BOFIT Forecast for China
3 October 2019

BOFIT China Team

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The slowdown in growth continues as China struggles with a shrinking labour force, ineffectual allocation of capital, an increasing role of the state in the economy and postponement of necessary structural reforms. Adding to this is the business cycle downturn and escalating trade tensions during the past year. Given China's rising public-sector deficit and soaring debt ratio, any room for stimulus is likely to be limited.

With unreliable official figures that often fail to capture economic trends, it is more challenging than ever to assess China's actual economic conditions. Nevertheless, we expect China's economic growth to slow this year by about one percentage point from 2018 and slow further in the next two years of our forecast period by just under one percentage point a year. The deteriorating financial positions of Chinese corporations and increasing financial market risks raise the likelihood of a more rapid slowdown in growth.

China's economic growth has slowed during the current decade, but official figures suggest only a mild slowdown. They show that gross domestic product increased by 6.6 % p.a. last year and 6.3 % in the first half of this year, a reading comfortably within the range needed to meet this year's official growth target of 6–6.5 %. In 2012, the Communist Party of China (CPC) declared its goal of doubling 2010 real GDP by 2020. To hit the target still requires annual growth above 6 % this year and next. We expect actual growth will be lower than this. In line with our earlier forecasts, we see China's growth slowing by about one percentage point a year until the end of the forecast period in 2021 (Fig. 1).

The guiding principle of China's economic policy is across-the-board stability, and it is governed by overambitious growth targets. The policy mix has led to increasing suspicions over the reliability of official national account statistics. Also the quality of some other statistics is poor. Assessment of China's true economic situation requires the review of a broad range of economic indicators and assessments. Multiple measures suggest the downturn in the business cycle that began early last year has been sharper that generally acknowledged (Fig. 2).

Most of the factors reducing growth are domestic. Companies face eroding bottom lines and financial market uncertainty has increased. Producer prices have fallen since late summer, which can reflect diminishing demand. The spread of the African swine fever virus has pushed up consumer inflation to almost 3 % y-o-y. New layers of complexity and the failure of the US and China to resolve their trade differences further degrade economic conditions.

China has turned to fiscal policy stimulus to sustain growth, even if room for stimulus is limited. The IMF estimates that the actual public-sector deficit this year will amount to 13 % of GDP even without the application of broad stimulus measures. Moreover, public-sector debt is expected to rise from 80 % this year to over 90 % in 2021. The government has placed monetary policies aimed at reducing indebtedness and the lowering of financial market risk on the back burner, but so far has refrained from broad monetary stimulus. Reliance on debt-fuelled stimulus and unrealistic stability demands in the current economic environment (which is still relatively benign) diminishes economic buffers and further delays implementation of reforms needed to lock in long-term growth. Current policies also increase the risk of a serious recession.

The CPC's role in the economy expands as market-based reforms are postponed

With decades of high growth now past, China's growth potential will keep trending downward due to structural factors such as its ageing population, the ongoing shift towards a more services-based economy, a slowdown in the move to cities and weaker profitability on fixed investment. China's working-age population has been contracting for years, and last year the labour force itself began to shrink. The greying of China's population will have severe impact on the dependency ratio. Last year there were still seven people of working age (15–64 years) for every person over 64 years. The World Bank expects this number to fall to just three by 2035, which will severely strain the pension system. The instatement of a general two-child policy in 2016 has not increased the birth rate as hoped. Environmental regulation also restrains growth, even if pollution reduction targets are sometimes relaxed to provide stimulus.

Productivity-enhancing reforms would be essential to sustaining growth potential, but major reforms have been overlooked for years. Reforms that would help make the economy more dynamic include reform of state-owned enterprises (SOEs), opening up markets to competition, land reform and relaxing the *hukou* household registration system, tax reforms, a free-floating exchange rate and ending of capital controls, improvements in public health care and education, as well as hikes in pensions and other social entitlements.

Financial market improvements have been in the forefront of China's reform policy, but since the 2015 market turbulence, they have tended to be more cautious and controls on capital exports from China have been tightened. Rules on bringing capital into China have been eased through, for example, introduction of stock and bond connect programmes with Hong Kong. There has been little relaxation on taking capital out of China, however, due to fears of uncontrolled capital outflows. As a part of the trade negotiations with the US, China has opened up the financial sector to foreign firms. The meaningfulness of reforms, however, depends on how they are executed. The government's ambitions about making the yuan a major international currency seem to have faded. There has been little increase in international use of the yuan since it was added to the IMF's SDR currency basket in 2016.

In lieu of market-based reforms, the role of the state and party in the economy continues to grow. Capital allocation is ever less efficient as an increasing share of financing goes to state-owned enterprises with low profitability. Foreign firms operating in China and privately held Chinese firms report an increasingly tough business environment. Private and foreign companies are forced to allow internal party committees. China has also unveiled plans to extend social credit scoring system for all corporations that many fear will increase the regulatory burden and lack transparency. Concentrating power upwards to the top party elite increases the ineffectiveness of reform efforts and likelihood for policy errors. The spread of the African swine fever virus over the past year provides an example of the systemic consequences of policy mistakes. Nearly half of all pigs in China have been slaughtered because of the disease, causing the price of pork to rise by 50 % y-o-y and lifting consumer price inflation by over one percentage point.

Risks increase as indebtedness continues to soar

Indebtedness continues to rise. The stock of bank lending is still climbing by 12 % y-o-y and the total credit stock by 11 % – both figures that clearly exceed the nominal GDP growth rate of around 8 %. BIS figures for the first-quarter gross aggregate debt of the Chinese government, corporations (not including the financial sector) and households was about 260 % of GDP. The IMF expects the debt-to-GDP ratio to increase this year by nearly ten percentage points and exceed 280 % by 2021 even without substantial stimulus measures. In

many countries, rapid increases in the debt-to-GDP ratio has been accompanied with banking crises. The household debt ratio also stands well above 50 % of GDP, a high figure given China's level of development. Corporate access to finance has become more difficult and late payments and defaults have increased. Combined with slowing domestic growth, this has sharply reduced foreign investment by Chinese firms. The profitability of Belt and Road projects, too, has come under scrutiny as domestic demand for financing has increased.

Monetary policy will continue to be characterised by a balancing of monetary stimulus and the need to counteract capital flight pressures. The monetary stance has been relaxed over the past year-and-a-half through multiple cuts in bank reserve requirement ratios, yet interest rates have remained largely unchanged. China has responded to the US tariff increases by letting the yuan depreciate slightly. The yuan's exchange rate in September vis-à-vis the dollar was down 4 % y-o-y and in trade-weighted terms 2 % y-o-y. Further yuan depreciation is held back by the government's focus to avoid capital flight with all means available.

Even with a decline in the use of shadow banking sector financing instruments, China's financial sector still faces large risks. The current condition of small and mid-sized banks is particularly troubling. Already this year, three mid-sized commercial banks have required government intervention and bailouts. Observers believe a number of other banks are in similar distress, but large market disturbances have so far been avoided. Ultimately, financial market stability is based on confidence in the government's ability and willingness to stabilise markets and cover incurred losses.

US-China trade war increases uncertainty

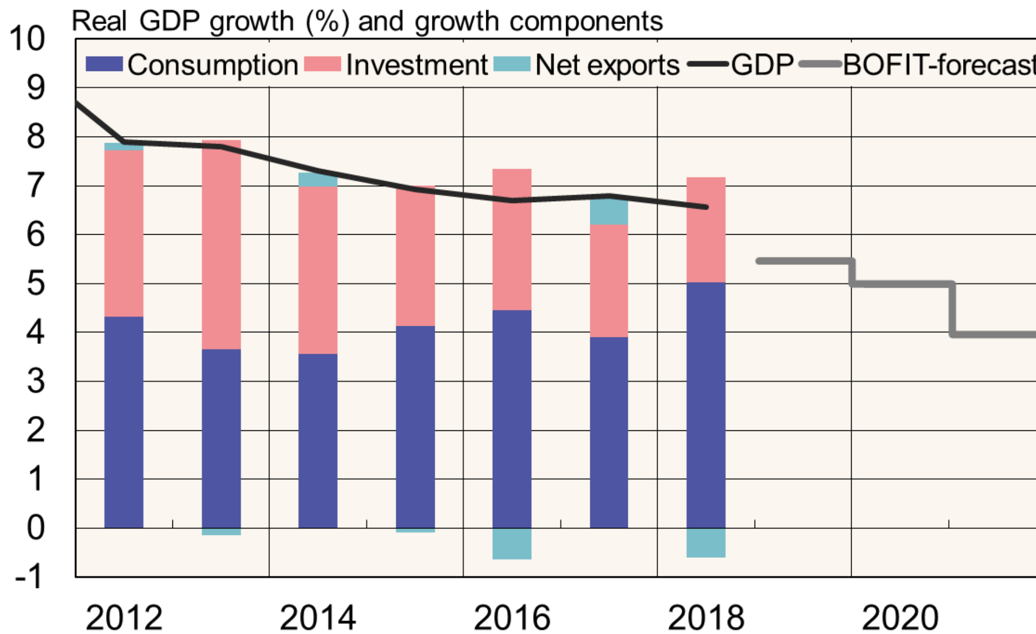
While the slowdown in China's growth can largely be attributed to domestic factors, the escalation of trade tensions over the past year has hardly helped. Current tariffs in force and announced tariff hikes this year cover already about 70 % of bilateral China-US trade. The average import tariff applied by China on American products is estimated to be around 25 %, whereas last year it was only about 8 %. China has slightly lowered import tariffs on other countries, and has granted more tax breaks to domestic export firms.

Tariff increases have reduced foreign trade and the uncertainty around the situation has dampened the corporate appetite for investment. The value of Chinese goods exports to the US this year has fallen by about 10 % y-o-y and the value of imports is off by over 25 %. Chinese goods imports overall have declined several per cent from a year ago and exports are roughly unchanged from last year. Thus, China's trade surplus with the United States continues to rise. China's current account surplus has also risen slightly to just over 1 % of GDP.

Several institutions (including the Bank of Finland, IMF and OECD) estimate that US punitive tariffs and Chinese counter-tariffs reduce Chinese growth by about one percentage point a year when 25 % tariffs are applied to the total bilateral trade between countries. Tighter global financial conditions would increase the negative impacts on the economy.

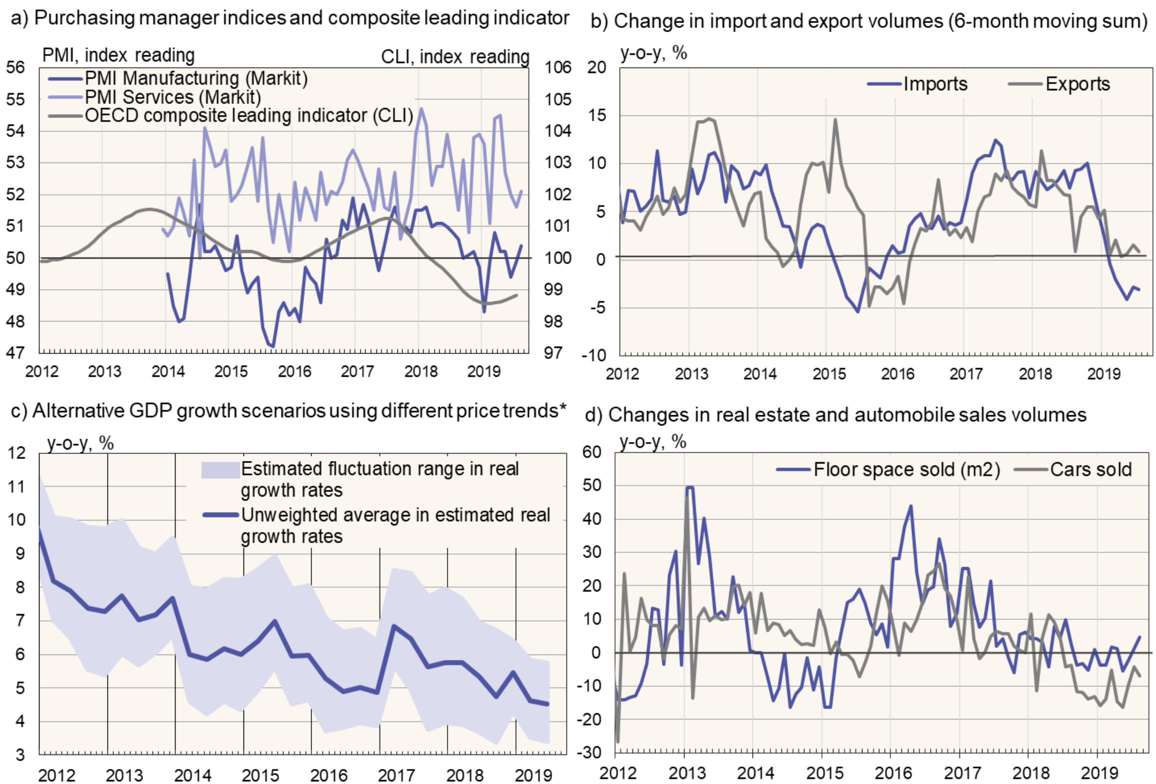
The underlying factors that touched off the trade war are integral to the Chinese economic system. The unfair advantages that distort competition are related to unjust subsidies to state-owned enterprises, forced technology transfers, closing domestic markets off to foreign competition and the absence of political appetite for conforming to international agreements. And the US is not the only country to have voiced such criticisms. We therefore expect trade tensions to continue as any lasting resolution to these issues is unlikely. Dealing with the actual causes of the dispute require system-level changes in China. Chinese attitudes towards the US have become more negative and the conflict has spread beyond trade policy to direct attacks on individual firms. A rise in protectionism or a full-blown technology war would have extensive negative impacts on the Chinese economy and growth.

Figure 1. Official GDP growth, growth components and BOFIT 2019–2021 forecast



Sources: China National Bureau of Statistics and BOFIT.

Figure 2. Business cycle indicators for the Chinese economy



Sources: BOFIT, CEIC, China Association of Automobile Manufacturers, China National Bureau of Statistics, China Customs, Macrobond, Markit and OECD.*See [Kerola, E. (2019)] and [China's GDP growth just keeps on hitting the official target].