CHINA

Economic growth is projected to hold up in 2017 and 2018, partly thanks to the impact of earlier fiscal and monetary stimulus. Infrastructure investment is picking up on the back of regional development initiatives, including the Belt and Road and the Beijing-Hebei-Tianjin Corridor. Real estate investment will remain buoyant notwithstanding measures to restrict demand. Private investment growth has bottomed out and consumption growth will remain stable, underpinned by continued strong job creation. Recovering global demand will spur exports, but surging tourism imports will limit the effect on the current account balance.

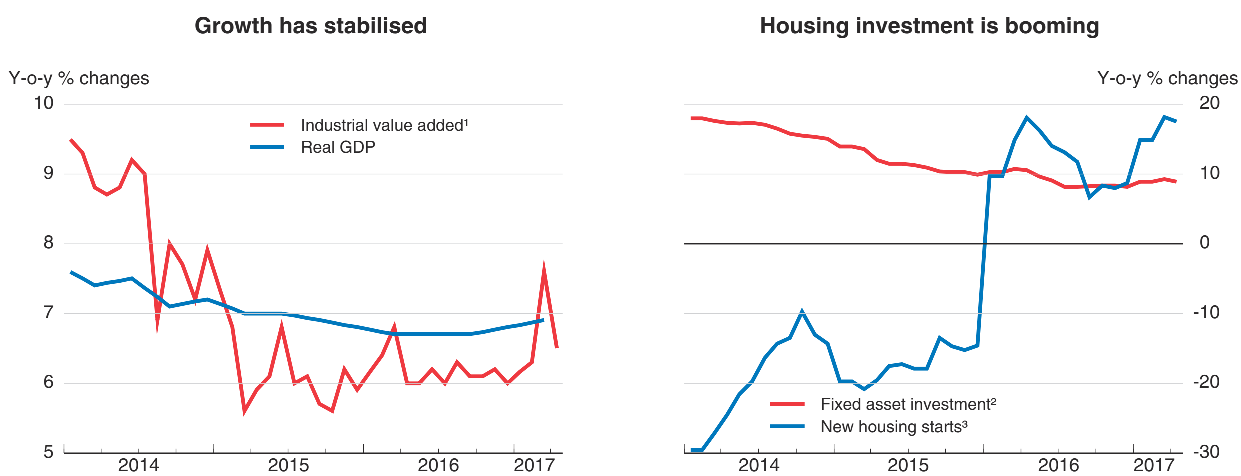
In a context of low inflation, monetary policy is appropriately geared to focus on financial risks, which have mounted. Fiscal policy will remain supportive but should prioritise social inclusion more. Productivity-enhancing reforms, such as further reducing the costs of doing business, phasing out the implicit guarantees enjoyed by state-owned enterprises and improving corporate governance frameworks, are necessary to keep up the pace of convergence in income per capita to the advanced economies.

Integration into global value chains was instrumental in China's spectacular economic growth in recent decades. Moving to higher value-added production calls for improvements in the quality and relevance of innovation and, as lower-skilled jobs move to lower-cost countries in the region, for upskilling.

Growth is holding up

Growth has picked up somewhat, with machinery and high-tech industry production in the lead. Investment in the service sector continues to be buoyant, but still considerable

China



1. Monthly industrial value added data for January and February are not published separately, but the two months are combined. Therefore missing data were filled by linear interpolation.
2. Fixed asset investment refers to nominal values and is expressed in cumulative terms.
3. New housing starts refer to residential floor space newly started by real estate developers during the reference month and are expressed in cumulative terms.

Source: National Bureau of Statistics China; and CEIC.

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China: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices CNY trillion	Percentage changes, volume (2005 prices)				
GDP at market prices	59.5	7.3	6.9	6.7	6.6	6.4
Total domestic demand	58.1	8.9	9.1	8.3	6.2	6.2
Exports of goods and services	14.5	4.2	-2.3	1.9	8.9	4.3
Imports of goods and services	13.0	8.3	2.6	6.6	7.5	3.5
Net exports[1]	1.4	-1.0	-1.7	-1.3	0.6	0.3
Memorandum items						
GDP deflator	_	0.8	0.1	1.2	4.5	3.1
Consumer price index	_	2.1	1.5	2.1	1.5	2.0
General government financial balance[2,3]	_	-0.3	-1.3	-2.0	-2.1	-2.2
Headline government financial balance[2,4]	_	-1.7	-2.4	-3.0	-3.0	-3.0
Current account balance[2]	_	2.3	2.8	1.7	1.5	1.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
3. Encompasses the balances of all four budget accounts (general account, government managed funds, social security funds and the state-owned capital management account).
4. 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 101 database.

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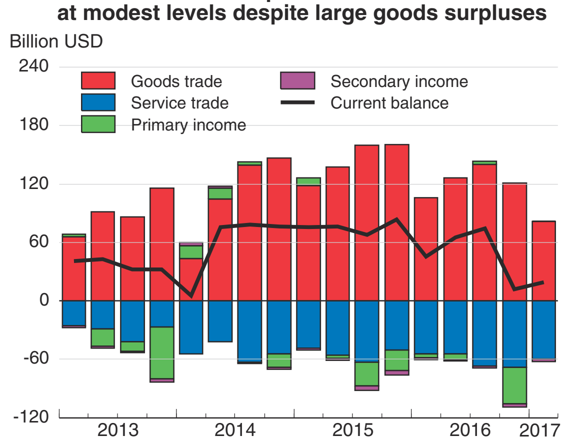
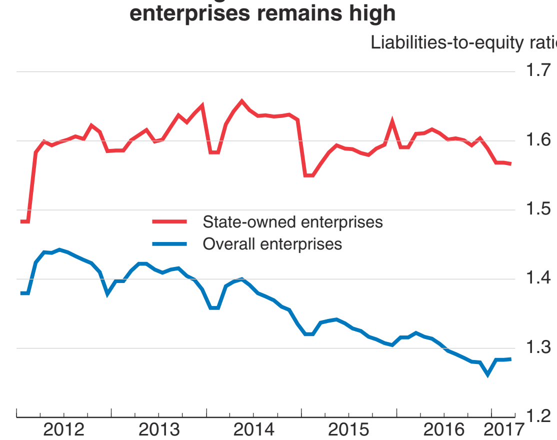
excess capacity in the industrial sector will continue to weigh on overall investment. Housing investment has accelerated sharply, notwithstanding a series of home purchase restrictions and tighter conditions for mortgages. Surging house prices in the largest cities continue to fuel residential investment, and prices are holding up even in small cities

China

Service deficits have kept the current account balance at modest levels despite large goods surpluses



The leverage[1] of state-owned enterprises remains high



1. Leverage is defined as the liabilities-to-equity ratio. Industrial enterprises only.
Source: CEIC.

StatLink http://dx.doi.org/10.1787/888933502902

where there is excess capacity. Supported by rising real incomes, consumption has remained robust, with buoyant housing-related purchases, e-commerce sales, and overseas tourism (which is an imported service). Stronger foreign demand has boosted exports and industrial production. Surging commodity prices have pushed up producer price inflation and helped reduce the current account surplus. Consumer price inflation, in contrast, remains subdued.

Tightening monetary and expansionary fiscal policies aim at stabilising growth while addressing risks

Monetary policy has moved to a tightening bias to safeguard financial stability. The rebound in producer prices has led to a fall in real interest rates, lowering real financing costs and boosting credit demand. Lending quotas and window guidance instructing banks to put a break on the growth of mortgage loans had limited effect as the shadow banking sector intermediates large amounts of funds. Money market rates have been raised to address the housing bubble, avoid further leveraging and curb the rise in corporate debt. Even more importantly, recent tightening of interbank market regulation is expected to curb the flow of bank funds to the shadow banking sector and ultimately to subprime borrowers and for leveraged investment in asset markets. Enterprise leverage, especially in the state-owned sector, remains high. Debt-equity swaps, concentrated in highly-leveraged industries such as coal mining and steel production, may provide temporary relief but risk delaying necessary adjustment, including the exit of unviable firms. Implicit guarantees to state-owned enterprises and public entities need to be removed to create a level playing field, instil greater market discipline and achieve better credit risk pricing.

Through the turn of the year, capital outflows put pressure on the exchange rate and led to a contraction in foreign exchange reserves. The intensified fight against state asset embezzlement led to increased scrutiny of overseas investments by state-owned enterprises. However, in recent months, money market rate hikes alongside tightened capital controls and improving enterprise profits contributed to curbing capital outflows and stabilising the renminbi.

Fiscal policy remains expansionary. Tax cuts have recently been announced to maintain the recovery's momentum. While a lower tax burden on small firms, technology start-ups and entrepreneurs will boost employment and innovation, lower tax revenues reduce the government’s ability to spend on areas where social returns are high but which are underfunded, such as social security, health and old-age care. Although the headline fiscal deficit target was kept at 3% of GDP for 2017, public investment funded through policy banks will prop up growth while slowing the pace of rebalancing. Local government debt swaps provide an additional avenue for increased infrastructure spending as the debt is issued at a lower cost than the original bank loans. The rapid expansion of public investment may lead to a further misallocation of capital. Entry barriers to private capital need to be further removed, especially in services. Furthermore, local government investment vehicles, which are still perceived to carry implicit guarantees, will be key players in implementing these projects, which may lead to further accumulation of implicit government debt and bailouts.

Growth is projected to remain strong but risks continue to build up

Infrastructure investment is expected to keep GDP growth around 6½ per cent this year and next. Recent measures to address the housing bubble are likely to contain real estate sales and mortgage lending, but as long as prices are expected to rise due to supply constraints they are unlikely to curb housing demand significantly. Employment creation, including through tax cuts for small firms and entrepreneurs, will support consumption growth, but without structural reforms to reduce precautionary saving, such as the provision of a better social safety net and higher-quality public services, rebalancing will advance only slowly. Economic ties with the Belt and Road economies are strengthening, but a further reduction of trade and investment barriers is necessary to keep up momentum.

Lower interbank activity as a result of more stringent regulation may cause liquidity problems in smaller banks that tend to rely more on interbank funding, but is necessary for deleveraging in asset markets and financial stability. Corporate deleveraging and working off excess capacity are crucial to avoid a sharp slowdown in the future. Weaker fiscal stimulus may adversely affect growth, but would reduce the risk of another build-up of implicit government liabilities. Trade protectionism may temper the export recovery, but intensified ties with a broader range of economies will help to limit this factor. Slower deleveraging would result in stronger growth in the short term but larger imbalances later. A stronger-than-foreseen global rebound and faster progress of collaboration under the aegis of the Belt and Road Initiative would support Chinese exports of goods and services, and hence, growth.