CHINA

After having held up well into 2018, growth has recently weakened and is projected to decline in 2019-20. Signs of slowdown include the weakening of industrial production, profits and revenues. Foreign trade flows will lose some momentum following the escalation of trade tensions. The slowdown of activity also reflects the cutback of infrastructure investment, as local government debt has been subject to greater scrutiny, though it could rebound following the recent acceleration of debt issuance and announcement of new projects.

Monetary conditions are now being eased to support economic activity. The escalation of trade tensions resulted in a fall of the exchange rate, which was halted by government interventions, and a decline in stock prices. Fiscal policy will remain supportive to counteract the weakening of growth. Government spending efficiency will benefit from newly introduced comprehensive performance budgeting, but capital allocation efficiency needs to be improved by gradually removing implicit guarantees to state-owned enterprises and other government entities. Measures introduced recently to lower average tariffs are welcome and should continue alongside further easing of the operation of foreign companies.

The economy has remained relatively unscathed by rising global uncertainties

Growth has been holding up well, notwithstanding the escalation of trade tensions and heightening global uncertainties. The frontloading of exports and the depreciation of the renminbi have mitigated the impact of tariff hikes so far. Imports have also held up well on the back of tariff cuts coming into effect earlier this year and subsequent targeted retaliatory tariff increases and as outbound tourism remained robust. As a result, the current account registered its first deficit in two decades in the first half of the year. Domestic demand, in particular consumption, has remained robust and will continue to be a stable driver of growth thanks to rising disposable incomes. Infrastructure investment has slowed following restrictions imposed on shadow banking, a major source of

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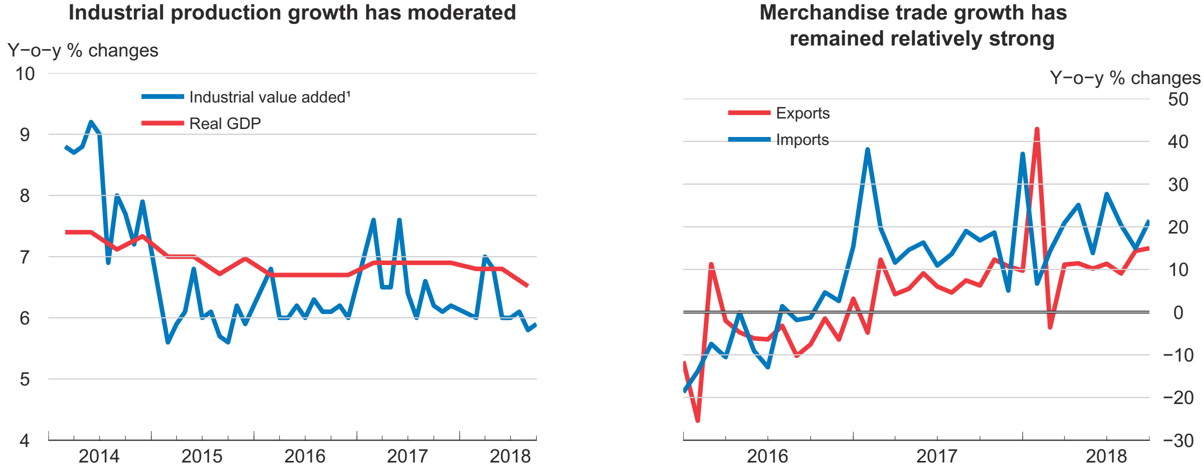
Industrial production growth has moderated | Merchandise trade growth has remained relatively strong



1. Monthly industrial value added data for January and February are not published separately, but for the two months combined. The missing data are computed by linear interpolation.

Source: CEIC.

StatLink http://dx.doi.org/10.1787/888933876461

China: **Demand, output and prices**

	2015	2016	2017	2018	2019	2020
	Current prices CNY trillion	Percentage changes, volume (2015 prices)				
GDP at market prices	68.9	6.7	6.9	6.6	6.3	6.0
Total domestic demand	66.7	7.7	6.0	7.1	6.3	6.0
Exports of goods and services	14.8	1.9	11.0	5.4	5.0	4.8
Imports of goods and services	12.6	6.3	6.9	7.9	4.9	4.7
Net exports[1]	2.3	-0.7	1.0	-0.3	0.1	0.1
Memorandum items						
GDP deflator	_	1.1	4.1	2.9	3.0	3.0
Consumer price index	_	2.1	1.5	2.0	3.0	3.0
General government financial balance[2] (% of GDP)	_	-3.0	-3.1	-3.1	-3.3	-3.5
Headline government financial balance[3] (% of GDP)	_	-2.9	-2.9	-2.9	-3.0	-3.1
Current account balance (% of GDP)	_	1.8	1.4	0.4	0.4	0.3

1. Contributions to changes in real GDP, actual amount in the first column.
2. Encompasses the balances of all four budget accounts (general account, government managed funds, social security funds and the state-owned capital management account).
3. The headline fiscal balance is the official balance defined as the difference between revenues and outlays. Revenues include: general budget revenue, revenue from the central stabilisation fund and sub-national budget adjustment. Outlays include: general budget spending, replenishment of the central stabilisation fund and repayment of principal on sub-national debt.

Source: OECD Economic Outlook 104 database.

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infrastructure financing. Excess capacity still plagues a number of industrial sectors, weighing on business investment. Services, in contrast, are expanding steadily, especially in the digital and sharing economies.

Monetary and fiscal policy may ease, but structural reforms should accelerate

Monetary policy was tightened somewhat by the restrictions put on shadow banking, which were necessary to maintain financial stability. This affected disproportionately

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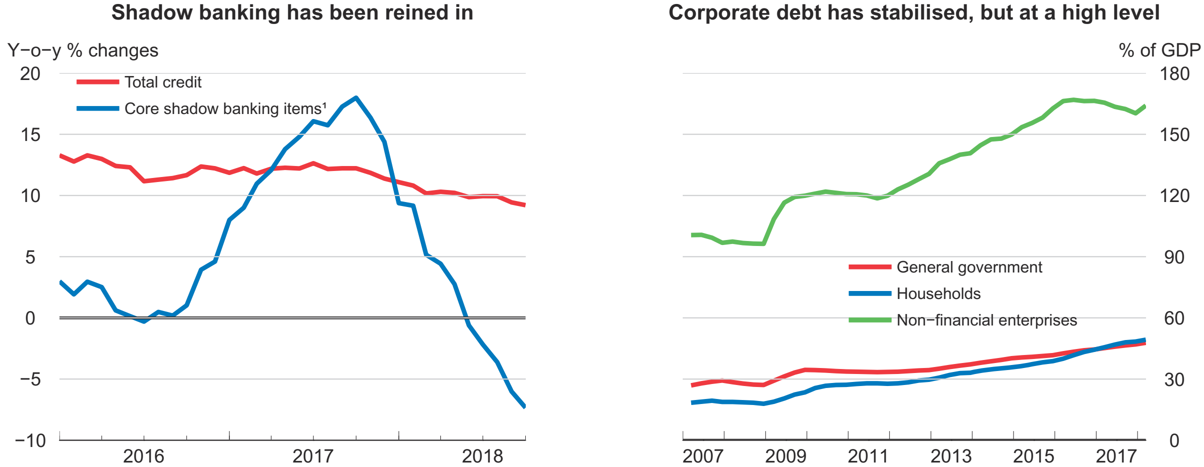
Shadow banking has been reined in | **Corporate debt has stabilised, but at a high level**



1. Core shadow banking items include entrusted loans, trusted loans and undiscounted bankers' acceptance.

Source: CEIC; and BIS.

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private and smaller firms, which have less access to commercial bank loans, and prompted the authorities to incentivise lending to smaller firms by exempting banks from tax liabilities related to their lending to such firms. Rising bond defaults resulted in a higher credit risk premium. Going forward, moderate easing of monetary policy is envisaged to reduce the debt burden. Corporate debt has levelled off relative to GDP, but deleveraging remains slow. Sliding stock prices will damp confidence.

Fiscal stimulus will hold growth up but better pricing of risk is needed to reduce misallocation of capital. Removal of implicit guarantees to state-owned enterprises and other public entities would help, and the recent announcement to let ailing local government investment vehicles exit the market is pointing in that direction. The impact of tax cuts aimed at boosting consumption may be mitigated by adverse confidence effects and slow progress in structural reforms. A minimum level of public services should be ensured through better allocation of resources to provide more equal opportunities to individuals regardless of their place of birth. Central funding for basic public services, such as education and health, is needed ensure a sufficient level of service provision.

Poverty reduction should focus on equipping people with marketable skills to avoid dependency on social assistance. Expanding low-cost childcare facilities and early childhood education across the country would help to curb child poverty and would provide more equal chances for moving up the social ladder. Furthermore, entrance exams to upper-secondary education should not require knowledge and skills that public education is not providing, so as to avoid leaving behind students whose families cannot afford expensive preparatory schools. Housing prices in the largest cities are unaffordable for low-income earners and there is insufficient social housing.

Growth is projected to remain robust

Growth is projected to slow modestly, which will ease producer price inflation. Consumer price inflation will nonetheless pick up due to surging fresh food prices, partly reflecting African swine fever, but these one-off pressures will remain benign. Goods exports and imports will slow somewhat, though import tariff cuts recently introduced by China and an increased VAT refund on exported products will mitigate the impact of trade tensions. In processing industries, where the share of intermediate inputs is high and value-added is low, this will significantly strengthen competitiveness. Round tripping of exports destined to the US market through third countries not affected by tariff hikes is already picking up. Surging overseas tourism will continue to reduce the current account surplus. Infrastructure investment will rebound thanks to the revival of bond-financed local projects.

Reining in shadow banking would enhance financial stability and transparency, but may cause funding difficulties for smaller firms. Acceleration in corporate deleveraging is necessary to restore balance sheets amid rising debt service costs. Slow deleveraging would result in stronger growth in the short term, but increases imbalances later. A weaker fiscal stimulus might adversely affect growth, but would reduce the risk of a further build-up of implicit government liabilities. Infrastructure investment is mainly financed by public funds, but only partly from the budget, thereby reducing transparency. Trade frictions may disproportionately affect smaller firms that are less able to squeeze profit margins to accommodate the tariff hikes and some geographical regions that are more reliant on exports for their growth. The exchange rate may again depreciate, which will provide some cushion against export restrictions.