# 36. CHINA

## Gradual slowdown in growth, cushioned by macroeconomic policy

*After a slow start to 2016 China regained momentum in the second half of the year, thanks to improved exports and domestic investment stimulus. A modest slowdown in growth is expected in 2017 and 2018. In the short term, risks to the outlook are broadly balanced, but rapid credit growth and high levels of corporate leverage pose substantial medium term risks if not addressed through policy reforms.*

The Chinese economy expanded by 6.7% in 2016, driven mainly by strong consumption growth. This is only marginally down on the 6.9% growth in 2015. The outlook remains largely unchanged, with a further slowdown expected to 6.4% growth in 2017 and 6.2% in 2018. Consumption should remain the principal source of growth, aided by a modest recovery in export volumes. Macroeconomic policy is likely to react flexibly to any significant weakening of momentum so as to keep overall growth in the range of 6 to 6.5%.

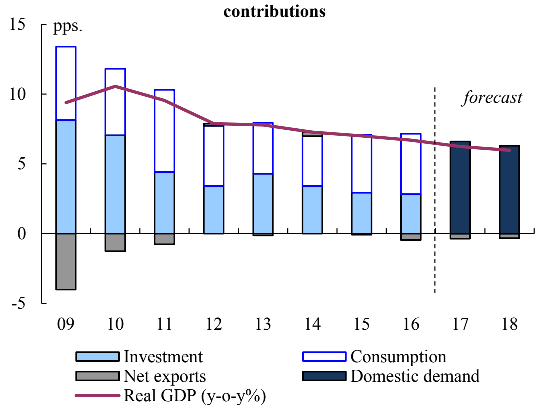
### Weak momentum in early 2016 was followed by a clear rebound

The Chinese economy lost momentum in early 2016 as trade volumes fell sharply, private investment weakened, and survey indicators turned downwards, leading to a sharp bout of turbulence in global financial markets. Growth was reported at 1.3% (q-o-q) in 2016-Q1, the lowest (q-o-q) growth rate since the series was first published in 2011. The rest of the year saw a substantial rebound. Export volumes picked up from 2016-Q2, while investment stimulus measures compensated for weaker private investment. Real GDP grew by 6.7% for the year as a whole, well within the 6.5%-7% target range set by the government. The composition of growth was consistent with some rebalancing of demand, with the consumption contribution rising to 4.3 pps. (4.1 pps. in 2015), investment falling slightly to 2.8 pps. (2.9 pps. in 2015) while net exports were a modest drag on growth, subtracting -0.5 pps. (-0.1 pps. in 2015).

### The near-term outlook points to a measured slowdown in growth

Looking ahead, domestic demand is expected to remain the main growth driver. Household consumption is expected to continue to grow at a steady pace, supported by disposable income that is growing faster than GDP, particularly in rural areas, by buoyant employment creation, and rising house prices. Investment is expected to grow more slowly than in 2016, as private investment weakened throughout the course of 2016, and only a significant expansion in investment by state owned enterprises and a rebound in real estate investment prevented this slowdown from having a much more significant impact on GDP growth.

*Graph II.36.1:* **China - Real GDP growth and contributions**




### Macroeconomic policies will be geared to support near-term growth

Fiscal policy is expected to remain expansionary throughout the forecast horizon and to respond flexibly to any signs of weakness, though precise assessment of the fiscal stance is hampered by inadequate data. The central government deficit will increase to just over 2% of GDP, but this does not capture fiscal stimulus sourced through SoEs or local government. Monetary policy is expected to remain accommodative. Policy rates have now remained unchanged since 2015-Q4 and real interest rates are now edging downwards. CPI inflation accelerated to 2.0% (y-o-y) in 2016 (1.4% in 2015), while producer price inflation turned positive in 2016, recovering sharply after several years of deflation. Some rebound in commodity prices and the weakening exchange rate will add to inflationary pressures. At the same time, credit growth remains very rapid, expanding at around twice the pace of nominal GDP. The corporate debt stock is now over 170% of GDP, concentrated in the state enterprise sector, raising concerns over potential non-performing loans and financial stability. House prices in tier 1 cities are also growing at over 20% per annum, renewing concerns over affordability and possible speculative bubbles. Finally, large capital outflows have persisted, and may be negatively affected by faster normalisation of US policy rates. Managing this combination of factors represents a considerable challenge. In the short run, stricter capital controls and targeted measures to cool house prices are likely to be the favoured response.

### Exports should improve gradually as global demand recovers

China's imports and exports of goods were tepid in 2016, both growing by around 2.5% in volume terms. Overall import volumes were boosted by rapid growth of services imports, while service exports fell marginally. The slow growth in goods trade is part of a broader global phenomenon, overlaid with specific Chinese factors, notably the slowdown in import-intensive investment and lower imports for export reprocessing. Goods exports did pick-up somewhat in 2016-H2 after a very weak 2016-H1, helped by depreciation of the RMB, which fell by 7% in real effective terms during the year. Looking ahead, export volumes should continue to improve slowly, while import volumes are expected to grow at a similar rate to 2016. Goods imports will be held back by slowing investment and real exchange rate effects, though service imports, underpinned by buoyant consumption, are expected grow at close to 10%. As a whole, net exports are expected to make a small negative contribution to overall growth.

### Short term risks appear balanced, but structural imbalances are worsening

Short term risks to the forecast are balanced. Continued policy support is likely to put a floor under domestic demand growth, though at the cost rising corporate debt and non-performing loans in the medium term. These issues are addressed in detail in Box I.2. It is unclear precisely to what extent the slowdown in private investment reflects cyclical or more fundamental structural factors, and a rebound in 2017-18 could lead to outperformance. On the external front, trade volumes could respond more positively than forecast to the lower RMB real exchange rate. However, overshadowing the external forecast is the evolution of US-China trade relations, which was a focal point of the US presidential campaign. While fiscal stimulus and faster growth in the US may add to Chinese exports, a shift towards greater protectionism could imply a significant negative shock to China's external trade flows.

*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 | **6.7** | **6.4** | **6.2** |
| 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 | **2.0** | **3.1** | **3.4** |
| Final demand | | | - | - | - | - | - | - | - |
| Imports (goods and services) | 12740.0 | 18.3 | 22.0 | 10.6 | 8.7 | 0.6 | **4.1** | **3.9** | **4.1** |
| 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 | **5.4** | **5.1** | **5.1** |
| Current-account balance (b) | | | 4.1 | 1.5 | 2.6 | 3.0 | **2.9** | **2.4** | **2.1** |
| 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.