

BOFIT Forecast for China
18.9.2013

BOFIT China Team

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The slowing of China's economy in the first half of 2013 was more than anticipated, but our long-term assessment for slowing Chinese economic growth holds. We expect GDP growth of around 7.5 % p.a. this year and around 7 % p.a. in 2014 and 2015. China's lower growth reflects structural adjustments. The current pace of economic growth is still fast enough that there seems to be no need for large-scale monetary or fiscal stimulus policies, particularly as stimulus measures are in any case constrained by the high debt levels of local administrations and many businesses. As regards economic reforms, China's new leaders seem to be delivering on their promises.

China's GDP growth was 7.7 % p.a. in 2012, and slightly below that in the first half of 2013. As a result of the weaker-than-anticipated first-half performance, we have lowered our 2013 GDP growth projection for China from 8 % to 7.5 %. Even with the slowdown, however, our current forecast generally conforms to our earlier long-term outlook for the Chinese economy. We still expect economic growth of around 7 % p.a. in 2014 and 2015. This year, the view that China is moving permanently to a lower-growth paradigm has gained broad acceptance among forecasters. Indeed, forecasters who still maintain that the recent deceleration of China's economy is due purely to weak cyclical conditions have become scarce.

Economic policy stresses reform

Lower export growth, structural distortions in the economy and debt problems arising from earlier stimulus rounds all drag down Chinese growth. China's economy still remains highly dependent on fixed capital investment. While overcapacity and excessive debt levels have started to quell the appetite for investment in production capacity in certain branches, the government continue to boost investment in infrastructure to sustain economic growth.

In any case, China's economy is gradually moving from an investment/export-driven model to a consumption-driven model, due in part to rapid urbanisation and the related emergence of a dynamic service sector. Structural reforms promote this shift, which should gain steam later this autumn when China is expected to announce reforms, among other things, to the *hukou* household registration system, as well as changes in public sector administration and budget systems.

The 2008–2010 stimulus package relied heavily on state banks to funnel money into the economy in the form of loans. Local administrations, in particular, borrowed heavily and created special financial vehicles to hide debt and finance their projects. At the same time, China's grey banking sector began to expand and evolve rapidly. The debt mountains of local administrations and companies, along with the need to get a grey banking sector to the reach of regulators, now threaten to depress investment and economic growth.

Unlike the massive stimulus a few years back, the relatively modest stimulus measures of recent months tend to use direct fiscal policy measures such as granting tax breaks

to firms or directing budget spending to a specific purpose e.g. boosting the pace of railway investment. Even if the subdued inflation outlook would now permit monetary-side stimulus, any significant relaxation of the monetary policy stance would be restricted by the existing debt mess. Thus, China's decision-makers are apparently satisfied this year's target of 7.5 % economic growth is appropriate under the current conditions.

Financial market deregulation moves ahead

The financial markets got a wake-up call in June when short-term interest rates in the interbank market soared and a number of small banks found themselves floundering until the central bank intervened to provide liquidity. Despite problems, reforms of the financial sector are progressing, indicating the commitment of the new leadership to structural adjustment. Bank lending rates, for example, were deregulated in July.

The use of the yuan in international payments has also become easier. In the past year, the yuan's market share as an international payment currency doubled to nearly 1 % of international transactions, making it the 11th most-used payment currency in the world. The Japanese yen, often used as a benchmark reference for the yuan, is currently the world's fourth-most-used payments currency with a 2–3 % share. International yuan use is expected to keep rising and it should soon become one of the world's top ten payment currencies.

Currency market expectations and interest rate trends drive capital flows

Recent exchange rate policy may offer insights into the motivation of China's policymakers and how confident they actually are with the current economic circumstances. Despite China's poor export performance in spring and early summer, the yuan has been allowed to appreciate against the dollar by nearly 2 % this year. Exports in July and August revived slightly and growth in export volumes is expected to reach 5–6 % in 2014 and 2015. Because economic growth in China is higher than in its trading partners, imports are expected to rise slightly faster than exports. The slight rise in China's trade surplus this year is due partly to lower prices for imported commodities. If the fall in import prices turns out to be modest over the next two years, the current account surplus would slide from about 2.5 % of GDP currently to around 2 % of GDP at the end of 2015.

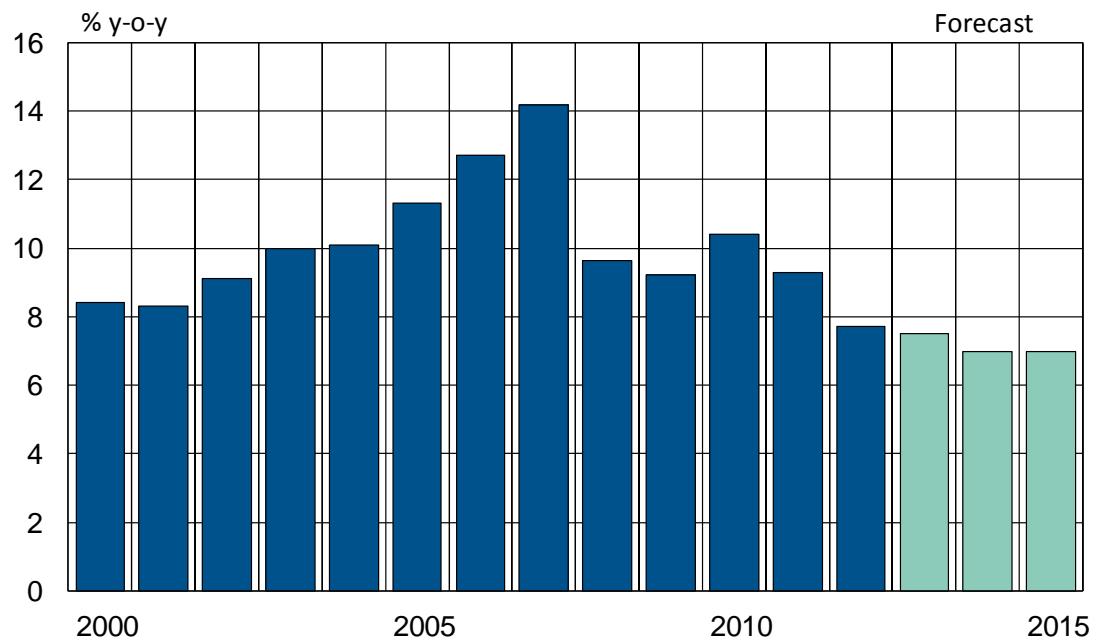
Long-term direct investment in China seems to have returned to a growth path, while the net flow of foreign direct investment has evened out relative to earlier years. Although FDI outflows from China are still smaller than FDI inflows into China, Chinese foreign investment will continue to grow substantially faster than FDI inflows. Prediction of short-term capital flows is difficult as expectations of yuan appreciation and international shifts in interest rates make capital flows to fluctuate. In any case, the situation has changed; capital moves more freely in both directions despite currency controls.

Near-term risks seem manageable

If debt problems worsen and expose vulnerabilities of the financial and real estate sectors, China's economic performance would likely fall below our basic outlook. Indeed, housing prices are again soaring despite official efforts to rein them in. Even with these challenges, however, the near-term risks to economic growth seem manageable overall. The new leadership's commitment to needed reforms is likely to reduce difficulties down the road, even if the reforms themselves are hard to implement and may come with surprises. It is worth

noting that in spite of some advancement and emergence of alternative statistical sources, the poor quality and availability of statistical data remain a major problem for anyone trying to paint a coherent picture of the Chinese economy.

Realised GDP growth and BOFIT forecast 2013–2015



Sources: NBSC, BOFIT