Box 2

THE OUTLOOK FOR CHINA'S ECONOMY: RISKS, REFORMS AND CHALLENGES

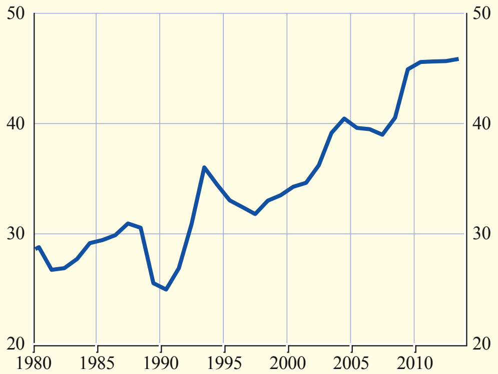
China's economic growth has slowed further in 2014, continuing the moderation seen since the stimulus package implemented in the wake of the financial crisis. Cyclical factors have played a role, including the softening in global demand and monetary tightening to keep credit growth in check. But much of the slowdown has been structural as the traditional drivers of buoyant Chinese growth – favourable demographics, manufacturing exports and the country's accession to the World Trade Organization – are running out of steam.

Although economic activity has weakened, internal imbalances continue to increase – particularly the reliance on credit-driven investment to fuel growth. China's investment reached 46% of GDP in 2013 (Chart A). Judging by current trends (i.e. for the period until the third quarter of 2014), it is likely that this ratio will only decline very marginally in 2014, largely shrugging off the drop in property investment resulting from a weak housing market. Meanwhile, leveraging activity has continued to rise: since the end of 2007, China's private sector credit-to-GDP ratio has increased by over 80 percentage points and credit growth remains well in excess of nominal GDP growth, despite having moderated somewhat since early 2013 (Chart B).

Imbalances have given rise to a number of policy challenges. Corporate and local government debt has expanded significantly, helped by the rapid growth of shadow banking. In addition, there has been growing concern among analysts and policy-makers about overinvestment and the misallocation of capital across a number of industries – in particular property and related heavy industries. The housing market slowed sharply in 2014, leading to higher inventories and lower house prices. Anecdotal evidence suggests that property developers, especially smaller firms, are under pressure to consolidate or scale back activities. Prices of construction-related goods

Chart A Investment

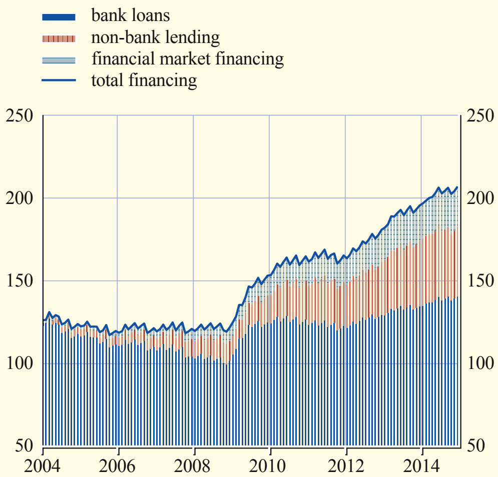
(percentage of GDP)



Source: Haver Analytics.
Note: The last observation is for 2013.

Chart B Breakdown of total financing

(percentage of GDP)



Source: People's Bank of China.
Note: The last observation is for December 2014.

(such as steel) have also fallen and PPI inflation in China has been negative since early 2012, putting pressure on profit margins in a range of heavy industries. Furthermore, fast credit expansion has led to rising non-performing loan ratios, but these are still at a low level. A number of defaults or near-defaults on bonds and other financial products, something previously unheard of in China, also point to growing tensions in the financial sector. Moreover, high and rising debt levels seem to be constraining local governments' ability to continue investing in infrastructure at the same high pace as a few years ago. It should be noted that the recent fall in oil prices is generally a positive development for China, given that it is a major net importer of oil. But this will only be significant if oil prices stay low for an extended period of time. Overall, although it is likely that China's growth will continue to decelerate gradually in the foreseeable future, in line with its declining potential, the downside risks to the economic outlook seem to have increased.

Structural reforms are needed to address vulnerabilities. A comprehensive reform agenda was announced at the end of 2013, based on a diagnosis of the structural economic challenges facing China. The broad principles underlying the agenda emphasise the need for markets to play a decisive role in allocating resources to all enterprises, regardless of whether they are in private or public ownership, with enterprises being able to compete under equal conditions. They also aim to limit the scope of government action to effective regulation and preserving macroeconomic stability, rather than micromanaging decisions by economic actors. The specific proposals are wide-ranging, including price and financial sector liberalisation, the opening up of markets to private firms and foreign competition, reform of state-owned enterprises (SOEs), fiscal reform, as well as land and household registration reform. If implemented in full, they should help reduce the medium-term risks of an abrupt slowdown in growth.

Some promising steps have been taken to date, but progress has been uneven. Substantial headway has been made in respect of financial sector reform, promoting cross-border capital flows, social security and fiscal reform, while measures to liberalise the economy and reform SOEs seem to have been more limited so far. The State Council has proposed a deposit guarantee system and approved plans to make local government debt more transparent and sustainable. Further action has been taken towards realising capital account liberalisation (the Shanghai-Hong Kong Stock Connect pilot programme being a case in point). The daily trading range of the exchange rate was increased to 2% and interest rates are gradually being liberalised. Labour mobility has also been promoted through a reform of China's hukou (household registration) system. In other areas, progress has been rather patchy. Some local governments have announced timetables for reforming SOE governance and reducing government holdings, but without clearly redefining the role of SOEs. In addition, measures to liberalise the economy appear quite modest, focusing on streamlining administrative approval processes and opening up a number of infrastructure projects and industries to private capital and foreign investment.

While important challenges remain, the Chinese authorities continue to be committed to the reform process. They have set 2020 as the deadline for implementing the bulk of reforms and they have recently reaffirmed their commitment to achieving that goal. As regards the financial sector, complementing the proposed deposit guarantee system with a clearer framework for the resolution of non-viable financial institutions will help further reduce moral hazard while allowing for more progress in interest rate liberalisation. Furthermore, dismantling administrative hurdles and investment restrictions in industries such as banking, telecommunications and energy would stimulate effective competition, enable new firms to enter the market and boost innovation and productivity, ultimately putting growth on a more sustainable footing.