People's Republic of China—Assessment Letter for the Asian Development Bank

May 1, 2020

This letter provides the IMF staff's current assessment of macroeconomic conditions, prospects, and policies of the People's Republic of China. It has been requested by the Asian Development Bank in relation to its Loans for Xiangtan Low-Carbon Transformation Sector Development Program in Xiangtan city in Hunan Province.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

China has been greatly affected by the COVID-19 pandemic. Since January, over 82,000 people have been diagnosed with the disease and more than 4,600 have died. The authorities had imposed strict containment measures, including the extension of the national Lunar New Year holiday, the lockdown of Hubei province, large-scale mobility restrictions at the national level, and social distancing. Most mobility restrictions have been gradually lifted with the virus retreating domestically, but new measures have been announced to control risks from abroad, including banning the entry of most foreigners.

The outbreak has caused a sharp decline in economic activity. Real GDP contracted by 6.8 percent (y/y) in 2020Q1, from 6 percent in 2019Q4, the first contraction since 1976. Nominal GDP growth fell by a similar degree to -5.3 percent (y/y), from 7.4 percent in 2019Q4. Domestic activity began to pick up in March, with a strong rebound in industrial production reflecting a focus on large-scale manufacturing in the first phase of normalization. However, smaller enterprises were slower to resume production and the recovery pace was relatively weaker in the services sector due to subdued private consumption on rising unemployment.

Financial conditions have eased on strong policy support. Total social financing growth accelerated to 11.5 percent (y/y) in 2020Q1, up from 10.7 percent in 2019Q4, as bank lending and corporate and government bond financing continued to expand reflecting policy support (see below). The average loan rate has declined and interbank funding rates and bond yields have fallen to multi-year lows, helping lower financing costs. The RMB has depreciated by about 1½ percent against the U.S. dollar in the course of Q1.

Real GDP growth is projected at 1.2 percent in 2020, down from 6.1 percent in 2019. While domestic activity is assumed to recover as containment measures are withdrawn and policy support gains strength, the sudden halt in 2020Q1 and increasing external headwinds brought by the global outbreak of the disease will leave their mark on the year. Growth is expected to improve to 9.2 percent in 2021 as the economy returns to its pre-virus trend.

Risks are firmly on the downside. Further outbreaks are possible as the economy goes back to work and concerns about the lingering virus and rising unemployment could weaken confidence and domestic demand. Exports could disappoint more than expected as the virus spreads globally and global containment measures persist. A protracted slowdown could exacerbate lingering financial vulnerabilities such as high corporate debt and weak banks.

POLICY RESPONSES AND SETTINGS

The authorities have reacted strongly to contain the virus, mitigate its impact on the economy, and support recovery. Broadly in line with the Fund's recommendations, the authorities have provided

timely and targeted on-budget fiscal support to the health sector and the most-affected firms and households, which mitigated the impact of the outbreak on jobs, contributed to avoiding unnecessary bankruptcies, and helped provide protection for the vulnerable. Fiscal policy has become more expansionary, adding welcome demand support during the recovery. Accommodative monetary policy has maintained sufficient liquidity in the banking system and kept debt-servicing costs low, enhancing the effect of fiscal stimulus. The People's Bank of China (PBOC) and regulators have acted to safeguard financial market stability. The exchange rate has been allowed to adjust flexibly to the changing economic conditions. Key measures are listed below (and the latest summary of policy responses can be found here):

- *Fiscal.* An estimated RMB 2.6 trillion (or 2.5 percent of GDP) of fiscal measures or financing plans have been announced, of which about half are already being implemented. Key measures include: (*i*) increased spending on epidemic prevention and control; (*ii*) production of medical equipment; (*iii*) accelerated disbursement of unemployment insurance; and (*iv*) tax relief and waived social security contributions. The overall fiscal expansion is expected to be about 5 percent of GDP, reflecting the proposed issuance of the central government special bonds, improvements of the national public health emergency management system, and automatic stabilizers. As a result, the augmented fiscal deficit (which adds off-budget activity to the general government statistics) is expected to rise to 17.6 percent of GDP and the augmented debt to reach 90.7 percent of GDP in 2020, up from the previous projection of 12.2 and 86.5 percent of GDP during the 2019 Article IV consultation.

- *Monetary.* The PBOC provided monetary policy support and acted to safeguard financial market stability. Key measures include: (*i*) liquidity injection of about RMB 3.3 trillion (gross) into the banking system via open market operations (reverse repos and medium-term lending facility); (*ii*) expansion of re-lending and re-discounting facilities by RMB 1.8 trillion to support manufacturers of medical supplies and daily necessities, micro-, small- and medium-sized firms, and the agricultural sector at low interest rates; (*iii*) reduction of the 7-day and 14-day reserve repo rates by 30 and 10 bps, respectively, as well as the 1-year medium-term lending facility rate by 30 bps, (*iv*) targeted RRR cuts by 50-10 bps for large- and medium-sized banks that meet inclusive criteria which benefit smaller firms, an additional 100 bps for eligible joint-stock banks, and 100 bps for small- and medium-sized banks to support SMEs, (*v*) reduction of the interest on excess reserves from 72 to 35 bps, and (vi) policy banks' credit extension to micro and small enterprises (RMB 350 billion).

- *Financial*. The authorities have taken multiple steps to limit tightening in financial conditions, including measured forbearance to provide financial relief to affected households, corporates, and regions facing repayment difficulties. Key measures include (*i*) delay of loan payments and other credit support measures for eligible SMEs and households; (*ii*) eased NPL provisioning requirements and temporary forbearance for loans for epidemic-hit sectors and SMEs; (*iii*) support for bond issuance by financial institutions to finance SME lending; (*iv*) support for corporate bond issuance; (*v*) increased fiscal support for credit guarantees; (vi) flexibility in the implementation of the asset management reform; and (*vii*) easing of housing policies by local governments.

China has the policy space for additional support should the recovery fall short. Given already high public debt and deficit levels and the intensive infrastructure build-up in recent years, additional fiscal measures should focus on support for sustainable, high-quality growth, including more "green" investment, improvements to the public health system, and stronger social safety nets. Monetary policy

can further lower policy rates and foster credit supply, while financial policies should continue to safeguard against an excessive increase in corporate leverage.

IMF RELATIONS

The People's Republic of China is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded by the IMF's Executive Board on July 31, 2019.

China: Selected Economic Indicators

	2016	2017	2018	2019	2020	2021
					Projections	
	(Annual percentage change, unless otherwise indicated)					
NATIONAL ACCOUNTS						
Real GDP	6.8	6.9	6.7	6.1	1.2	9.2
PRICES						
Consumer prices (average)	2.0	1.6	2.1	2.9	3.0	2.6
FISCAL						
Augmented debt (percent of GDP) 1/	59.2	63.8	68.4	76.3	90.7	97.8
Augmented net lending/borrowing (percent of GDP) 1/	-10.4	-10.7	-11.0	-12.8	-17.6	-16.5
MACRO-FINANCIAL						
Total social financing 2/	16.7	14.1	10.3	10.7	10.7	12.3
BALANCE OF PAYMENTS						
Current account balance (percent of GDP)	1.8	1.6	0.4	1.0	0.5	1.0
EXCHANGE RATE						
7-day repo rate (percent)	2.7	5.4	3.1	3.1	…	…
10 year government bond rate (percent)	2.9	3.1	3.3	3.2	…	…
	3.7	2.9	3.0	4.0		
Real effective exchange rate (average)	-4.9	-2.9	1.3	-1.0	…	…
Nominal effective exchange rate (average)	-5.4	-2.5	1.5	-1.8	…	…

Sources: Bloomberg, CEIC, IMF International Financial Statistics database, and IMF staff estimates and projections.

1/ The augmented balance expands the perimeter of government to include government-managed funds, state-administered SOE funds, adjustments to the stabilization fund, and social security funds as well as the activity of local government financing vehicles and other off-budget activity.

2/ Not adjusted for local government debt swap.