Where is China headed? Five key insights from the 2019 OECD Economic Survey of China

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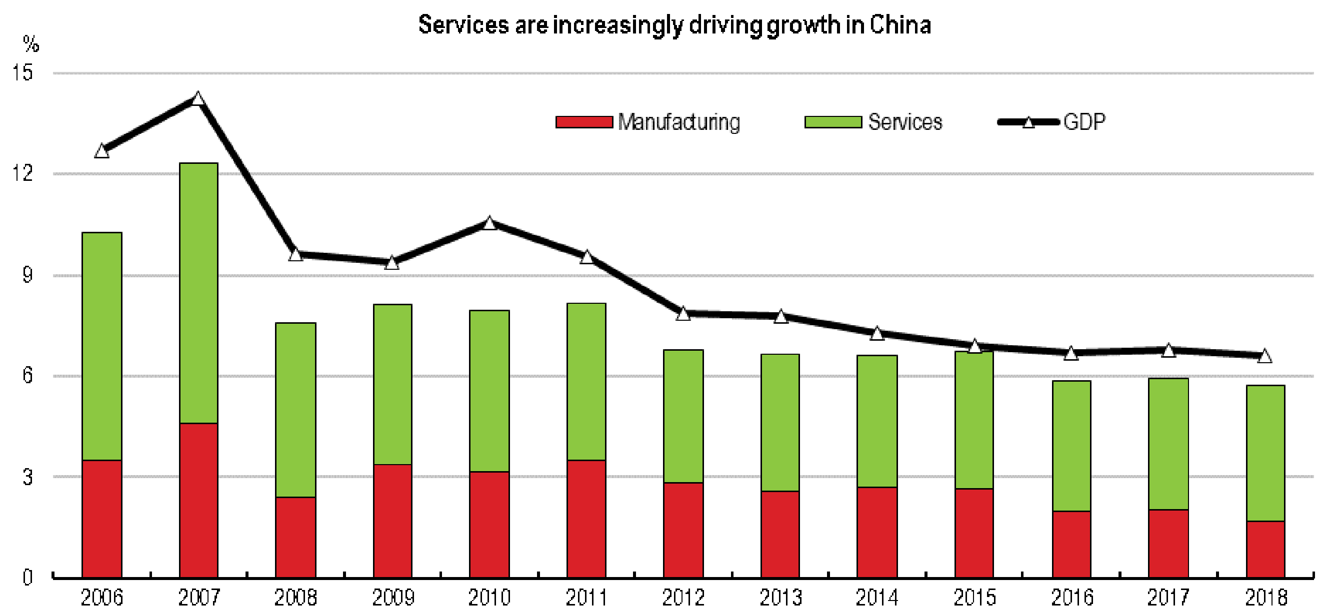
A short-term slowdown?

Although China's economic growth has slowed, it is still very robust by international standards and contributes to worldwide economic expansion. Consumption is supported by steady employment growth and rising incomes. Households are spending increasingly on items such as e-commerce and shared services. Labour shortages keep wage growth relatively high. However, continuing trade frictions are undermining exports and creating uncertainties. Small and medium-size enterprises are disproportionately affected. A further escalation of import tariffs faced by Chinese exporters would have an even more severe impact on activity, jobs, and corporate earnings – with a negative impact on the global economy.

Source: OECD Economic Outlook database.

Less manufacturing, more services?

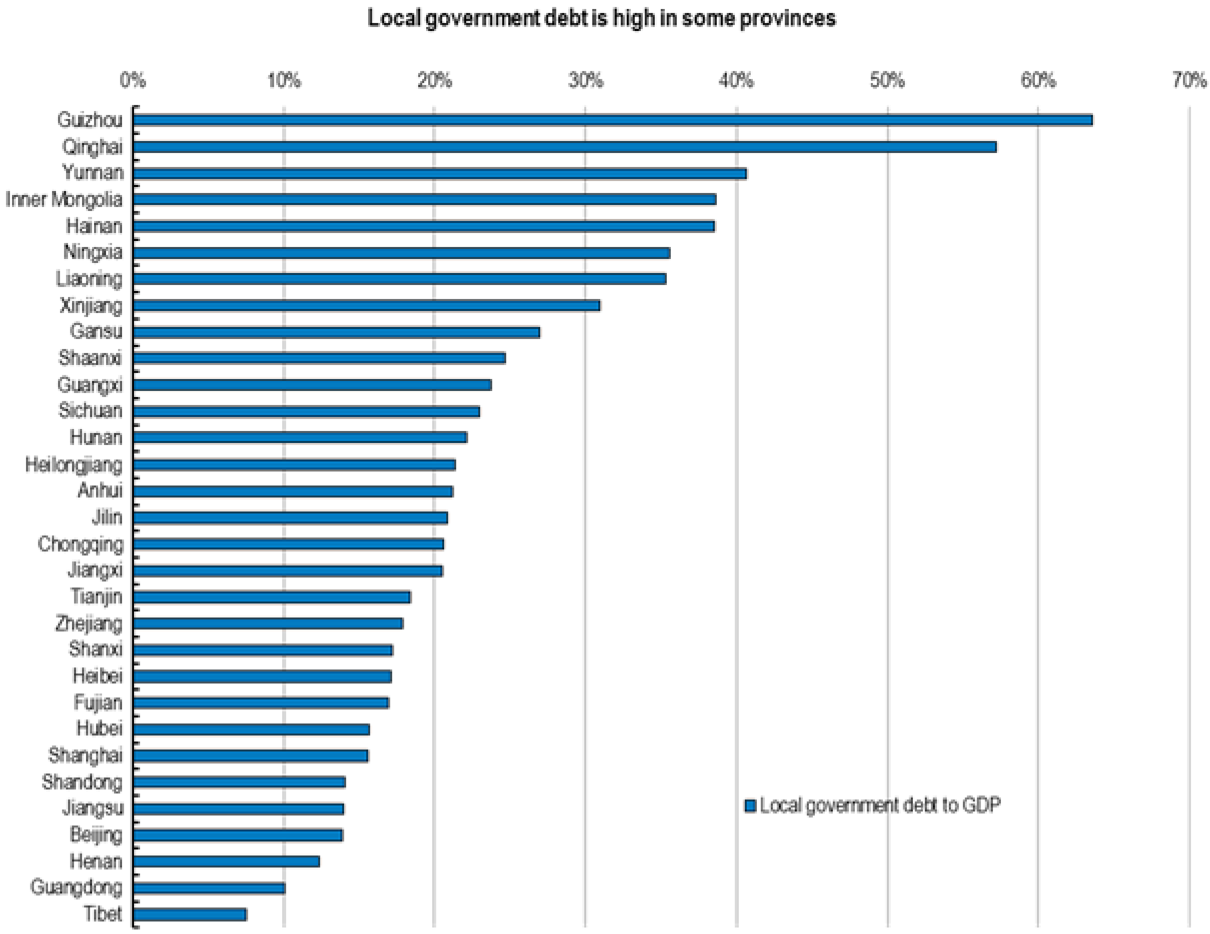
China's past development was mainly based on manufacturing production and capital accumulation. However, this model has run its course and led to misallocation of capital and excess capacity. Services are now increasingly driving growth, and not only the financial sector, but also e-commerce or digital services. Services related to international trade and global value chains, such as transport, logistics and computer services, are growing, but would benefit from further liberalisation.



Source: CEIC database.

Is local government debt a threat?

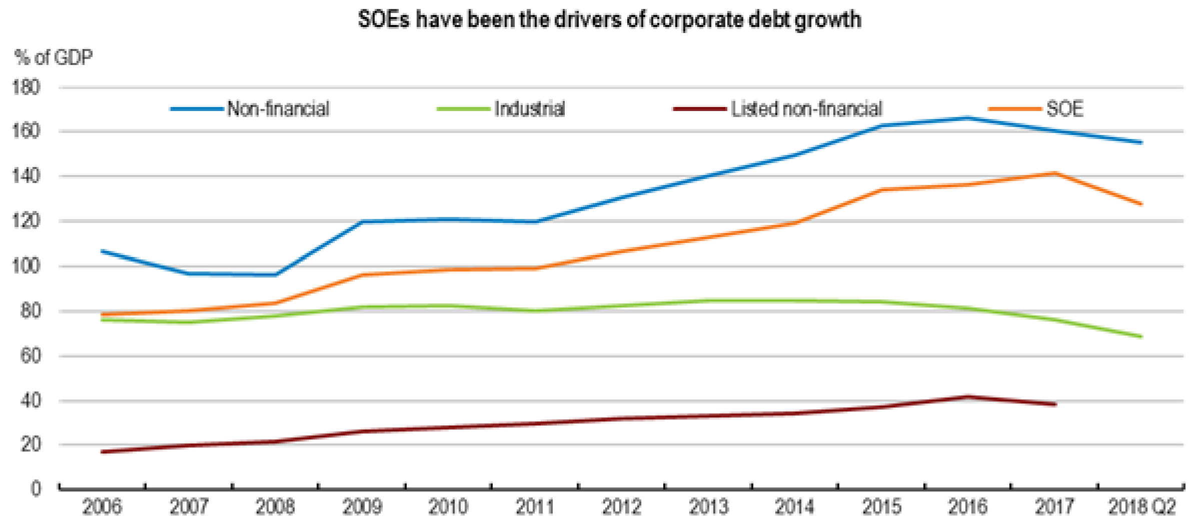
Infrastructure investment is mainly the responsibility of sub-national governments. To finance these investments, local governments have issued large amounts of debt, which have accumulated rapidly and now exceed a third of local output in eight provinces and in two provinces exceed half of it. Moreover, to circumvent borrowing limits, innovative ways to borrow have emerged and the illegal practice of guarantees is continuing. This has prompted the central government to curb such practices. However, the county level is mandated to deliver crucial public services such as education, environmental protection, health and social protection – with many of these mandates remaining unfunded. Recentralising some of these responsibilities to the central government, which is better funded, would ensure that wages of teachers, doctors and nurses are paid in every locality.



Note: Debt refers to outstanding amount.
Source: CEIC and Wind databases.

Is corporate debt a threat?

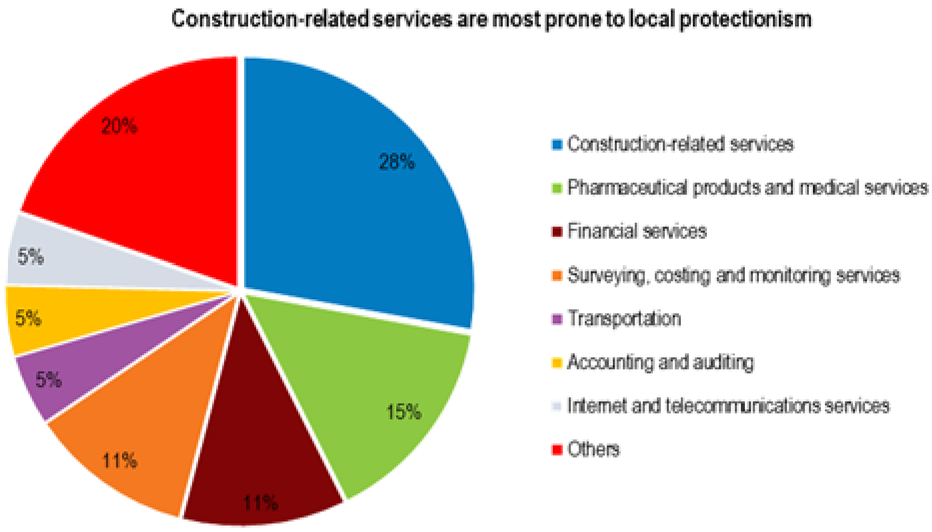
China's non-financial corporate debt reaches roughly 155% of GDP, much higher than in other major economies. The state-owned enterprises (SOEs) have been the major group behind the soaring corporate debt: as of end-2017, non-financial SOE debt reached CNY 118.5 trillion. This is an increase of nearly four folds compared to end-2007. In particular, local SOEs have led the debt accumulation, with their debt reaching above 70% of GDP in 2016. In contrast to perception, it is not SOEs in industries plagued by overcapacity that shouldered most debt, but services firms in construction, real estate and transportation industries. Many of these SOEs are in fact local government investment vehicles, implementing urban construction projects. In late 2018, the authorities made it clear in a new document that they will let ailing SOEs and local government investment vehicles exit the market.



Source: Bank of International Settlements and CEIC databases and Ministry of Finance.

Why break down internal barriers to trade?

Local protectionism has long prevented the integration of product markets across China. Local governments have protected their market to keep the tax base within their jurisdiction and to stimulate local production of goods and services. Most measures are in residential construction, service procurement, tendering, insurance and medical goods and services. They relate to choosing specified service providers and excluding outside firms from participation in local tenders. This has prompted the central government to order all local governments to undertake self-investigation of measures hindering competition and to eliminate them within a year.



Source: Price Supervision and Anti-Monopoly Bureau, National Development and Reform Commission.

References:

OECD (2019), *OECD Economic Surveys: China 2019*, OECD Publishing, Paris.