The Chinese economy has experienced a slowdown in recent years. This stepped up in the second half of 2018 as a result, initially, of the measures previously adopted to reduce the high debt in the private sector and, shortly after, of the growing trade tensions with the United States. Consequently, Chinese, GDP growth has eased from year-on-year rates of over 10% at the start of the decade to 6.4% in 2019 Q1, the lowest rate since the global financial crisis (see Chart 1.1).

To address this downturn in activity, the authorities have implemented a series of expansionary demand-side policies since mid-2018. These have been strengthened following the March 2019 meeting of the National People's Congress (the legislative body), where, moreover, the growth target was lowered to a range of 6%-6.5% (from 6.5% previously). Specifically, the legislative body resolved to make fiscal policy more expansionary, whereas monetary policy would retain an accommodative but prudent stance, with a view to mitigating financial risks. On the fiscal front, a stimulus package of around 2% of GDP was incorporated. The stimulus would be through cuts in VAT and in Social Security contributions, and a raising of the local government debt ceiling (the quotas for special bond issuance have increased by over 50%), in order to boost infrastructure investment (see Chart 1.2). As regards monetary policy, the central bank has kept benchmark interest rates unchanged, but it has cut the reserve requirement ratio by 350 bp since 2018, placing it at 13.5% (see Chart 1.3). Furthermore, it has introduced two facilities: one is aimed at promoting the granting of medium-term loans to private companies, especially to SMEs; and the other enables commercial banks to replace perpetual bonds with central bank securities, thereby shoring up their capital and affording them greater liquidity, since the securities are eligible as collateral in the central bank's lending facilities. Compared with the stimuli applied in the global financial crisis and in the 2015-16 slowdown, the current measures are on a lesser scale, with a more contained monetary and credit impulse. Further, unlike the previous episodes, financial regulations and housing market controls are now stricter, which mitigates the risks to financial stability although, in turn, this limits the effectiveness of the stimulus.

At the start of the year, these measures appeared to have managed to stabilise the economy, with somewhat higher than expected growth recorded in 2019 Q1. However, activity appears to be turning down again at the start of Q2, which raises some doubts over the effectiveness of the policies implemented (see Chart 1.4). Admittedly, on one hand, there is normally some lag between the time at which the measures are adopted and when they begin to take effect; and, on the other, moreover, the fiscal package has not yet been fully rolled out. Nonetheless, the moderate impact of the measures adopted might be due to the fact that around half of the fiscal expansion has been implemented through tax cuts. That tends to reduce policy effectiveness in conditions of uncertainty, insofar as households and firms tend to save the resulting extra income.

In any event, the risks to economic growth in China are clearly tilted to the downside. In the external arena, the heightening of the trade war with the United States may check growth considerably. The United States account for almost 23% of total Chinese exports (4.2% of GDP). Accordingly, the trade tensions might significantly harm the Asian giant's economy. The damage would not only be through the tariffs channel, but also through other indirect channels, such as financial market confidence, the re-location of certain segments of global production chains and the effects on productivity. On the domestic front, the main challenge lies in correctly calibrating the stimuli stemming from economic policies. These must strike an appropriate balance between prudence and ambition, so as to effectively reduce the risks to short-term growth and, at the same time, prevent an increase in medium and long-term imbalances, which raises the risks of a more abrupt adjustment in the future. China would, then, be retaining some room for manoeuvre to further reinforce its expansionary demand-side policies should it have to face a more unfavourable environment. Specifically, new monetary policy measures cannot be ruled out. These might include, for example, further cuts in the reserve requirement or action through the credit mechanisms that channel liquidity to the sectors most affected. On the fiscal policy side, further stimuli will likely be announced in the coming quarters, chiefly involving cuts in VAT rates and in Social Security contributions, and higher infrastructure investment.

In any event, the space for potential demand-side policy measures has shrunk in recent years, owing to the increase in the Chinese economy's debt. The non-financial sector's debt/GDP ratio has grown by 120 pp in 10 years to 260% of GDP in 2018, and the deleveraging measures adopted in the past two years have managed to stabilise this ratio (see Chart 1.5). In the short run, the volume of debt will foreseeably resume its rising path, owing both to the recent measures to boost credit and to promote public investment in infrastructure, and to the lower growth outlook. That all entails greater risks to financial stability in the medium and long term.

In the monetary policy realm, the central bank does have tools to boost liquidity and credit. But the main obstacle lies in the limited effectiveness of the transmission mechanism, based on quantitative and credit-control instruments. These instruments are biased towards large corporations and entities linked to the public sector, meaning financial system reforms are needed to enable balanced access by private firms to financing. Moreover, as regards exchange rate flexibility, there are also constraints arising from the fear of capital outflows and of the repercussions that a heavy depreciation of the renminbi would have for the trade tensions with the United States.

Despite the fact that the official budget deficit and public debt ratios are not very high (3.9% and 37% of GDP, respectively), there is less fiscal space available if regard is had to a broader perimeter of the public sector and its contingent liabilities, along with other items, especially those pertaining to local governments and their financing vehicles. The IMF estimates that, with a broader definition than the usual one, the budget deficit would have been

To address the downturn in activity derived from the measures adopted to reduce China's high debt and, also, from the growing trade tensions with the United States. the authorities have applied a series of demand-side policies since mid-2018. However, the room for manoeuvre for these policies is increasingly smaller.

Chart 1
GDP by component

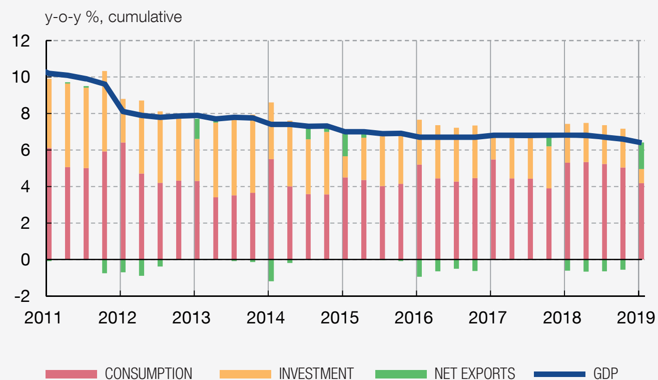


Chart 2
EXPANSION OF FISCAL STIMULUS: CUTS IN TAXES AND CHARGES

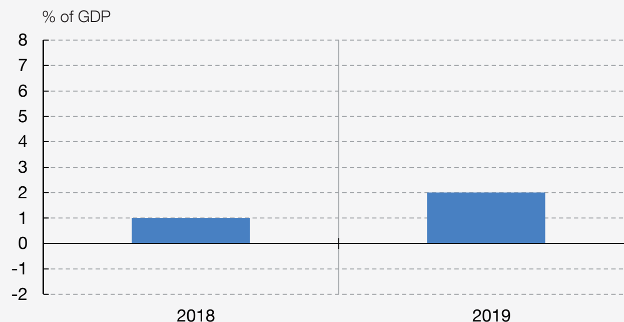


Chart 3
RESERVE REQUIREMENT RATIO FOR LARGE BANKS

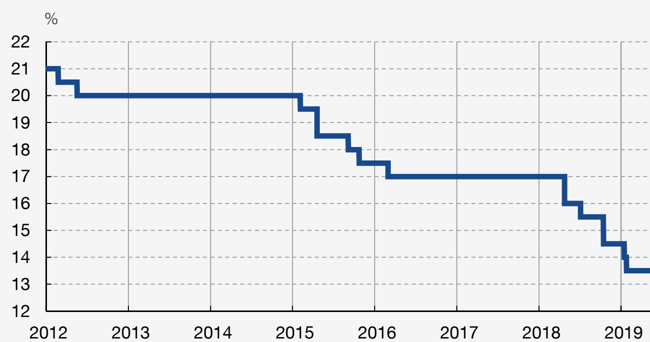


Chart 4
KEY INDICATORS

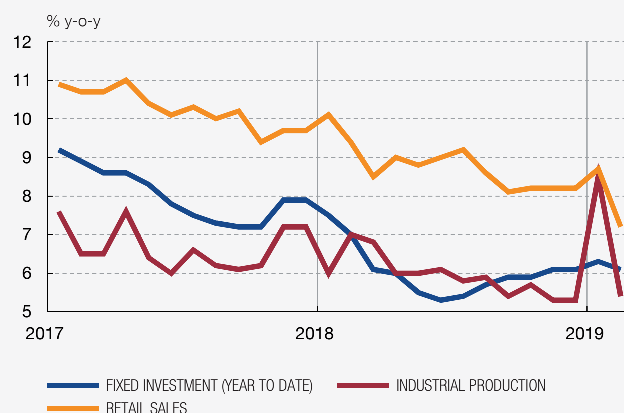


Chart 5
DEBT BY SECTOR

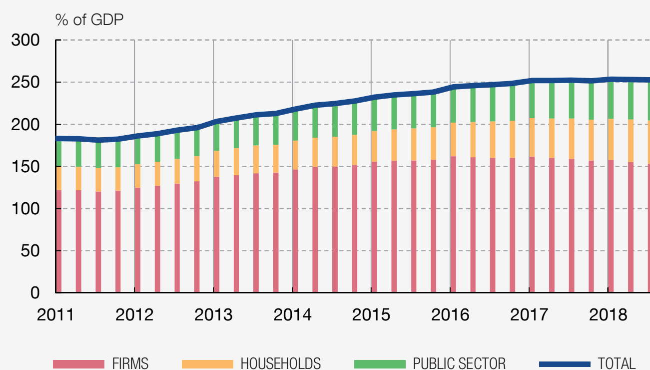
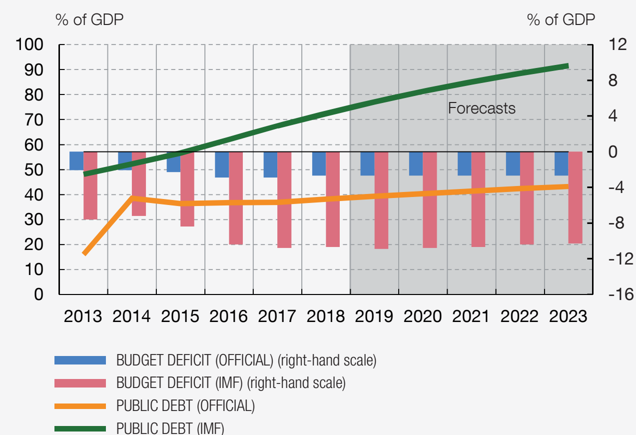


Chart 6
CHINA'S FISCAL SPACE IS LESS THAN OFFICIAL FIGURES SUGGEST



SOURCES: IMF, BIS and CEIC.

close to 10% of GDP last year, while public debt would have risen to 67.5% of GDP (see Chart 1.6). Compounding this in the medium term are the pressures on public finances stemming from population ageing, and from lower potential growth.

Against this background, Chinese economic policy should focus on structural reforms. Indeed, mindful of the limitations of demand-side policies, the Chinese authorities have so far opted for gradualism and for limiting the size of the stimuli applied. However, if growth were to be further impacted and measures on a greater scale were adopted, that might exacerbate the risks to financial stability. Ahead of this, the authorities should opt to promote comprehensive structural reforms that manage to reduce leveraging and enhance the efficiency of credit allocation, introducing greater competition into the markets and reconsidering the role of State companies.