

## Box 2

**CHINA – SHORT-TERM PROSPECTS AND MEDIUM-TERM POLICY INTENTIONS**

Growth in China has been slowing recently. This box reviews the factors that have been driving the slowdown, as well as China's medium-term growth prospects, particularly in the light of the new government's policy intentions so far.

Consistent with the historical experience of other economies, China's economic growth potential is on a long-term downward path as its GDP per capita increases. The momentum generated by a number of traditional drivers of buoyant Chinese growth and one-off factors (China's demographics, its accession to the World Trade Organisation and its adoption of foreign technology) has weakened. These factors are unlikely to be fully replaced by new drivers, such as rapid urbanisation or a rise in private consumption, in the context of the need to rebalance the economy. Recent government statements also suggest that growth might be lower in the medium term than previously expected, as part of policy efforts to put growth on a lower but more sustainable path.

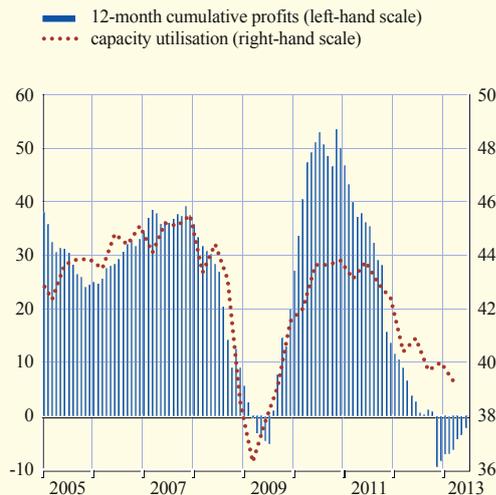
Growth has already moderated substantially. While China remains a cornerstone of global growth, the pace of economic expansion has eased. After reaching a peak of 12.1% in the first quarter of 2010, year-on-year growth gradually slowed to stand at 7.9% at the end of 2012 and at 7.5% in the second quarter of this year. That contrasts with an average annual growth rate of 10.3% over the period 2000-10.

Lower export growth has been one factor behind the recent slowdown. Having rebounded after the 2008-09 crisis to reach levels of over 30%, annual export growth since 2010 has trended downwards and is now in single digits, as GDP growth in key markets has weakened. Improving growth prospects in the European Union and the United States are likely to support exports in the coming quarters, but a return to the very high growth rates seen following China's entry into the World Trade Organisation in 2001 seems unlikely. China's gains in market share have gradually moderated as the appreciation of the renminbi (RMB) and the emergence of other low-cost competitors, such as in South-East Asia, have constrained China's export growth.

In turn, lower export growth is spilling over into the domestic economy. Growing exports are no longer absorbing the capacity created by continuous investment in export-oriented manufacturing industries. This is leading to overcapacity in some industries, which bodes ill for future investment growth. According to the entrepreneur survey of the People's Bank of China, capacity utilisation is dropping at the fastest pace seen since the 2008-09 crisis. Overcapacity already seems to have had an impact on industrial profits, which have also declined (see Chart A). The emergence of deflationary pressures is another indicator pointing to overcapacity. Annual PPI inflation has been negative since March 2012 – the longest such period since 2001-02. Heavy industries, such as coal mining and steel production, which suffer the most from overcapacity according to anecdotal evidence, have seen much larger price falls (see Chart B). In response, the government ordered banks earlier this year to reduce loans to industries suffering from overcapacity.

**Chart A Industrial profits and capacity utilisation**

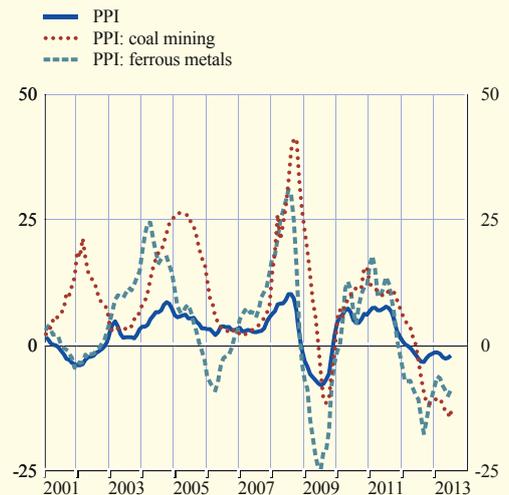
(annual percentage changes; diffusion index, neutral=50)



Sources: CEIC, People's Bank of China, National Bureau of Statistics of China and ECB calculations.

**Chart B Annual PPI inflation**

(annual percentage changes)



Sources: CEIC and National Bureau of Statistics of China.

Despite lower growth, downside domestic risks have continued to build up. Credit has been expanding rapidly, growing at about double the pace of nominal GDP since 2009. As a result, China's credit-to-GDP ratio has risen to about 170%, which is much higher than for other countries at a similar level of development. To a certain extent, this reflects a financial deepening of the economy against the background of increasing financial sector liberalisation. However, there are fears that some of the credit growth is linked to inefficient investment, raising concerns about risks in the financial sector. In particular, some of the local government investment projects that were part of the RMB 4 trillion stimulus package implemented in 2008-09 (equivalent to 12% of GDP at that time) to counter the effects of the global downturn have yielded poor returns. According to a report by the National Audit Office in 2011, over half of the projects, many of which were financed through so-called "shadow banking", generate insufficient cash flow to repay debts. In addition, a fundamental re-assessment of GDP growth prospects and hence future household income growth could trigger a correction in house prices, which have risen very strongly over the last 15 years. While strict prudential measures, such as high initial deposit requirements, discourage speculative activity, a sudden fall in house prices, even if only temporary, could lead to a decline in real estate investment, which would have a negative impact on the overall economy.

Authorities are aware of the need to rebalance the economy and moderate growth. The new government, which came to power in March this year, has recognised that the current high-growth economic model based on manufacturing investment and exports is unsustainable, and has repeatedly stated the need to put growth on a lower but more sustainable path by reducing misallocations in the Chinese economy and by increasing the role of pricing signals. It has already ordered a reduction in the number of administrative permits linked to corporate investment activities and has replaced the services sector business tax with a uniform value added

tax. Furthermore, it has pledged to continue reforms in many areas, including the financial sector (covering interest rate, exchange rate and capital account liberalisation) and the labour market (to facilitate migration from rural areas to urban areas), as well as the liberalisation of fuel and electricity pricing and property tax reforms. Detailed policy plans should become available by the autumn of 2013. In addition, the growth target for 2013 has been lowered to 7.5% from 8% last year. Government statements throughout the year suggest that this new target seems more credible than previous targets, which were typically beaten by a sizeable margin.

A large-scale stimulus to prop up growth is therefore increasingly unlikely. Moreover, the 2008-09 stimulus package has led to a large increase in local government debt, raising the outstanding debt stock to about 20% of GDP and reducing the government's appetite for further fiscal stimulus. In addition, rapid credit growth precludes a substantial loosening of the monetary stance, even though inflation is low. At the same time, growth will not be allowed to decline rapidly. With growth dipping during the first half of 2013, the government announced at the end of July that it would implement targeted stimulus measures to ensure that the 7.5% target is met. For 2014-15, Premier Li Keqiang has pledged to keep growth at a reasonable level, which likely means that growth will remain above the 7% growth target specified in the current five-year plan.

Growth rates tend to decline as a country's GDP per capita increases, reflecting the waning effect of one-off gains, such as the start of a process of moving idle, agricultural labour into more productive activities and the adoption of foreign technology. At around USD 8,000 (in purchasing power parity terms), China's GDP per capita has reached a level at which growth rates in Japan, Korea and other Asian economies also started to trend down. Demographics also play a role: China's working-age population declined in 2012, if only marginally, having risen continuously since the start of reforms in 1978.<sup>1</sup> In addition, the initial effects of China's accession to the World Trade Organisation in 2001, which led to a six-fold increase in its exports by the end of 2008, are also thought to be waning.

Overall, although China's growth is likely to moderate further in the medium term, a dramatic decline seems unlikely. Declining growth rates are part of the catching-up process that China is undergoing. In addition, reducing the economy's reliance on credit and investment will inevitably entail lower growth.

<sup>1</sup> Even so, the shift of agricultural labour into more productive activities seems likely to continue, given that it still accounts for a high share of employment (34%) compared with its share of value added (10%).