In recent years China has made progress in reducing the imbalances in its economy. The readjustment has been significant (see Charts 1 and 2) as regards both expenditure (with a decline in the weight of investment, from accounting for 48% of GDP growth in 2011 to 35% in 2017, in favour of consumption) and branches of activity (with an increase in the weight of the services sector of more than 10 pp during that period, to 60% of GDP growth, at the expense of industry). China has also adopted a set of policies since 2016 to reduce its high level of debt. These measures, particularly those relating to shadow banking, have reduced aggregate credit growth and stabilised debt, mainly that acquired by non-financial corporations, as a percentage of GDP (see Charts 3 and 4).

However, this process is facing a series of difficulties in recent months, with economic activity performing less favourably both for internal reasons (partly owing to the deleveraging process itself) and for external ones (mounting trade tensions with the United States). Against this background, the Chinese authorities seem to be opting for ensuring growth at short term, even at the expense of slowing down the correction of imbalances. This box describes the policy measures adopted recently and analyses their implications for the process of rebalancing China's economy.

The first clear sign of the new expansionary economic stance arose on the monetary front. At end-June, the People's Bank of China (PBoC) reduced the reserve ratio by 50 bp. It also adopted a more expansionary tone in press releases relating to liquidity management. As a result of these two measures, the interbank rate declined to around 2.8%. Other regulatory changes relating to financial institutions (with less restrictive guidelines on the management of financial assets and products) and the lending policy were also agreed, including: i) laxer collateral eligibility criteria for loan facilities in monetary policy transactions; ii) adjustment of macroprudential assessment parameters to encourage lending; and iii) greater incentives for the granting of loans to SMEs and to local government financing vehicles.

Chart 1
GDP GROWTH BY COMPONENT

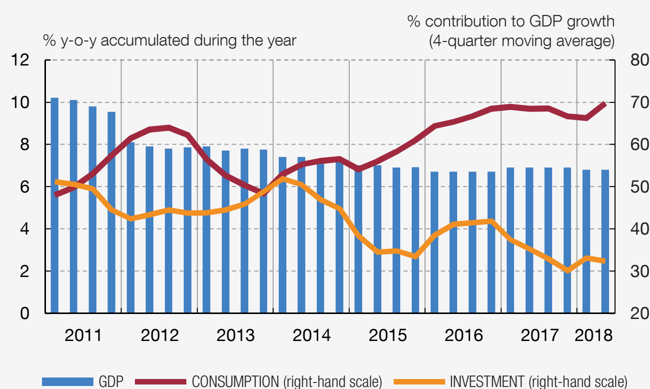


Chart 2
SECTORAL CONTRIBUTION TO GDP GROWTH

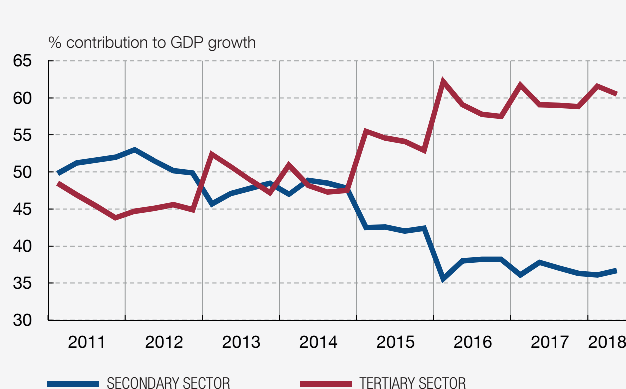


Chart 3
DEBT BY SECTOR

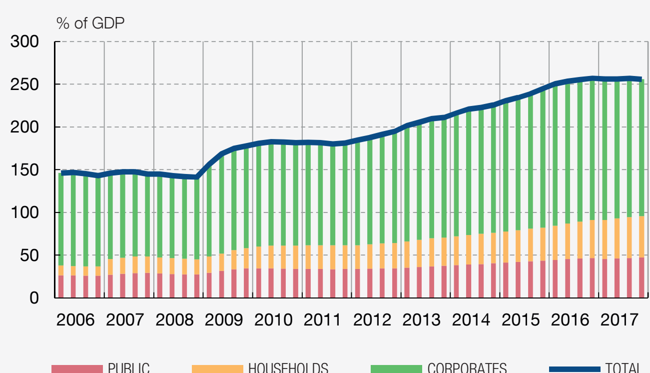
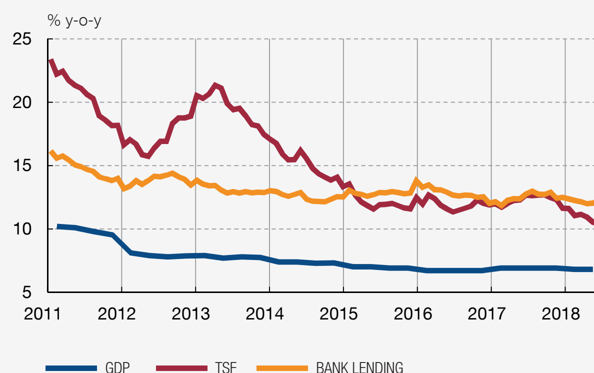


Chart 4
REAL GDP GROWTH, BANK LENDING AND TOTAL SOCIAL FINANCING



SOURCE: CEIC. Latest observation: 2018 Q2.

As regards the fiscal policy, at end-July the State Council revealed plans to cut taxes to firms (in part through the deduction on R&D expenses). This amounts to 0.1% of annual GDP and is additional to the decrease in taxes and levies for an amount equivalent to 1.3% of GDP (announced in March), including most notably a decrease in income tax amounting to 0.4% of GDP. Also until June 2018 China had issued only 30% of the annual quota for local government special bonds and had incurred only 30% of the fiscal deficit target, which suggests that there is ample margin for a proactive fiscal policy in the future. In this connection, the State Council also advised local governments to speed up the issuance of special bonds (amounting to 1.6% of GDP) and encouraged financial institutions to cover the funding needs of local government financing vehicles aiming to finance infrastructure investment spending.

Finally, the recent depreciation of the renminbi has ambiguous effects on economic activity. On the one hand, it may favour exports; but, on the other it may have adverse effects on investor confidence, generating capital outflows. In fact, since mid-June, the PBoC appeared not to be intervening in the foreign exchange markets and, accordingly, depreciation was driven by the market, owing to divergences in growth expectations between the United States and China, the reduction in interest rate spreads and the escalating trade tensions between the two countries. However, in August the Chinese monetary authority apparently commenced to intervene in favour of the renminbi to anchor exchange rate expectations, reintroducing the so-called "counter-cyclical factor"[1] and raising the reserve requirement from 0% to 20% for foreign exchange transactions.

All of these measures, which were designed to stabilise growth in the near term, contribute to partially halt the process of reducing imbalances in the economy, which could increase the risks to growth in the medium and long term. Also, foreign exchange market intervention and capital flow controls could hamper the internationalisation of the renminbi and the full opening of the capital account. Nonetheless, it can be stated that their impact on the imbalances is, to date, very limited, although there is still no hard evidence that it has been possible to halt the deceleration of activity.

1 The "counter-cyclical factor", which aims to moderate short/medium-term fluctuations in the renminbi's exchange rate, was introduced by the PBoC in May 2017.