BOFIT Forecast for China
20 March 2020

BOFIT China Team

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Bank of Finland
BOFIT – Institute for Economies in Transition

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PO Box 160
FI-00101 Helsinki
Phone: +358 9 183 2268
bofit@bof.fi

www.bofit.fi/en

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China's economic growth was already slowing before the outbreak of the coronavirus epidemic in the latter half of January. The epidemic and strict measures imposed by the government to rein in the accelerating infection rate brought China's economy to a standstill. While we are now witnessing a recovery of the economy that is supported by stimulus measures, it is clear that some lost production will never be made up. Accordingly, our forecasts have been revised downwards. We now estimate that China's real GDP will turn negative this year, but as the situation normalizes, growth is likely to be impressive next year before falling back to the earlier trend. Downside risks have dramatically increased due to the unpredictable fallout from the coronavirus pandemic.

Official Chinese figures show GDP growth fell to 6.0 % in the fourth quarter of 2019. For all of last year, GDP growth was 6.1 %, the level needed for the Party to reach its official growth target. China's official GDP growth figures have been disturbingly stable for several years now, indicating only a minor slowdown. This is not a credible description of the actual growth pace, which has fluctuated considerably. While Chinese growth was still higher than in most countries, the slowdown has been much more substantial than reported.

Based on such indicators as purchasing manager indices (PMIs), Chinese growth in January was slowing even before the coronavirus epidemic outbreak. The coronavirus struck the Chinese economy with full force just ahead of the Lunar New Year holidays in late January at a time when economic policymakers were already struggling with an acceleration in inflation to over 5 % due to skyrocketing pork prices caused by the African swine fever.

In an effort to deal with the rapid spread of the coronavirus, the authorities ordered an extension of the holiday period, restricted travel within the country and imposed quarantines on the Hubei province (ground zero of the outbreak) along with several other provinces and urban centres. Manufacturing and service PMIs fell to record lows in February. Economic growth in January-February was miserable: industrial output was down 14 % y-o-y, retail sales down 24 % and fixed investment down 25 %. The unemployment rate increased a percentage point to over 6 %. As of mid-March, daily indicators showed economic activity was still far below normal levels. GDP in the first quarter will be much lower than a year ago.

Limited potential for stimulus

As the spread of the coronavirus epidemic began to slow within China in the latter half of February, government policy shifted to restarting production. The government has promised firms a wide range of tax breaks, relaxed payment schedules and other support to get production back on track. Several cities have loosened their restrictions on apartment sales to ease the distress of heavily indebted construction firms and developers. Provinces have been active in issuing "special purpose bonds" to help finance infrastructure projects. The People's Bank of China has kept monetary policy accommodative. In addition to regular central bank financing to commercial banks to support corporate lending, the PBoC has offered "special" central bank financing for firms in the hardest-hit provinces. Although reserve requirements of banks have been relaxed, interest rates have seen only marginal cuts so far.

The overall picture for fiscal and monetary stimulus remains fragmented, for example, with respect to real (not just promised) measures by provinces and banks. Banks are apparently unwilling to increase lending to troubled firms as they want to avoid further growth in their stocks of non-performing loans. After years of loose fiscal and monetary policy, it is generally unclear how much growth investment-driven stimulus can generate – especially as services increasingly dominate Chinese economic activity.

At the moment, China's stimulus measures appear limited, but could increase if the situation worsens. Room for stimulus is limited, however, by soaring government debt, inflation and the threat of capital flight. So far, there is little evidence of capital flight and the yuan-dollar exchange rate appears to be holding steady. The current account surplus was 1.2 % of GDP in 2019.

Given the massive economic impacts of the coronavirus epidemic on China, reviving the economy has become quite challenging. In addition to the slow process of mending and reconstituting production chains spanning multiple provinces and branches, there is the stark fact that the clawing back of all losses in service branches will be impossible. Services demand remains overshadowed by fear and wariness. Household demand has been directly impacted by delayed wage payments and worker layoffs. The global spread of the coronavirus depress demand for Chinese exports, making recovery that much more difficult.

China's clouded short- and long-term economic outlook

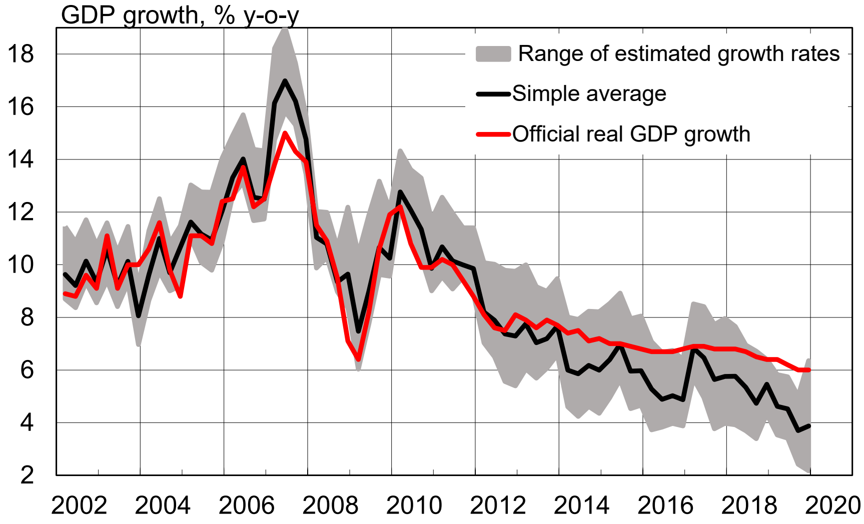
Even before the coronavirus outbreak, China's growth was pushed down by structural trends such as the shift from manufacturing to services and ageing population. The trade war with the United States added a new layer of problems. Indeed, uncertainty around trade policy remains high despite the January signing of the "phase one" trade deal and its entry into force in February. The postponing of needed reforms and the Party's unrealistic growth targets that feed indebtedness have increased the risk of a rapid slowdown in economic growth.

The coronavirus epidemic will directly affect China's growth this year and compound earlier problems and their associated risks. With the huge first-quarter impacts already locked in, a good deal of lost production will never be made up. If China manages to get the epidemic under control, growth will recover later this year. The coronavirus crisis, however, will have long-term impacts such as increased indebtedness and possibly acceleration in the pace of production off-shoring. These phenomena are likely to depress China's growth outlook for years to come.

The poor quality of China's statistical data make evaluation of actual Chinese economic conditions extremely difficult. In the big picture, however, it is apparent that growth has been slowing and market disruptions have become more frequent in accordance with our earlier forecasts. Taking the newest factor, the coronavirus, into account, we now expect Chinese GDP this year to decline from the 2019 level, even if growth resumes in the second half of the year. Following the coronavirus-related recession this year, next year's growth rates could be impressive. Depending on how the recovery unfolds, growth should fall back to around 3 % p.a. in 2022. Although 2–3 % below our October 2019 forecast, the volume of GDP at the end of the forecast period will still be significantly higher than in 2019.

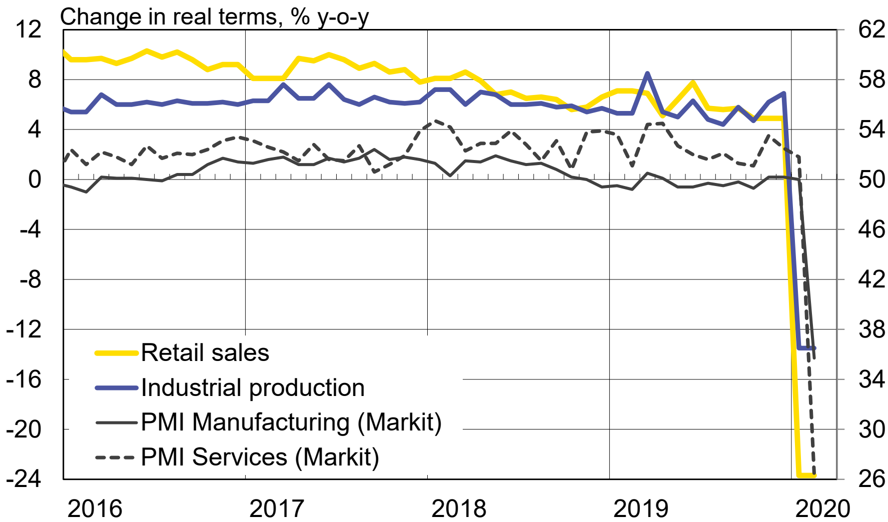
The coronavirus has magnified the downside risks of this forecast over both the short and long term. In the worst-case scenario, the collapse of weak and over-indebted firms triggers a crisis in China's financial sector even before the coronavirus disaster gets resolved. The housing market exemplifies a sector in which heavily indebted real estate developers find themselves increasingly hard-pressed. A rapid deterioration in global conditions, will cause new problems for Chinese companies.

Figure 1. Poor quality of Chinese data complicate analysis of economic conditions and prospects: China's official GDP growth rate and Bank of Finland alternative growth estimates



Sources: Kerola, E. (2019), "In search of fluctuations: Another look at China's incredibly stable real GDP growth rates," Comparative Economic Studies 61(3): 359-380; China National Bureau of Statistics, Macrobond, BOFIT.

Figure 2. Chinese growth collapsed in January-February 2020



Sources: Macrobond, CEIC, BOFIT.