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In a nutshell

- China’s economic strength is underpinned by its large economy, high national savings rate and low level of external debt. Being the world’s largest economy on a purchasing power parity basis, it continues to enjoy robust gross domestic product (GDP) growth (2018: 6.6%). In 1Q2019, GDP growth pace came in above expectation at 6.4% following stronger-than-expected industrial production and retail sales. A major contributor to global growth and trade, it is the world’s largest manufacturer and merchandise trader. Meanwhile, Beijing’s credibility in assuring markets of its ability to stabilise any disruption is an important factor in supporting economic resilience.

- China has accumulated massive external buffers with persistent current account surpluses. As of end-March 2019, foreign exchange reserves stood at USD3.09 trillion, the highest since August 2018. Meanwhile, its net international investment position (NIIP) came in at around 14% of GDP at end-2018. The decline from the 2007 peak of 33% had been partly driven by a sustained high pace of growth. Despite the decline, its NIIP is not expected to be a source of risk given that gross foreign assets remain high with foreign exchange reserves dominating and gross liabilities being mostly foreign direct investment-related.

- China’s central government debt in 2018 stood at 16.6% of GDP while general government debt, which includes local government debt, came in at 37.0% of GDP. As far as central government debt is concerned, the latest available data show that debt affordability is high given that debt and interest payments made up a mere 2.5% of GDP. In addition, as of 2017, less than 1.0% of China’s debt is externally funded given its large domestic savings, which the World Bank estimates at around 47% of GDP.

- China’s continuing reform agenda remains a plus point for the economy. Its economic reform plan, which among other objectives aims to shift the economy away from one based on government spending, state-owned enterprises (SOEs) and low-cost exports toward one based on private investment, entrepreneurial innovation and domestic consumption should set it on a sustainable path.

- Notwithstanding this, China’s fiscal deficit in 2018 came in markedly higher at 4.2% of nominal GDP (2017: 3.7%) following a pickup in expenditure (2018: 8.8%, 2017: 8.2%) on the back of increased spending on infrastructure projects. Given the considerably lower government revenue and GDP growth further moderating, the fiscal deficit had exceeded the official target of 2.6%. While concerns have been raised about this, it is important to note that much of the deficit stems from investment in roads, railways and so forth, not general spending, and thus generates assets for the government.

- Risks in China’s non-financial corporate sector are tilted to the upside given its high leverage. As of end-June 2018, credit to the sector stood at 155.1% of GDP. Given the stronger headwinds coming from the ongoing domestic slowdown, trade tensions and weakening global trade, credit risk concerns have risen. As of end-2018, As of end-2018, non-performing loans had risen to RMB2.03 trillion (USD307.5 billion) from RMB1.96 trillion (USD295.3 billion) in mid-2018.

- The US-China trade war may not have caused China's economic slowdown, though it has introduced significant uncertainties. According to the results of a recent survey conducted by QIMA, a leading supply chain auditor, foreign firms are already diversifying their sourcing, production and supply chains away from China. At the time of writing, the US halted a five-month trade truce and announced its plans to increase tariffs to 25% from the initial 10% on USD200 billion of Chinese goods as well as on another USD325 billion of goods that are not currently covered. The renewed trade tension will likely put a dent on global trade sentiment before investor confidence returns.

The economy remains resilient

- Despite GDP growth moderating from double-digit figures before 2013, China continues to enjoy robust growth. In 2018, growth came in at 6.6%, down from 6.9% in 2017, but still better than the government's target of "around" 6.5%. The government expects growth in 2019 to slow down further to 6.0%-6.5%. In 1Q2019, China's GDP growth pace came in at 6.4%, beating expectations following stronger-than-expected industrial production and retail sales.

- China is the world's largest economy on a purchasing power parity basis. It contributed about one-third of global growth in recent years and is the world's largest manufacturer and merchandise trader. Based on World Economic Forum data, it was the 28th (out of 140) most competitive economy in 2018. And according to the World Bank's Doing Business 2019 report, China is ranked at number 46 in terms of ease of doing business, a significant improvement from 78 in the previous edition.

- The economy's resilience despite record-breaking economic expansion fuelled by credit over a long period can be attributed to a combination of factors. The large size of the economy, a high national savings rate and low level of external debt all point to a large shock absorption capacity. Beijing's credibility in assuring markets of its ability to stabilise any systemic disruption, especially given its successes thus far, is also a factor.

Table 1: China: selected economic indicators

	2013	2014	2015	2016	2017	2018
Real GDP growth (%)	7.8	7.3	6.9	6.7	6.9	6.6
CPI inflation (%)	2.6	2.0	1.4	2.0	1.6	2.1
Current account balance (% GDP)	1.5	2.3	2.8	1.8	1.4	0.4
Net international investment position (% GDP)	20.7	15.4	15.3	17.5	14.9	13.9
Foreign exchange reserves (USD billion)	3,821.3	3,843.0	3,330.4	3,010.5	3,139.9	3,072.7
Government fiscal balance (% GDP)	-1.9	-1.8	-3.4	-3.8	-3.7	-4.2
Gross government debt (% GDP)	14.6	14.9	15.5	16.2	16.4	16.6
Bank system total capital ratio (%)	12.2	13.2	13.5	13.3	13.6	14.2
Bank system tier-1 capital ratio (%)	10.0	10.8	11.3	11.2	11.3	11.6
Bank system non-performing loans ratio	1.0	1.2	1.7	1.7	1.7	1.8
Household debt (% GDP)	33.3	35.8	38.7	44.7	49.0	n.a.
Unemployment rate (%)	4.1	4.1	4.0	4.0	3.9	3.8
WEF Global Competitiveness Index (rank)	29.0	28.0	28.0	28.0	27.0	28

Sources: IMF, World Economic Forum, Bloomberg, MARC Economic Research

Negative growth pressures from trade war, economic rebalancing and deleveraging

- Given that the US is China's largest export market, the trade war is expected to be a drag on exports in 2019. This had not happened as expected in 2018 because of front-loading by importers ahead of the scheduled January 1, 2019 tariff rate hike, which was eventually postponed due to progress in trade negotiations. The trade war renewed in May 2019 after US accused China of reneging on earlier commitments to end forced technology transfers of US companies seeking to do business in China. Nevertheless, the situation remains fluid as China prepares to visit Washington amid the tariff threat to de-escalate trade tensions.

- At the time of writing, the US halted a five-month trade true and announced its plans to increase tariffs. It is possible that exports growth to the US will still come under pressure given the fading impact from front-loading and stronger drag from cooling global growth even after negotiations have concluded. Global trade growth has slowed to below 2017 averages. Even more disconcerting is the fact that the situation could be much worse because the headline numbers may have been lifted by front-loading by importers ahead of tariff hikes. On top of slower exports growth to the US and expected slower global trade, there will also be negative growth pressures coming from the government's ongoing economic rebalancing and deleveraging efforts.

- Over the long term, these rebalancing efforts are credit positive as they should lead to a more efficient allocation of resources, improve total factor productivity and therefore lead to growth quality and sustainability.

More policy flexibility as growth slows

- When the Chinese growth momentum continued to weaken, there were expectations that the central bank could shift its monetary policy stance from "deleveraging" to "buttressing growth." This expectation was in fact borne out when regulators started tapping the brakes on the deleveraging campaign around mid-2018 as the escalating trade conflict further clouded the short-term outlook.

- The People's Bank of China (PBOC) has gradually shifted towards a looser monetary policy stance. Reserve requirement ratios have been cut, liquidity boosted, and some macro-prudential tightening measures diluted. Due to the liquidity boost by the central bank to support GDP growth, money market funding costs in August 2018 in fact fell below the interest rate of the seven-day reverse repurchase agreements it offered.

- In April's monetary policy committee meeting, the central bank pointed that it will effectively control the amount of money supply and total social financing by ensuring ample liquidity in the economy to bolster the GDP. However, PBOC reiterated that it will refrain from "flood-irrigation" style stimulus of excessive money supply and unsustainable level of government debt, which could result in adverse economic impact in the medium- and long-term.

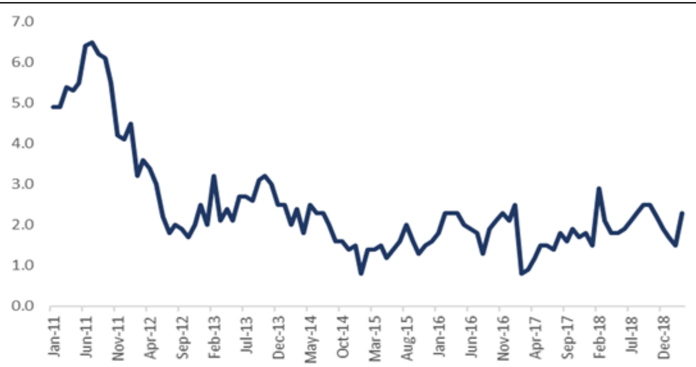
- In January 2019, the central bank cut the required reserve ratio (RRR) (50bps on the 15th and another 50bps on the 25th) partly to provide liquidity support across the financial system and partly to support growth. The fifth cut since January 2018, the net funds released by the larger-than-expected cut was the largest. It is notable that on January 16, 2019, the central bank injected through reverse repos a net RMB560 billion (USD83 billion) into the banking system. In 1Q2019 alone, new loans surged by RMB5.81 trillion, a 19.5% increase from a year earlier.

- Shortly after the tariff threat by the US, PBOC announced another cut in deposit reserve ratio for small and medium-sized banks from 11.5% to 8%, effective May 15, 2019. The move will benefit about 1,000 rural commercial banks and pump RMB280 billion (USD41.5 billion) into the economy.

- The central bank has pledged to keep monetary policy prudent and the Chinese currency basically stable and orderly while offering reasonably ample market liquidity. It must be said though that it is treading a fine line as recent monetary easing moves could cause vulnerabilities, given China's internal fault lines, to build up further.

- As for the exchange rate, the RMB is not expected to diverge significantly from the past given that it is not fully convertible and remains tightly controlled. This is despite its current weakness against the greenback following renewed trade tensions with the US in May. China's rather closed capital account means it remains somewhat protected from extreme exchange rate volatility. Its massive foreign exchange reserves of about USD3 trillion should enable it to exercise well-planned interventions to smooth out exchange rate volatility when required. While central bank Governor Yi Gang has assured markets that Beijing will not devalue the RMB to boost exports or ease US-China trade tensions, investors remain concerned nevertheless.

Chart 1: CPI inflation (% yoy, eop)



Sources: CEIC, MARC Economic Research

Chart 2: Real effective exchange rate (2010 = 100)

Sources: Bank for International Settlements, MARC Economic Research

A moderate increase in fiscal deficit

- China's fiscal deficit in 2018 came in markedly higher at 4.2% of nominal GDP (2017: 3.7%) following a pickup in expenditure (2018: 8.8%, 2017: 8.2%) on the back of increased spending on infrastructure projects. Together with a considerably lower government revenue (2018: 6.2%, 2017: 8.1%) and GDP growth moderating further, the fiscal deficit had exceeded the official target of 2.6%.

- MARC is not disconcerted by the jump in fiscal deficit as a percentage of GDP in 2018. The reason is direct fiscal spending could provide a more powerful impetus to growth rather than reliance on bank credit and inefficient investment. In other words, the Chinese economy could get more support with less if there is greater reliance on central government borrowing and social spending.

- Because of tight limits placed on local government debts, provinces and cities have used local government financing vehicles (LGFVs) to borrow from banks and issue bonds to fund their quasi-fiscal spending. Hence, the International Monetary Fund's (IMF) augmented fiscal deficit figures, which take into consideration the vast amount of spending that occurs off China's public balance sheet, portray a clearer picture of China's fiscal health. It expects the augmented deficit to average around 9.0% until 2021.

- While concerns have been raised about this, it is important to note that much of the deficit stems from investment in roads, railways and so forth, not general spending, and thus generates assets for the government.

Central government debt sustainably low

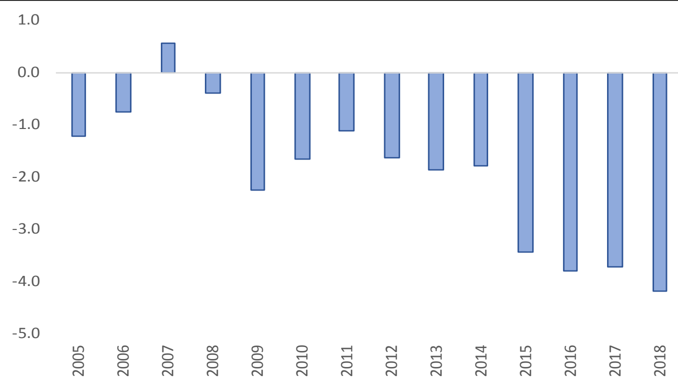
- According to official data, China's central government debt as in 2018 stood at 16.6% of GDP while general government debt, which includes local government debt, came in at 37.0% of GDP.

- MARC is of the view that the government's deleveraging efforts will continue, albeit at a slower pace as it attempts to support growth amid a challenging external environment of slower global growth and trade war tensions. Recent statistics do provide some level of comfort though. For instance, the liability-to-equity ratio of state-owned enterprises (SOE) had moderated to 1.8 in 2018 from 1.9 in 2017 although their liability-to-GDP ratio did rise (2018: 128.5%, 2017: 121.5%). Local SOEs had seen their liabilities growing faster (2018: 26.1%, 2017: 23.4%) compared with those of central SOEs (2018: 6.4%, 2017: 7.3%).

- While SOE liabilities may be massive (2018: RMB115.6 trillion), it is important to note that the size of their assets (2018: RMB178.7 trillion) are significantly larger. In addition, SOE equity has been expanding at a double-digit pace (2018: 21.4%, 2017: 16.4%).

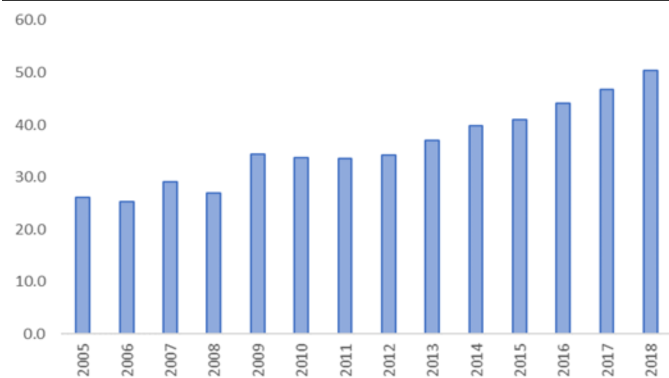
- As far as central government debt is concerned, the latest available data show that debt affordability is high given that debt and interest payments made up a mere 3.1% of GDP (2017). In addition, less than 1.0% of China's debt is externally funded given its large domestic savings, which the World Bank estimates at around 47% of GDP.

Chart 3: China: fiscal balance (% GDP)



Sources: CEIC, MARC Economic Research

Chart 4: China: general government debt (central & local) (% GDP)



Sources: Bloomberg, MARC Economic Research

Challenging environment, but sustainable banking system

- At its high, shadow banking assets were estimated to have reached USD10 trillion. However, due to the regulatory crackdown on shadow banking that was aimed at tackling risks in the financial industry, the shadow banking tally was estimated to have dropped to USD9 trillion in 2018.

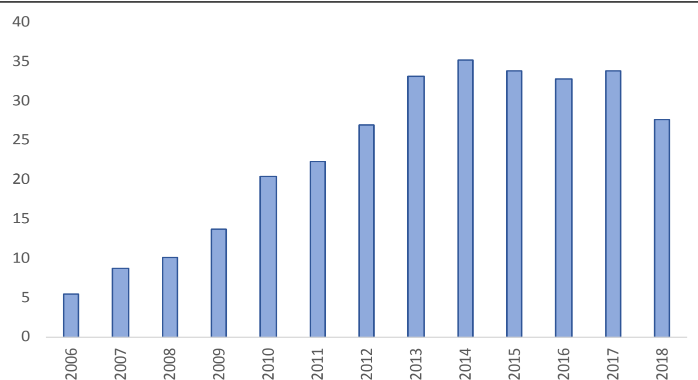
- To reduce potential systemic risk stemming from shadow banking activities, NBFIs are, for example, no longer allowed to channel funds into the property and infrastructure sectors via entrusted loans. As entrusted loans are a popular form of shadow financing, this closes an important loophole for non-traditional financing. Given this development, shadow banking activities have slowed, as evidenced by falling shadow banking assets as a percentage of GDP. Measures curbing shadow banking activities have reduced the interconnectedness of banks and non-bank financial institutions (NBFIs), a positive credit development as it would reduce potential systemic risk.

- Thanks partly to China's shadow-banking sector crackdown, which includes stricter rules for recognising bad debt, bad loans rose by RM68.3 billion (USD9.96 billion) to RMB2.03 trillion (USD295.3 billion) as of end-2018. As a percentage of total advances, soured loans represented 1.86%. The latest available data show that as of end-2018, outstanding RMB loans registered RMB136.3 trillion, up 13.5% y-o-y (2017: +12.7%).

- Recent official announcements indicate that policymakers, in an attempt to support GDP growth, are toning down their two-year deleveraging drive. This could be due to the improvement in non-financial corporate debt ratio from all sectors which had fallen from a high of 161.5% of GDP in 1Q2017 to 156.9% in 4Q2017. In 2018, the ratio dropped further to 152.9% as the China Banking and Insurance Regulatory Commission (CBIRC) continued to wage a war against financial risks amid a structural deleveraging drive.

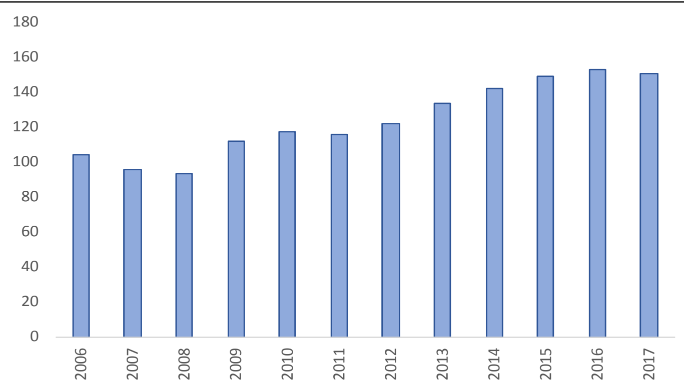
- According to the PBOC, the results of solvency tests based on sensitivity analysis indicate that the banking system remains generally sustainable to credit portfolio deteriorations. The results show that under a moderately adverse scenario, whereby non-performing loans (NPL) ratio increases by 300%, the average capital adequacy ratio (CAR) of the banking system would decrease by 1.65 percentage points to 10.79%. Under a severely adverse scenario (NPL ratio increases 700%), the average CAR would decrease by 3.96 percentage points to 8.48%

Chart 5: China: shadow banking assets (% GDP)



Sources: CEIC, Bloomberg, MARC Economic Research

Chart 6: China: non-financial sector corporate debt (% GDP)



Sources: BIS, MARC Economic Research

Significant improvement in ease of doing business

- China's ranking in the World Bank's Doing Business 2019 report significantly improved to number 46 in 2019 from 78 in the previous edition of the report. One of the economies with the most notable improvement in Doing Business 2019, it is the only economy from East Asia and the Pacific in the list of top ten improvers.

- China had focused its reform efforts over the 2017-2018 period on increasing the efficiency of business processes. It introduced new measures to enhance business activity in seven out of the ten areas covered in the report. For example, China introduced reform measures to streamline its construction permitting process. It implemented unified platforms for all building review processes carried out before the approval of a building permit in both Beijing and Shanghai. To facilitate trading across borders, it implemented a single national trade window that links together all agencies involved in the export and import processes. The agencies include customs and tax administration, port authorities, and the Ministry of Commerce.

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