People's Republic of China

Growth decelerated in 2018, weighed down by efforts to control risk in the financial sector, a tighter fiscal policy in the first half of the year, housing market restrictions, and uncertainty in the global trade environment. Growth will moderate further in 2019 and 2020 as global growth slows. Inflation will remain benign as the current account edges into deficit. Social security reform can help rebalance the economy toward consumption.

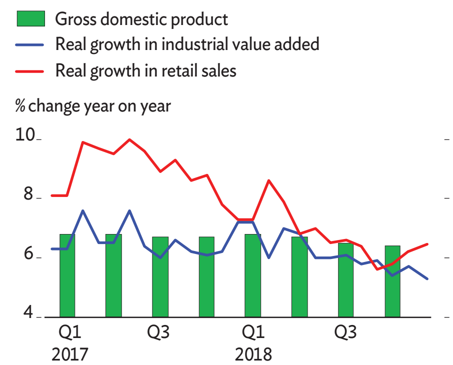
Economic performance

The People's Republic of China (PRC) saw growth slow from 6.8% in 2017 to 6.6% in 2018, in line with the government's growth target of around 6.5% (Figure 3.11.1). On the demand side, consumption confirmed its role as the main driver of growth by contributing 5.0 percentage points, up from 3.9 points in 2017 (Figure 3.11.2). Consumption found support in a rapid increase in government social spending, a cut in personal income tax, and solid growth in household disposable income, though it softened somewhat in the fourth quarter (Q4). Real growth in household consumption expenditure accelerated from 5.4% in 2017 to 6.2% in 2018. However, while spending on services such as tourism and information technology kept increasing rapidly, real growth in retail sales of consumer goods decelerated from 8.5% in 2017 to 6.9% in 2018, owing mostly to a slump in car sales, but edged up in early 2019. Rural households' real income and consumption expenditure increased faster than those of urban residents thanks to growth in online shopping in rural areas and the government's Rural Vitalization Strategy, which boosts support for agricultural modernization, land reform, and financial services (Figure 3.11.3).

The contribution of investment to growth slipped to 2.1 percentage points in 2018 from 2.3 points in 2017 because of an infrastructure investment downturn as local governments tightly controlled expenditure, both on budget and off budget, in the first 9 months of 2018 (Figure 3.11.4). Growth in infrastructure investment plummeted from 19.0% in 2017 to 3.8% in 2018, though its declining trend reversed in Q4 of 2018, and growth continued in early 2019 as more projects were rolled out, financed mainly by a sharp increase in special bond issues by local governments. Growth in manufacturing investment doubled from 4.8% in 2017 to 9.5% in 2018 as supply side reform, notably industrial upgrades, continued and as

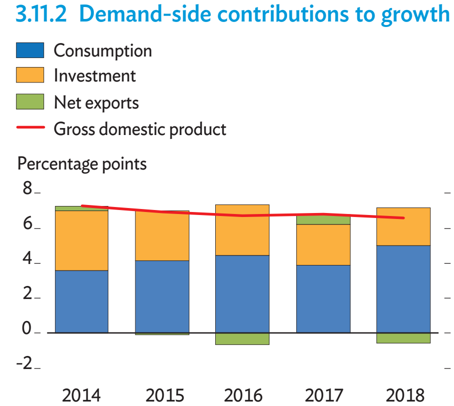
This chapter was written by Dominik Peschel and Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

3.11.1 Economic growth



Q = quarter.
Sources: National Bureau of Statistics; ADB estimates.

3.11.2 Demand-side contributions to growth



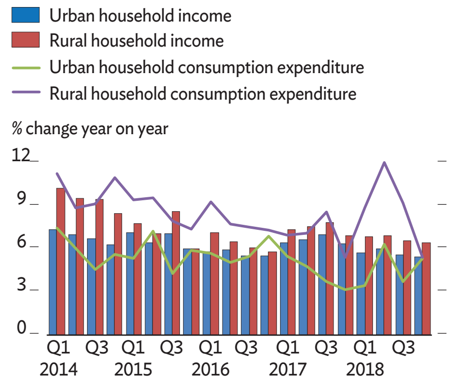
Source: National Bureau of Statistics.

exports grew quickly. Investment in high-tech manufacturing such as medical, electrical, and communication equipment kept growing at double-digit rates. Meanwhile, growth in real estate investment, comprising land purchases and new construction, increased from 7.0% in 2017 to 9.5% in 2018. This trend persisted in early 2019 as property sales continued to exceed new property completed and as floor space waiting for sale declined. Net exports dragged growth down by 0.6 percentage points in 2018, reversing a 0.6-point contribution in 2017, as merchandise imports outgrew exports.

On the supply side, services remained the main driver of growth, despite slowing from 7.9% growth in 2017 to 7.6% last year. Services contributed 3.9 percentage points to GDP growth, lifting the sector's share in GDP from 51.9% to 52.2% (Figure 3.11.5). Growth was strong in transport, leasing and commercial services, and information technology services, while financial and real estate services remained weak. The contribution to growth of industry including construction and mining remained unchanged at 2.4 percentage points as real growth in the sector moderated marginally from 5.9% in 2017 to 5.8% in 2018. Strong increases in consumer, high-tech, and export-oriented manufacturing partly offset deceleration in mining and raw materials, where retrenchment targets reined in production. Robust service sector growth helped edge down the unemployment rate in cities, determined using a recently instituted survey, from 5.0% in January to 4.9% in December 2018; as fluctuation continued, unemployment rose again to 5.3% in February 2019. At the same time, media reports pointed to a weakening job market for fresh graduates and migrant workers in line with decelerating growth. A poor grain harvest and the spread of pig disease decelerated agriculture growth from 4.0% in 2017 to 3.5% in 2018, but the sector's contribution to GDP growth remained unchanged at 0.3 percentage points given its small share in GDP.

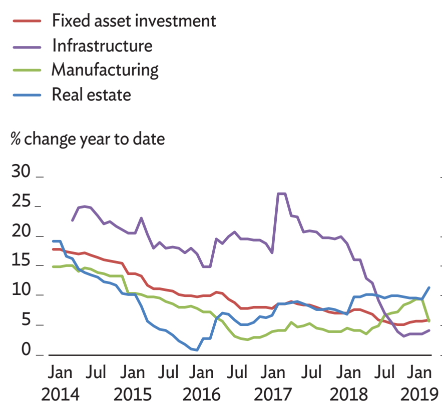
In 2018, consumer price inflation averaged 2.1%, up from 1.6% in 2017 but softened at the beginning of 2019 (Figure 3.11.6). Spikes in food prices, mostly caused by weather, and pricier health care, education, and rent, were key drivers of inflation. Core consumer inflation, excluding food and energy, stayed modest at 1.9%, suggesting a steady underlying trend. Prices for newly constructed homes in the 70 largest cities were on average 7.0% higher than a year earlier as inventories continued to shrink, with price increases more pronounced in the second and third tiers of this group (Figure 3.11.7). Average housing prices accelerated further in early 2019. Producer price inflation softened significantly to 3.5% from 6.5% in 2017. While this reflected a base effect following an index spike in 2017 owing to substantial supply-side reform, the decline in the second half of 2018 derived as well from weaker industrial activity. With further moderation in industry, producer prices stayed virtually flat in January and February 2019.

3.11.3 Real growth in urban and rural household income and consumption expenditure



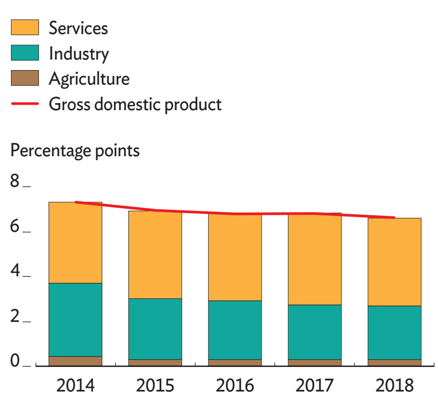
Q = quarter.
Sources: National Bureau of Statistics; ADB estimates.

3.11.4 Growth in fixed asset investment



Source: National Bureau of Statistics.

3.11.5 Supply-side contributions to growth



Sources: National Bureau of Statistics; ADB estimates.

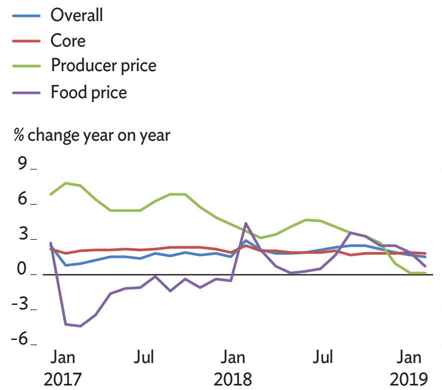
Monetary policy became more accommodative in mid-2018 to temper and smooth the growth slowdown. Through cuts in the reserve requirement ratio and liquidity injections via medium-term lending facilities, the People's Bank of China, the central bank, lowered interbank interest rates in the second half of 2018 (Figure 3.11.8), while leaving unchanged benchmark 1-year lending and deposit rates. It eased the reserve requirement in several steps from April 2018 to January 2019, lowering it for large banks from 17.0% to 13.5%. Nevertheless, broad money (M2) growth remained at 8.1% in 2018, as in 2017.

Continued tightening of regulations on shadow banking caused it to contract, while outstanding bank loans were 12.7% higher by the end of 2018. The contraction in shadow bank financing slowed growth in outstanding social financing—a broad measure of credit that includes elements of shadow banking—from 13.4% in 2017 to 9.8% (Figure 3.11.9). Despite a rising corporate default rate and declining profits, bond issuance recovered in 2018 from a low base in 2017, and the value of corporate bonds outstanding grew by double digits.

Fiscal policy was tight in the first half of 2018 but loosened in the second half. Besides increases in special bond issues in August and September 2018, the government revised the personal income tax law to ease the tax burden on low- and middle-income earners. This cushioned moderation in private consumption in Q4 of 2018. Expansionary fiscal policy continued in Q4 as the revised personal income tax law went into effect on 1 October 2018 and the government strongly increased spending on rural infrastructure, employment, social security, and environmental protection. Growth in consolidated central and local government revenue slowed to 1.0% in second half of 2018, sharply down from 10.6% in the first half, while growth in consolidated fiscal budget expenditure increased from 7.8% to 9.5%. The on-budget deficit thus rose from the equivalent of 3.7% of GDP in 2017 to 4.2%, contributing to a rise in outstanding government debt (Figure 3.11.10). Actual government support to the economy should have been recorded as larger, as these figures exclude off-budget expenditure, which has been large in the past and was unlikely to have declined substantially in 2018.

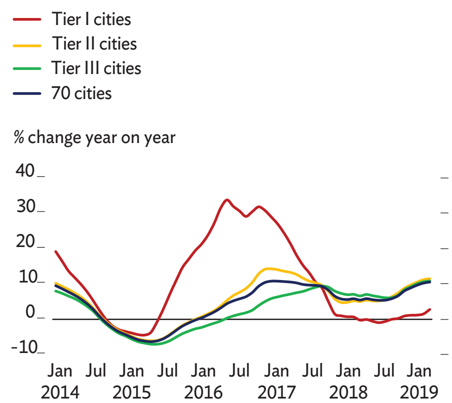
External trade expanded in 2018. With exports to the US having profited from frontloaded orders in mid-2018, and despite some deceleration in both export and import growth in Q4, merchandise exports grew by 9.1% in 2018, or 7.1 percentage points less than import growth. The merchandise trade surplus shrank in 2018, and data for January–February 2019 signaled further trade deceleration. As the deficit in the service balance widened further in line with the rising trend in outgoing tourism in recent years, the current account surplus narrowed to 0.4% of GDP in 2018 from 1.4% in 2017 (Figure 3.11.11). At the same time, encouraged

3.11.6 Monthly inflation



Source: National Bureau of Statistics.

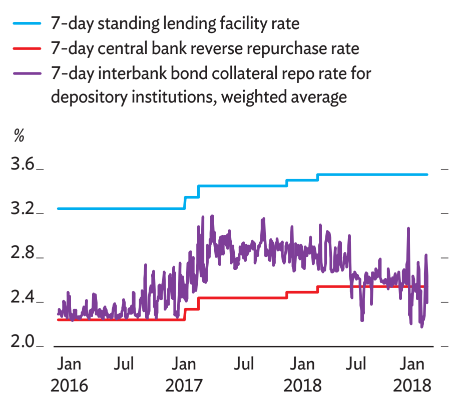
3.11.7 Price inflation for newly constructed residences



Note: Tier I includes 4 cities: Beijing, Guangzhou, Shanghai, and Shenzhen; Tier II includes 31 provincial capital cities, municipalities, and sub-provincial cities; Tier III includes 35 other cities.

Sources: National Bureau of Statistics; ADB estimates.

3.11.8 Policy and interbank interest rates

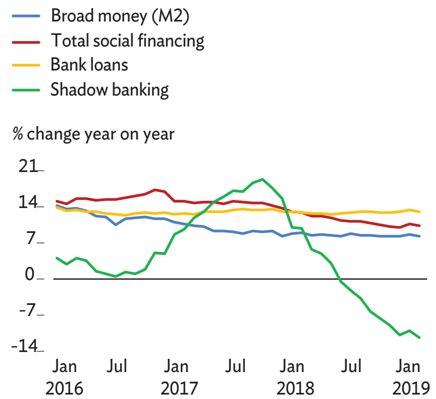


Sources: People's Bank of China; National Interbank Funding Center.

by more attractive investment conditions, inward foreign direct investment (FDI) increased by 21.0% in 2018, while FDI outflows declined owing to tighter controls. Net capital outflows excluding FDI but including errors and omissions are estimated to be virtually unchanged because the central bank reintroduced regulatory measures to curb them, as described in *ADO 2018 Update*. Official gross international reserves fell by $68 billion to stand at $3.2 trillion at the end of 2018.

The renminbi strengthened in 2018 by 1.2% in nominal effective terms (against a trade-weighted basket of currencies) and by 0.9% in real effective terms (taking inflation into account), while it weakened in nominal terms by 5.0% against the US dollar (Figure 3.11.12). Depreciation had multiple causes, including lost momentum in the domestic economy, uncertainty related to the trade conflict, a smaller current account surplus, and, as domestic interest rates declined while US rates rose, a narrower yield spread that had favored PRC bonds over US Treasuries. Amid ongoing trade talks, the renminbi rallied against the dollar in early 2019.

3.11.9 Growth of broad money, total social financing, bank loans, and shadow banking



Note: Shadow banking = entrusted loans + trust loans + banker's acceptance bills.

Sources: People's Bank of China; ADB estimates.

Economic prospects

The downward trend in GDP growth is expected to continue in 2019 and 2020 as uncertainty pertaining to trade tensions with the US continues to weigh on domestic consumption and investment, and as restrictions on shadow banking remain in place. Growth is expected to slow to 6.3% in 2019 and, reflecting ongoing efforts to contain risk in the financial sector, moderate a bit further to a more sustainable 6.1% in 2020 (Figure 3.11.13). Monetary and fiscal policy are expected to remain supportive, but no major stimulus is expected. The policy, which in the second half of 2018 aimed to prevent a sharp deceleration in growth but not to raise the growth rate, should continue. An agreement with the US in 2019 would limit adverse effects from the trade conflict and help revive consumer and investor sentiment. However, growth will be lower as ongoing restrictions on shadow banking continue to limit expansion in credit to the economy, albeit partly compensated by fiscal support.

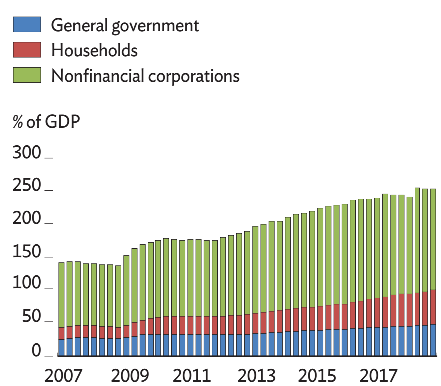
On the demand side, consumption will remain the main driver of growth, though consumption growth is expected to moderate slightly in line with slowing growth in household income. Consumer staples are expected to hold up well, but discretionary consumer spending will likely remain subdued in the short run before recovering later in 2019. The expected gradual loosening in 2019 of local housing market restrictions will boost property-related consumer spending, supporting retail sales in late 2019 and 2020. Growth in disposable income will likely slow because the economic slowdown has started to affect the labor market. In this respect, cuts to personal income tax in October 2018 and higher allowances from January 2019

3.11.1 Selected economic indicators (%)

	2019	2020
GDP growth	6.3	6.1
Inflation	1.9	1.8
Current account balance (share of GDP)	0.0	–0.1

Source: ADB estimates.

3.11.10 Debt structure



Sources: Bank of International Settlements; ADB estimates.

were timely policy measures to alleviate the adverse effect of anticipated weaker wage growth. Public spending in 2019 and 2020 is expected to be higher than in 2018, to support the economy.

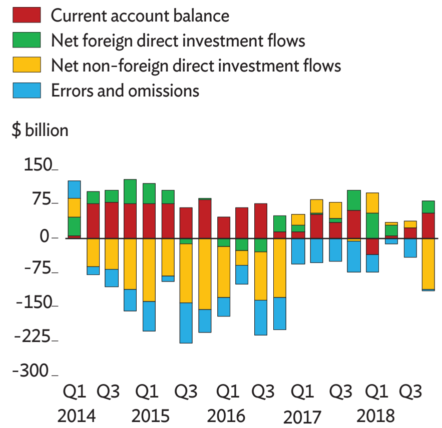
Investment growth recovered in Q4 of 2018 on a sharp increase in infrastructure investment, which will continue under a higher quota for special bond issues in 2019. Government support for high technology and continued industrial upgrading should ensure that investment in manufacturing keeps growing but at a reduced rate as manufacturing profits decline, growth slows, and external trade loses its luster. Investment in real estate is expected to hold up well as housing market restrictions gradually loosen. Net exports are projected to continue to drag on growth in 2019 as the current account surplus wanes and edges into deficit in 2020.

On the supply side, services are expected to outgrow industry. Value added in financial services should grow solidly, driven by solid bank profits from expanded lending, while construction and services related to real estate will benefit from expected recovery in the housing market. Headwinds will likely moderate manufacturing growth, especially as trade growth slows in 2019, though government support will help high-tech manufacturing and innovative industries continue to grow rapidly. Mining is expected to suffer under lower commodity demand, given slower domestic and global growth, while upstream industries, especially steel and cement, are set to profit from rising construction of both infrastructure and housing. Agriculture is expected to grow steadily as in previous years.

The outlook for the labor market is less robust. Moderation in consumption growth and less dynamic foreign trade are expected to dampen demand for low-skilled and blue-collar workers. However, some companies, especially state-owned ones, may find it difficult to lay off workers, affecting their profitability. This could increase corporate debt in the form of bank credit and bond issues, as access to alternative financing, especially from shadow banks, will remain difficult (Figure 3.11.10).

Under declining domestic growth, lower global oil prices, a largely stable renminbi against the US dollar, and sharply lower producer prices, consumer price inflation will remain moderate, edging down from 2.1% in 2018 to 1.9% in 2019 and 1.8% in 2020 (Figure 3.11.14). Apart from potentially volatile food prices, spending on health remains the main driver of inflation. At the same time, reform to pharmaceutical procurement, currently planned on a trial basis, may be rolled out on a broader scale to contain medical costs. Producer prices may fall a bit further from their high base and even decline briefly, but they will stabilize as demand for construction materials rises under continued high infrastructure investment and the pickup in housing construction later in 2019.

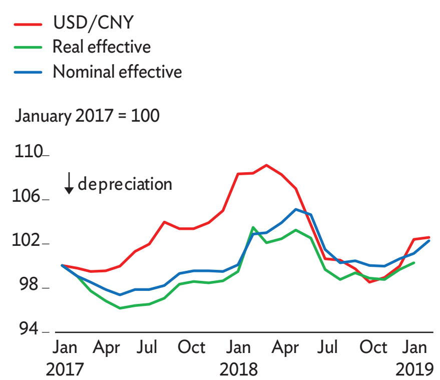
3.11.11 Balance of payments



Q = quarter.

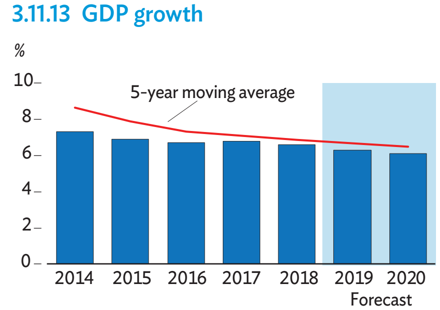
Sources: State Administration of Foreign Exchange; ADB estimates.

3.11.12 Renminbi exchange rates



Sources: Bank for International Settlements; People's Bank of China; ADB estimates.

3.11.13 GDP growth



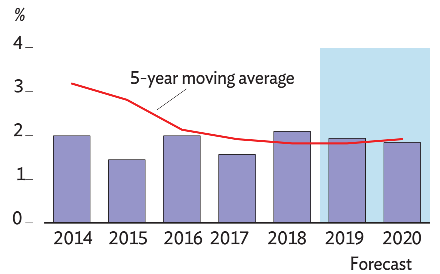
Source: *Asian Development Outlook* database.

Monetary policy is expected to become more accommodative. Data on new bank loans in January–February 2019 suggest a slight pickup in bank credit. At the same time, the monetary policy transmission mechanism has been undermined by banks' reluctance to lower lending rates as long as deposit rates remain unchanged. The central bank will continue to cut the reserve requirement ratio to ensure sufficient bank liquidity and keep interbank interest rates low, which should enable banks to lend on favorable terms to companies. In Q4 of 2018, following guidance from the central bank and the regulator, fewer loans were priced above the benchmark rate, driving down the weighted average of interest rates charged by banks (Figure 3.11.15). However, as long as deposit rates remain unchanged, banks will likely shy away from lowering their lending rates much further, partly because credit demand remains high as financing alternatives are drying up and partly because the risk of corporate default has increased as the economy slowed. Going forward, the central bank has room to lower benchmark 1-year lending and deposit rates, thereby reducing financing costs for the real economy while preserving banks' interest margin. Such loosening would benefit in particular highly indebted enterprises by lowering their interest payments.

State-owned and other larger companies enjoy better access to bank loans than do private small- and medium-sized enterprises (SMEs) because they generally offer better collateral, more transparency, and lower default rates. The central bank and financial regulator may therefore find it necessary to lean on banks to ensure that SMEs obtain credit at a reasonable cost. At the same time, while restrictions on shadow banking, the main alternative financing vehicle for SMEs, are expected to continue through 2019 and 2020, they may be relaxed to allow the volume of outstanding shadow credit to be reduced more gradually. While both measures support growth in the short run, they come at the potential cost of continued accumulation of risk pertaining to shadow banks and more nonperforming loans for banks.

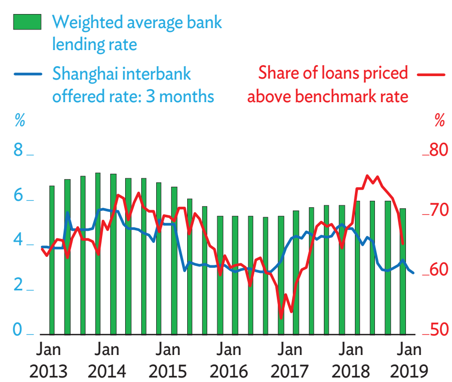
Fiscal policy became more expansionary in the second half of 2018, especially with increased special bond issues, but any large fiscal stimulus remains unlikely as the government continues to try to stabilize debt. Going forward, some support will come from the government. A cut in the highest value-added tax rate from 16% to 13%, and in the next highest rate from 10% to 9%, was approved at the National People's Congress in March 2019. The direct effect of the tax cut on growth will likely be modest as only companies in markets with fierce competition will pass on the lower rates to customers. Further, given slowing economic growth, most firms are expected to save the extra revenue instead of investing it. However, as growth in tax revenue slows along with the economy, these cuts will

3.11.14 Inflation



Source: *Asian Development Outlook* database.

3.11.15 Bank loan and interbank interest rates



Sources: People's Bank of China; National Interbank Funding Center.

put additional pressure on the budget, limiting the increase in public spending, especially for local governments, which receive half of the value-added tax collected but are not allowed to raise taxes or issue public debt without central government approval. The deficit in the consolidated budget, at 4.2% in 2018, is expected to be higher in both 2019 and 2020. Local and central government debt alike are expected to increase in both years.

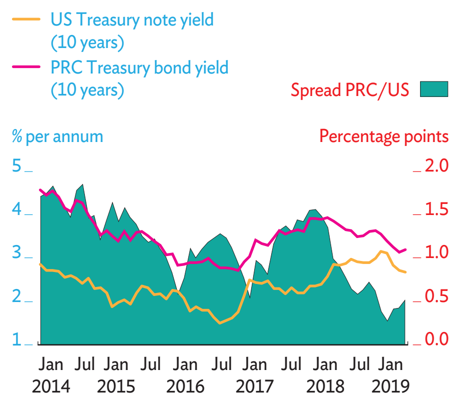
To sustain a revival in infrastructure investment that started in Q4 of 2018, local governments have been authorized to continue issuing special bonds to finance infrastructure before the 2019 budget is finalized. The annual special bond quota will rise from CNY1.35 trillion in 2018 to CNY2.15 trillion. This quota will likely remain high in 2020 to enable local governments to reduce their off-budget financing for infrastructure.

The current account is forecast to be in balance in 2019. Merchandise exports are expected to decelerate in 2019 in the aftermath of frontloaded exports to the US in mid-2018, and in light of forecast slower growth in Europe, which will weaken demand for PRC exports. At the same time, imports are projected to grow much less than in 2018 with decelerating growth in domestic demand, and the widening of the service trade deficit is expected to slow in line with lower import growth and only a moderate rise in outbound tourism. In 2020, the current account is expected to cross into deficit as declining global growth hampers export demand while the service deficit persists.

Notwithstanding recent government steps to improve investment opportunities for foreigners, FDI inflows are projected to moderate slightly in the shadow of the trade conflict with the US and as supply chains consequently reorganize somewhat away from the PRC. FDI outflows will also be lower owing to tight capital controls and greater scrutiny of FDI inflows in the advanced economies. Inflows of capital will pick up as foreign investors continue to acquire PRC bonds and stocks to diversify their portfolios despite the narrowing spread between PRC and US bond yields (Figure 3.11.16). These inflows will help compensate for deterioration in the current account, while unregistered capital outflows are expected to remain moderate under strict capital controls.

The forecast is subject to external uncertainties and domestic risks. The main downside international risk is any intensification of the trade conflict with the US in the absence of a durable deal. This could have spillover effects, damaging investor and consumer sentiment. On the upside, a comprehensive trade deal that covers intellectual property rights protection, technology transfer, market access, and the role of state-owned enterprises, though unlikely, would assuage uncertainty and provide a more stable external environment. A domestic downside risk is that policy makers see measures to stabilize growth as insufficient, abandon efforts to stabilize lending, and/or loosen restrictions on shadow banking, thereby allowing nonbank financing to

3.11.16 Spread between PRC and US treasury bond and note yields



PRC = People's Republic of China, US = United States.
Note: Yields are period average of monthly yields.
Sources: National Interbank Funding Center; Federal Reserve Board; ADB estimates.

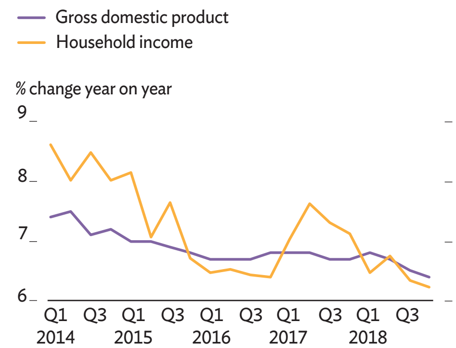
reaccelerate and debt to balloon. Such measures would boost growth in the short run but endanger financial stability over the longer term. Sustaining growth in the PRC depends instead on continued efforts to control financial leverage and on accelerated structural reform.

Policy challenge—reforming social security contributions

Since the PRC shifted its growth model toward higher domestic consumption during the global financial crisis of 2008–2009, consumption has become the main contributor to growth, fueled by solid increases in household income (Figure 3.11.17). However, private consumption is likely to face headwinds as the economy slows, the job market weakens, and wage growth decelerates. The government reinforced its support for private consumption when it introduced personal income tax reform comprising new tax brackets and a higher standard allowance effective on 1 October 2018, with more specific additional deductions effective on 1 January 2019. It is debatable, though, that such policies can sustainably raise household consumption to support growth and bring about economic rebalancing. The potential for more consumer spending in the PRC is limited by a high savings rate largely necessitated by a social safety net that is much weaker than in the advanced economies.

In the medium term, enhancing the social security system remains pivotal to lowering households' precautionary savings, provided that it is carried out in a manner that avoids causing unemployment and strengthens job growth. Higher unemployment would undermine consumption, especially because the social safety net remains weak. With this concern in mind, the National People's Congress approved in March 2019 a rate cut for employers' contributions to pension funds, lowering it from 19%–20% of the wage bill to 16%. While this was a step in the right direction, other anomalies remain. First, pension contribution rates are set by each province and vary from 14% in Zhejiang and Guangdong to 19%–20% in most other provinces (though capped at 16% from May 2019, following the recent decision). Moreover, these contributions are pooled within provinces. These features limit the transferability of pensions nationwide and probably hinder labor mobility. According to the Thirteenth Five-Year Plan, 2016–2020, pension contributions should be pooled nationwide by 2020. Attaining this goal may prove challenging. Pooling has been hampered by slow progress in standardizing contribution rates and because richer provinces see national pooling as redistribution. Yet addressing the problems of underreporting and nationwide pooling are essential to enhance efficiency and create room to lower nominal contribution rates.

3.11.17 Real household income growth and real GDP growth



Q = quarter.

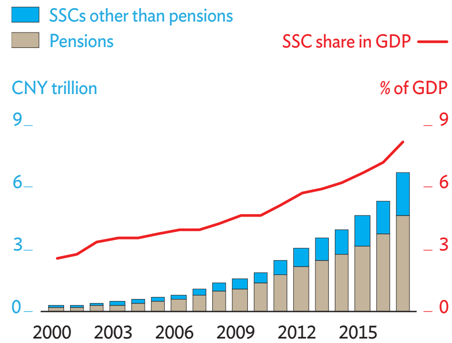
Sources: National Bureau of Statistics; ADB estimates.

A second important step toward improving the social security system as a whole would be to address the following inefficiencies in the collection of social security contributions (SSCs), which include contributions not only to pensions but also to cover medical care, unemployment, maternity, and work-related injury (Figure 3.11.18). High statutory SSC rates and the way they are determined create incentives for employers to underpay contributions by underreporting salaries. PRC social security law requires both employers and employees to make SSCs. Employers, though, bear the significantly larger share. A flat SSC contribution rate, slightly different by province and locality, is applied to employees' gross salaries. With the latest cut to the pension component of SSCs, the national average rate for employers has dropped to 30%—still nearly double the 16% average in the 10 advanced economies in the Group of 20. The average contribution rate for employees is 11%, similar to the average in the same comparator group. Though an employee's salary in the previous year serves as the basis for SSCs, those employees earning below a threshold must pay a fixed minimum amount, and those earning above a threshold pay a fixed maximum amount. The lower threshold is generally set at 60% of the previous year's average local wage, and the top threshold at 300%.

To reduce their contributions, companies often underreport employee salaries to the social security administration, which cannot check the reports because it has no access to tax data. According to a 2018 white paper on social security, only 27% of surveyed enterprises paid the full SSC based on employees' actual salaries. Others either based payments on underreported employee salaries or paid the minimum contribution per employee. These practices suppress the effective rate of SSCs, including for pensions. To consolidate the SSC base before lowering the contribution rate, the government decided to transfer authority for SSC collection from the Ministry of Human Resources and Social Security to the State Taxation Administration, to which salaries are reported for tax purposes. This promised to make systematic underreporting more difficult. However, the transfer, which was to occur on 1 January 2019, was postponed in response to resistance from employers that feared having to pay higher contributions as a result. Despite such resistance, the transfer of authority should be pursued and speeded up to streamline the collection of SSCs.

Finally, the government should pay legacy costs that arise from obligations to retirees who became eligible for state pensions when the pension system was modified in 1997. To raise pension fund revenues toward financing these payments, the government should implement its plans to raise both the share of state-owned enterprise equity transferred to the pension fund, which currently stands at 10%, and the dividends state-owned enterprises pay out to their shareholders.

3.11.18 Social security contributions as a share of GDP



SSC = social security contribution.

Sources: Ministry of Human Resources and Social Security; ADB estimates.