Prospects

No. 20/049 – 11 March 2020

The point of view

China is slowing down in the short, medium and long term

In the very short term, **the coronavirus epidemic that has been ravaging China is likely to result in a sharp drop in economic activity in the first quarter,** as was the case during the SARS (Severe Acute Respiratory Syndrome) outbreak in 2003. The timing and magnitude of the recovery will then depend on the extent and duration of the epidemic currently paralysing the country; in the best case, China will make a rapid recovery spurred by catch-up effects followed by a return to economic normality.

This sudden brake on growth comes at a time when the economy is already weakened by the effects of the US/China trade war. These tensions have had a direct impact due not only to the drop in trade with the US but also their knock-on effects on global value chains in which China is a key link. Even so, some corporations have skirted US trade tariffs by having goods manufactured in China transit through an intermediate country not subject to extra tariffs (thus masking the source country) – a short-term avoidance strategy that does nothing to address the issue of how supply chains might be reorganised should the conflict persist. Furthermore, these strategic questions about the global value chain could proliferate following the coronavirus crisis, which has highlighted the vulnerability of global logistics centred on China. This has encouraged the Chinese authorities to pursue their strategy of upscaling Chinese manufacturing and encouraging consolidation in industry with the aim of increasing locally generated added value, and redirecting growth towards consumption, which is less dependent on global ups and downs. Growing uncertainty against a backdrop of mounting trade tensions has also hampered both foreign and domestic investment in China.

Beyond these ups and downs, there are deeper reasons underlying China's slowdown. Firstly, efforts to reduce debt, or rather to manage growth in debt, including tighter control over the shadow banking system[1], have had an impact on the economy's financing capacity, and thus on investment and growth. The shadow banking system has grown, fuelled by the inability of the highly regulated traditional banking sector to finance SMEs and high-risk sectors in a rapidly growing economy, hence the Chinese authorities' initial benevolent stance. Following the 2008 stimulus plan, local authorities also had to turn to non-bank borrowing via dedicated financing vehicles in order to continue with their investment strategies. Meanwhile, state-owned banks continued to supply state-owned enterprises with credit, overwhelmingly driven by the race for volume without regard for the credit quality of these government-backed corporations. All of this resulted in overaccumulation, with overcapacity in heavy industry and the indiscriminate development of infrastructure and urban development projects that were as unprofitable as they were useless. Having loosened the reins due to the health crisis, the authorities are likely to **make debt reduction a priority again to safeguard against financial risks and stabilise the foundations for growth at a time when China is embarking on a new phase in its development.**

Indeed, China is faced with a declining trend in total factor productivity. During the period when the economy was taking off, growth was both extensive, with a combination of fast-paced growth in production factors (labour and capital), and intensive, with high productivity gains stemming from technological catch-up effects and the massive shift in the workforce from farming to the more productive manufacturing sector. **As capital accumulation and job creation slow, Chinese growth is becoming relatively more intensive and thus more dependent on productivity gains.** Yet productivity gains in the manufacturing sector have traditionally

[1] Loans by trust companies, intercompany loans, peer-to-peer platforms, structured wealth management products...

tended to lose steam once the catch-up phase is over. While the “Made in China 2025” plan advocates an industrial policy focused on cutting-edge sectors of the economy, it is still far easier to approach the technological frontier by adopting, copying and then incrementally improving existing innovations than it is to push back that frontier through disruptive innovation. Furthermore, the current rebalancing of growth in favour of consumption and services should enable the Chinese economy to reap the benefits of a middle class with growing purchasing power and to gain independence thanks to more self-sustaining growth. This shift towards a more service-based economy will see jobs migrate towards service businesses, particularly in local services, which are less dynamic in productivity terms – a structural bias that goes hand in hand with structurally weaker growth. ■

Isabelle Job-Bazille
isabelle.job@credit-agricole-sa.fr

Consult our last publications

Date	Title	Theme
04/03/2020	The power of "animal spirits"	Economics
03/03/2020	France – Residential real estate: recent developments and outlook for 2020	France, real estate
26/02/2020	Can flexible packaging do without plastic?	Sectoral
19/02/2020	Portugal – The country's momentum continues	Portugal
12/02/2020	US election pages – February 2020: how do you outmanoeuvre an elephant…	USA
11/02/2020	Italy – 2019-2020 Scenario: Consumption to the rescue of growth	Italy
06/02/2020	Italy: how many votes are the "Sardines" worth – 6,000, 250,000 or 25%?	Italy
06/02/2020	France – Pension reform: What impacts will the reform have? What issues are still unresolved?	France
05/02/2020	Italy – Monthly News Digest	Italy

Crédit Agricole S.A. — Group Economic Research
12 place des Etats-Unis – 92127 Montrouge Cedex
Publication Manager and chief Editor: Isabelle Job-Bazille
Information centre: Dominique Petit - **Statistics:** Robin Mourier
Contact: *publication.eco@credit-agricole-sa.fr*

Access and subscribe to our free online publications:
Internal Website: https://portaileco.ca-sa.adsi.credit-agricole.fr/en
Website: https://etudes-economiques.credit-agricole.com
iPad: Etudes ECO application available in App store platform
Android: Etudes ECO application available in Google Play