A difficult year ahead for China: growing risks, but less margin for manoeuvre than in 2015

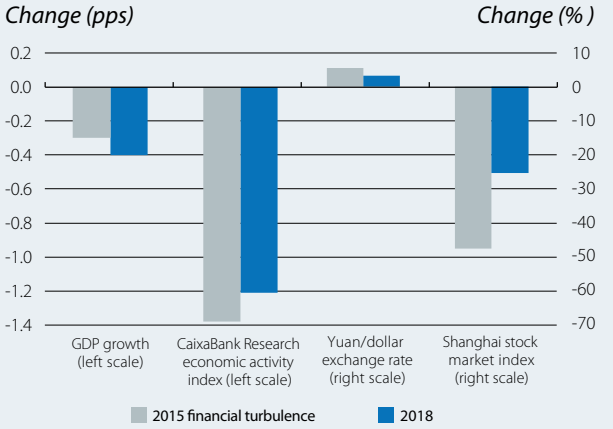
China is back on the radar of leading analysts and investors after the slowdown in its economy intensified in the second half of 2018. To what extent are the concerns founded and what room do the Chinese authorities have in terms of economic policy to avoid a sharp slowdown? A natural way to put the cooling of the Chinese economy in 2018 into context is to compare it with the period of economic and financial instability it experienced between mid-2015 and early 2016.[1] As we shall see below, this comparison shows that, to date, the 2015-2016 episode was somewhat more severe than the current situation, although the current cooling is also notable.

In this regard we see that, between Q3 2017 and Q4 2018 (the period of the current slowdown), GDP growth has decelerated by 0.4 pps, compared to 0.3 pps during the episode of 2015. On the other hand, the growth of the CaixaBank Research economic activity index declined by almost 1.4 pps in 2015, compared to a 1.2-pp reduction in the current episode. Although the magnitude of the two episodes appears to be similar, the slowdown in 2015 was much more abrupt than the current one as it occurred over a period of just nine months (in contrast, the current slowdown has been spread over 18 months, so far, in a gentler pattern). In addition, both the stock market correction and the capital outflows (see second chart) were much greater in the 2015 troubles than at present.

China's slowdown should not come as a surprise. In fact, we can expect growth to continue to decelerate in 2019 and 2020, down to around 6.0% (growth in 2018 stood at 6.6%). In terms of the general trend, a moderation in growth over the next few years is inevitable due to structural forces, such as population ageing and the reduced weight of investment with the change of productive model (a change that will allow for a healthier and more balanced pattern of growth in the medium term, even if the economy may suffer to some extent in the short term). In fact, estimates[2] suggest that China's potential growth between 2021 and 2025 could range between 4.0% and 5.0%.

However, from a more short-term point of view, two major risks stand out. On the one hand, in a difficult international context, the publication of worse-than-expected economic activity figures in a particular quarter can generate episodes of financial instability that end up having an impact on activity. On the other hand, the macroeconomic fundamentals of the Chinese economy could prove to be weaker than expected and economic activity could end up suffering a more abrupt slowdown. For the time being, however, the available indicators suggest that it will not come to this: the Chinese authorities have some room to implement fiscal, monetary and financial policies in order to avoid an abrupt slowdown. That said, and as we shall see, the margin is slightly smaller than in 2015, hence both its scope and its sustainability over time are much more constrained than the last time.

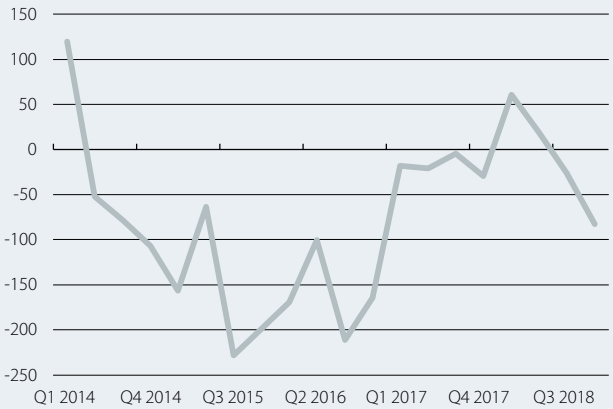
China's slowdown: comparison with the episode of 2015 *



Note: ** We compare the slowdown in GDP growth and in the growth of our economic activity tracker between Q4 2018 and Q3 2017 (when the current slowdown began) with the slowdown that occurred between Q4 2015 and Q2 2015. With regards to the exchange rate and the stock market index, we calculate their change between June 2017 and December 2018, and between June 2015 and February 2016 (coinciding with the episode of economic and financial turbulences in 2015).*
Source: *CaixaBank Research, based on data from Thomson Reuters Datastream.*

China: net capital inflows

(USD billions)



Source: *CaixaBank Research, based on data from SAFE.*

1. See the Focus «China: the doubts return», published in the MR10/2015.
2. See A. Dieppe, R. Gilhooly, J. Han, I. Korhonen and D. Lodge (2018). «The transition of China to sustainable growth – implications for the global economy and the euro area» (No. 206). ECB Occasional Paper.

Starting with the fiscal front, the Government has already announced in the Central Economic work Conference held in December[3] that expansionary fiscal measures will be taken (although what form they will take is yet to be determined). As was the case in 2015, most of these measures will encourage local public administrations to borrow and to finance infrastructure projects by issuing special debt securities off-budget (so-called local government financial vehicles). However, the public finances leave less room for manoeuvre than in 2015: according to the IMF, the «augmented» public debt of China's government administrations as a whole (i.e. including these debt issues) in 2019 will reach 77.0% of GDP (56% in 2015).[4] When we focus on the fiscal measures that are included in the budget, these already show some signs of exhaustion: the budget deficit of all the public administrations in the second half of 2018 stood at –6.2% of GDP. This is a significant amount and similar to that registered in the second half of 2015 (–6.9% of GDP) at the height of the troubles.

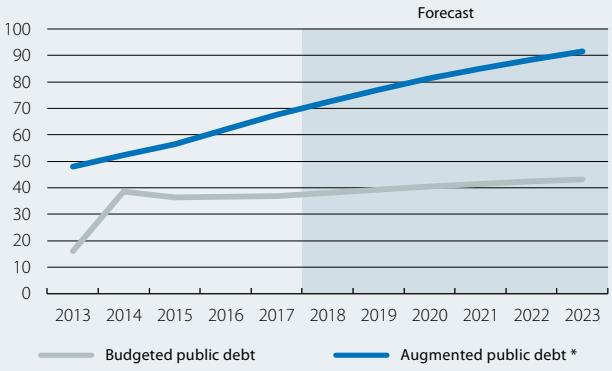
With regards to monetary policy, the margin is also somewhat smaller than in the previous situation due to two factors. Firstly, when the doubts began to arise in 2015, the central bank's reference rates were higher than at present, so there was more scope to cut rates in order to stimulate the economy. Secondly, the expansionary policies of four years ago generated a significant increase in borrowing, particularly through shadow banking.[5] However, these dynamics stoked fears that the risks of financial instability would be accentuated. Therefore, in the current scenario, despite introducing expansionary measures on the fiscal and monetary front, the Chinese authorities are likely to continue to tighten regulations in order to reduce China's high levels of corporate debt. This has already been reflected in the increase in defaults in the corporate sector in 2018 (which has particularly affected private companies, as the financial system still makes it much easier for public companies to borrow), as well as in the reduction of the relative importance of shadow banking (which went from representing 87% of GDP at the end of 2017 to just 70% by the end of 2018). Logically, this reduction in credit flows implies that monetary policy is being transmitted to the real economy to a lesser extent than previously, although the Chinese Government could soften the slowdown to a certain extent by cutting the reference rate (which has remained unchanged at 4.35% since October 2015).

Finally, with regards to exchange rate policy, the ad-hoc management of the yuan's exchange rate is likely to be gradually phased out of economic policy. This is because China is expected to gradually reduce its level of control over its currency, allowing it to fluctuate much more according to the markets. This measure is unavoidable for allowing the yuan to become more internationalised, which is one of China's key objectives, especially as its current account switches from being in surplus to in deficit, increasing the country's need for a stable currency backed by international support. All in all, the maintenance of capital controls for investing outside of China will prevent the yuan from depreciating sharply in 2019.

In short, all the indicators suggest that in 2019, China will be able to resort to expansionary fiscal and monetary policies that minimise the tightening of the regulatory framework and prevent an abrupt slowdown of the economy. However, the data suggest that there is less scope for these policies than there was in the past and that the cost could be higher. In addition, these policies may be useful for a specific period, but they are not sustainable over time. Therefore, in the medium term,

China: public debt

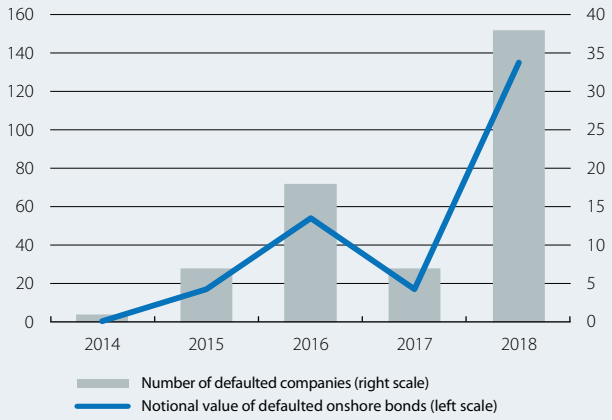
(% of GDP)



Note: ** Augmented public debt includes items that do not appear in the budgets, such as debt issues of local administrations through special financial vehicles to finance infrastructure projects.*
Source: *CaixaBank Research, based on data from the IMF.*

China: default on domestic bonds

(CNY billions) *(Number)*



Source: *CaixaBank Research, based on data from Bloomberg and Wind.*

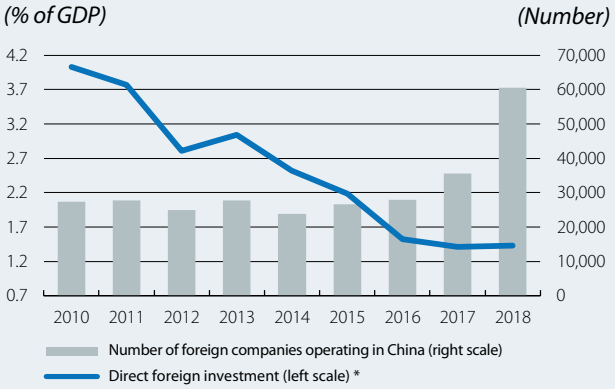
3. At an annual meeting of China's major political and economic leaders to outline the economic policy for the following year.
4. See China's 2018 Article IV published by the IMF.
5. For further details, see the Focus «Shadow banking in China: a looming shadow» from the MR02/2017.

China should resort to more ambitious economic policy measures that are not so nearsighted.

An example of such measures would include facilitating the increase in direct foreign investment in order to reverse its current declining trend (see the last chart). In this regard, the Chinese authorities have already begun to take action, although the pace of this action is still slower than would be desirable. In July, a plan was announced that would eliminate restrictions on foreign investment entirely by 2021-2022 in certain important sectors (many of them strategic), such as insurance, the electrical grid, the automotive industry and rail passenger transport, bringing the number of economic sectors affected by the restrictions down from 63 to 48.

This is clearly a first step, but more could be done. Besides opening up the country, other complementary mechanisms that could improve the pattern of growth include offering greater incentives to workers in rural areas so that they can migrate to the cities, seeing through the pending reform to modernise inefficient public companies and reducing the high levels of corporate debt. Without a doubt, it is time for China to take greater steps in order to avoid greater evils.

Foreign investment and foreign companies established in China



Note: ** Direct foreign investment data only available for the first three quarters of 2018.*
Source: *CaixaBank Research, based on data from SAFE and China's Ministry of Trade.*