China

Fiscal stimulus: the best option

Economic growth slowed to 6.6% in 2018 from 6.8% in 2017 and should continue to decelerate in the short term. The extent of the slowdown will depend on the still highly uncertain evolution of trade tensions between China and the United States as well as on Beijing's counter-cyclical policy measures. However, the central bank's manoeuvring room is severely constrained by the economy's excessive debt burden and the threat of capital outflows. Moreover, whereas Beijing has pursued efforts to improve financial regulation and the health of state-owned companies over the past two years, its new priorities increase the risk of interruption in this clean-up process. Faced with this situation, the central government will have to make greater use of fiscal stimulus measures.

In Q4 2018, real GDP growth slowed to 6.4% year-on-year (y/y), down from 6.8% in Q1 2018. The Chinese slowdown has been confirmed and is bound to continue in the short term. The size of the slowdown will depend on the evolution of China's trade relations with the United States, as well as on the authorities' actions to stimulate domestic demand. Although uncertainty persists over the signing of a trade agreement between Washington and Beijing anytime soon, the orientation of Chinese economic policy has become much clearer in recent weeks: counter-cyclical measures will be given priority in the short term.

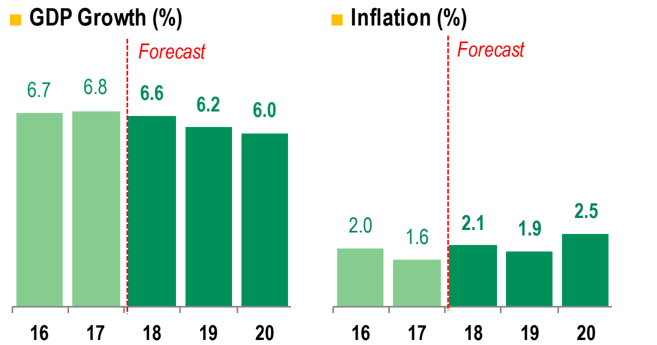
Industry facing difficulties due to declining demand

The slowdown in the industrial sector worsened towards the end of the year. Industrial production slowed from 6.9% y/y in January-May to 6% in June-August, and to 5.7% in September-December (chart 2). The poor performance of exports and retail sales, especially in the automobile sector, continue to darken prospects in the very short term. In December, manufacturing PMI dropped below 50, notably due to the sharp drop-off in the "new orders" and "export orders" components. The industry must also deal with the rapid decline in producer price inflation (+0.9% y/y in December, compared to +4.7% in June), in line with the decline in commodity prices and with the reduction in demand and production capacity utilisation rates. As a result, growth in profits of industrial enterprises has deteriorated sharply since Q3 2018.

Performance in the services sector is stronger. After losing momentum in Q1 2018, services growth has recovered slightly, bringing full-year 2018 growth to 7.6%. The PMI indexes also picked up towards the end of the year.

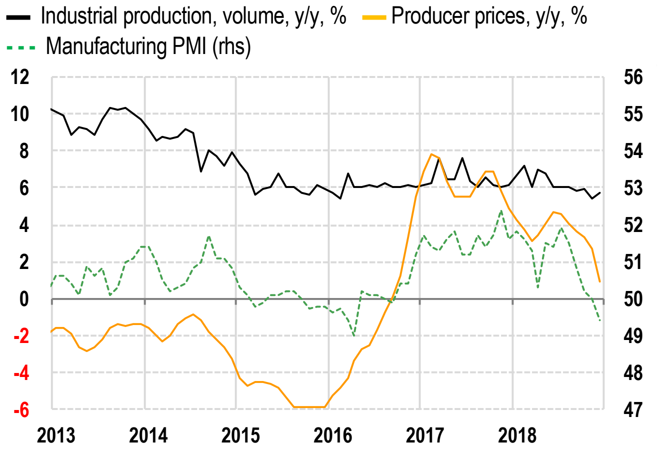
Exports levelled off recently, notably due to higher US trade tariffs[1]. After a Q3 rebound, fuelled in part by the acceleration of shipments to the United States in anticipation of higher tariffs and by the yuan's depreciation, sales of Chinese products slowed sharply in November (+5% y/y in value, after averaging +13% in the first 10 months of 2018) and contracted in December (-5%). Imports have

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Worsening slowdown in the industrial sector



Source: NBS

followed the same trends. Foreign trade should continue to contract at least through the first part of 2019. Thereafter, trends will largely depend on the result of current trade negotiations between Washington and Beijing.

Household consumption growth is slowing. Retail sales growth dropped to an all-time low in Q4 2018 (+8.3% y/y in value), hit by the downturn in durable goods purchases (reflecting the decline in housing sales) and the contraction in automobile sales (in line with the expiration of fiscal incentives and the structural slowdown in the

[1] About half of exports of Chinese goods to the US (USD 250 bn) is actually hit by tariff hikes of between 10% and 25%. The latest 10% increase was introduced in September on about USD 200 bn in merchandise sales. If Beijing and Washington fail to reach an agreement by March (the end of the truce), tariffs could be raised by 25% on these USD 200 bn in goods, or even extended to cover all Chinese exports. If an agreement is reached and Beijing makes concessions on the purchase of US goods (which is now our central scenario), the status quo could be maintained or recent tariff increases could be revised downwards.

sector). Online sales have also slowed but remain buoyant (+25% in 2018), and the same can be said for the consumption of services. Recent downward trends can also be blamed on the moderation of consumer credit (in a tighter regulatory environment), the erosion of household confidence, and another drop in income growth after the improvement of 2017. Weaker wage dynamics can be attributed to the troubles facing industry. In the short term, only stimulus measures can bolster household demand.

Economic policy easing is beginning to boost investment in infrastructure projects. Investment picked up in Q4 2018 after local governments were authorised to make more bond market issues for project financing. However, already heavy debt will continue to restrict severely their manoeuvring room. In the manufacturing sector, investment recovered in 2018 despite rising trade tensions, but should weaken again in early 2019 as a result of weakening exports and the deterioration in corporate profits. Real estate investment is unlikely to make a notable rebound, since volumes of transactions have declined since September 2018 and because the authorities should avoid overly easing the prudential regulations in the property sector. As a matter of fact, promoting a balanced and healthy development of the housing market and the combat against speculation remain top priorities of the government. All in all, the rebound in total investment (to 7.9% y/y in value terms in October-November 2018, from 5.4% in the first 9 months of the year) is likely to be mild in the short term.

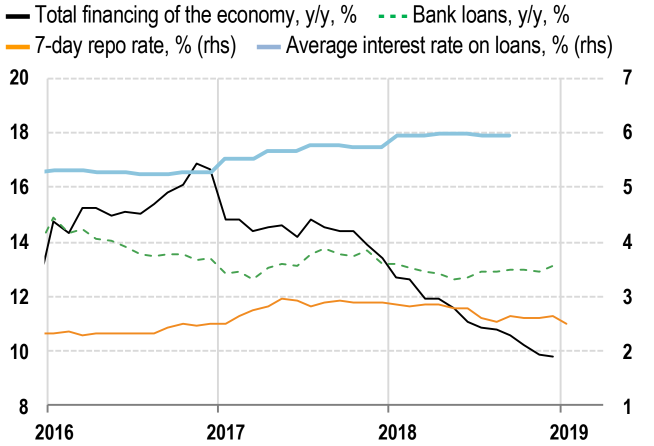
The authorities must give preference to fiscal stimulus

In recent months, the authorities have launched a series of contra-cyclical policies that should help contain the slowdown in economic growth. Monetary policy has been eased very cautiously. A new "targeted" financing facility has just been announced, essentially aimed at encouraging bank lending to small and mid-sized enterprises, and reserve requirement ratios continue to be lowered (to 13.5% in January 2019, down from 17% in March 2018). Net liquidity injections via open-market operations have also increased in recent days (but one of their main objectives is to prepare to respond to peak seasonal demand for liquidity).

The authorities are seeking to lower credit costs for corporates, stimulate lending and facilitate financing of local government investment projects. So far, money market rates have not decreased much (the 7-day repo rate has averaged 2.49% since early January, down from 2.63% in Q4 2018) and the average lending rate barely declined in 2018, after reaching 5.94% at the end of September (chart 3). The acceleration in inflation helped ease real interest rates through October, but this trend has since been reversed. Moreover, the increase in total credit to the economy continued to slow through the end of 2018 (reaching 9.8% y/y, down from 11.1% in mid-2018). This nonetheless masks a slight upturn in bank loan growth and bond financing in Q4 2018, which was more than offset by the contraction in shadow banking activities.

The timid easing of credit conditions reflects several problems. First, the debt excess of the economy and the low efficiency of new credit severely restrict the manoeuvring room of the monetary authorities

3- The easing in credit conditions remains timid



Source: Central bank

and the banks. Moreover, over the past two years, Beijing has pursued efforts to reinforce financial regulation, improve the health of state-owned companies and clean-up the real estate sector. It probably wants to avoid disrupting this process despite the redefinition of its priorities. Monetary policy is also constrained by the risk of capital flight and downward pressure on the yuan, at a time when 1) China's external constraint is already being tightened due to the substantial narrowing in the current account surplus, and 2) currency depreciation would further feed trade tensions with the United States.

Faced with this situation, the central government will have to make more use of fiscal measures to stimulate demand without aggravating financial instability risks. It has the capacity to act, given the moderate level of its deficits and debt (estimated at 16% of GDP at the end of September 2018). Household and corporate income tax cuts have already come into effect since 1 January 2019, and other measures are likely to be announced soon, notably a lower VAT rate and new fiscal incentives for household purchases of cars and durable goods.

Yet if the economic slowdown were to continue in the very short term, the authorities probably wouldn't hesitate to ease further monetary policy and to accelerate the implementation of infrastructure projects. More time will thus be needed to absorb the excessive debt burden of corporates and local governments.

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