36. CHINA
Downward pressure intensifying

The Chinese economy grew by 6.2% in the first nine months of 2019 amid intensifying downward pressure from both the external environment and softening domestic demand. Growth is projected to edge down over the forecast horizon as persistent economic tensions with the US, elevated uncertainty as well as domestic structural headwinds continue to weigh on economic activity. Macroeconomic policy easing is expected to contain the extent of the slowdown but not offset it fully.

Broad-based slowdown continues

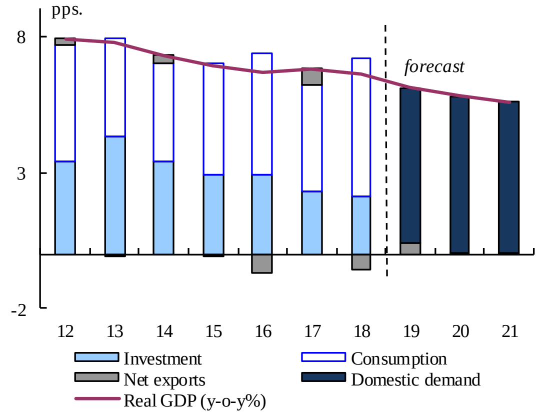
The Chinese economy remains on a gradual decelerating trend. GDP growth stabilised at 6.4% (y-o-y) in the first quarter of 2019 but decelerated to 6.2% in the second quarter and further down to 6% in the third, the lowest growth in several decades, amid softer domestic demand and escalation of economic tensions with the US. Consumption remains the main growth driver but its contribution to growth dropped sharply during this year, from around 5 pps in 2018 to only 3.6 pps in 2019-Q3. The contribution of investment to growth was also significantly lower than in 2018 and the positive contribution from net exports reflected weak imports rather than strong export performance.

Recent high frequency indicators point to intensifying downward pressure on the Chinese economy. In particular, the downturn in trade since late 2018 has been very sharp. While the export weakness is linked mainly to the ongoing tensions with the US, the persistent and stronger-than-expected decline in imports signals a continuing weakness in domestic demand. This is confirmed by consumer spending indicators which have been softening. Persistent uncertainty, a slowing economy and worsening job prospects led to more cautious consumer behaviour and higher propensity to save. Industrial activity remains weak, with trade tensions, mounting tariffs as well as slowing demand for consumer durables, in particular cars, weighing on the manufacturing sector. Lingering uncertainty as well as weak industrial profit outlook are also having a negative impact on private investment.

Growth set to drop below 6% …

Looking ahead, the Chinese economy is expected to continue slowing down over the forecast horizon with growth projected to decelerate from 6.1% in 2019 to 5.8% in 2020 and further to 5.6% in 2021. Economic tensions with the US, global uncertainty as well as subdued global growth is expected to continue to weigh on trade, business sentiment and investment decisions. Moreover, underlying structural factors such as a shrinking working-age population, high debt levels, declining efficiency of investment as well as ongoing rebalancing of the economy towards more consumption-led growth will act as additional drags. With rising trade tensions over the summer and prospects for a comprehensive trade deal with the US still uncertain, the trade outlook has worsened significantly compared to previous forecasts. Under the assumption of no further escalation of trade tensions, trade growth is expected to rebound only modestly over the next two years but will overall remain sluggish and significantly lower than GDP growth.

Graph II.36.1: **China - Real GDP growth and contributions**



… with policy stimulus unlikely to fully offset the slowdown

The fiscal and monetary policy stance is expected to remain supportive of growth and will thus help to partly cushion the negative impact of the above-mentioned factors on economic activity. At the same time, the effectiveness of the policy stimulus deployed by the Chinese authorities so far has been rather limited. Fiscal measures included tax cuts for households and businesses as well as incentives for local governments to increase infrastructure spending but they have not resulted in a material boost of consumption and investment. Selective loosening of monetary policy together with credit easing measures have increased bank lending modestly but the ongoing crackdown on the shadow banking sector together with rising funding costs and risks in smaller banks are causing a funding squeeze in some segments of the private sector with defaults on the rise in recent months.

Overall, the policy space has narrowed, with the Chinese authorities facing a complex policy trade-off between stimulating growth and containing financial risks and leverage. The baseline scenario assumes that the policy stimulus will remain targeted and selective and that the authorities will refrain from more aggressive policy easing that would include stimulus of the property sector.

Important downside risks remain

Both the growth and the trade outlook are subject to downside risks. In particular, the risk of further escalation of trade and economic tensions with the US remains a concern. The US-China conflict is increasingly spreading to other areas than trade, notably the currency, technology and investment which can further the decoupling of the two economies. Full materialisation of these risks would imply further deterioration of business and consumer sentiment, exports and investment with negative implications for trade, productivity and GDP growth. More aggressive policy stimulus in case of a persistent slowdown may lift GDP growth moderately in the short run but would further exacerbate financial imbalances and increase the risk of a sharp economic adjustment in the future. Finally, an additional downside risk concerns the property sector, which plays a very important role in the Chinese economy and which has so far remained relatively resilient. With rising financial pressure on developers, reduced fiscal space in local governments and house prices and household debt levels at historical highs, the housing market is in the late stage of the cycle. Given its key role in investment, consumer sentiment and financial market behaviour, a downturn would amplify the slowdown in the whole economy and increase the risk of a hard landing. On the upside, a material and lasting improvement in trade and economic relations with the US would reduce uncertainty, increase trade flows and business confidence with positive impact on activity.

Table II.36.1:

Main features of country forecast - CHINA

	2018		Annual percentage change						
	bn CNY Curr. prices	% GDP	99-15	2016	2017	2018	2019	2020	2021
GDP	90031.0	100.0	9.5	6.3	6.8	6.6	**6.1**	**5.8**	**5.6**
Consumption	48034.1	53.4	-	-	-	-	-	-	-
Gross fixed capital formation	38077.2	42.3	-	-	-	-	-	-	-
of which: equipment			-	-	-	-	-	-	-
Change in stocks as % of GDP			-	-	-	-	-	-	-
Exports (goods and services)	19164.9	21.3	15.0	1.1	9.1	4.0	**1.1**	**1.4**	**2.5**
Final demand			-	-	-	-	-	-	-
Imports (goods and services)	18420.9	20.5	14.7	4.7	7.1	7.9	**-1.7**	**1.1**	**2.2**
GNI (GDP deflator)	-	-	-	-	-	-	-	-	-
Contribution to GDP growth : Domestic demand			-	-	-	-	-	-	-
Inventories			-	-	-	-	-	-	-
Net exports			-	-	-	-	-	-	-
Employment			-	-	-	-	-	-	-
Unemployment (a)			4.0	4.0	3.9	3.8	-	-	-
Compensation of employees/head			-	-	-	-	-	-	-
Unit labour costs			-	-	-	-	-	-	-
Real unit labour costs			-	-	-	-	-	-	-
Saving rate of households			-	-	-	-	-	-	-
GDP deflator			3.3	1.5	3.9	2.9	**1.7**	**1.7**	**2.1**
Private consumption deflator			-	-	-	-	-	-	-
Index of consumer prices (c)			2.0	2.0	1.6	2.1	-	-	-
Merchandise trade balance (b)			4.5	4.4	3.9	2.9	**3.2**	**3.0**	**2.8**
Current-account balance (b)			3.9	1.8	1.6	0.4	**0.8**	**0.7**	**0.6**
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.