CHINA ECONOMIC UPDATE FEBRUARY 2019

Year of the Pig brings an uncertain outlook

NAB Group Economics

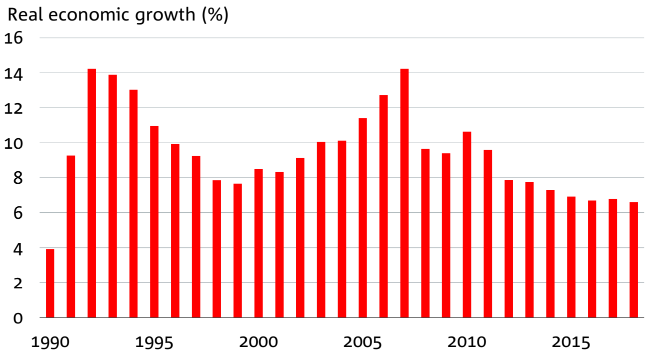
China's workforce has returned following the Chinese New Year holiday period and an apparently soft January. Prospects for the Year of the Pig appear a little weaker than last year – and as a result, near the weakest for almost three decades. The outlook for China's growth is also as uncertain as it has been over this period and a range of risks could see China's growth slow more sharply than otherwise expected.

THE BIG PICTURE: CHINA'S SLOWING GROWTH TREND

Official data suggests that China's economy grew by 6.6% in 2018 – the slowest rate of growth since 1990. At a high level, growth is becoming harder to come by, as China has closed technology gaps to advanced economies, lost low cost manufacturing competitiveness with other emerging market economies and faces growing constraints – from trade to credit and demographics.

CHINA'S GROWTH SLOWING

2018 was weakest year since 1990

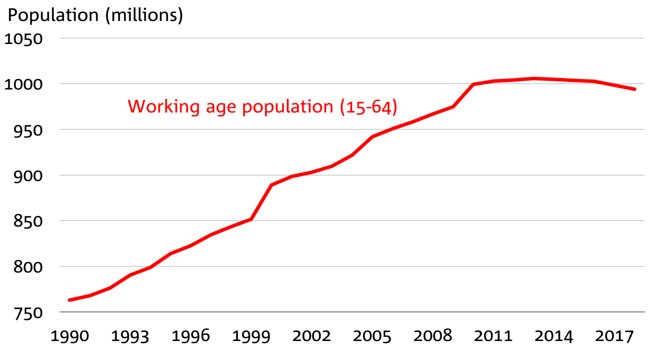


Source: CEIC, NAB Economics

The latter is perhaps the most crucial factor. China's working age population – nominally the age group from 15 to 64 years – peaked in 2013 and has subsequently fallen by around 12 million people. Given falling birth rates since the 1970s, the working age population will continue to shrink in coming years, with these workers having to support a larger pool of retirees.

CHINA'S AGEING POPULATION

Workforce has declined since 2013

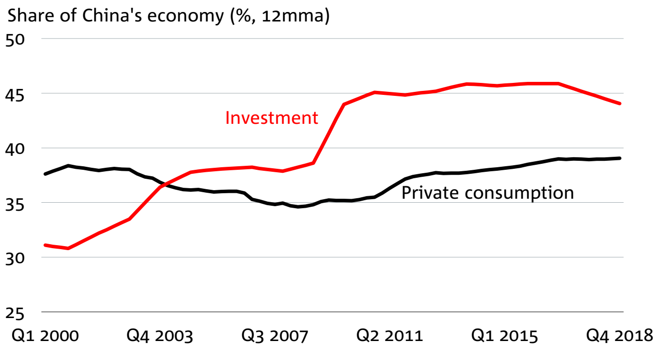


Source: CEIC, NAB Economics

At the same time, China's long slow transition away from investment-led growth continues. According to estimates from Oxford Economics, China's investment share of GDP remains remarkably high by international standards (at around 44% of GDP in Q4 2018), however private sector consumption is increasing its share of the economy – up to 39% in Q4, compared with a low near 35% in early 2008.

THE GRADUAL ECONOMIC TRANSITION

Investment still a large share of GDP



Source: Oxford Economics, NAB Economics

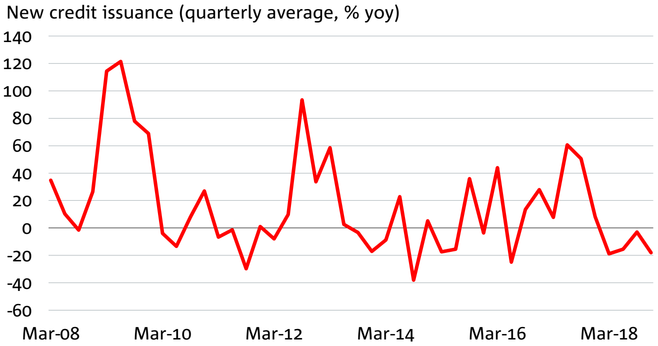
Date **February 2019** | Author **Gerard Burg** – Senior Economist – International

Even ahead of the US-China trade dispute, the capacity to generate additional growth via export markets was limited. China is the dominant producer in a range of industrial and consumer goods, leaving limited opportunity to expand via trade. China needs to increase its domestic consumption – the driver of the transition towards a consumer based economy – but historical examples show that this leads to a slower growth path.

The third major trend has been efforts to deleverage the economy. Two major periods of stimulus – in 2009 following the Global Financial Crisis and the smaller "mini-stimulus" in 2012 – have resulted in surging debt levels, particularly in the country's corporate sector. Our estimate of China's debt sits at around 325% of GDP – similar to some of the highest debt advanced economies. Efforts to address the debt problem culminated in the deleveraging program evident across 2018, which saw new credit issuance decline year-on-year. The People's Bank of China has indicated that it intends to continue the program in 2019 (although it should be noted that the PBoC lacks independence from the government).

CREDIT ISSUANCE SLOWING

Credit weaker in 2018 on deleveraging

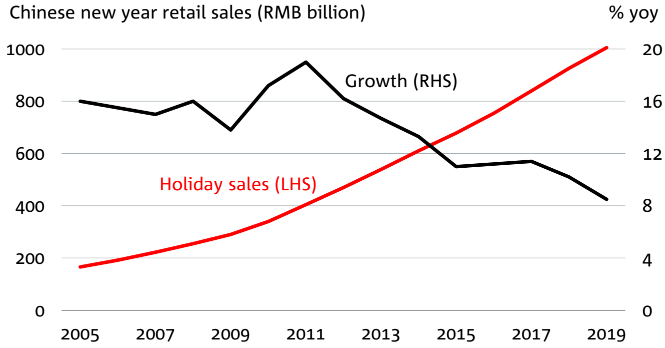


Source: CEIC, NAB Economics

In line with these trends, we expect China's economic growth to continue to slow – down to 6.25% in 2019. That said, when compared with the previous decade, there is a wider range of uncertainty around this forecast. There are early indicators pointing to some softness – albeit there should always be some caution around data in the volatile New Year period – with manufacturing PMIs turning negative (for the first time since early 2016) and factory gate price inflation stalling, highlighting weak conditions in the industrial sector. Similarly, retail sales over Chinese New Year were soft compared with the past decade, in line with the downturn in retailing across the second half of 2018.

SOFT CNY RETAIL SALES

Weakest rate of growth since 2005



Source: CEIC, NAB Economics

THE UNCERTAINTIES ARE GREATER THAN PREVIOUSLY

The key uncertainty around China's economy remains its trade dispute with the United States. The relationship between the two countries continues to evolve – with the current "ceasefire" set to conclude on 1 March, at which point the rate on the second phase of US tariffs is scheduled to increase from 10% to 25%. At the time of writing, an agreement still appears distant, however that is not to say that a cooling in tensions is impossible, with the possibility of an extension to the deadline mooted by President Trump.

China's economic growth could be boosted by an agreement that reduced trade tensions, or further impacted by additional measures – such as the increase in the rate on phase two tariffs or the introduction of the proposed third phase (that would lead to all Chinese exports coming under US trade measures). Similarly, any retaliatory trade measures imposed by China on US imports would also negatively impact economic growth.

Allied to this trend is the uncertainty around the stimulus response from Chinese authorities. While many observers have expected a flood of bank lending to boost domestic demand, public statements from the PBoC have suggested that any stimulus measures will be modest compared to earlier episodes. Following on from a contraction in new credit issuance in 2018, lending surged in January to record levels. It is too early to see if this represents major stimulus or if the outcome is distorted by typical volatility around Chinese New Year (January is typically the peak month for lending). This is a key area to watch in 2019.

The scale of stimulus this year may depend on the tolerance of political leaders for downside risk to growth – and particularly its impact on labour market conditions – but carries with it significant risk, given the existing scale of debt in the economy. It also presents uncertainty around the credit-dependent housing sector, where sales have weakened in recent months. The broader real estate sector comprises a sizeable share of China's economy.

In addition there is the usual uncertainty around monetary policy. There is a growing belief that the pause in US monetary policy provides some room for an easing in Chinese rates this year – however the PBoC provides little in the way of forward guidance.

CONCLUSIONS

Our forecast for China's growth in 2019 has remained unchanged since July 2017, however the range of uncertainty around this forecast has increased more recently. There has been a clear downward trend in growth, as potential has slowed, but outside factors such as the trade dispute, along with policy responses, add to the risk.

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