36. CHINA

Steady headline growth, but underlying risks are rising

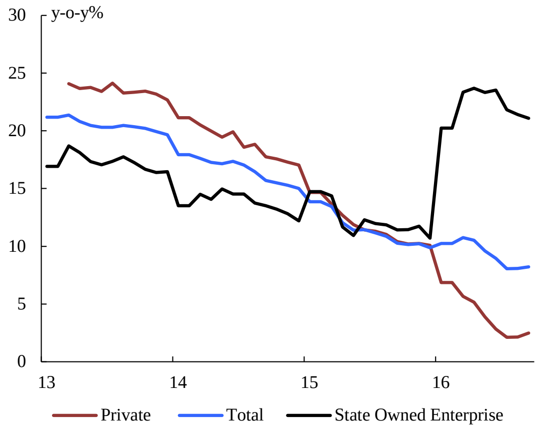
Growth has steadied in China following a weak first quarter and a turbulent start to the year, when poor high frequency data rattled Chinese and global financial markets. Stimulus measures have now kicked in and growth is set to reach the 6.5% target for the year with ease. Short term risks are balanced. However, the continued reliance on state-led investment to support activity suggest that the pace of structural reform is not fast enough to open up new, more sustainable growth drivers, with the risk of somewhat slower growth in the medium term and rising financial fragilities

China's real GDP growth rate over the first three quarters of 2016 was 6.7% (y-o-y), only marginally lower than the growth rate in 2015. However, this stability of headline growth masks important underlying trends, with growth supported by renewed policy stimulus, as a sharp rise in state-led investment offset weakness in private sector investment. Credit has continued to expand more rapidly than nominal GDP and corporate leverage continues to rise. The risk of an abrupt slowdown in the short run appears low, as consumption growth remains solid, the real estate sector has recovered from 2015 lows, and further policy support can be expected if growth should falter. The current projection therefore is for a continued gradual slowdown in activity, with growth of 6.6% in 2016, 6.2% in 2017 and 6% in 2018. However, without a marked revival of private investment, or a sustained period of faster consumption growth, this forecast implies rising domestic imbalances, rising hidden costs in the financial system and rising medium term risks.

Investment stimulus holds up growth again

China's growth in 2015 appeared consistent with a smooth rebalancing of demand and a controlled growth slowdown. The economy grew steadily at 6.9%, despite a marked step down in the growth of fixed asset investment, with consumption providing a bigger share of growth than in previous years. However, late 2015 saw emerging weakness as retail sales and fixed asset investment both slowed perceptibly. Exports also recorded a string of poor readings, down over 7% in both October and November, and seemingly reflecting the impact of the sharp rise in the RMB between mid-2014 and mid-2015. In this context, poor manufacturing PMI readings in early January, following on from weak service sector PMI readings in December, provoked a sharp sell-off in Chinese and global financial markets. The Shanghai composite index dropped 15% in less than 2 weeks and advanced economy indices dropped by 10%. Growth in 2016-Q1 was subsequently recorded at just 1.2% (q-o-q), compared to 1.6% for 2015-Q4. Growth subsequently picked up to 1.9% in Q2 and 1.8% in Q3. This is partly attributable to some recovery in exports, supported by a fall in the RMB real effective exchange rate of 7% between January and September. However, growth has also been underpinned by a steep rise in state-led investment.

Graph II.36.1: **China - Growth of fixed asset investment**



Policy is likely to remain reactive

Looking ahead, macroeconomic policy is expected to remain flexible and accommodative, with fiscal policy in particular expected to react to any further weakness in demand that puts annual growth targets at risk. Continued rapid credit growth suggests that the underlying monetary policy stance is highly accommodative. Total social financing, a measure of overall credit, has grown at over 12% over the first three quarters of 2016. The interbank SHIBOR rate has been kept stable at just below 2.5% while CPI inflation has remained below 2%. Growth in public and private consumption is set to continue to receive some support from looser fiscal policy and growth of household income is broadly in line with GDP growth. Private investment has received some support from a revival in real estate in 2016, but public investment is expected to continue to act as the main shock absorber, aiming to offset any further emergent weakness in demand.

External trade is expected to pick up modestly

China saw a sharp adjustment in trade volumes in 2015, with goods export volumes contracting for the first time since the global financial crisis in 2009. The sharp rise in the RMB real exchange rate from mid-2014 and tepid global growth both played a role. Exports volumes have subsequently picked up to low positive growth rates in 2016, broadly in line with global trade growth. A further slight pick-up in 2017 and 2018 is expected to be underpinned by the recent drop in the RMB's trade-weighted exchange rate. Import volumes were flat in 2015, reflecting a combination of the slowdown in real estate and lower construction material imports, the broader restructuring of the economy away from import-intensive investment, and reduced imports for reprocessing into exports. Imports appear to have recovered a little in 2016 to reach modest growth rates, and a further rise in 2017 and 2018 to growth rates of around 3% is anticipated, supported by continued private income growth, some revival of imports linked to real estate investment, and buoyant service sector imports. The net contribution to growth from the external sector is expected to be negligible. It is noteworthy that there are differences emerging in historical estimates from different sources (WTO, CPB, Chinese customs) of growth rates of Chinese imports and exports (in volume terms).

Short term risks are balanced, but medium term risks are rising

Short term risks are balanced. Private investment may rebound from current low levels, while exports could respond more positively than expected to the lower RMB. China is likely to continue to use established policy levers to provide an effective floor to growth, limiting downside risks in the short run. However, to maintain growth over 6.5% in 2016 China has relied on state-led investment and continued rapid credit growth which appears increasingly unsustainable. China faces a complex task if a smooth transition to lower but more sustainable growth rates is to be achieved. This would likely require a combination of a step-shift to higher levels of household income and consumption as a share of GDP, and structural reforms to open up new avenues for productive investment. Developments in 2016 so far suggest that this process may be stalling, raising the prospect of growing financial fragilities and potentially slower growth in the medium term.

Table II.36.1:

Main features of country forecast - CHINA

	2015		Annual percentage change						
	bn CNY Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	69630,0	100,0	9,8	7,8	7,3	6,9	**6,6**	**6,2**	**6,0**
Consumption	35952,0	51,6	55,1	-	-	-	**-**	**-**	**-**
Gross fixed capital formation	30196,0	43,4	38,7	-	-	-	**-**	**-**	**-**
of which: equipment			-	-	-	-	**-**	**-**	**-**
Change in stocks as % of GDP			-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	15141,0	21,7	26,0	8,8	6,9	-1,8	**1,9**	**2,6**	**2,8**
Final demand			-	-	-	-	**-**	**-**	**-**
Imports (goods and services)	12740,0	18,3	22,0	10,6	8,7	0,6	**3,0**	**3,2**	**3,6**
GNI (GDP deflator)	-	-	-	-	-	-	**-**	**-**	**-**
Contribution to GDP growth : Domestic demand			-	-	-	-	**-**	**-**	**-**
Inventories			-	-	-	-	**-**	**-**	**-**
Net exports			-	-	-	-	**-**	**-**	**-**
Employment			-	-	-	-	**-**	**-**	**-**
Unemployment (a)			4,0	4,1	4,1	4,1	**-**	**-**	**-**
Compensation of employees/head			-	-	-	-	**-**	**-**	**-**
Unit labour costs			-	-	-	-	**-**	**-**	**-**
Real unit labour costs			-	-	-	-	**-**	**-**	**-**
Saving rate of households			-	-	-	-	**-**	**-**	**-**
GDP deflator			3,4	2,4	1,2	0,4	**1,0**	**1,0**	**1,5**
Private consumption deflator			-	-	-	-	**-**	**-**	**-**
Index of consumer prices (c)			1,9	2,6	2,0	1,4	**-**	**-**	**-**
Merchandise trade balance (b)			4,1	3,7	4,1	5,1	**5,5**	**5,2**	**5,1**
Current-account balance (b)			4,1	1,5	2,6	3,0	**3,0**	**2,6**	**2,3**
Net lending(+) or borrowing(-) vis-à-vis ROW (b)			-	-	-	-	**-**	**-**	**-**
General government balance (b)			-	-	-	-	**-**	**-**	**-**
General government gross debt (b)			-	-	-	-	**-**	**-**	**-**

(a) urban unemployment, as % of labour force. (b) as a percentage of GDP. (c) national indicator.