CHINA

Economic growth is being supported by stimulus, but is set to edge down further to 6.1% by 2018. At the same time, risks are rising. The economy is undergoing transitions on several fronts. Private investment will be reinvigorated by the removal of entry restrictions in some service industries, but held back by adjustment in several heavy industries. Housing prices are again rising fast in the bigger cities, but working off housing inventories in smaller cities will take time. Consumption growth is set to hold up, especially as incomes rise and urbanisation continues. Reductions in excess capacity will ease downward pressure on producer prices but consumer price inflation will remain low. Import demand for goods will be damped by on-shoring, while services imports, in particular tourism, will grow rapidly. Exports will be held back by weak global demand and loss of competitiveness.

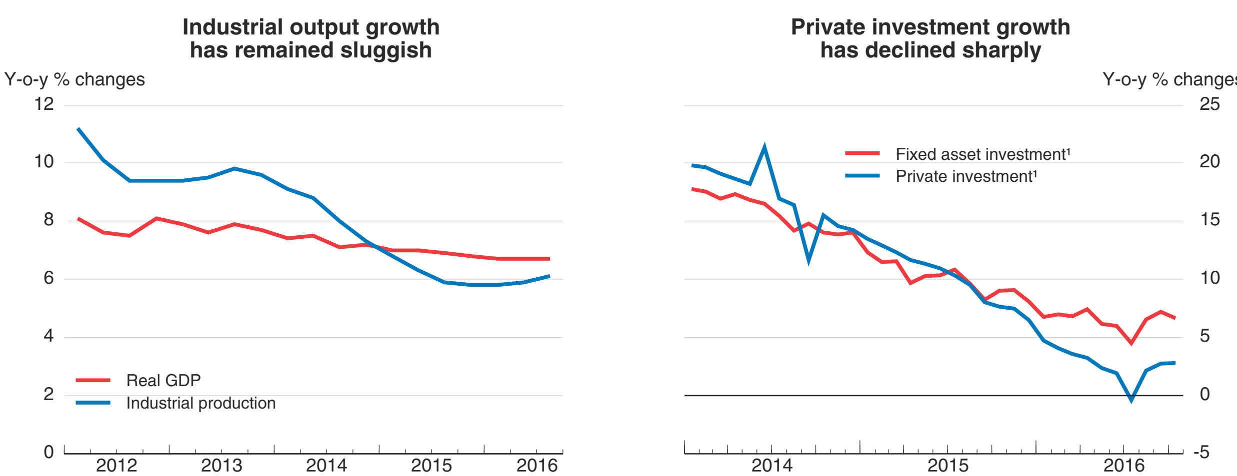
Fiscal policy, including via the policy banks, is very expansionary. Monetary policy prudence is called for so as not to aggravate imbalances. Removing implicit public guarantees and ending bailouts would make for better and more market-based pricing of risk. Corporate debt has risen substantially to high levels and the enterprise sector therefore needs to deleverage. Supply-side reforms to cut excess capacity need to accelerate and bankruptcy of zombie firms be made easier. Leveraged investment in asset markets should be contained and monitored.

Public investment should focus on efficiency and avoid crowding out the private sector. New revenue sources, such as property taxation or a more progressive personal income tax, can be used to meet increasing spending needs for public services and social security. Fiscal relations across government levels should be revamped so that local mandates are adequately funded.

Overcapacity and diminishing private investment have weighed on growth

Growth continues to decline very gradually as adjustment in manufacturing sectors plagued by excess capacity gathers momentum and as private domestic investment

China



1. Fixed asset investment and private investment refer to nominal values and do not include investment by rural households.
Source: CEIC.

StatLink http://dx.doi.org/10.1787/888933437512

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	6.4	6.1
Total domestic demand	58.1	8.2	9.5	8.3	6.5	6.4
Exports of goods and services	14.5	6.8	-2.0	0.9	2.3	2.4
Imports of goods and services	13.0	9.3	3.9	5.4	2.2	3.0
Net exports[1]	1.4	-0.3	-2.0	-1.4	0.1	-0.1
Memorandum items						
GDP deflator	_	0.8	-0.5	0.9	2.0	2.5
Consumer price index	_	2.1	1.5	2.1	2.2	2.9
General government financial balance[2,3]	_	-0.6	-1.3	-1.8	-2.3	-2.7
Headline government financial balance[2,4]	_	-2.1	-2.4	-2.9	-3.5	-4.0
Current account balance[2]	_	2.7	3.0	2.4	2.4	2.4

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 100 database.

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diminishes. Capacity cuts in the coal and steel sectors, together with disruptions in the distribution chain due to floods, have resulted in regional coal shortages and price hikes. The private-sector share in investment has shrunk partly because many services, which are a growing part of the economy, are not open for private investment. Real estate

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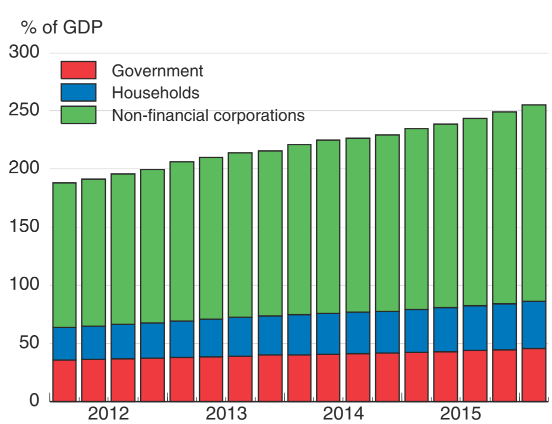

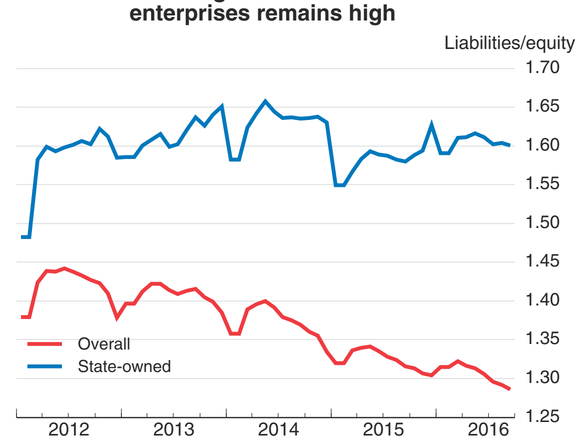

1. Leverage is defined as the liabilities-to-equity ratio. Overall as well as state-owned refer to industrial enterprises.
Source: CEIC.

StatLink http://dx.doi.org/10.1787/888933437520

investment is bottoming out, although trends in upper and lower-tier cities are increasingly diverging, with sharply rising demand and prices in the former, prompting new home-purchase restrictions. In lower-tier cities, working off excess capacity may take several more years.

Consumption has remained robust, with buoyant e-commerce sales and tourism services imports. Job vacancy rates have fallen sharply in the Eastern regions, where most export-processing industries are located, and migrant worker wages are slowing significantly. Weak business investment demand weighs on imports and rising costs weigh on exports. Producer price inflation turned positive in September after 54 months of deflation, but excess capacity continues to put downward pressure on producer prices.

Expansionary policies are propping up growth, while structural reforms are very gradual

Monetary policy has been gradually loosened since 2014, but the case for accommodation has lately been tempered by the need to safeguard financial stability. Liquidity provision to mitigate the effect of capital outflows tends to be channelled to overheated sectors. With falling returns and more enterprise defaults, banks are shifting new lending from the productive sector to the property and securities markets. Enterprise leverage, especially in the state-owned sector, is high. Debt-equity swaps may provide temporary relief but risk delaying necessary adjustment, including the exit of unviable firms. Loans with past-due payment have soared, foreshadowing a surge in bad debt. Recent defaults are expected to instil greater market discipline and better credit risk pricing, but occasional bailouts strengthen the perception that public sector entities enjoy implicit guarantees.

Capital outflows have continued, leading to a contraction of foreign exchange reserves and pressure on the exchange rate. Expected renminbi depreciation has led the corporate sector to reduce its foreign liabilities and build up foreign assets. Individuals will also likely diversify their asset holdings as the capital account opens up further. Large foreign bond investors can now access the domestic bond market without quotas and the Shenzhen-Hong Kong Stock Connect will be operational soon, opening up new channels for capital inflows. In addition, the recent inclusion of the renminbi in the IMF Special Drawing Rights will boost demand for renminbi assets.

Fiscal policy has become even more expansionary. Policy banks have issued large amounts of debt, exceeding the original target, to support major infrastructure projects. The rapid expansion of public investment may lead to further misallocation of capital. Furthermore, local government investment vehicles will be key players in implementing these projects. As they are still perceived to carry implicit guarantees, their re-leveraging may lead to another round of accumulation of implicit government debt and bailouts. Although gross public debt is still around 40% of GDP, large future spending obligations loom in the areas of social security, health and old-age care.

Risks are mounting

Policy stimulus will help keep growth above 6% over 2016-18. However, investment is increasingly financed by public funds. Opening up additional sectors to private investment will provide new opportunities for private capital. Current growth rates of disposable income will support consumption growth, but without structural reforms to reduce precautionary savings such as the provision of a better social safety net and higher-quality public services, rebalancing will advance only slowly. The slow pace of reform of state-owned enterprises and high leverage will continue to take up resources, preventing reallocation for more efficient use.

Soaring property prices in first-tier cities and leveraged investment in asset markets magnify the risk of disorderly defaults. Excessive leverage and mounting debt in the corporate sector compound financial stability problems. Rapid adjustment in the real estate and industrial sectors would drag down growth temporarily, but is necessary to strengthen resilience. Supply-side policies, including deleveraging and working off excess capacity, are crucial to avoid a sharp slowdown down the road. Greater-than-expected stimulus, in contrast, would result in stronger growth in the short term but larger imbalances later. On the upside, a stronger-than-foreseen global rebound would support Chinese exports and growth.