial difficulties, the authorities were faced with the ever-growing dilemma of stimulating growth or reducing debt and pursuing reforms [1]. The authorities opted to make greater use of fiscal stimulus measures and to continue prudent monetary easing actions. The most recent measure, effective on January 6th, 2020, aims to stimulate bank loans to corporates via another cut in reserve requirement ratios (by 50 basis points to 10% for small and mid-sized banks and to 12.5% for the big banks).

3- Credit efficiency deteriorated again in 2019



Source : NBS, BNP Paribas

Further stimulus measures might help boost economic growth in the short term, but they would also delay the process of cleaning up the economy while undermining medium-term growth prospects, notably due to the risk of financial instability and the declining efficiency of credit and investment. This danger was highlighted by the erosion of credit efficiency in 2019, after two years of improvement (chart 3). Stepping up structural reforms, in contrast, should limit these risks.

The most recently announced structural reforms aim to accelerate the opening of the financial sector. For example, foreign investors would benefit from greater access to asset markets and the limit on foreign ownership of certain asset managers and securities firms is to be lifted by the end of 2020. Faced with the need to make progress in negotiations with the US, but above all given the growing difficulties of rebalancing China's growth sources, Beijing might seek to give new impetus to structural reforms in 2020. In particular, the continued restructuring of state-owned enterprises (deleveraging, end of implicit state guarantees) and the strengthening of the financial system should help pave the way for better capital allocation and stronger medium-term economic growth prospects.

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[1] See EcoPerspectives: *China: what lies behind the rise in corporate defaults?",* Q2 2019 and *"China: difficult policy choices,* Q4 2019.