# CHINA



## CONFIDENCE ISSUES

**The economic rebound that has followed the abandonment of the zero-Covid policy is quickly losing momentum. Domestic demand is held back by a significant fall in consumer and investor confidence, and export momentum is stalling. The authorities are cautiously easing monetary policy, but this may end up having limited effects on credit activity. Further stimulus measures are expected in the short term. They should, among other things, aim to encourage youth employment.**

### THE POST-COVID REBOUND IS ALREADY LOSING STEAM

Household consumption and activity in the service sectors recovered rapidly following the abandonment of the zero-Covid policy in December 2022 and after a few weeks of disruption caused by an upsurge of the epidemic. However, this recovery already lost momentum in Q2 2023.

Growth in the services sector accelerated to +9.1% year-on-year in the first five months of 2023, after a slight contraction in 2022. However, on the one hand, this figure is inflated by favourable base effects resulting from the very strict lockdowns imposed in the Shanghai region in spring 2022; on the other hand, activity in services showed first signs of weakening in May. The same applies to retail sales volumes, which rebounded by almost 9% y/y over the first five months of 2023, but whose growth slowed in May. Households are limiting their spending. They remain cautious in the face of the severe crisis in the real estate sector and the uncertainties weighing on their income and employment prospects.

FORECASTS

| | 2020 | 2021 | 2022 | 2023e | 2024e |
|---|---|---|---|---|---|
| Real GDP growth, % | 2.2 | 8.4 | 3.0 | 5.6 | 4.5 |
| Inflation, CPI, year average, % | 2.5 | 0.9 | 2.0 | 1.1 | 2.5 |
| Official budget balance / GDP, % | -3.7 | -3.1 | -2.8 | -3.0 | -3.2 |
| Official general government debt / GDP, % | 45.9 | 46.8 | 50.4 | 52.2 | 53.5 |
| Current account balance / GDP, % | 1.7 | 2.0 | 2.2 | 1.7 | 1.2 |
| External debt / GDP, % | 16.3 | 15.4 | 13.7 | 14.0 | 14.0 |
| Forex reserves, USD bn | 3 217 | 3 250 | 3 128 | 3 100 | 3 050 |
| Forex reserves, in months of imports | 16.2 | 12.6 | 11.9 | 11.1 | 10.1 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

### LABOUR MARKET CONDITIONS ARE STILL WEAK

The labour market has not recovered its pre-pandemic situation. In particular, while the unemployment rate in all urban areas fell to 5.2% in May (compared to 5.5% at the end of 2022) and is approaching its pre-Covid level, unemployment among young people aged 16–24 has increased since the beginning of the year. It reached a record high of 20.8% in May, compared to 16.7% at the end of 2022 and 12% in 2019. This development can be notably explained by a mismatch between supply and demand that has appeared on the labour market since the regulatory tightening imposed in 2021 in various service sectors.

On the supply side, the number of young graduates entering the labour market has increased gradually over the past few years, and their level of education has risen. The number of young graduates leaving university reached 10.5 mn in 2022, up from 7.9 mn in 2017. Meanwhile, the total number of migrant workers from rural areas increased by only 3.1 mn in 2022 (to 295.6 mn), down from 4.8 mn in 2017.

On the demand side, total employment in the services sector stabilised in 2021 and then contracted in 2022 for the first time (with job losses totalling 12.9 mn). Total employment in industry also decreased in 2022 (resuming the trend followed from 2015 to 2019) while employment in the primary sector rose for the first time in twenty years (Chart 1).

In the tertiary sector, job losses in 2022 were mainly concentrated in services affected by the health restrictions (such as retail and leisure), real estate, and high-end services that have been targeted by regulatory tightening (education, Internet and tech, in particular). The former have benefited from the post-Covid rebound since the beginning of 2023, which should translate into new job creation. On the other hand,

CHINA: JOB LOSSES IN THE SERVICES SECTOR

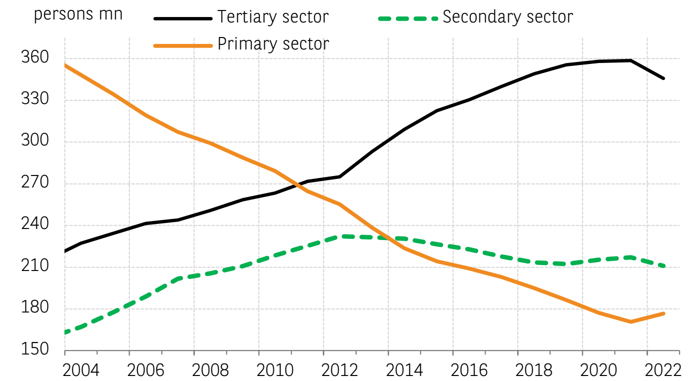


CHART 1

SOURCE: MINISTRY OF HUMAN RESOURCES AND SOCIAL SECURITY, BNP PARIBAS

the regulatory framework is still uncertain for sectors considered sensitive by Beijing, which weighs on their investment and employment. However, these sectors specifically recruit young graduates and the most qualified workers.

### THE REAL ESTATE CRISIS LINGERS ON, EXPORTS STALL

The ongoing crisis in the real estate and construction sectors and the slowdown in the manufacturing sector could also lead to further job losses.

Admittedly, the number of completed construction sites has recovered over the first five months of 2023 (+19% y/y) thanks to support policy measures. In particular, the authorities have encouraged short-term financing to developers who are able to complete the projects under way. They are aiming, firstly, to deliver prepaid housing in order to restore consumer confidence in the housing market. Secondly, the authorities are aiming to reduce the risks of both buyers defaulting on their mortgages and developers defaulting on their bank and bond loans (these defaults can result in even greater losses for lenders, as the recovery rate is very low if the real estate project is not completed). Nevertheless, potential buyers' sentiment still appears depressed and many developers continue to face cash flow issues and insolvency risks. This is preventing activity from recovering. Housing sales have continued to fall since the start of the year (-8% y/y) and the decline in real estate investment worsened in May (falling -6% y/y in value terms over the first five months of 2023).

The manufacturing sector is bearing the brunt of the slowdown in global demand and tensions with the United States. Industrial production only increased by +3.6% y/y over the first five months of 2023, which is unchanged compared to growth in 2022. Goods exports have barely increased since the beginning of the year (+1.1% y/y in current USD terms); they fell again in May following an upturn in March-April. Meanwhile, the decline in imports continued (-4.4% y/y over the first five months of 2023). Growth in manufacturing investment has slowed (+6% y/y in value terms over the first five months of 2023), constrained by sluggish demand, the production capacity utilisation rate hitting rock bottom (it fell to 74.3% in Q1 2023, which was its lowest level since 2016), and falling profits.

Overall, private investment has stagnated in recent months, and this situation could go on for some time: the uncertain outlook for exports and household consumption, the real estate crisis, domestic regulatory risks and geopolitical tensions are lingering on, and are all factors contributing to the pessimism among Chinese and foreign investors.

The public sector has partially offset the anaemic private investment since the start of 2022. The authorities now need to take further measures to support demand and try to build confidence among Chinese investors and consumers.

## MONETARY AND FISCAL POLICY EASING IS CONSTRAINED

In mid-June, the central bank cut its policy rates for the first time since summer 2022 (Chart 2). The one-year MLF rate fell from 2.75% to 2.65%, followed by the one-year loan prime rate (from 3.65% to 3.55%) and the five-year loan prime rate (from 4.3% to 4.2%) – which is used as the reference rate for mortgages.

Further monetary easing measures are expected in the short term. Even though consumer price inflation is low (+0.2% y/y in May 2023), the authorities are expected to continue taking a cautious approach, as they are constrained by their long-term objective (i.e. reducing the debt excess of the corporate sector) and by depreciation pressures on the RMB. The Chinese currency fell a further 3.5% against the US dollar during H1 2023, after depreciating by 8.5% over 2022, largely due to the deterioration in capital flows[1].

Moreover, the effect of lower interest rates on credit activity could be limited due to the low demand for loans. Banks are also expected to take a cautious approach, given that their net interest margins are being squeezed, their profits are weakening and their asset quality is deteriorating. The average non-performing loan ratio (including special-mention loans) posted by commercial banks gradually improved from 4.8% of total loans at the end of 2019 to 3.9% at the end of 2022.

CHINA: MONETARY POLICY LOOSENING

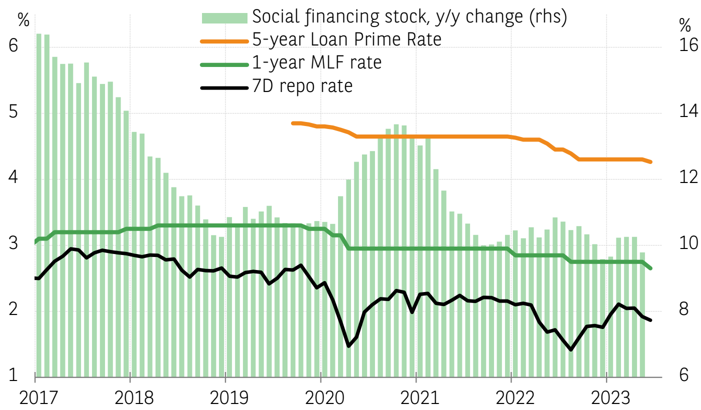


CHART 2 SOURCE: PBOC, NIFC, BNP PARIBAS

However, this decline is due to the widespread use of loan write-offs, which are offsetting the rise in new NPLs but are also contributing to a decline in profits. Loan quality is expected to deteriorate in the short term, due to the real estate crisis and the industrial slowdown. Large commercial banks are considered to have sufficient capital to absorb further losses, while, by contrast, smaller institutions are seen as much more fragile.

Since the start of the year, growth in total social financing has barely recovered despite the rebound in economic activity (Chart 2). Bank loans in local currency (which make up 64% of the social financing stock) rose by 11.7% y/y in May 2023, compared to 10.9% in December 2022. Regarding loans to the real estate sector (25% of total bank lending in 2022, compared to 29% in 2019), the measures taken by the authorities led loans to developers to recover (+5.9% y/y in Q1 2023 vs. +0.8% at the end of 2021), but they have not succeeded in reinvigorating housing loans to households (-0.2% y/y in Q1 2023).

Bond financing has slowed since mid-2022, given the sluggishness of the corporate securities market. Bond issues by the central government and local governments have been more dynamic. They slowed during the spring, but they are expected to increase again in the coming months as fiscal policy should become more supportive.

Indeed, monetary policy easing is likely to precede other stimulus measures on the fiscal front. Given the fragility of local government finances[2], further support could come from the central government. Measures to tackle youth unemployment are also expected to become a priority for the authorities. Public-sector job creation programmes and support programmes for companies to hire young graduates have been launched since last year. However, they are still small-scale programmes and will need to be reinforced and expanded.

**Christine PELTIER**
christine.peltier@bnpparibas.com

*1See BNP Paribas, EcoEmerging, China: Further turmoil, Q1 2023.*
*2See BNP Paribas, EcoEmerging, China: Moving Off Uphill, Q2 2023.*