

## 36. CHINA

### A benign short term outlook, but imbalances continue to rise

*The pick-up in momentum seen in the second half of 2016 has been sustained into early 2017. Growth in 2017 and 2018 is nevertheless still expected to be slightly below that in 2016. Short term risks remain balanced, but both rapid credit growth and high levels of corporate debt continue to pose medium term risks unless addressed via policy reforms.*

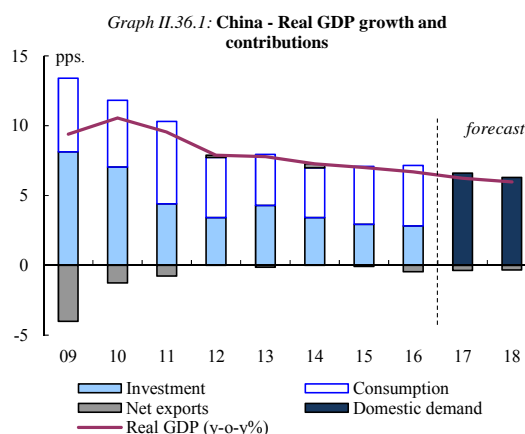
#### Growth in early 2017 surprises on the upside

China grew by 6.9% (y-o-y) in 2017-Q1, a little more strongly than expected. This compares to 6.7% growth in 2016. High frequency indicators have also maintained solid momentum in recent months while trade volumes have picked up in line with broader trends in trade in Asia. China is now forecast to grow by 6.6% in 2017 and 6.3% in 2018. Risks to the short term outlook remain balanced, with domestic investment and trade being the major uncertainties, particularly given potential tensions in US-China relations. Despite the relatively benign short term outlook, risks linked to rapid growth of corporate leverage remain a significant concern, but are not expected to precipitate a major adjustment over the forecast horizon.<sup>(43)</sup>

#### Rebalancing of demand makes some headway, but concerns remain

The composition of growth in 2017-Q1 was also consistent with continued rebalancing on the demand side of the economy away from excessively high levels of investment and towards more consumption-driven growth. The contribution of consumption was 5.3 pps. (compared to 4.3 pps. for 2016 as a whole) while investment contributed just 1.3 pps. (2.8 pps. in 2016) and net exports made a positive contribution of 0.3 pps. (-0.5 pps. in 2016), the first positive contribution to growth since late 2015. The composition of investment demand also showed some signs of rebalancing, with a slower pace of growth in state-led investment, though it continues to grow somewhat faster than private investment. Public investment sourced via state enterprises (SoEs) and local government makes a substantial contribution to overall investment (around 40%) and is closely linked to the rapid growth in local

authority borrowing and particularly the sharp rise in corporate leverage in the SoE sector, which has risen by around 70 percentage points since 2010.



#### Momentum to be maintained in the short run, underpinned by supportive policies

High frequency indicators paint a positive short-term picture, with PMIs in both manufacturing and services well into expansionary territory. Monthly industrial production and fixed asset investment are showing modest upticks in growth rates, while trade volumes are picking up. Private investment remains tepid, with the exception of the real estate sector where fixed asset investment expanded at the fastest pace in two years in the first two months of 2017. Fiscal policy is expected to remain modestly expansionary, though the precise assessment of the fiscal stance is hampered by inadequate data, as central government data do not capture fiscal stimulus sourced through SoEs or local government. Monetary policy headline rates have now remained unchanged since 2015-Q4. But in recent months the Chinese central bank has started to tighten a number of money market rates (repo rates), most likely reflecting reduced concerns over the short term outlook, and some desire to moderate the still fast pace of credit growth, which is expanding at

<sup>(43)</sup> See Box I.1 in the EC 2017 Winter Forecast for a discussion on the adjustment challenges posed by China's rapid growth in corporate leverage and high investment rates.

roughly twice the pace of nominal GDP growth. CPI inflation accelerated to 2.0% (y-o-y) in 2016 (1.4% in 2015) and is likely to edge up further in 2017 as higher commodity prices and the weakening of the RMB exchange rate during 2016 add to inflationary pressures. The large capital outflows seen in 2015 and 2016 appear to have abated in recent months. This reduces downward pressure on the RMB, which is now expected to remain broadly stable in real terms.

### Trade volumes are picking up noticeably

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. 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, supported both by the weaker currency and accelerating growth in trading partners. Import volumes are expected to grow a little more slowly than in 2016, reflecting the impact of a weaker RMB on domestic demand. As a whole, net exports are expected to make a small negative contribution to overall growth in 2017.

### Short term risks remain balanced

Short term risks to the forecast are balanced. It remains unclear to what extent the current slowdown in private investment, seen throughout 2015 and into 2016 reflects short term cyclical factors or more fundamental structural constraints. A significant rebound in (non-real estate) private investment is an upside risk to the forecast, though a sharp acceleration would likely be met with some further gradual tightening of monetary policy and some scaling back of existing public investment stimulus. Although house prices have cooled notably over the last 12 months, real estate investment activity has picked up and risks of a generalised sharp downturn in real estate appear low. On the external front, trade volumes could respond more positively than forecast to the lower RMB real effective exchange rate, particularly given the broader recovery in regional trade volumes and some prospect of faster growth in the EU and US feeding into export demand. However, overshadowing the forecast is the evolution of US-China trade relations, where a shift towards greater protectionism could imply a significant negative shock to China's external trade flows. Finally, despite the relatively buoyant short term outlook, the continued growth in China's corporate leverage remains a significant medium term risk.

Table II.36.1:

### Main features of country forecast - CHINA

	2015			97-12	Annual percentage change					
	bn CNY	Curr. prices	% GDP		2013	2014	2015	2016	2017	2018
GDP	69630.0	100.0	9.8	7.8	7.3	6.9	6.7	6.6	6.3	
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	1.8	3.1	3.4	
Final demand			-	-	-	-	-	-	-	
Imports (goods and services)	12740.0	18.3	22.0	10.6	8.7	0.6	5.1	4.6	4.7	
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	5.3	4.8	4.7	
Current-account balance (b)			4.1	1.5	2.6	3.0	2.8	1.9	1.6	
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.