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China Economic Outlook: Defying Gravity

Introduction

It has been a challenging 12 months for the Chinese economy. First came the escalation in trade tensions with the U.S., which has seen the Trump administration slap tariffs on a myriad of U.S. imports from China. Then came the deepening economic slowdown, with real GDP growth slowing last year to its weakest pace in almost three decades. But 2018 had started on a solid note, with GDP growth accelerating close to a three-year high in the first quarter. Yet as the economy lost momentum through the year, fears of a worsening slowdown mounted.

China Outlook: Defying Gravity

BY VEASNA KONG

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It is said that when China sneezes, the rest of the world catches a cold. Today, this is truer than ever. The Chinese economy, in terms of purchasing power, is the largest in the world, having overtaken the U.S. in 2014. China now accounts for almost one-fifth of global GDP, up from 13% a decade ago, and has accounted for one-third of global GDP growth in the last eight years. China is also the largest trading partner for many countries and a growing source of foreign investment. Meanwhile, its economy is now more leveraged than ever. Total debt has increased rapidly to 250% of GDP from 143% in 2008, leaving the economy more vulnerable to shocks. In short, China's slowdown has global repercussions, and beyond the slowdown there are risks that bear watching.

The long view

Although cyclical factors such as the slowdown in global trade and related downswing in the tech cycle are weighing on China's economy, in truth the slowdown in China has been in train for a number of years. Since the stimulus-induced surge in GDP growth over 2009 and 2010, GDP growth has been on a steady decline, save for a period of remarkable stability from 2015 to 2017.

This steady decline is reflected in four key indicators that are widely followed on a monthly basis (see Chart 1). Industrial production growth, for instance, slowed to a 17-year low in January-February, weighed down by softer local and foreign demand. Similarly, retail sales growth has gradually declined since 2010 and is hovering near an 11-year low. The best example of this gradual slowdown is fixed asset investment. Since peaking at close to 35% year over year in mid-2009, fixed asset investment growth has been in a clear downtrend and fell to a record low of 5.3% year to date to August 2018.

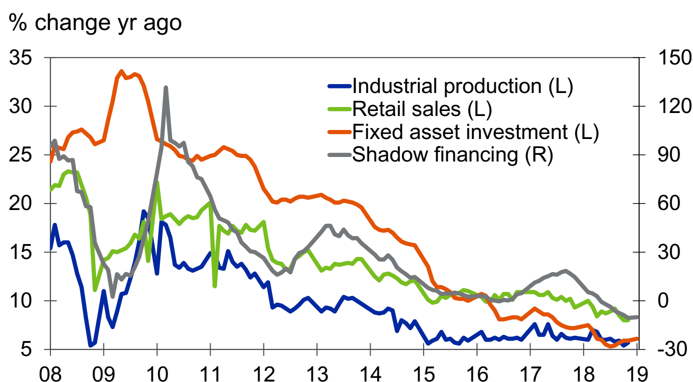
Of course, the trade dispute with the U.S. has not helped. Global trade had been driven by the synchronized upturn in growth among the world's major economies from around mid-2016. But with this upturn fizzling in 2018, exports and manufacturing have weakened, with the impact of the trade war exacerbating the slowdown. Reflecting this, the new export orders component of China's official manufacturing PMI has remained in contraction territory in the last 10 months. However, even without the trade war, growth of world trade volumes was already relatively weak (see Chart 2).

To be sure, China's growth performance is remarkable. Yet the factors underpinning this rise, such as rapid physical capital accumulation, the reallocation of labour toward export manufacturing, and improvements in technology and human capital, are not unique. Now that China is at a more mature phase of its development, economic growth is inevitably slowing. Two reasons underscore this view.

Labour force and productivity

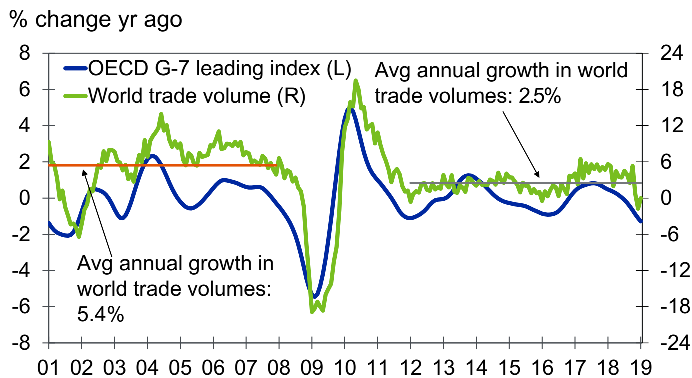
First, China's potential pace of economic growth can no longer be supported by an expanding labour force. By Moody's Analyt-

Chart 1: A Broad Slowdown



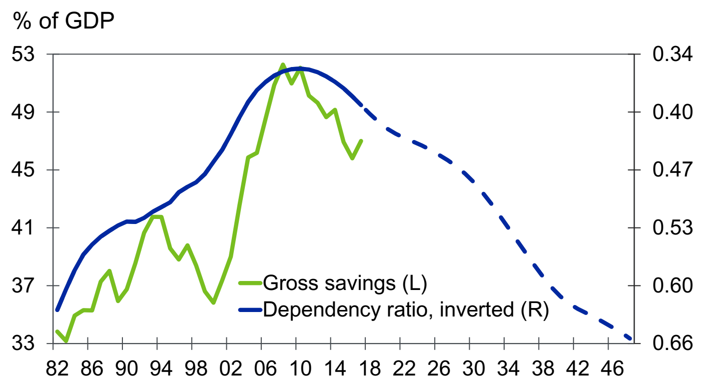
Sources: National Bureau of Statistics, Bloomberg, Moody's Analytics

Chart 2: Global Trade Weakens



Sources: OECD, CPB World Trade Monitor, Moody's Analytics

Chart 3: Savings Likely to Shrink Further



Sources: The World Bank, Moody's Analytics

ics estimates, the working-age population—those age 15-64—peaked in 2014 and will gradually shrink over the foreseeable future absent a significant increase of the fertility rate and/or immigration. China's demographic profile, which was once a tailwind, is now a drag on economic growth with the number of dependents to the working-age population expected to continue rising.

Second, with the labour supply shrinking, China needs to rely on increasing labour productivity if it is to lift economic growth. Although there are many more gains still to be made, these are unlikely to more than offset the impact of the declining labour force. The shrinking pool of labour and ageing population itself makes this a challenge, since the drag on household savings reduces the amount of domestic funds available to make productivity-enhancing investments (see Chart 3). Moreover, a lot of the low-hanging fruit has already been picked, so generating further labour productivity gains will become increasingly difficult. Thus, China's potential rate of economic growth is necessarily slowing. In itself this is not negative given the large debt overhang and need for more sustainable growth following previous excesses.

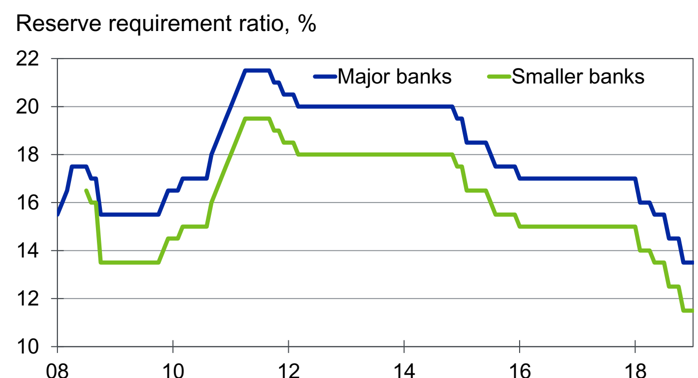
Still, from Beijing's perspective, economic growth became uncomfortably weak through 2018, and with the trade dispute with the U.S. threatening to undermine China's growth prospects further, Beijing has stepped up its efforts to stimulate growth. Measures include reserve requirement ratio cuts, higher tax reimbursement rates for exporters dealing with U.S. tariffs, tax cuts, and a push to increase bank lending and public works—the latter being tried and tested favorites of Beijing. But in contrast to Beijing's efforts during the 2008-2009 global financial crisis, when it unleashed a mammoth CNY4 trillion (13.4% of GDP) stimulus package, recent easing efforts have been more targeted and focused on key pressure points in the economy.

For example, amid the crackdown on shadow financing, small and medium private enterprises have found it difficult to obtain financing. These SMEs account for 90% of all businesses in China. To help ease the constraint, banks were recently directed to increase their nonperforming loan tolerance threshold by 3 percentage points for loans to SMEs. The banks, under pressure to boost lending at a time of comparatively slower deposit growth while still meeting capital adequacy requirements, are also getting a helping hand. On top of reserve requirement ratio cuts (see Chart 4), the Bank of China was granted permission in January to issue perpetual bonds, the first such issuance for a bank in China. In the words of the China Banking and Insurance Regulatory Commission, the perpetual bonds will "help banks replenish capital, improve capital structure, expand lending, and boost risk resilience".

In a similar vein, at the National People's Congress in March, Premier Li Keqiang announced the government's intention to reduce taxes and other company costs by CNY2 trillion (US$298 billion) this year, on top of CNY1.3 trillion worth of cuts in 2018. The tax cut is especially generous for the manufacturing industry, whose value-added tax was lowered by 3 percentage points to 13%, a timely boost given softer local and foreign demand and slowdown in industrial profit growth. The transportation and construction industries have also received a 1-percentage point tax cut.

Meanwhile, the budget deficit target for this year is 2.8% of GDP, 0.2 percentage point higher than in 2018. While modest, this slightly wider fiscal deficit will be accompanied by a 12% increase in local government bond issuance, much of which will

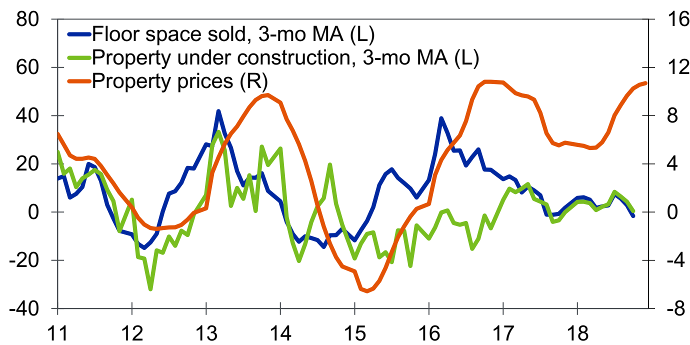
Chart 4: Measured Monetary Stimulus



Sources: Bloomberg, Moody's Analytics

Chart 5: Housing Market Stabilizing

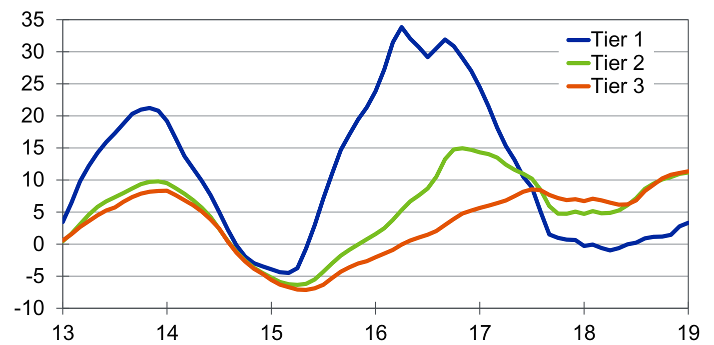
% change yr ago



Sources: National Bureau of Statistics, Moody's Analytics

Chart 6: Lower Tier Cities Lead the Charge

Newly built house prices, % change yr ago



Sources: National Bureau of Statistics, Bloomberg, Moody's Analytics

be used to accelerate infrastructure projects. Local governments will be looking to raise as much as CNY3.1 trillion from bonds in 2019. Of this, the quota for "special purpose" bonds is CNY2.15 trillion, up 59% from the prior year. Special purpose bonds differ from regular local government bonds in that cash flows from the project being funded are used to repay the debt, independent of other local government revenues. These bonds are generally issued to fund land and infrastructure development, such as transportation infrastructure and public housing, and have become a key source of funding since being introduced in 2015. Bonds, more generally, also impose a degree of market discipline and transparency on local government finances that was largely absent prior to 2014. Local governments were barred from borrowing until 2014 despite accounting for 85% of the government spending burden. This spawned the development of local government financing platforms that tapped into the shadow banking system to obtain off-balance sheet financing for local governments under pressure to achieve growth targets.

Green-ish shoots

There is some evidence that the easing measures have begun to stabilize pockets of the economy. In February, fixed asset investment growth improved for the fifth consecutive reading, coming in at 6.1% year over year in the year to date. While still well down from the 7.9% pace that was notched in the first two months of 2018, the steady improvement since the record low last August does suggest that measures such as reserve requirement ratio cuts are helping to lift investment. The improvement in the latest reading was driven by a noticeable increase in infrastructure investment led by a double-digit increase in road and railway transportation investment. However, growth of investment in the manufacturing industry was weak, in part reflecting the decline in overseas demand and uncertainties surrounding China's trade dispute with the U.S.

Importantly, the housing market, which drives demand in a range of industries, has also stabilized. Residential fixed asset investment increased by 11.6% year over year in the first two months of 2019, the strongest rise since November 2014. National house price growth has also picked up, having slowed through much of 2017 and into 2018 under the weight of tighter housing market regulations (see Chart 5). Housing market cycles in China are strongly influenced by Beijing, and since early 2016, the authorities have targeted real estate speculation by progressively tightening a range of regulations. These include higher down payment requirements, minimum holding periods, restrictions on second-home purchases, home ownership limits for nonresidents, bans on corporate purchases of residential property, and a crackdown on overseas funding of real estate development.

It is telling, however, that the slowdown in national house price growth in 2017-2018 was less pronounced than prior downswings, in large part due to relatively solid house price growth in lower tier cities (see Chart 6). House prices in lower tier cities have been buoyed by Beijing's shantytown redevelopment program, which has boosted demand for new housing at a time when restrictions have been placed on sales. Lower mortgage interest rates for first-time home buyers have also spurred demand in more affordable housing markets in lower tier cities.

Beijing has also increasingly turned to local governments to set housing policy according to local conditions, which may have helped some cities avoid a sharper slowdown. A growing number of cities have eased restrictions in recent months. For instance, in December the city of Heze in Shandong shelved a two-year minimum holding period for newly purchased homes. Meanwhile, Guangzhou has lifted a ban prohibiting developers from selling apartments on commercial land. Taken together with relaxation of residency restrictions under China's hukou system, which will not only increase urbanization but also allow those previously without a residency permit to purchase a home in their place of residence, these developments are likely to encourage a pickup in residential construction activity.

The bottom line

All told, we expect Beijing's easing measures to help temper the economic growth slowdown in 2019. It is commonly believed that the official statistics overstate GDP growth in China, and the Moody's Analytics China GDP tracker persistently undershoots the official GDP growth numbers. Neverthe-

less, the tracker continues to point to weaker growth in first-quarter 2019, indicating GDP growth is unlikely to improve until the second quarter at the earliest. Beijing has set an annual growth target of 6% to 6.5% for 2019, and Moody's Analytics expects growth to come in comfortably in that range at 6.3%, with some upside if stimulus measures gain more traction than expected.

On the trade front, pressure is building on both sides to reach an agreement, suggesting some form of deal is likely in coming months. This would help boost sentiment and lift the veil of uncertainty that has undermined capital expenditure plans since tensions ratcheted up last year. Should GDP growth come in at 6.3%, this would be the slowest annual expansion since 1990. But while Beijing can temper the slowdown, growth of above 6% is unlikely to be sustained in coming years. Indeed, the downtrend in GDP growth that has been evident for a number of years is unlikely to change course, and sub-6% growth will be the new norm. Beijing can play with the cycle; shifting the course of potential growth is a more difficult challenge.

About the Author

Veasna Kong is an economist in the Sydney office of Moody's Analytics. He covers national and metropolitan economic issues across the Asia-Pacific region. He previously worked as an economist at IMA Asia, the Economic Cycle Research Institute, and the Australian Treasury, where he covered China and South East Asia. Veasna has a master of applied econometrics from Monash University.

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