

Asia and Pacific Department

# Overview of the IMF's Annual Consultation with China



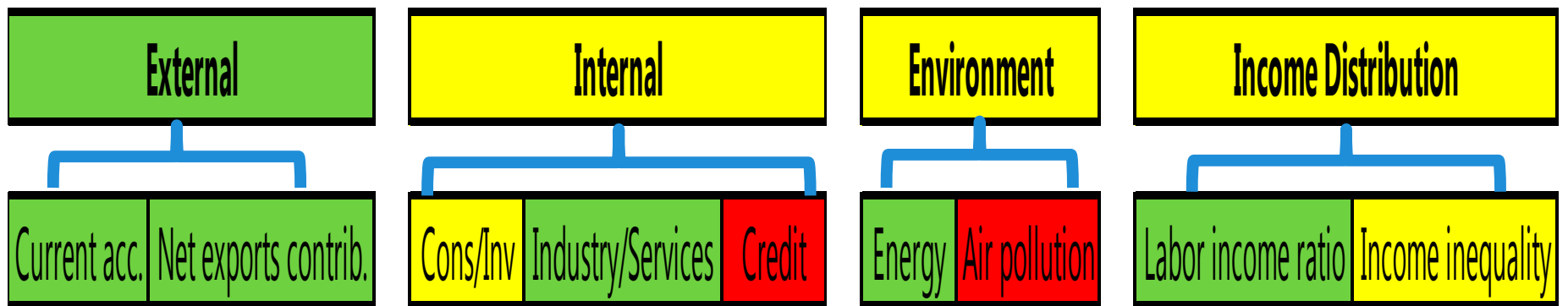
September, 2016

# Overview

- ❑ Economy becoming more balanced in many areas and reforms progressing
- ❑ But critically, credit growth remains excessive and SOE reforms have lagged
- ❑ Which clouds the outlook, threatening growth and financial stability
- ❑ And which requires urgent action to address:
  - Tackle the corporate debt problem
  - Stop credit/investment stimulus and allow growth to slow
  - Guard against financial risks
  - Continue to an effectively floating FX regime
  - Strengthen transparency (communications and data)

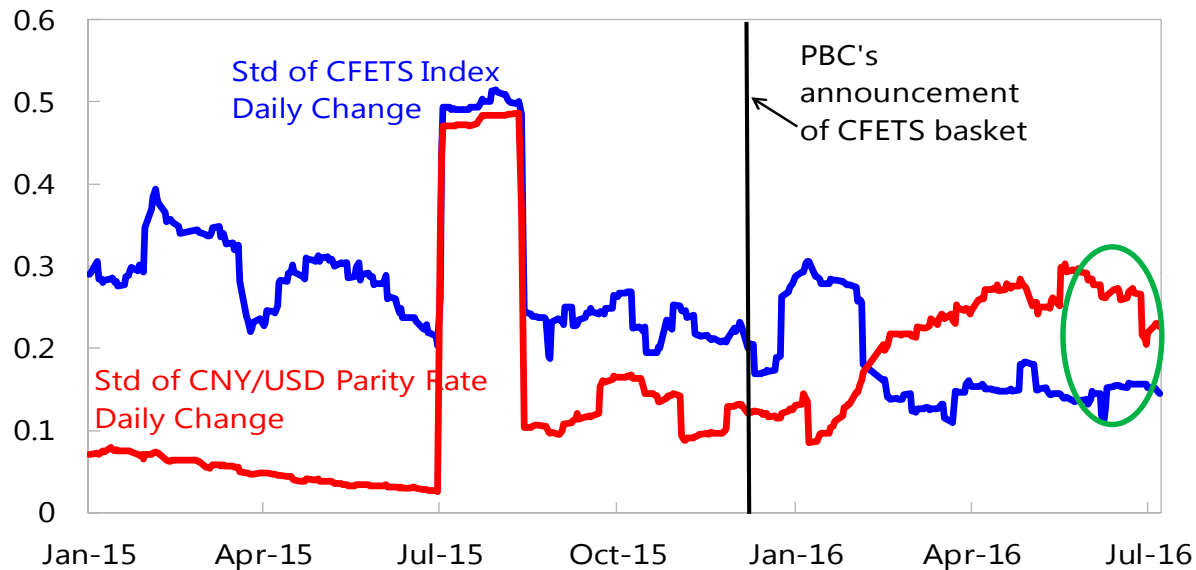
# Mixed Progress on Rebalancing

## Rebalancing Scorecard



# Reform Progress on Many Fronts

## RMB Increasingly Referencing a Basket 1/



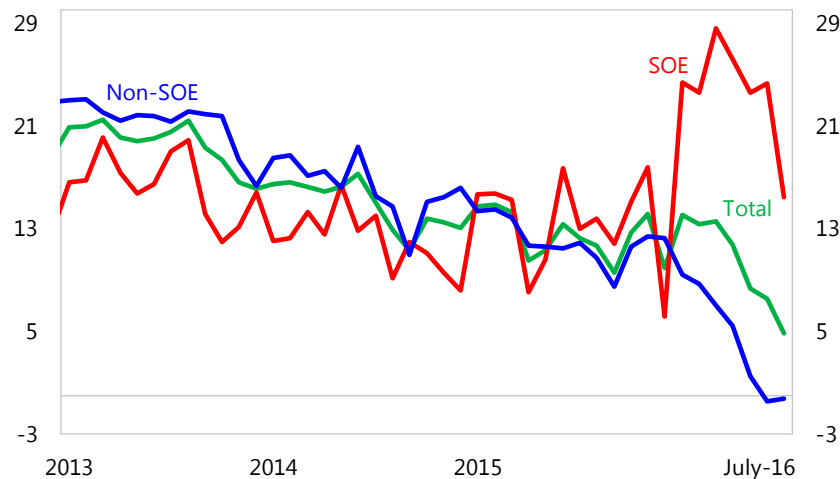
Sources: Bloomberg LP; and IMF staff calculations.

1/ Standard deviation calculated on a 30-business-day forward rolling window.

- Monetary framework
- Fiscal framework
- Urbanization
- New 5-year plan has the right goals
- Also plans to reduce overcapacity/zombie SOEs

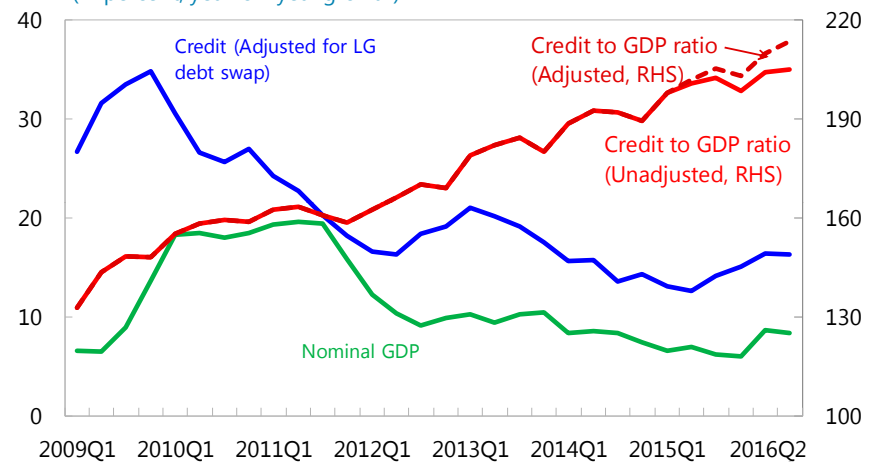
# But Policy has at Times Also Obstructed Reform and Rebalancing

**Real Fixed Asset Investment Growth 1/**  
(In percent, year-on-year)



1/ Deflated by FAI prices; authorities publish quarterly index and staff estimates monthly index.

**Credit: High and Rising 1/**  
(In percent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

1/ Total social financing stock.

- Traditional stimulus – from mid 2015
- Uneven reform progress – especially on governance, SOEs, corporate debt, opening up
- Lack of policy clarity – reform or growth? Eg equity market response/ role of private sector

# Rising Vulnerabilities... Hard Landing in Overcapacity/Regions

## Wide Regional Growth Disparity

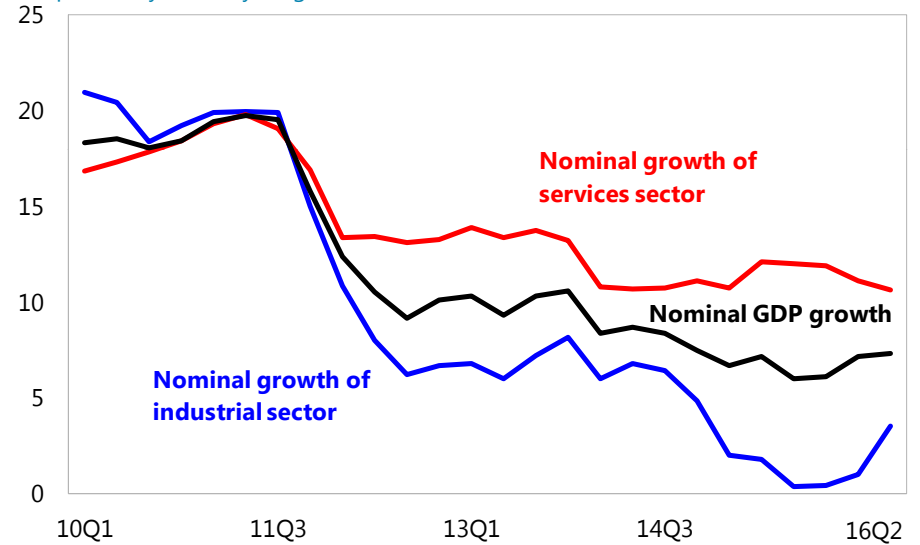
(In percent, year-on-year growth of nominal GDP, 2016H1)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

## Two-speed Economy

(In percent, year-on-year growth)

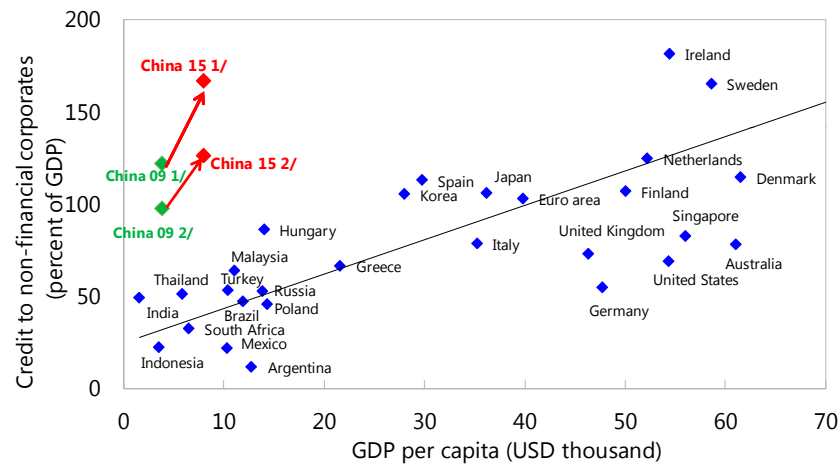


Sources: CEIC Data Company Ltd.; and IMF staff estimates.

# ...High Corporate Debt and Weakening Fundamentals

## Corporate Credit: High vs. Peers

(Selected economies, 2014)



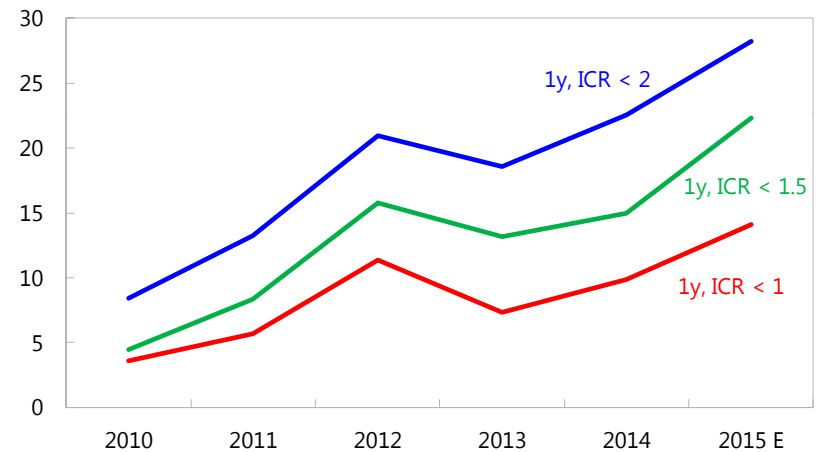
Sources: Bank for International Settlements (BIS); and IMF staff estimates.

1/ Calculated as total social financing minus equity and household loans.

2/ Calculated as total social financing minus equity, LGFV borrowing and household loans.

## China Listed Companies' Potentially Impaired Loans 1/

(In percent of debt)

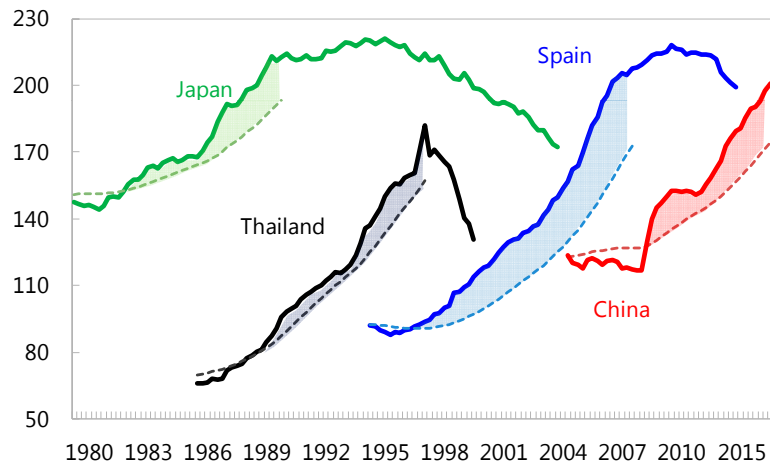


1/ Estimated impaired loans on each ICR standard as a share of total loans in the sample. The sample is from the S&P Capital IQ database.

# ...Large Credit "Gap" and Increasing Credit Intensity of Growth

## Fast Credit Growth and Wide Credit Gap 1/

(In percent of GDP)

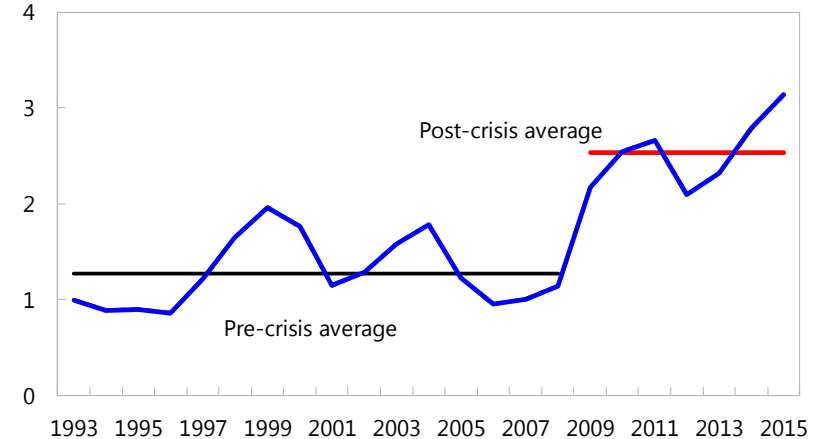


Sources: Bank for International Settlements (BIS); and IMF staff estimates.

1/ Total credit to the private nonfinancial sector. Dotted lines represent the credit trend.

## Credit Intensity Rising Further 1/

(New credit per unit of additional GDP)



Sources: Bank for International Settlements (BIS); *World Economic Outlook (WEO)* and IMF Staff estimates.

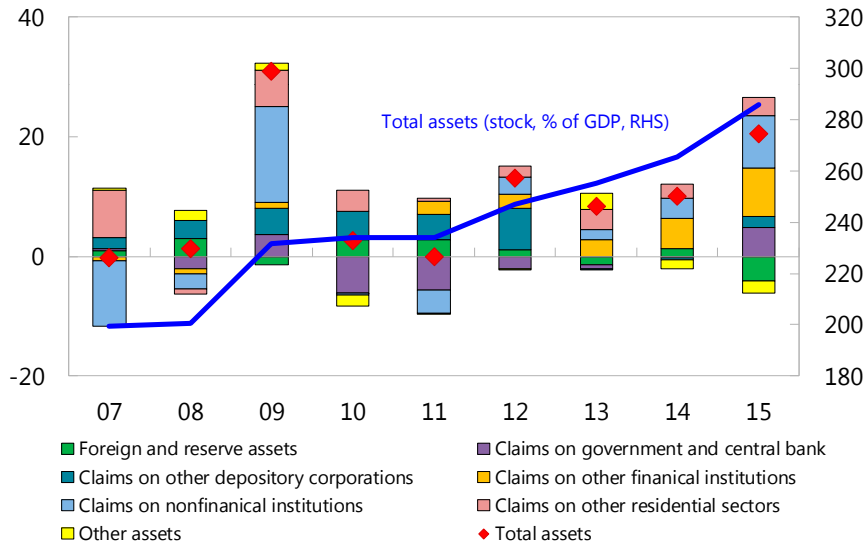
1/ Plotted as 3-year rolling average.



# ...Increasingly Large, Leveraged, Interconnected and Opaque Financial System

## Commercial Bank Balance Sheets Expanding Rapidly

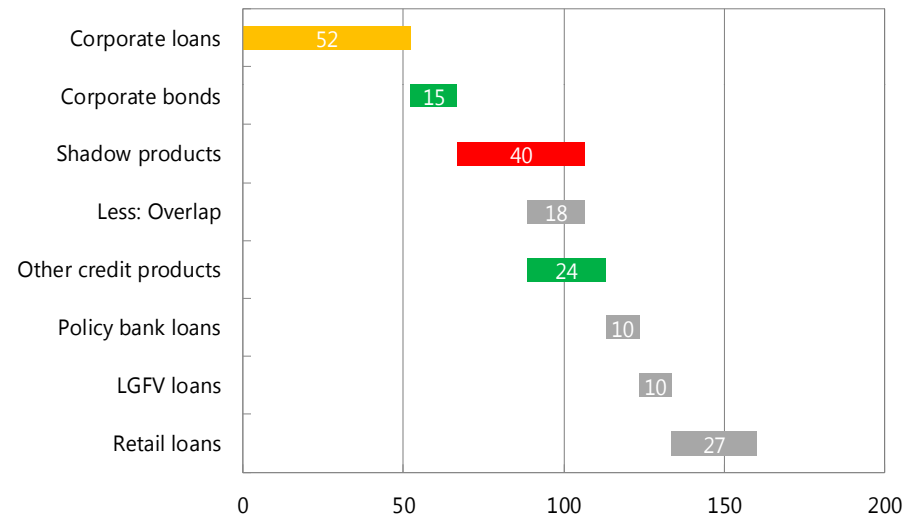
(In percentage points of GDP, year-on-year growth)



Sources: Haver Analytics; and IMF staff estimates.

## Shadow Products in a Credit System Context, 2015

(In trillion of RMB)

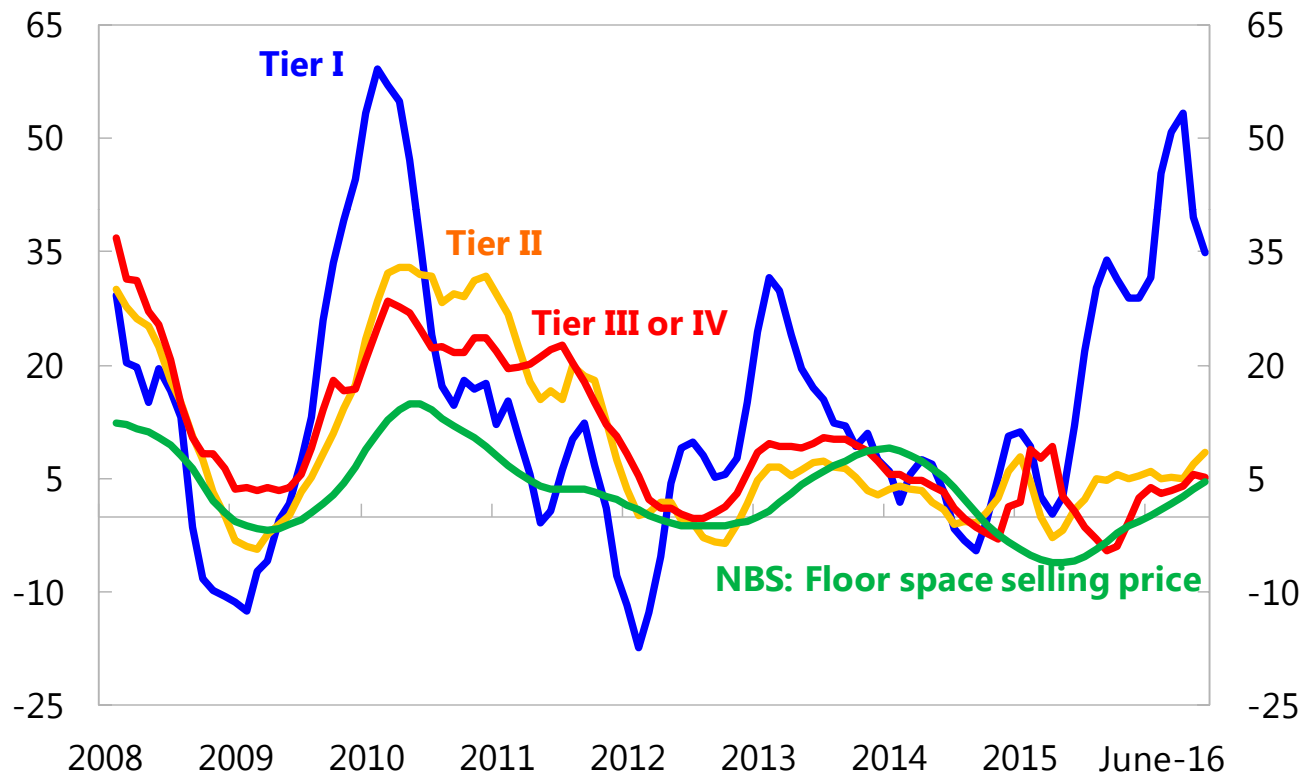


Note: Segments highlighted in red are high-risk, yellow indicates medium-risk, and green is low-risk. Segments in gray are outside the scope of analysis or assumed to be zero-risk.

# ...A Propensity for Asset Price Booms

## Booming Tier 1 House Prices

(In percent, year-on-year growth, 3mma)

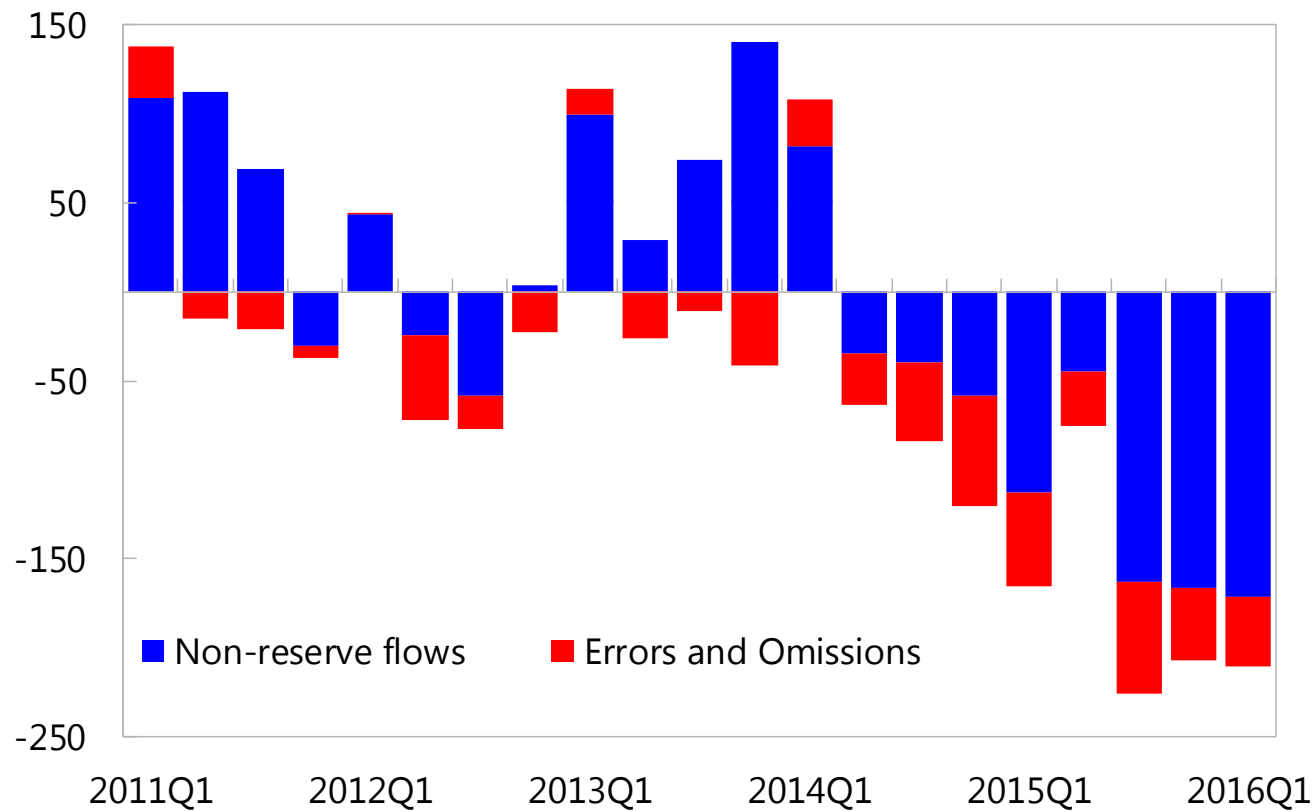


Sources: Fangguanju; and IMF staff estimates.

# ...Significant Capital Outflows

## Financial Account and Errors and Omissions

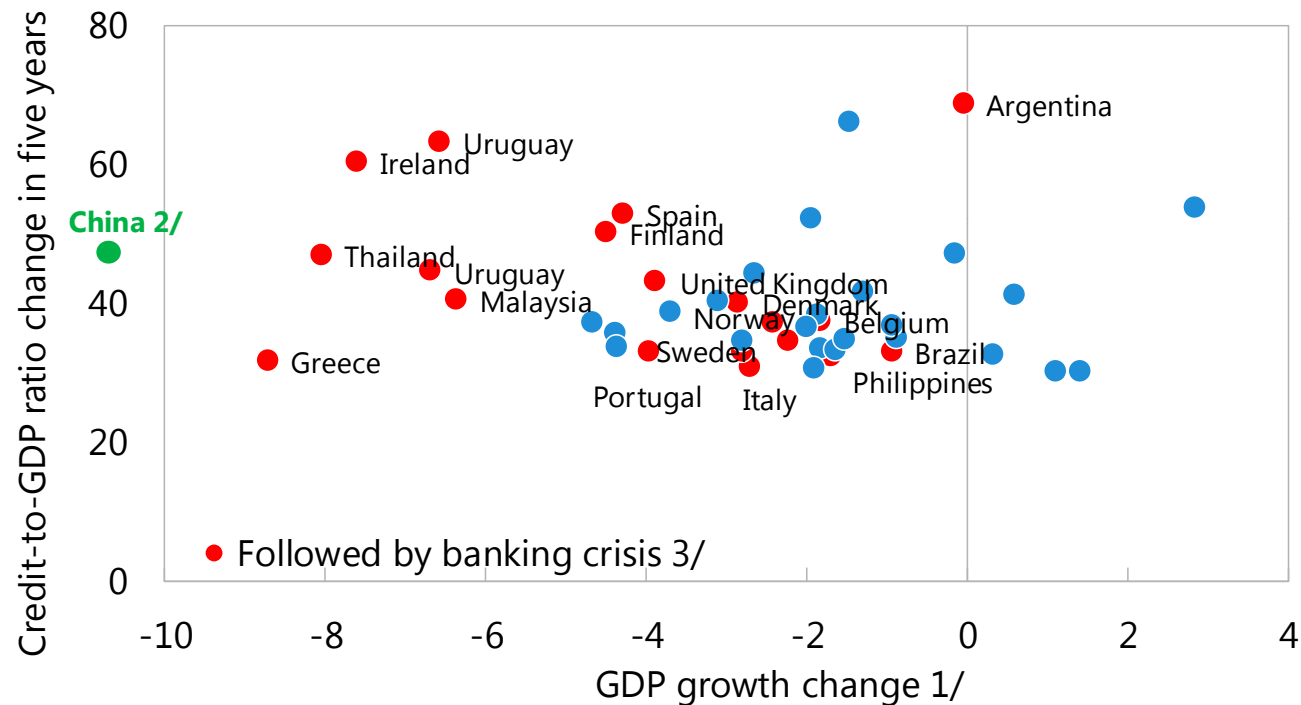
(In billion of US dollars)



# Risks

## Credit Booms Tend to End Badly

(In percentage points)



Source: IMF staff estimates.

1/ Average growth differential between 5-year post-boom and 5-year pre-boom periods.

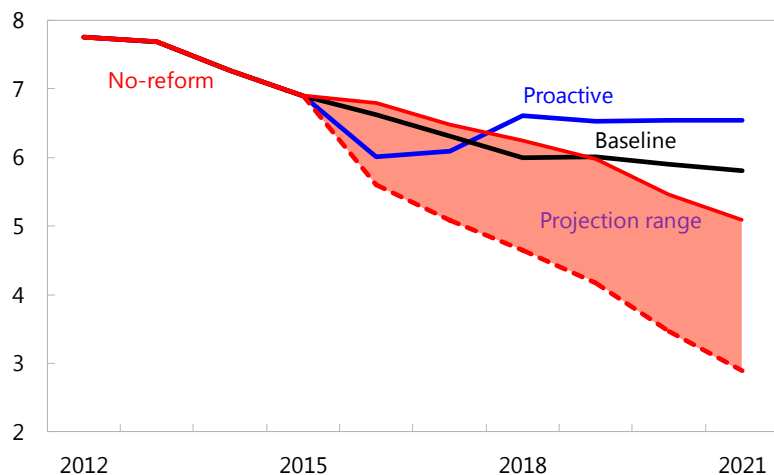
2/ No growth change as China's boom has not ended.

3/ Banking crisis is identified following Laeven and Valencia (2012).

# Outlook—Benign Near-term but Increasingly Weak Medium-term without Reform

## GDP Growth: Illustrative Scenarios

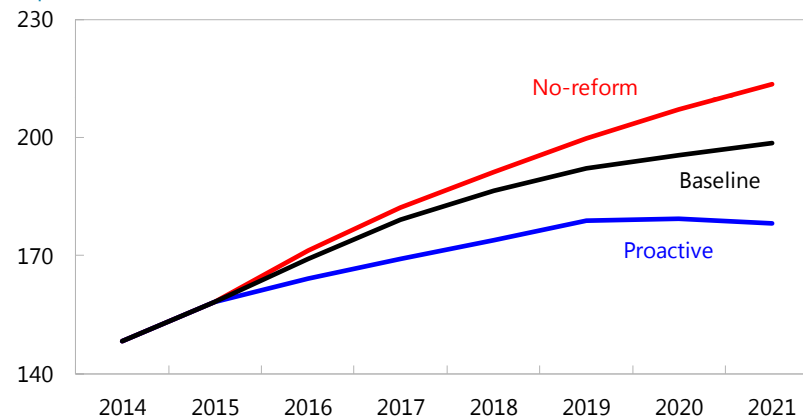
(In percent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

## Credit Ratio: Illustrative Scenarios 1/

(In percent of GDP)



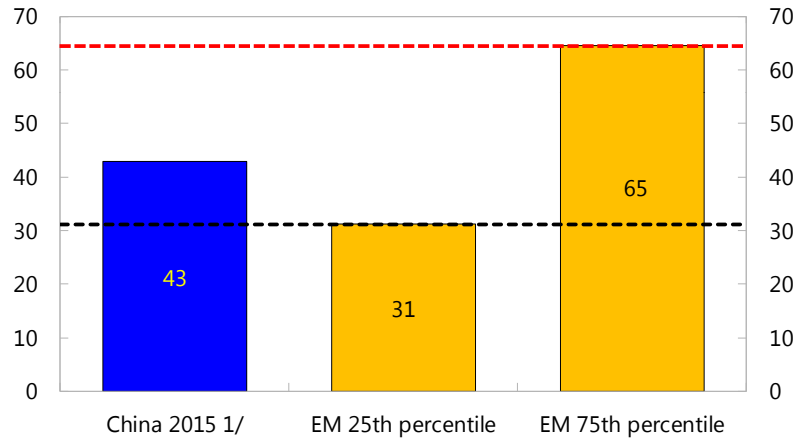
Sources: CEIC Data Company Ltd.; *World Economic Outlook (WEO)* and IMF staff estimates.

1/ Nonfinancial private debt, calculated as total social financing stock adjusted for local government debt swap minus equity financing and LGFV borrowings.

# Buffers still High, but Shrinking Fast

## Gross Government Debt ...Not High

(In percent of GDP)

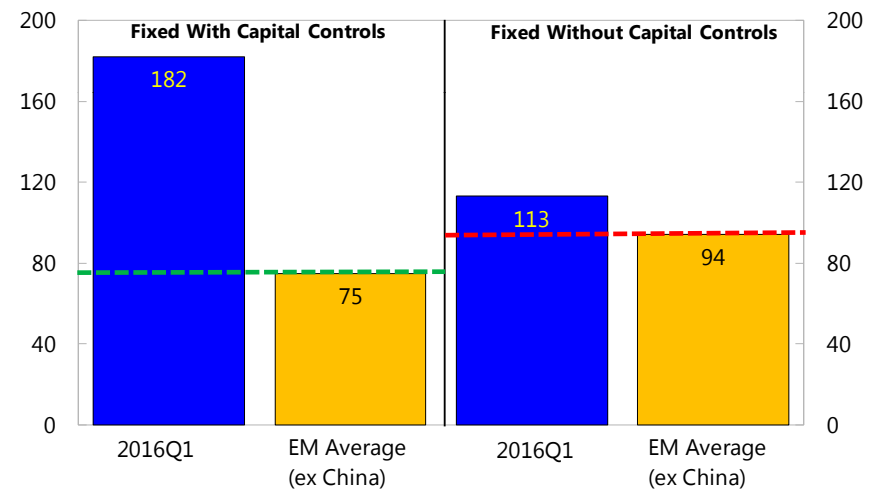


Sources: *World Economic Outlook (WEO)*; and IMF staff estimates.

1/ Including all explicit government (central and local) liabilities and part of the contingent liabilities that the government might be responsible for.

## Reserves Still Adequate

(In percent of IMF Reserve Adequacy Metric)



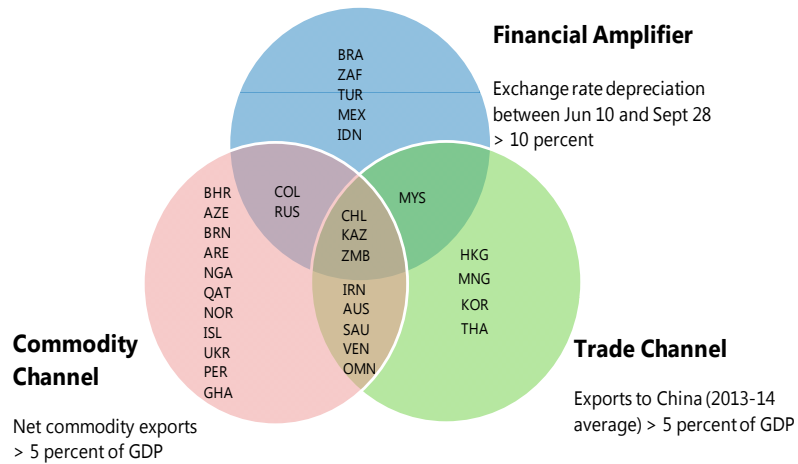
Sources: *Assessing Reserve Adequacy*; IMF Policy Papers; February 14, 2011.

# What were Beijing's Views?

- ❑ **Outlook:** saw 6 ½ - 7 as sustainable, infrastructure spending was needed, quality of growth improving
- ❑ **External:** commodity prices to recover, tourism increase, current account 2-3% GDP in medium term, outflows to moderate
- ❑ **Risks:**
  - External: uncertainty/weak investment in some EMs; sluggish recovery AEs; rising geopolitical tension
  - Domestic: corporate debt (but manageable); financial sector (limited and supervisors reacting)

# Spillovers

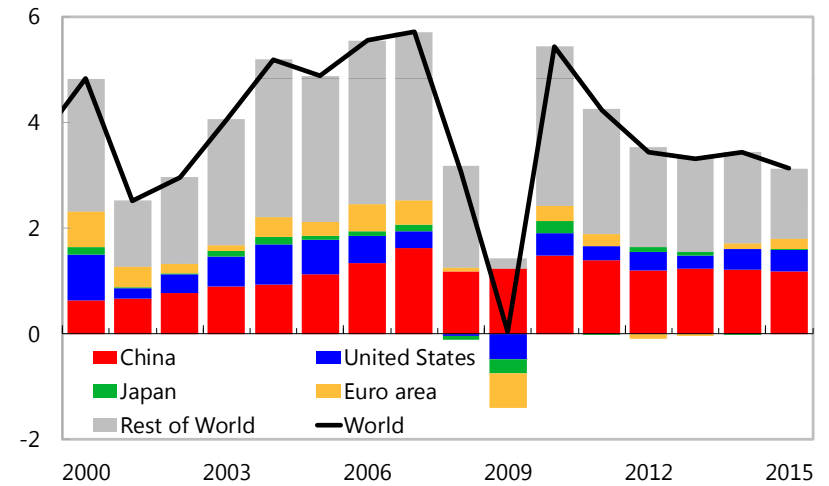
## Spillover Channels and Countries



Source: IMF staff estimats.

## Contribution to Global Growth: Still Large

(In percentage points)



Sources: *World Economic Outlook (WEO)*; and IMF staff estimates.

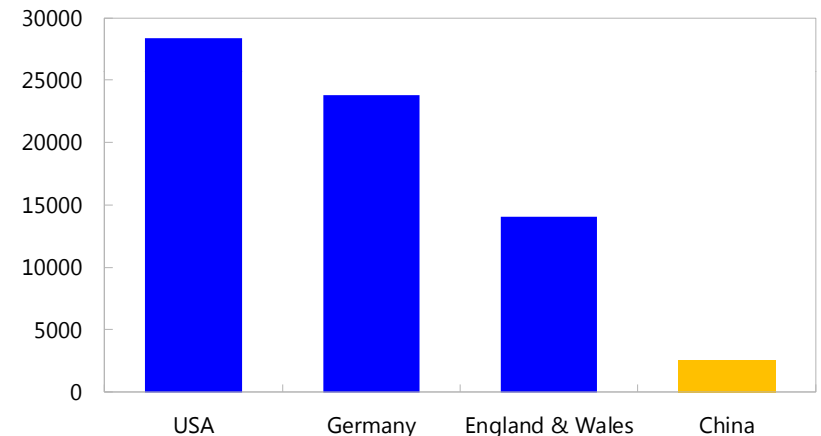


# Policies – (1) Tackle Corporate Debt Problem

- High level – political – decision to let weak firms go
- Harden budget constraints
- Triage: good, bad and the ugly
- Recognize losses
- Share the burden
- Out of court debt restructuring / distressed debt market
- Social costs
- Facilitate market entry

## Insolvency Little Used

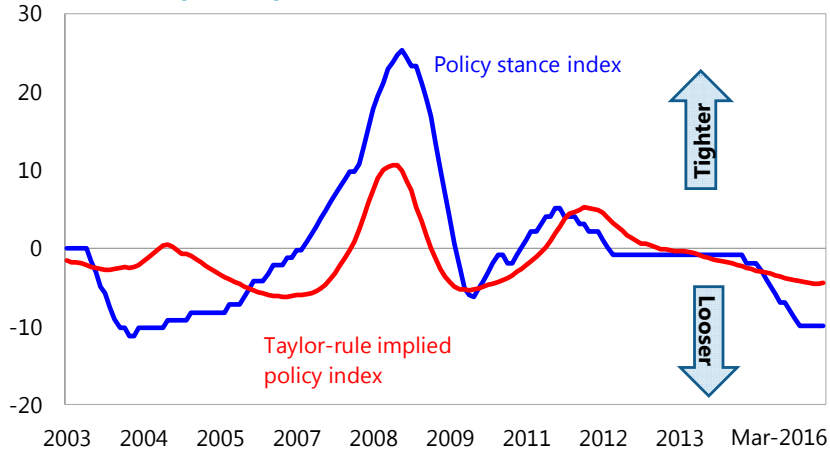
(Number of cases, 2014)



Sources: China Court; Sinotrust; Euler Hermes; US Trust Offices; Credireform; and UK Insolvency Service.

# Policies – (2) Accept the Slowdown

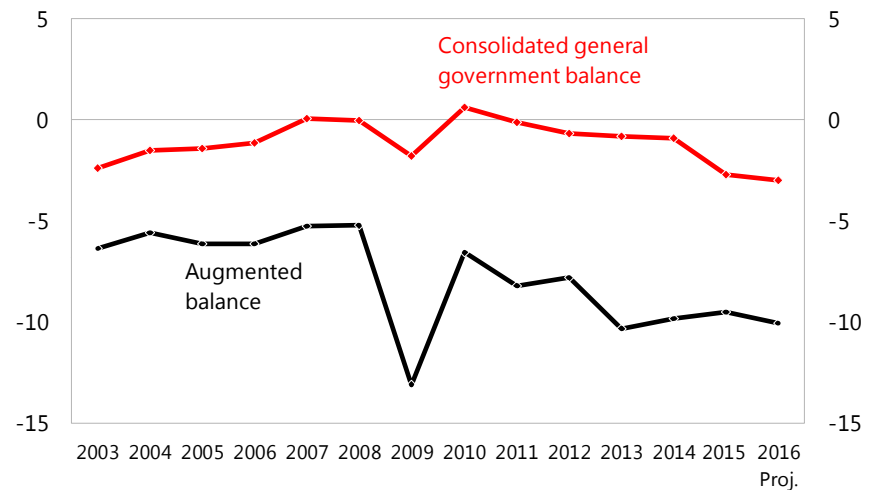
Monetary Policy Looser than Implied 1/



Source: IMF staff estimates.

1/ The monetary policy stance index is constructed on the basis of a short-term interest rate, reserve requirement ratio, open market operations and credit growth. The implied policy index is estimated with a simple Taylor rule that includes inflation and output developments.

Fiscal Deficit Remains Large, But More on Budget  
(In percent of GDP)

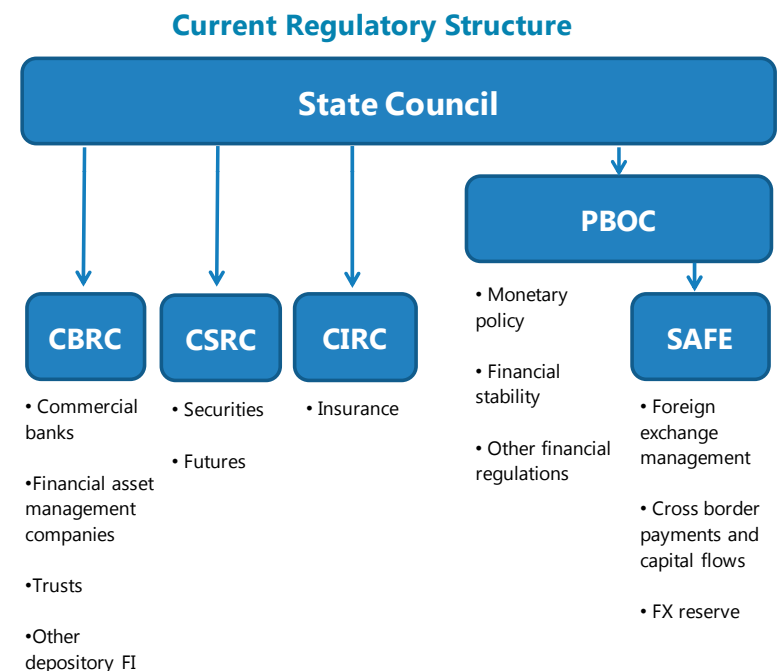


Sources: CEIC Data Company Ltd.; Authorities; and IMF staff estimates.

- Move away from growth targets
- Slow credit growth—tackle at source
- Interest rates—eventually/gradually rise
- Fiscal—reduce augmented deficit, switch from off budget investment to on-budget pro-rebalancing, introduce substantial carbon/coal tax

## Policies – (3) Guard against Financial Risks

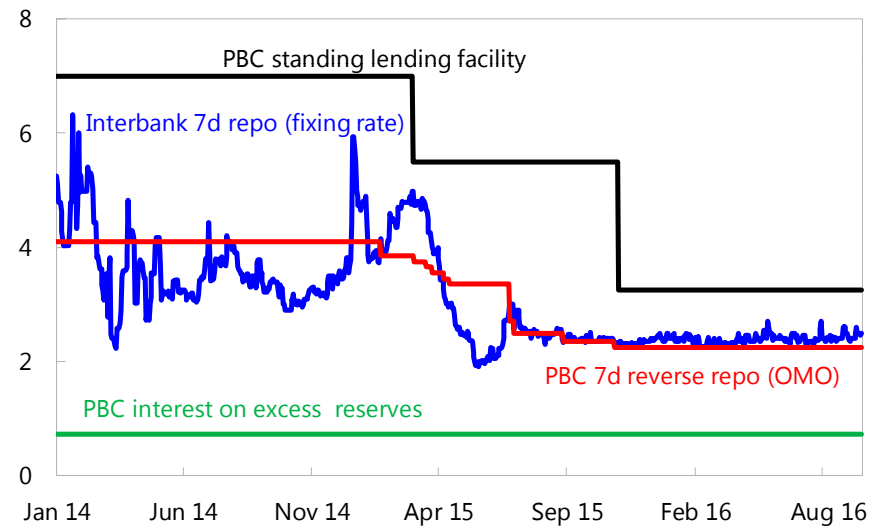
- Banks: proactive recognition of losses; build capital; improve funding quality
- Shadow products: holistic/aggressive approach to supervision
- Capital markets: orderly functioning, not intervention
- Property: restrict demand in Tier I; restrict supply in lower tiers
- Crisis preparedness: prepare for potential idiosyncratic and systemic stress
- Regulatory structure: no best practice, but major upgrade in effectiveness needed



## Policies – (4) Move to Effective Float

- Transition difficult but should continue—  
effective float ideally by 2018
- Couple with short-term management to  
avoid excessive volatility
- RMB broadly in line with fundamentals,  
but should respond to market conditions
- Support with move to more market-based  
monetary framework
- Caution with further capital account  
liberalization

Narrowing Corridor around 7-day Repo Rate



Sources: CEIC Data Company Ltd.; and People's Bank of China.

## Policies – (5) Enhance Transparency

- **Data:** progress made but major gaps
- **Communications:** clear, authoritative, consistent

## What were Beijing's Views?

- **Corporate debt:** part of 5-year plan; progress being made; but has to be gradual and market driven
- **Macro policies:** expected credit growth to slow, but will also need to be gradual; do not recognize "augmented" deficit, fiscal to remain "proactive"
- **Financial stability:** disagree with debt at risk estimates; taking action on shadow products; funding diversification natural and stable; no need for countercyclical buffer
- **FX:** pressures eased, progressing to more market based system by allowing progressively more role for market forces while curbing overshooting. Capital account to be gradually liberalized.
- **Transparency:** data quality being upgraded, recognize importance of communications but also constraints

## Key Takeaways

- Significant progress made on rebalancing and reform
- But lagging in critical areas: reining in rapid credit growth and SOE reform
- As a result, vulnerabilities continue rising on a dangerous trajectory
- Buffers still adequate, but eroding
- Thus hard landing unlikely in near term, but risks rising and timing uncertain
- Challenges manageable, but urgent action needed to ensure they remain so
- Many reforms ongoing and planned but focused and more forceful action needed in critical areas

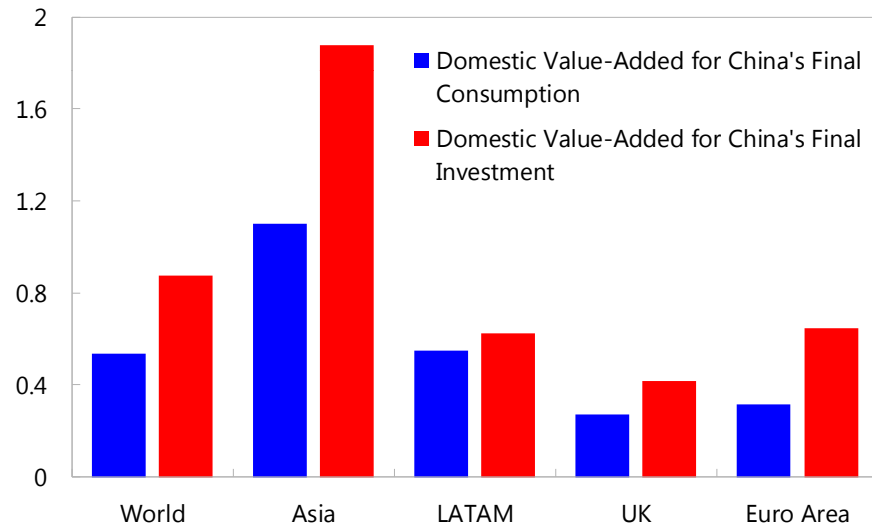
## Check out the Reports

- Staff Report <http://www.imf.org/external/pubs/cat/longres.aspx?sk=44181.0>
- Selected Issues <http://www.imf.org/external/pubs/cat/longres.aspx?sk=44182.0>
- Project Syndicate Op-ed by David Lipton <https://www.project-syndicate.org/commentary/china-corporate-debt-problem-by-david-lipton-2016-08>
- Video <http://www.imf.org/external/mmedia/view.aspx?vid=5080114876001>
- IMF Survey Interview with James Daniel  
<http://www.imf.org/en/News/Articles/2016/08/11/14/40/NA081216-Proactive-Reforms-Critical-to-China-Medium-Term-Growth-Prospects>



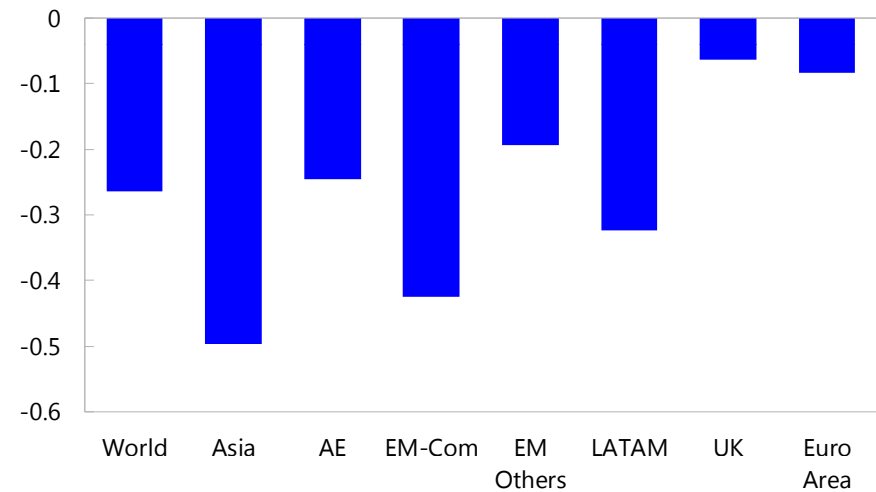
# Annex—Spillovers to U.K.

**Share of Domestic Value-added Used for China's Final Demand**  
(In percent of GDP)



Source: IMF staff estimates.

**Change of Value-Added Exports from China's Rebalancing:**  
(Change in value-added exports, in percent of total exports, due to 5 ppt increase/decrease in consumption-to-GDP/investment-to-GDP ratio)

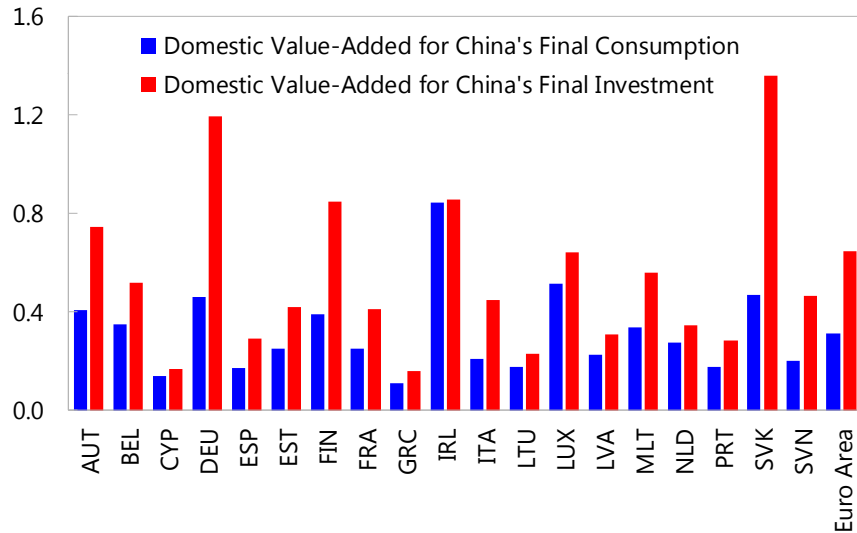


Source: IMF staff estimates.

# Annex—Spillovers to Euro Area

## Share of Domestic Value-added Used for China's Final Demand

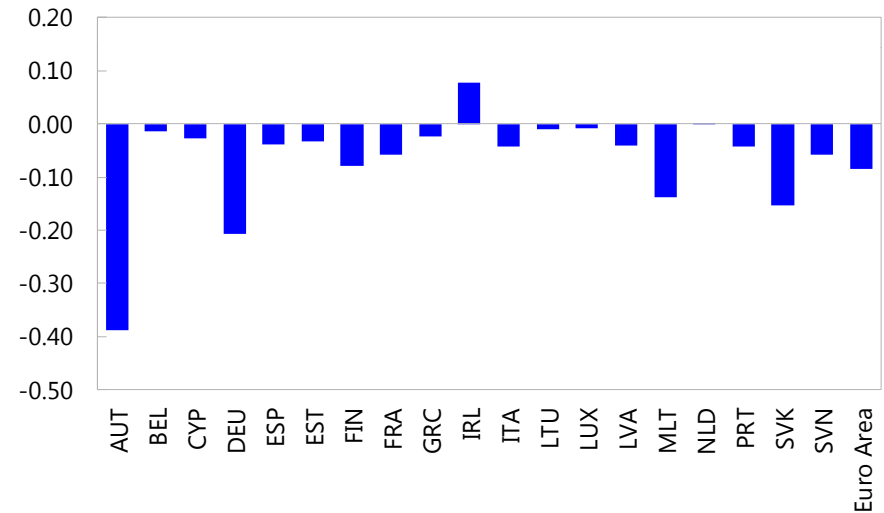
(In percent of GDP)



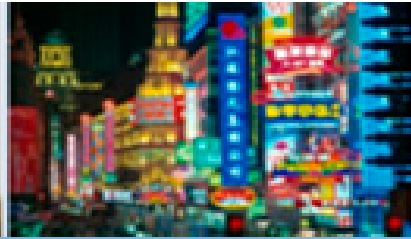
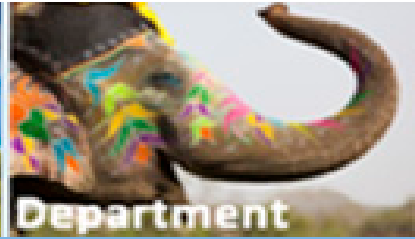
Source: IMF staff estimates.

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**THANK YOU**