

CHINA ECONOMIC UPDATE

MAY 2019



MANAGING HIGHER UNCERTAINTY

Acknowledgements

The World Bank *Economic Update* provides an overview of recent economic and social developments and policies in China and presents findings from ongoing World Bank work on China. The *Update* was led by Elitza Mileva (Senior Economist) under the guidance of John Litwack (Lead Economist) and with contributions from Luan Zhao (Economist) on recent economic developments and outlook, Ekaterine Vashakmadze on the global outlook and risks, and Elitza Mileva and Luan Zhao on China's global trade and investment role. The team would like to thank Jia He and Lu Liu for excellent research assistance. Helpful comments are gratefully acknowledged from Francesca de Nicola, Ergys Islamaj, Andrew Mason, Deepak Mishra, Martin Reiser, and Ekaterine Vashakmadze. The team would also like to thank Tianshu Chen, Li Li, Xiaoting Li, Lin Yang, and Ying Yu for support in the production and dissemination of this report. The findings, interpretations, and conclusions expressed in this report do not necessarily reflect the views of the Executive Directors of the World Bank or governments they represent. Questions and feedback can be addressed to Li Li (lli2@worldbank.org).

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Executive Summary

Growth in China has remained resilient in the face of weakening domestic demand. GDP growth was 6.4 percent year on year (yoy) in the fourth quarter of 2018 and in Q1 2019, compared to 6.8 percent in the first half of 2018. Stronger net exports compensated for weak domestic consumption and investment in the first quarter. In an external environment that has become less favorable due to slowing global growth and rising trade tensions, China's economy will need to rely increasingly on domestic demand to sustain rapid growth. Urban households have been cautious, spending a lower share of their income and saving more.

Weaker domestic demand was reflected in declining imports in the first quarter of 2019, with the current account surplus widening again. In 2018, strong import growth pushed the current account balance down to 0.4 percent of GDP. While goods exports to the US contracted in the first quarter, China's total export growth slowed but remained positive. By contrast, the imports of goods and services contracted across product categories and trading partners. Net capital outflows have increased since the second half of 2018 but remain moderate.

Renewed trade tensions contributed to rising financial market volatility in early May. In the year to April 30, financial asset prices recovered most of the losses incurred in 2018, but they sharply dropped again in early May in response to the US announcement of higher tariffs on US\$200 worth of imports from China. Amid higher market volatility, the People's Bank of China (PBOC) has maintained a prudent overall monetary policy stance with some targeted easing. While policy rates remain unchanged, there are signs that higher liquidity in Q4 2018 and lower reserve requirement ratios (RRR) have contributed to lower corporate borrowing costs. Higher bank loans and corporate and government bond issuance explain slightly stronger growth in credit to the non-financial sector in the first four months of 2019.

In response to the growth moderation and less favorable external conditions, the government introduced a fiscal stimulus emphasizing tax incentives. In 2018, lower value-added tax (VAT) rates and import duties, higher export VAT refunds, and slower growth in personal income taxes contributed to a consolidated fiscal deficit of 3.9 percent of GDP. In 2019, new tax and fee reductions and a higher limit for local government on-budget borrowing may lead to a higher consolidated deficit of about 5.9 percent of GDP. While the central government has fiscal space to further increase spending, if necessary, the additional stimulus should be appropriately funded either directly at the central level or through additional fiscal transfers to the provinces. Higher and more efficient spending on health, education, and social protection could also be prioritized.

The World Bank baseline projection for GDP growth in 2019 remains unchanged at 6.2 percent. Despite the positive surprise in GDP growth in Q1 2019, net exports are unlikely to provide a sustained boost in the coming months, as new trade tariffs take effect and global growth slows. Growth will increasingly depend on domestic demand, including the planned fiscal stimulus. In 2020, growth in China is projected at 6.1 percent, down from 6.2 percent forecasted previously. The escalation in trade tensions, weaker business confidence, and slower global trade growth, are expected to weigh on investment and exports. While the forecast revisions are small, the outlook is subject to greater downside risks than previously.

Today China is an essential part of the global economic landscape. The country is the world's top exporter in low-skilled labor-intensive industries (despite rising labor costs), medium-skilled, and high-skilled innovator sectors. It is also an increasingly important source of final demand, in particular for Asian countries. At the same time, China still has significant room for catching up to the productivity level of high-income countries and can continue to benefit from global integration. Economic prospects both in China and in its trading partners would receive a significant boost from resolving the current trade disputes.

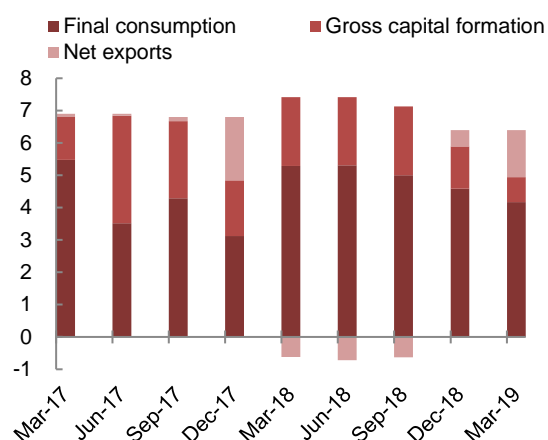
A. Recent Economic Developments and Outlook

1. GDP growth stabilized but domestic demand weakened

In the first quarter of 2019, growth was 6.4 percent yoy, the same pace as in Q4 2018, but domestic demand growth slowed. Seasonally-adjusted quarterly GDP growth declined to 1.4 percent in Q1, from 1.5 percent in Q4 2018. Both consumption and investment growth have declined since Q2 2018, with gross capital formation contributing just 0.8 percentage points (pp) yoy to growth in the first quarter of 2019 (Figure 1). By comparison, the growth contribution of investment was 1.3 pp in Q4 2018 and 2.1 pp in Q1 2018. Net exports contributed strongly to growth by 1.5 pp in Q1. The increase in net exports compared to Q4 2018 was due to a combination of somewhat slower export growth and possibly some import substitution, as imports contracted (see Section 2).

Figure 1: Contribution to real GDP growth

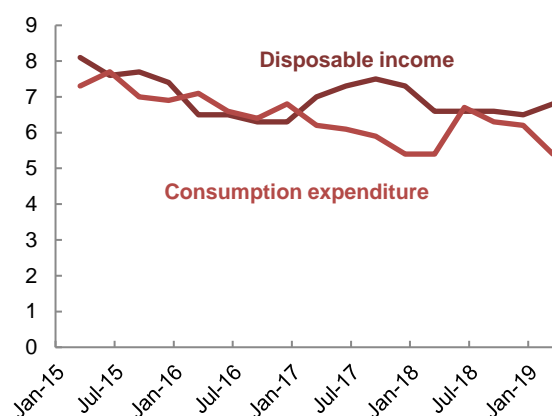
(percentage points yoy)



Source: National Bureau of Statistics (NBS).

Figure 2: Real household consumption and income growth

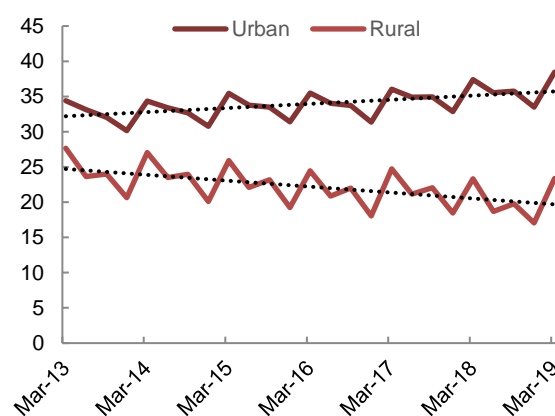
(percent yoy, year to date)



Source: NBS.

Figure 3: Urban and rural household saving rate

(percent of disposable income, year to date)



Source: NBS, World Bank staff calculations.

Consumption continues to drive economic activity, but its contribution to growth declined to 4.2 pp yoy from 4.5 pp in Q4 2018 and 5.3 pp in Q1 2018. According to household survey data, growth in real consumption expenditure has been generally weaker than real disposable income growth in recent years (Figure 2). This trend has been driven by urban households, while for rural families consumption growth has been, on average, higher than income growth. Hence, the saving rate of urban households continues to rise, while that of rural households has gradually decreased (Figure 3).¹ The recent decline in China's national saving

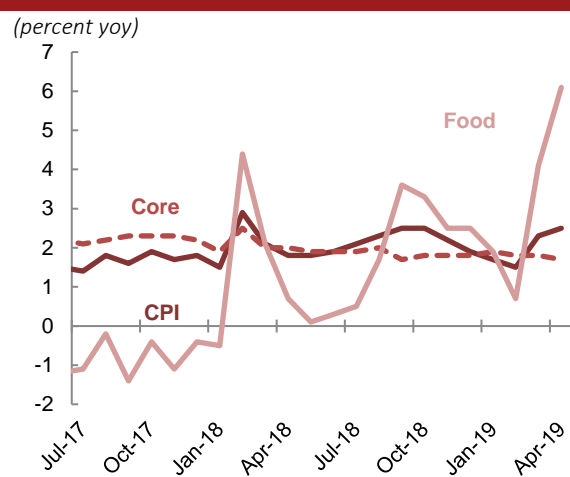
¹ The aggregate household saving rate is defined as 1 - household consumption/disposable income.

rate has been the result of lower saving by corporations, the government, and rural households. A decline in the urban household saving rate and higher consumption will be important for rebalancing from investment to consumption and sustaining growth in the future.

From the production perspective, the GDP growth contribution of industry was stable at 2.4 pp in Q1 2019 compared to Q4 2018, while the contribution of services increased by 0.4 pp to 4.0 pp. Mining production rebounded, possibly reflecting restrictions on coal imports. Growth in automobile production also improved, possibly in anticipation of new tax incentives for car purchases announced earlier this year. The growth contribution of construction, transportation, and real estate declined further, while that of financial intermediation increased. Software and IT services continued to rise at double-digit rates, contributing 1.0 pp to growth in Q1.

Consumer price inflation bottomed out in February, but the rebound was caused mainly by higher food prices. CPI inflation accelerated to 2.5 percent yoy in April, from an average of 2.1 percent in 2018 (Figure 4). While weaker energy prices exerted downward pressure in early 2019, strong food price growth contributed to higher inflation in March and April. Food prices are volatile and, during this period, were driven by a supply shortfall caused by bad weather and an outbreak of swine flu. Core inflation, excluding food and energy prices, has averaged 1.8 percent yoy since September 2018, compared to 2.0 percent in the first three quarters of 2018. This points to continued weakness in domestic demand. CPI inflation remains below the government's 2019 target of 3 percent. Because of slower growth in commodity prices, producer price inflation moderated to 0.4 percent yoy in the first four months of 2019, down from 3.5 percent yoy last year.

Figure 4: Monthly change in consumer prices



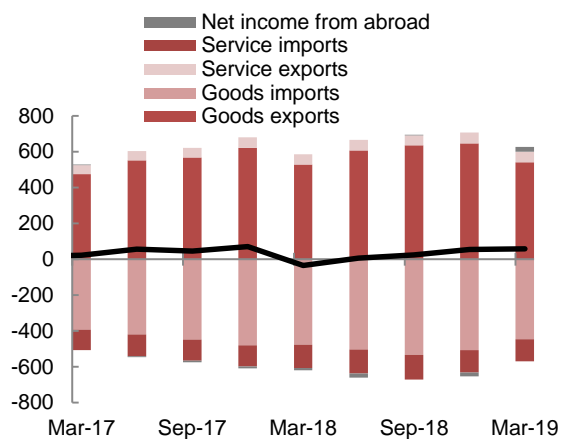
Source: NBS, World Bank staff calculations.

2. Weaker domestic demand and higher tariffs weighed on trade

In 2018, the current account surplus declined to 0.4 percent of GDP, from 1.6 percent in 2017, while net capital outflows declined. The main reason for the narrowing of the current account surplus was stronger imports of goods and services, which grew by 15.2 percent in 2018, up from 13.9 percent in 2017 (Figure 5). Export growth slowed slightly but remained resilient at 9.1 percent in 2018. Net capital outflows (including errors and omissions) declined to US\$30 billion (0.2 percent of GDP) in 2018, from US\$104 billion in 2017 (Figure 6). In an environment of reduced appetite for Chinese investment in recipient countries, outbound FDI declined further to US\$96 billion in 2018. Inbound FDI increased to US\$203 billion in 2018 from US\$166 billion in 2017. Non-resident portfolio inflows were strong in the first half of 2018, but rising trade tensions and heightened uncertainty led to a sharp decline in the second half. Foreign reserves in the balance of payments rose by US\$19 billion last year. China's stock of foreign reserves stood at US\$3.17 trillion (23 percent of GDP).

Figure 5: Composition of the current account

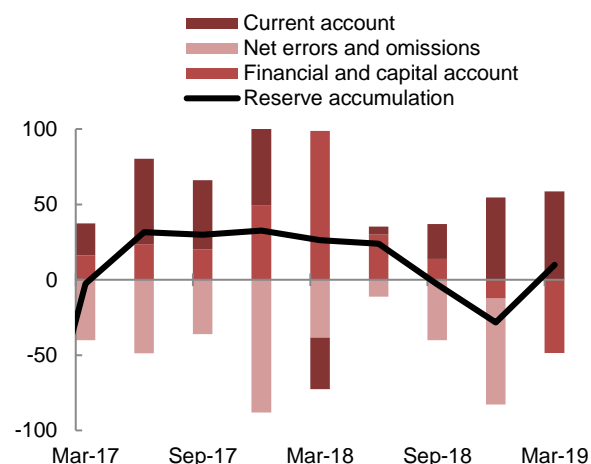
(USD billion)



Source: State Administration of Foreign Exchange (SAFE).

Figure 6: Components of the balance of payments

(USD billion)

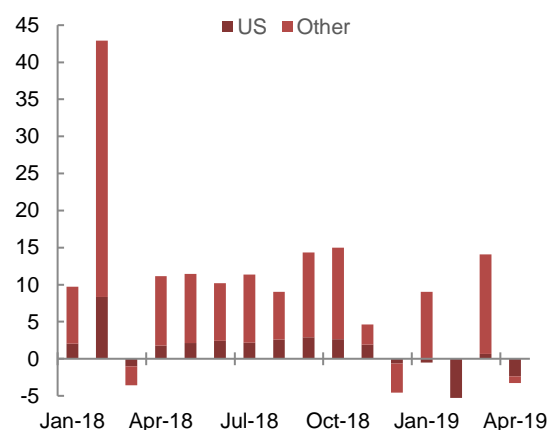


Source: SAFE.

In the first quarter of 2019, the current account surplus widened to 1.9 percent of GDP as imports declined. Growth in the exports of goods and services slowed but remained positive. As a result of higher US tariffs, goods exports to the US have contracted in most months since November 2018 (Figure 7). Merchandise exports to both ASEAN and the EU picked up in Q1. On the other hand, the decline in the imports of goods and services in the first quarter was broad-based. Not only goods imports from the US decreased due to the new tariffs, but non-US goods imports also declined, pointing to weakness in domestic demand and in the processing trade, and possibly import substitution (Figure 8). Net capital outflows were US\$49 billion (0.4 percent of GDP) in Q1, compared to US\$83 billion in Q4 2018.

Figure 7: Contribution to growth in goods exports

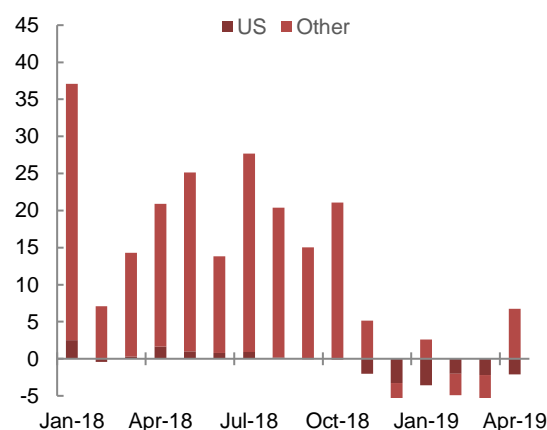
(percentage points yoy)



Source: General Administration of Customs, World Bank staff calculations.

Figure 8: Contribution to growth in goods imports

(percentage points yoy)



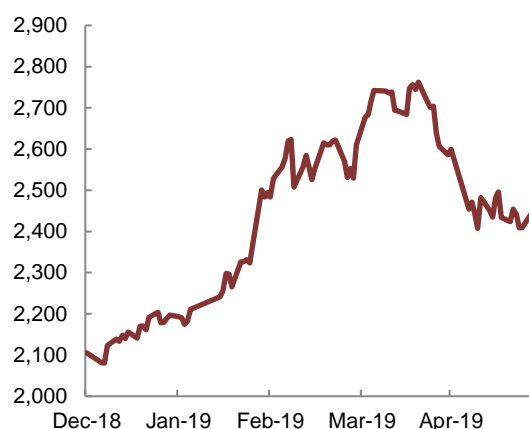
Source: General Administration of Customs, World Bank staff calculations.

3. Renewed trade tensions have raised financial market volatility

At the start of 2019, China's financial markets had recovered most of the heavy losses incurred in 2018, but volatility returned in May with the escalation in US—China trade tensions. The Shanghai Composite Index declined by 24.6 percent in 2018, rose by 23.5 percent in the year to April 30, and then lost 7.4 percent in the four days after the US announcement of higher tariffs of 25 percent on USD 200 billion of imports from China (Figure 9). In 2018, the Renminbi depreciated by 2.6 and 5.2 percent against the US dollar and the trade-weighted currency basket (Figure 10). In the year to April 30, 2019, the Renminbi had appreciated by 2.1 and 2.3 percent against the US dollar and the basket, only to reverse these gains in May. Higher uncertainty has spilled over to other countries, with the JP Morgan Emerging Markets Currency Index also losing its earlier strength and ending 1.1 percent down in the year to May 24.

Figure 9: Shanghai Composite Index

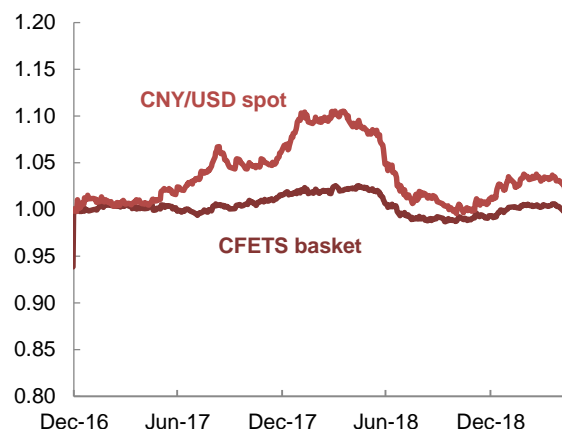
(index)



Source: Shanghai Stock Exchange.

Figure 10: Spot and currency basket exchange rates

(Indices Dec. 31, 2014 = 1)

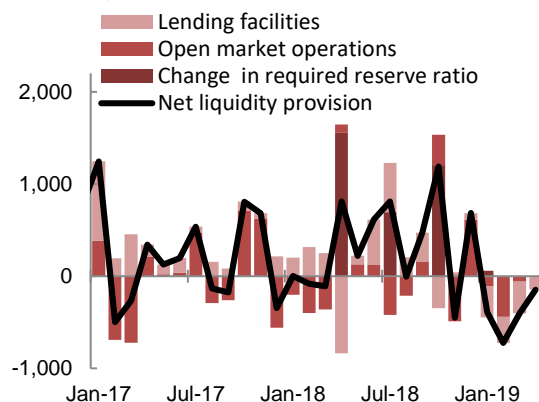


Source: SAFE, World Bank staff calculations.

Amid higher market volatility, the PBOC has maintained a prudent overall monetary policy stance with some **targeted easing**. In January 2019, the central bank reduced the reserves that all banks are required to maintain at the PBOC by 1 percent of liquid liabilities. After accounting for maturing medium-term lending facility loans and changes to open market operations, the PBOC withdrew net liquidity of RMB 1.7 trillion in the first four months of 2019, compared to a net injection of RMB 1.4 trillion in Q4 2018 and RMB 0.6 trillion in January-April 2018 (Figure 11). Another targeted cut in the required reserve ratio (RRR) for about 1,000 smaller banks became effective on May 15. While policy rates remain unchanged, there are signs that higher liquidity in Q4, the RRR cuts, and targeted easing have contributed to lower borrowing costs (Figure 12).

Figure 11: PBOC liquidity provision

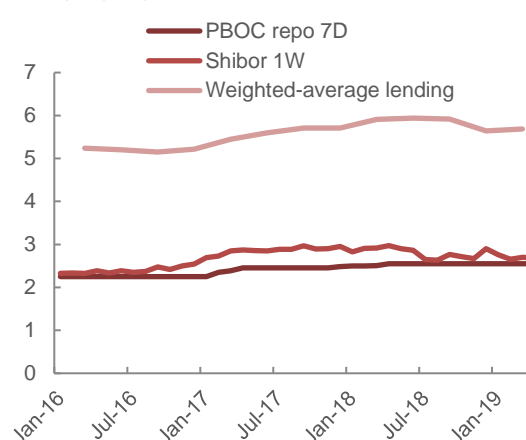
(RMB billion)



Source: PBOC, World Bank staff calculations.

Figure 12: PBOC policy and market rates

(percent per year)

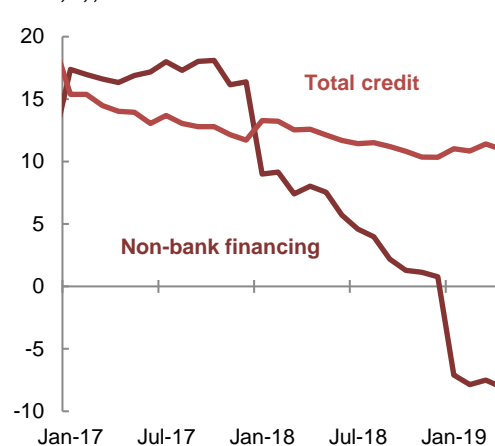


Source: PBOC, World Bank staff calculations.

Credit growth increased at the start of 2019 because of higher bank loans and corporate and government bond issuance. Growth in total credit to the non-financial sector² increased by an average of 11.1 percent yoy in January-April, up from 10.3 percent in 2018 (Figure 13). In the first four months of 2019, the authorities accelerated the issuance of special purpose local government bonds to bolster infrastructure spending: RMB 707 billion was issued, up from RMB 158 billion during the same period last year. Growth in the stock of both bank loans and corporate bonds rose by 13.1 and 10.5 percent yoy in January-April, respectively, compared to 12.7 and 9.2 percent yoy in 2018. In contrast, regulatory tightening continues to weigh on non-bank financing (i.e., entrusted loans, trust loans, and banker's acceptances) which continues to contract.

Figure 13: Credit to the non-financial sector

(growth yoy)



Note: See footnote 2 for the definition of credit. Non-bank financing includes entrusted loans, trust loans, banker's acceptances, and corporate bonds.

Source: PBOC, World Bank staff calculations

4. Recent fiscal stimulus measures have emphasized tax incentives

Owing mainly to accelerated government spending in the second half of the year, the consolidated fiscal deficit rose to 3.9 percent of GDP in 2018 (Table 1). Last year, revenue growth weakened due to several fiscal stimulus measures, including lower VAT rates and import duties, higher export VAT rebates, slower growth in personal income taxes, as well as slower nominal GDP growth. For the full year, the consolidated

² Total credit = total social financing – equity financing + government bonds – local government special bonds, using the revised definition of TSF which includes special government bonds, asset-backed securities held by banks, and loan write-offs.

revenues in the four budgets³ increased by 9.5 percent yoy in 2018, down from 14.9 percent in 2017. Sharp increases in spending in the second half of 2018 contributed to annual growth in overall expenditures of 14.1 percent in 2018, up from 12.8 percent in 2017.

Table 1: Government finance

<i>(RMB billion unless otherwise noted)</i>	2017	2018	2019 Budget	2019 Jan-Apr
Public Finance Budget				
Revenues	18,263	19,812	20,764	7,265
<i>Revenues (% of GDP)</i>	22.3	22.0	21.3	7.5
Central government	8,112	8,545	8,980	3,467
Local government (excludes transfers from central budget)	9,147	9,790	10,270	3,798
Withdrawal from Stabilization Fund	1,004	1,477	1,514	
Expenditures	20,643	22,192	23,524	7,567
<i>Expenditures (% of GDP)</i>	25.2	24.6	24.1	7.8
Central government (excludes transfers to local governments)	2,986	3,271	3,540	1,030
Local government	17,323	18,820	19,935	6,537
Contribution to Stabilization Fund	335	102	50	
Fiscal balance (authorities' definition)	-2,380	-2,380	-2,760	-302
<i>Fiscal balance (% of GDP)</i>	-2.9	-2.6	-2.8	-0.3
Government Fund Budget				
Revenues	6,146	7,540	7,795	1,956
<i>Revenues (% of GDP)</i>	7.5	8.4	8.0	2.0
Central government	382	403	419	126
Local government	5,764	7,137	7,375	1,830
Of which land-lease revenues	5,206	6,510	6,708	1,659
Expenditures	6,196	8,149	9,980	2,242
<i>Expenditures (% of GDP)</i>	7.5	9.1	10.2	2.3
Central government	367	402	340	37
Local government	5,829	7,747	9,641	2,206
Social security net revenue	978	806	543	
SOE Fund net revenue	62	74	96	
Consolidated fiscal balance*	-2,059	-3,484	-5,771	
<i>Consolidated fiscal balance (% of GDP)</i>	-2.5	-3.9	-5.9	
<i>Memo: Nominal GDP**</i>	82,075	90,031	97,413	97,413
<i>Note: * The consolidated fiscal balance = Public Finance Budget balance + Government Fund Budget balance + Social security and SOE Fund net revenues - Net withdrawal from Stabilization Fund. ** World Bank forecast for 2019.</i>				
<i>Source: Ministry of Finance, NBS, World Bank staff calculations.</i>				

³ China's budget system consists of (i) a Public Finance Budget which includes tax and non-tax revenues, current expenditures, and a portion of capital expenditures; (ii) a Government Fund Budget which reflects mainly land-lease revenues of local governments and expenditures for specific infrastructure and social projects; (iii) a Social Security Fund Budget which records social insurance contributions and disbursements; and (iv) an SOE Fund Budget which is the state-owned assets operation budget. Revenues and expenditures in this section refer to the sum of (i) and (ii). The consolidated budget balance refers to the sum of (i), (ii), (iii), and (iv) minus net withdrawals from the stabilization fund.

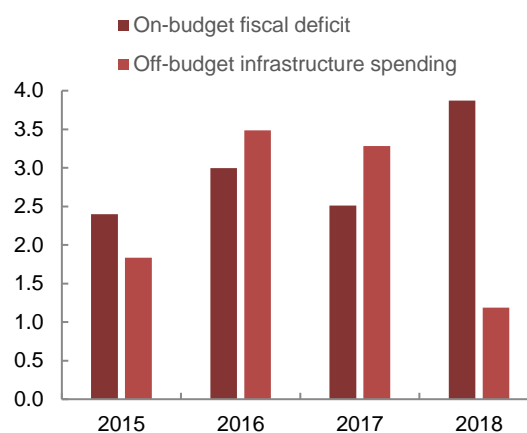
While the on-budget fiscal deficit increased in 2018, off-budget (quasi-fiscal) infrastructure spending contracted. Prior to 2017, a rapid expansion in credit to the state sector, particularly local government financing vehicle (LGFV) debt supporting local public investment, led to an unsustainable accumulation of debt. In 2017, China changed course by reining in the credit expansion and restricting off-budget borrowing by local governments. We estimate that in 2018 more public expenditure was shifted on budget, while off-budget infrastructure spending by SOEs contracted (Figure 14).

Fiscal policy became more expansionary in January—April 2019, with revenues significantly weaker and expenditure growth faster than in the same period last year. Revenues in the consolidated Public Finance and Government Fund Budgets increased by only 2.9 percent yoy, compared to 17.0 percent yoy during the same period in 2018. Partly due to tax cuts (see below), growth in both corporate VAT and import taxes declined. Personal income tax revenue contracted notably by 30.9 percent in the first four months of 2019, compared to an increase of 20.8 percent yoy in the same period last year. Growth in property-related taxes also moderated owing to a weaker real estate market. Overall expenditures rose by 19.8 percent yoy, up from 16.3 percent yoy in January-April 2018.

At the National People's Congress in March 2019, the government announced new tax and fee reductions and a higher limit for local government on-budget borrowing. The new measures include additional VAT rate cuts and lower corporate social security contribution rates. The Ministry of Finance estimates that the total tax cuts in 2019 will amount to about 2.0 percent of GDP. In the investment-oriented Government Fund Budget, the limit for local government special bond issuance was raised by RMB 800 billion (0.8 percent of GDP) to RMB 2.15 trillion. Higher bond quotas will partly offset lower land-lease revenues. In 2019, the authorities plan to increase land-lease revenues, the main source of local government revenues, by just 3.0 percent, compared to 25.0 percent in 2018. Adding all four budgets together, the projected consolidated deficit may reach 5.9 percent of GDP in 2019, if local governments meet their annual special bond quotas. The fiscal stance of the general government would also depend on the level of off-budget spending for public projects.

Figure 14: Budget deficit and estimated off-budget public infrastructure spending

(percent of GDP)



Note: Off-budget infrastructure investment is estimated by subtracting on-budget infrastructure investment from total SOE fixed-asset investment in transport, water, environment, and utility management.

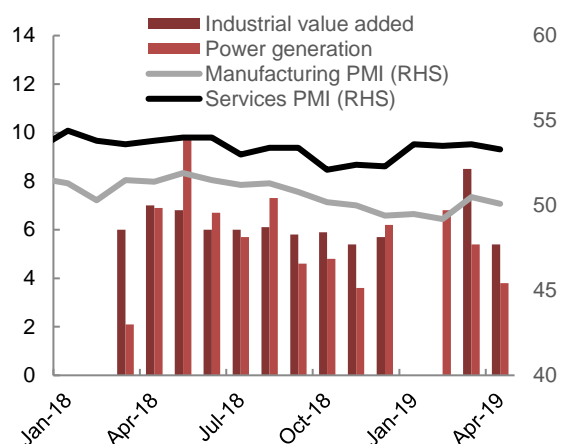
Source: Ministry of Finance, NBS, World Bank staff calculations.

5. Renewed trade tensions cloud the economic outlook

The World Bank forecast for GDP growth in 2019 remains unchanged at 6.2 percent (Table 2). The projections reflect several factors. On the upside, there was a positive surprise in actual GDP growth in the first quarter and a larger-than-expected fiscal stimulus announced in the 2019 Budget. Higher US tariffs on exports worth US\$200 billion, heightened uncertainty from the escalation in trade tensions, and weaker global growth (see Box 1) are expected to have a negative effect on China's outlook. The World Bank estimates that the increase in tariffs on China's exports to the US on May 10 would decrease GDP by about 0.2 percent. High-frequency indicators for China reflect the rising economic uncertainty. While in the first quarter of 2019 average monthly data was somewhat better than in Q4 2018, in April most indicators weakened (Figure 15).

Figure 15: Monthly economic activity indicators

(real growth, percent yoy, LHS; index>50 indicates improving activity, RHS)



Note: Some observations for January and February are not available.
Source: NBS.

In 2020, growth is expected to slow further to 6.1 percent, down from 6.2 percent forecasted previously. In addition to the negative impact of the new US tariffs on exports, the escalation in trade tensions and weaker business confidence, as well as slower-than-expected global trade growth, are projected to weigh on investment in the near term.

Table 2: Macroeconomic indicators and outlook

	2016	2017	2018	2019f	2020f	2021f
Real GDP growth, at constant market prices (percent)	6.7	6.8	6.6	6.2	6.1	6.0
<i>Contributions to growth (pp):</i>						
Final consumption	4.5	3.9	5.0	4.4	4.3	4.3
Gross fixed capital investment	2.9	2.3	2.1	2.1	2.1	2.0
Net exports	-0.6	0.6	-0.6	-0.3	-0.3	-0.3
Real GDP growth, at constant factor prices (percent)	6.7	6.8	6.6	6.2	6.1	6.0
<i>Contributions to growth (pp):</i>						
Agriculture	0.3	0.3	0.3	0.3	0.3	0.3
Industry	2.6	2.4	2.4	2.2	2.1	2.0
Services	3.9	4.0	3.9	3.7	3.7	3.7
Inflation (average percent change in Consumer Price Index)	2.0	1.6	2.1	2.2	2.0	2.0
Current account balance (% of GDP)	1.8	1.6	0.4	-0.1	-0.3	-0.5
Financial and capital account (excl. reserves) (% of GDP)	-3.7	0.9	1.0	0.2	0.6	0.7
Net foreign direct investment (% of GDP)	-0.4	0.2	0.8	0.5	0.5	0.5
Consolidated fiscal balance (% of GDP) *	-3.0	-2.5	-3.9	-5.9	-4.0	-3.7

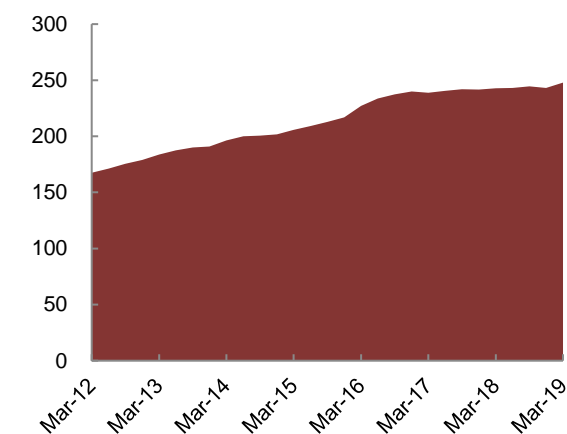
Note: f-forecast. * The consolidated fiscal balance = Public Finance Budget balance + Government Fund Budget balance + Social security and SOE Fund net revenues - Net withdrawal from Stabilization Fund. Numbers may not add up due to rounding.

Source: Ministry of Finance, NBS, SAFE, World Bank staff calculations and projections.

High leverage remains the key domestic risk, as tighter financial conditions have contributed to higher debt distress in companies with weaker balance sheets. Monetary policy and regulatory measures implemented since late 2016 have mitigated the risk of further debt build-up. Non-financial sector domestic debt to GDP has stabilized below 250 percent of GDP (Figure 16).⁴ However, lower market liquidity, higher credit standards, and a weaker economy since 2017 have contributed to a larger number of implicit debt defaults, bankruptcy cases, and actual bond defaults. Anecdotal evidence points to a large increase in implicit debt defaults such as delayed payments leading to debt restructuring. Furthermore, according to the Supreme People's Court, 18,823 cases of compulsory liquidation and bankruptcy were filed in 2018, sharply up from 5,665 in 2016 and 9,532 in 2017. Bond defaults are on the rise too. According to WIND Info, China's corporate bond default rate was 0.7 percent in the January-April 2019, up from 0.3 percent in 2017 and 0.6 percent in 2018 (Figure 17). By comparison, the average bond default rate was 1.5 percent in 1981-2018 for the S&P global sample of rated companies.⁵ While the number of defaults and bankruptcies is still relatively small, careful liquidity management by the PBOC would be crucial in ensuring that corporate debt distress does not become a systemic threat.

Figure 16: Non-financial sector domestic debt to GDP

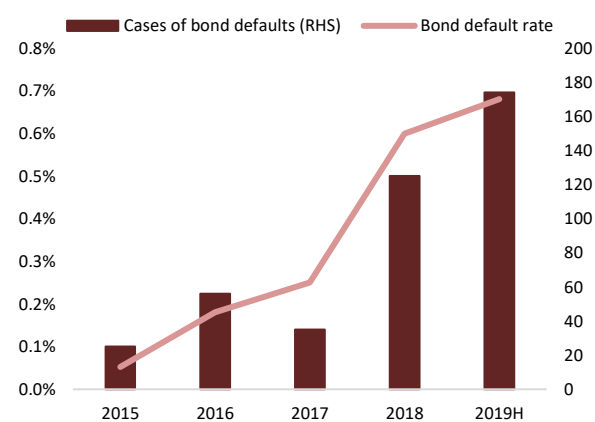
(percent of 4-quarter rolling GDP)



Source: PBOC, NBS, World Bank staff calculations.

Figure 17: Bond defaults

(percent, LHS; number of cases, RHS)



Note: The default rate measures the value of defaults as a percentage of the overall market.

Source: WIND Info, World Bank staff calculations.

The other significant challenge for macroeconomic management is heightened external risks. These stem both from a weaker-than-expected global outlook in the near term and from the escalation in US—China trade tensions. The World Bank estimates that 25-percent tariffs on China's remaining goods exports to the US (worth about US\$300 billion) could reduce GDP by an additional 0.5 percent. But these additional tariffs and their growth impact are not included in the baseline projections above. The World Bank also expects that the government will provide further stimulus if necessary, which will partly offset the negative impact of the trade restrictions.⁶ While the direct economic impact of the trade measures is expected to be manageable, the effect of a wider trade war and higher investor risk aversion could be significant.

⁴ The external debt of China's non-financial sector is small at 8.2 percent of GDP in 2018.

⁵ S&P, 2019, "Default, transition, and recovery: 2018 annual global corporate default and rating transition study," <https://www.spratings.com/documents/20184/774196/2018AnnualGlobalCorporateDefaultAndRatingTransitionStudy.pdf>. US firms comprise almost half the sample.

⁶ Recent empirical estimates for China suggest that the fiscal expenditure multiplier remains sizeable, with the multiplier on investment stronger than the one on consumption. In 2010-2015, the fiscal multiplier was 1.4 (Chen et al., 2017). See World Bank (2018b) for a discussion of the effectiveness of fiscal spending in China.

Simulations suggest that the long-term impact of a 25-percent tariff on all China-US trade, coupled with a 0.5 pp decline in the ratio of investment to GDP, could be a 9.3 pp fall in China's export revenues and 3.5 pp decrease in GDP compared with a baseline of no trade war (Freund et al., 2018)

The scope for additional monetary easing is somewhat constrained by both external and domestic factors.

While a lower expected US Federal Reserve policy rate provide some space for lower interest rates in China, high external risks and currency depreciation pressure limit the scope for rate cuts. Renminbi depreciation cushioned some of the impact of higher trade tariffs and supported the competitiveness of China's exports in 2018. Exchange rate flexibility, with central bank interventions limited to smoothing excess volatility, is an important tool to mitigate external risks. In addition, the authorities remain focused on limiting financial risks, which also constrains monetary policy.

There is fiscal space at the central government level to respond to a larger-than-expected growth slowdown.

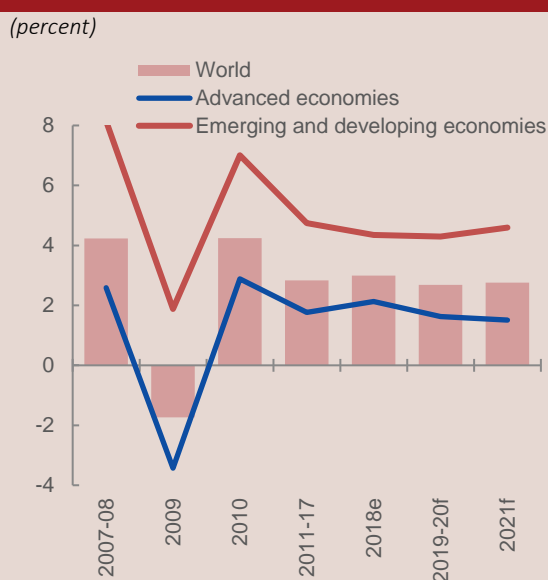
However, any increases in local government spending should be appropriately funded either through on-budget borrowing or by higher fiscal transfers from the central government. In addition, stimulus could target higher and more efficient spending on health, education, and social protection rather than on investment in areas with low return (World Bank, 2018b). The government's continued commitment to addressing the challenges associated with off-budget borrowing is evident in new government investment rules which will take effect on July 1.⁷ The rules specify that public investment should be channeled to sectors where resources cannot be effectively allocated by the market: social services, public infrastructure, agriculture and rural sectors, environmental protection, potential areas of significant technical advancement, social management, and national security. Government departments are also prohibited from illegal borrowing and investing beyond their pre-determined budgets.

Over the medium term, China's transition to more sustainable growth depends on deepening reforms to increase the role of markets, the private sector, and competition. Building on the business climate reforms introduced in 2018, enforcing fair competition and financial discipline, and reducing administrative costs will lower costs and encourage more investment. A new foreign investment law approved in March 2019 addresses some concerns about intellectual property rights and foreign investor protection, but its impact will depend on how the law is interpreted and implemented by government officials and the courts. China could also commit to further shorten the negative investment list and limit it to industries involving national security, which would reinforce the country's commitment to the rules-based multilateral trading system. These policies will reduce inefficiencies in the allocation of resources and drive productivity-led and greener growth in the future.

⁷ www.gov.cn/zhengce/content/2019-05/05/content_5388798.htm

Box 1: World Bank global outlook and risks

Global growth is expected to edge up to 2.7 percent in 2020 and to 2.8 percent in 2021, from a 2.6 percent dip in 2019. The global economic growth rate is projected to slow to 2.6 percent in 2019, reflecting a broad-based weakness in advanced economies and major Emerging Market and Developing Economies (EMDEs) at the start of the year. As recent softness abates, global growth is projected to gradually edge up to 2.8 percent on average in 2020-21 (Figure 18). Growth in advanced economies is projected to moderate from 2.1 percent in 2018 to 1.6 percent on average in 2019–2021 toward its potential rate, as capacity constraints become more apparent and labor markets tighten. Growth in EMDEs is projected to slow to 4.0 percent in 2019 before recovering to 4.6 on average in 2020-21. This forecast assumes a waning impact of financial pressures currently weighing on activity in some large EMDEs (e.g., Argentina and Turkey).⁸

Figure 18: Real GDP growth

Source: World Bank Global Economic Prospects, June 2019 (forthcoming).

Figure 19: Global GDP and global trade volume growth

Source: World Bank Global Economic Prospects, June 2019 (forthcoming).

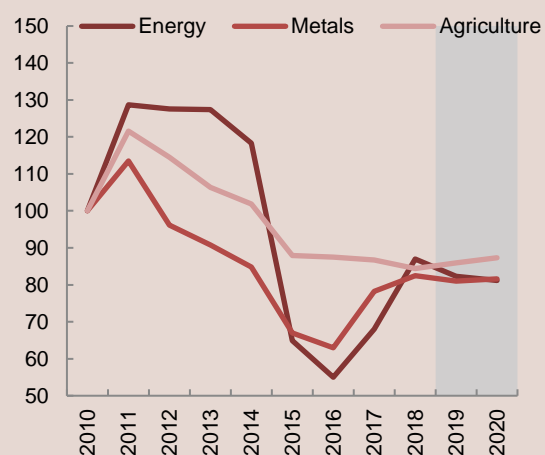
Global economic conditions are expected to remain challenging over the forecast period. The increase in tariffs by China and the US that were announced in May 2019 are likely to have more severe effects than tariff hikes implemented in 2018. Beyond economic losses for the affected exporters, the escalation in trade tensions is contributing to heightened policy uncertainty, which is expected to dent confidence and investment. Barring a renewed escalation of trade tensions, global trade growth is projected to weaken from 4.1 percent in 2018 to 2.6 percent in 2019, and then stabilize at 3.2 percent on average in 2020-21 (Figure 19). This forecast is predicated on new stimulus measures implemented in China and, to a lesser degree, the Euro Area; and firming domestic demand in some EMDEs. This modest rebound notwithstanding, global trade is expected to be weaker than previously envisaged over the forecast horizon, reflecting a softer outlook for global investment and evidence of a lower income elasticity of trade.

⁸ These are working assumptions which will be finalized and published in the June 2019 Global Economic Prospects (World Bank, forthcoming).

Global financing conditions are expected to remain volatile, even if generally more supportive. This reflects a more accommodative monetary policy stance adopted by major central banks in the near term due to the deteriorating global growth prospects. Financial market volatility will continue to have the strongest impact on countries with high vulnerabilities, weak growth prospects, and elevated policy uncertainty. An eventual rise of advanced-economy yields would have a negative effect on capital flows to EMDEs. Policy uncertainty, geopolitical risks, and security concerns could also continue to adversely impact EMDE capital inflows. Oil prices are expected to average US\$66 per barrel in 2019 and US\$65 in 2020, with high uncertainty around the outlook. Overall, metals prices are expected to decline slightly in 2019 and 2020, reflecting a weaker outlook for global metal demand. Agricultural prices are expected to decline in 2019 and stabilize in 2020 (Figure 20) (World Bank, 2019).

Figure 20: World commodity price forecast

(index=nominal U.S. dollars, 2010=100)



Source: World Bank Commodity Markets Outlook, April 2019.

There is considerable uncertainty around the outlook for the global economy. Risks remains firmly on the downside and have recently intensified, reflecting the escalation in trade tensions amid heightened global uncertainty. Although unlikely in the near term, the simultaneous occurrence of a sharper-than-expected slowdown in China, Euro Area, and the United States could trigger a significant downturn in global activity. Further escalation in trade tensions could be highly disruptive to global value chains. The risk of severe and broad-based financial stress adversely affecting the outlook for EMDEs remains high amid elevated debt levels in many countries. Policy uncertainty and geopolitical risks are high and could negatively impact confidence and investment globally. Policy uncertainty is particularly elevated in a number of European countries—including in the United Kingdom as it transitions out of the European Union.

B. Medium-Term Development Agenda

1. China's changing role in global trade and investment

China's rapid economic expansion and integration into the world economy has made the country an essential part of the global economic landscape. China is the world's largest exporter of manufactured goods and a major destination for foreign investment. Outbound investment has also grown rapidly in recent years, including as part of the Belt and Road Initiative. China's production, trade, and investment are deeply integrated in the global value chains (GVCs). In recent years, its economy has generated about 30 percent of global growth and two thirds of growth in the East Asia Pacific region. Hence, economic developments and policy choices in China – in terms of trade and investment, but also with respect to domestic demand – today have a considerable global impact.

In recent years, China's role in international trade has begun to shift: not only is the country a leader in both low-skilled and high-skilled manufacturing, but also an increasingly important source of final demand. China is moving into higher value-added sections of the GVCs. At the same time, because it produces more of the value added of its exports domestically, its share of global labor-intensive exports in terms of value added remains high. Today China is the world's top exporter in all three types of industries: low-skilled labor-intensive, medium-skilled, and high-skilled innovators. Finally, China is also an increasingly important source of final demand, in particular for Asian countries, an aspect rarely noted in discussions on the changing trade climate.

Building on its enormous success, China can continue to benefit from global integration, which is why the efforts to resolve ongoing trade tensions are crucial. China still has significant room for catching up to the productivity and private capital per worker levels of high-income countries (World Bank, 2018a). China's total factor productivity is less than half the US level, and it still lags several other middle-income countries (DRC and World Bank, forthcoming). Restrictions on China's access to the US market could lead to less outsourcing to China and lower foreign investment in manufacturing in the future. In addition, concerns in the US and in other trading partners over technology transfer and reciprocity in investment conditions may limit China's access to global technologies and skills.

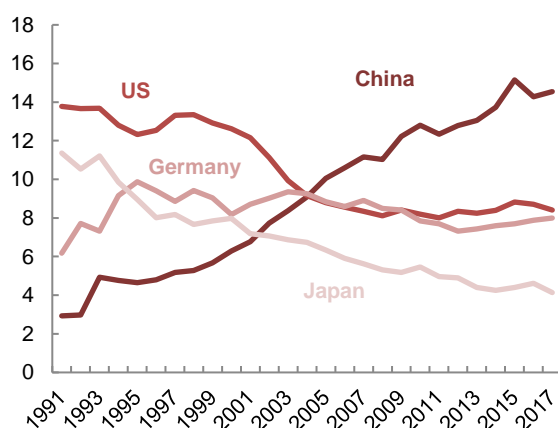
a. A major global manufacturing hub

China has become the world's largest exporter of manufacturing goods. In 1996-2017, China's exports soared by 14 percent per year and its export market share – both in gross and in value added terms – increased significantly (Figure 21). The contribution of China's exports to its growth fell with the slowdown in world trade after the global financial crisis, but its share of global trade rose. China's share of global merchandise exports increased from less than 5 percent in 1996 to 14.5 percent in 2017.

The country has evolved from a peripheral actor to a major global manufacturing hub for the GVCs. Over the years, China invested heavily in transportation, internet, information and communication technology (ICT) related

Figure 21: Share of global trade in goods by country

(percent of total world imports)

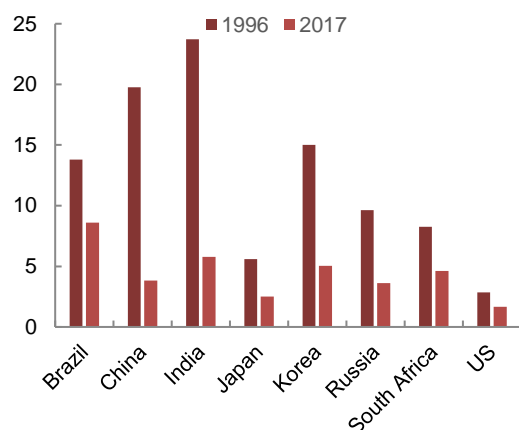


Source: WITS.

infrastructure. The country ranks 26th globally in the World Bank's Logistics Performance Index, performing particularly well with respect to the quality of trade-related infrastructure and the ease of arranging competitively priced shipments. China also implemented reforms to improve trade facilitation and the business environment and to attract foreign investment. Import tariffs were significantly reduced from a weighted average of 20 percent in 1996 to 3.8 percent in 2017 (Figure 22). Integration into GVCs helped improve firm productivity and competitiveness. As a result, today China is one of three main global manufacturing hubs; the others are the US and Germany (Figure 23).

Figure 22: Trade-weighted average applied tariff

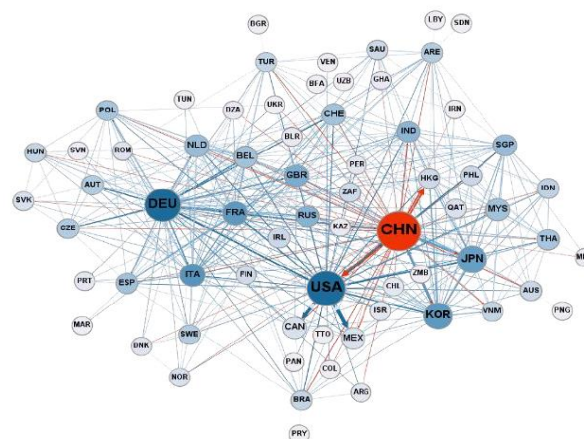
(percent)



Note: WITS.

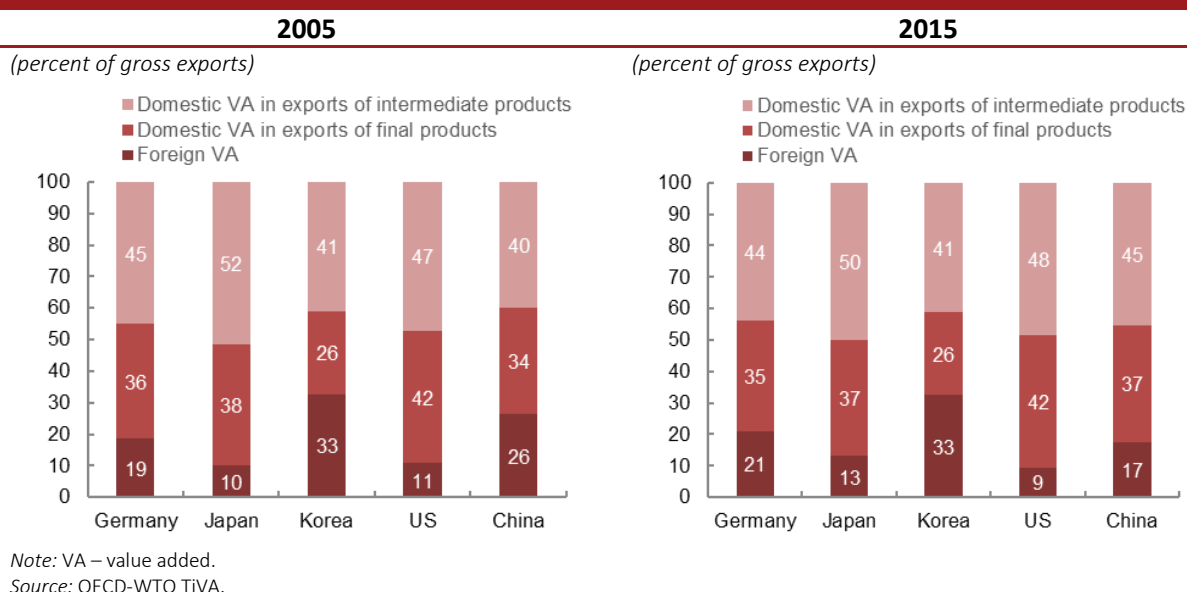
Figure 23: Global manufacturing hubs

(trade network for intermediate goods in 2016)



Source: DRC and World Bank (forthcoming).

Figure 24: Value added content of gross exports



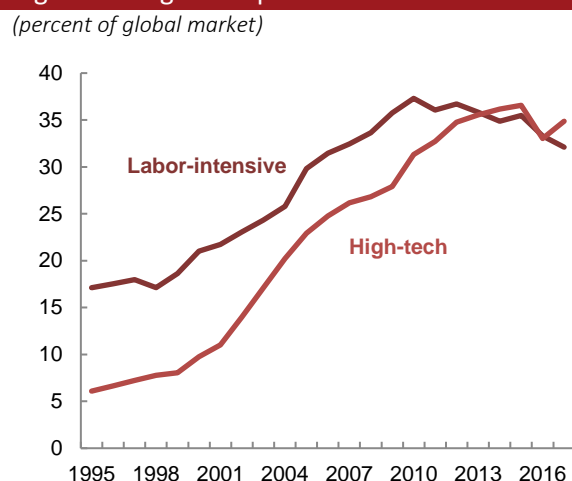
Note: VA – value added.
Source: OECD-WTO TIVA.

As China's importance as a manufacturing hub has grown, its role in GVCs has changed. The foreign value added content of China's exports declined from 26 percent in 2005 to 17 percent in 2015 (Figure 24). Rather than being a last stage assembler, China produces more of the value added of its exports domestically. The domestic value added content of exports of computer and electronic equipment and instruments, albeit lower than the average for all exports, increased from 60 percent in 2005 to 73 percent

in 2015. Furthermore, China increasingly supplies intermediate inputs for production in other countries: 45 percent of gross exports in 2015, up from 40 percent a decade earlier. China's GVC participation is shifting toward the upstream links in the chain, closer to the role played by more advanced countries.

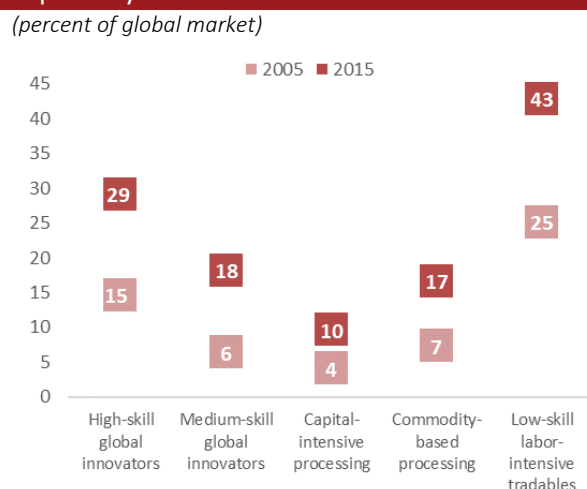
In addition, China's comparative advantage has increased across manufacturing sectors – from low-skill labor-intensive to high-skill innovator industries. In 1995, China was already second behind Italy in the export of labor-intensive manufactures (textiles, apparel, leather products, furniture), and in a few years was ranked first (Hallward-Driemeier and Nayyar, 2018). According to customs trade data, China's global share in the exports of labor-intensive products seems to have declined since 2010 (Figure 25). However, due to the increase in the domestic content of exports, China's market share in labor-intensive exports in terms of domestic value added kept rising from 36 percent in 2010 to 43 percent in 2015. In 2015, China still ranked first globally in the exports of low-skilled labor-intensive products (Figure 26). Furthermore, the country's manufacturing prowess is particularly evident in the rise of medium-skill (machinery, electrical and transport equipment) and high-skill (computing, electronics, optical and pharmaceutical products) innovator industries. China is the top exporter in both groups of manufacturing subsectors.⁹

Figure 25: China's share in labor-intensive and high-tech in gross exports
(percent of global market)



Note: Labor-intensive and high-tech are defined in the text.
Source: UN Comtrade and World Bank staff calculations.

Figure 26: China's share of manufacturing exports by domestic value added
(percent of global market)



Source: OECD-WTO TiVA and World Bank staff calculations.

b. An increasingly important source of final demand

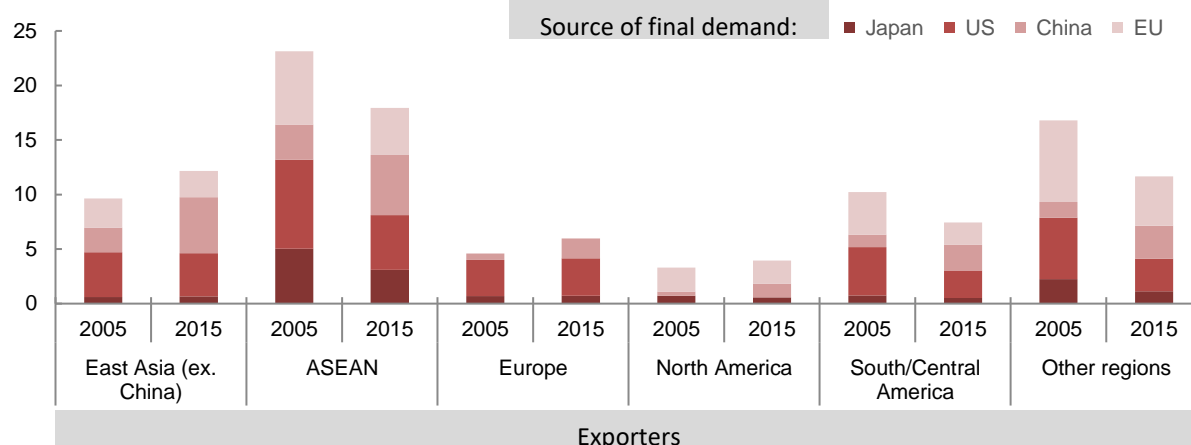
As with its exports, China also produces more of the value added of its domestic demand; nevertheless, it has become a significant source of final demand. The share of foreign value added in China's final demand (consumption plus investment) declined from 20 percent in 2005 to 14 percent in 2015. At the same time, the size of China's economy and its rapid growth have led to a substantial expansion in the demand for imports. Exposure to final demand from China has grown across regions, most importantly in Asia (Figure 27). While 3.2 percent of ASEAN's value added was exported to China as a final destination in 2005, this

⁹ In 2015, China also ranked first in commodity-based processing (food processing, wood products, paper products, basic metals, fabricated metal products, nonmetallic mineral products, and rubber and plastic products) and second in capital-intensive processing industries (chemical products and refined petroleum products). The grouping of manufacturing subsectors follows the methodology of Hallward-Driemeier and Nayyar (2018) and is based on certain subsector characteristics such as employment share, value added per worker, R&D intensity, etc.

share increased to 5.5 percent in 2015. Final demand from China contributed more than 5 percent of valued added in East Asia excluding China in 2015, more than double the share in 2005. While Asian countries are now more dependent on consumers in China, they are less dependent on Western demand. China has overtaken the US, Japan, and the EU to become the largest source of final demand for East and South-East Asia.

Figure 27: Domestic value added dependent on final demand from the EU, Japan, US, and China

(percent of exporting region value added)

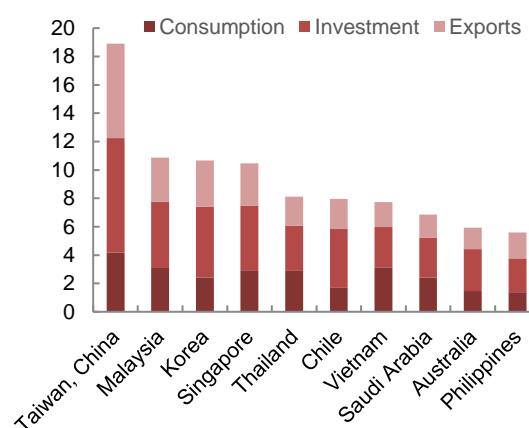


Source: OECD-WTO TiVA and World Bank staff calculations.

For some countries, mainly in Asia, China has become a crucial trading partner. In 2015, 19 percent of the economy of Taiwan, China, depended on demand from China: 12 percent for domestic consumption and investment and close to 7 percent as inputs into China's exports (Figure 28). Over 10 percent of the value added of Malaysia, Korea, and Singapore was also destined for China. For now, the exports of capital goods from relatively more advanced countries and commodities from major commodity exporters (Chile, Saudi Arabia, and Australia) dominate the trade relationship. As China's economy gradually rebalances away from an export- and investment-led growth model, its import basket is expected to contain more consumer goods.

Figure 28: Domestic value added exported to China, by expenditure component

(percent of source country value added in 2015)



Source: OECD-WTO TiVA and World Bank staff calculations.

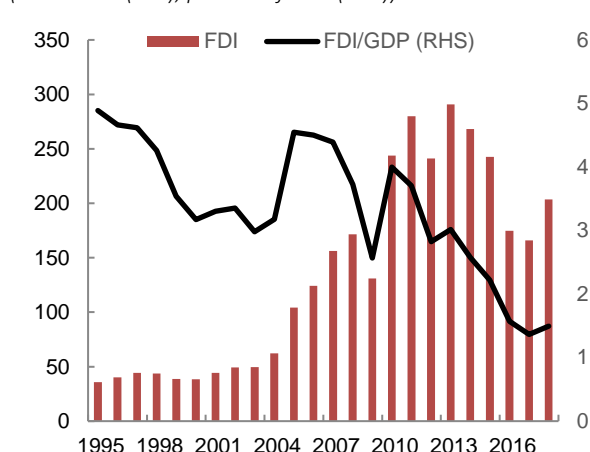
c. The evolution of FDI flows

While China remains among the top FDI recipients in the world, FDI inflows have declined in recent years due to factors of both temporary and structural nature. In 2000-2009, the country attracted 6.5 percent of global FDI. That share doubled to 12.9 percent in the following five years. In 2015, a weaker domestic growth outlook, equity market turmoil, and Renminbi devaluation lowered business confidence and contributed to an investment slowdown. China's share of global FDI fell to an average of 8.6 percent in 2015-17. As the

domestic economy continued to grow rapidly, FDI inflows as a share of GDP also declined from 3.7 percent in the decade before the global financial crisis to 1.5 percent in 2016-2018 (Figure 29). Some of the reasons for lower FDI – like the 2015-16 investment slowdown – may prove to be temporary (for example, the ongoing trade tensions and concerns over market access and the business climate). Others are long-term: China’s attractiveness as an FDI destination may be eroding with rising labor and land costs, stronger competition from domestic firms, and stricter environmental standards (Figure 30).

Figure 29: FDI inflows into China

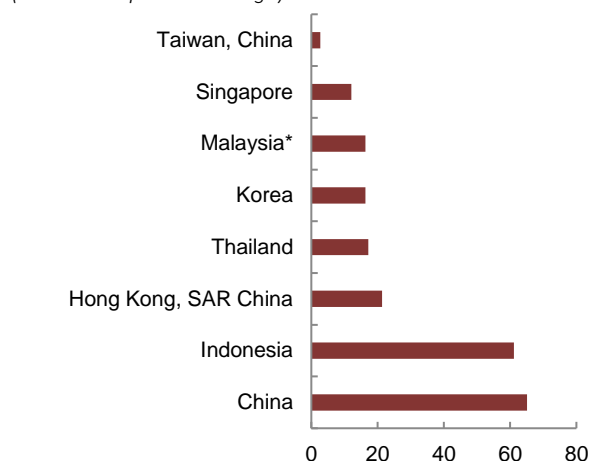
(USD billion (LHS), percent of GDP (RHS))



Source: State Administration of Foreign Exchange and World Bank staff calculations.

Figure 30: The rise in unit labor costs between 2010 and 2017

(cumulative percent change)



Note: * Manufacturing unit labor costs.

Source: National statistical offices and World Bank staff calculations.

To attract FDI, China has liberalized its investment regime, but foreign investor concerns persist. The FDI Catalogue, which lists industries encouraged, restricted, or closed to foreign investment, had 93 restricted sectors in 2015 and 48 in 2018. In 2017, China began to move towards a national negative list for FDI which restricts foreign investment in listed sectors but requires equal treatment of domestic and foreign firms in the rest of the economy. China’s Free Trade Zones are covered by a shorter negative list, with 45 restricted sectors in 2018. As a result, China’s score in the FDI restrictiveness index improved from 0.43 in 2011 to 0.32 in 2017. However, it still has the fourth most restrictive investment regime out of 63 countries assessed by the OECD.

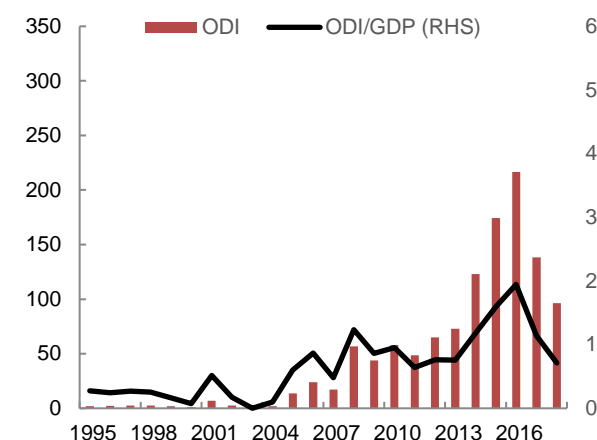
China is gradually evolving into a major source of direct investment too. Outbound direct investment (ODI) has risen sharply in recent years (Figure 31). China is a relative newcomer as a foreign investor; hence, the ratio of the stock of ODI to GDP is still relatively low. According to UNCTAD data, China’s ODI accounted for 4.8 percent of the global ODI stock in 2017, up from only 0.3 percent in 2000. China’s investment is critically important for some developing countries such as Cambodia, Laos, and Mongolia (Figure 32).

Furthermore, the composition of ODI has changed over the past years. While China’s engagement in developing countries still consist primarily of construction contracts, other investment, diversified across sectors, is gaining share. Acquisition of natural resources is no longer the main motivation for China’s overseas investment. In 2003-2007, mining accounted for almost a third of China’s ODI tracked by the Ministry of Commerce. In the last five years, the share of mining declined to 6 percent. Instead, access to new markets, technologies, and global distribution networks is increasingly important. While trade tensions have contributed to a decline in China’s investment into the US since 2017, China’s investment in other advanced countries (Germany, the UK) has risen (World Bank, 2018). Reportedly, Chinese investors have

diverted technology-related investment from the US as concerns over potential investment restrictions have grown.

Figure 31: China's ODI

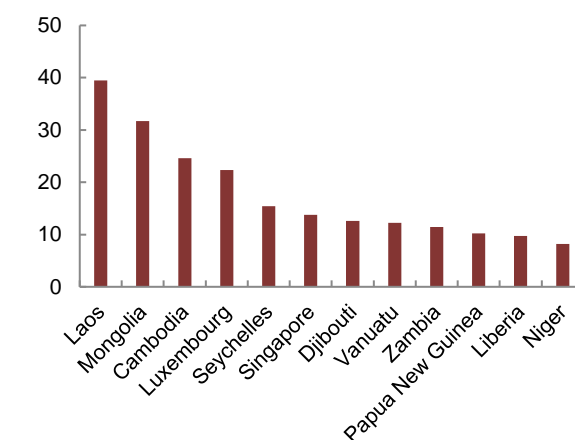
(USD billion (LHS), percent of GDP (RHS))



Source: State Administration of Foreign Exchange and World Bank staff calculations.

Figure 32: Cumulative direct investment from China in 2003-2017

(percent of 2017 GDP)



Source: China's Ministry of Commerce, WDI and World Bank staff calculations.

d. Opportunities and challenges of further global integration

The evidence above showed that industrial upgrading and rising wages have not yet resulted in production relocation to low-wage countries, though this remains a possibility in the future. China is moving up from the lower-value-added end of GVCs but, despite declining competitiveness in terms of unit labor costs, it has not yet “moved out” of these sectors. Investors’ relocation decisions likely reflect the combination of benefits from China’s established ecosystem of suppliers, workforce skills, and business culture in addition to cross-country wage differentials (Hallward-Driemeier and Nayyar, 2018).

At the same time, China’s gradual rebalancing from investment to consumption is likely to create opportunities for exporters of final goods. In the past, other countries’ exports to China often followed the rise and fall in demand in advanced countries, as China assembled textiles and computer and electronic products destined to those markets (Pula and Peltonen, 2009). However, today China is already Asia’s most important source of final demand. Therefore, domestic policies will have an increasingly significant impact on the region and globally.

Finally, as China is still catching up to the global technology frontier, it needs to access foreign technologies, and this has become more challenging in recent years. Despite being among the global leaders in technologies such as e-commerce, artificial intelligence, fintech, high speed trains, renewable energy and electric cars, China remains behind the advanced and some upper middle-income countries in terms of aggregate productivity. FDI and ODI in advanced manufacturing and high-end services can drive technological innovation and industrial upgrading in China. However, China’s overseas investment expansion has raised concerns in advanced countries over reciprocity in investment conditions. Working together with trading partners to address emerging challenges in global trade and investment rules is of crucial importance.

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