BOFIT Forecast for China
17 September 2020

BOFIT China Team

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China's economy has bounced back from lockdown in the first months of this year, as the country was able to lift restrictions to prevent the spread of the coronavirus, implement stimulus measures and demand for pandemic-related products boosted industrial output. We expect China's GDP to grow slightly this year. While the rate of recovery has levelled off, the 2021 growth figure will be impressive given the weak comparison number for this year. The recovery of the economy has been uneven, with many existing structural problems made worse. The largest risks of the forecast are associated with a new broad-based wave of coronavirus infections and financial sector problems from a reacceleration in indebtedness while firms in many branches are finding it harder to service debt. Uncertainty is heightened by deteriorating foreign relations, especially with the United States.

Many firms were forced to suspend operations and people required to stay home as the government put in place heavy measures to prevent spread of the Covid-19 epidemic in the first months of this year. The spread of the virus was suppressed quickly. Over 80,000 confirmed infections were reported in January-March, but just 3,000 cases in April-August. With the epidemic largely under control, the government was able to lift many restrictions. This easing, combined with stimulus and a successful ramp-up of industrial output to meet the demand for products needed in the new environment, helped the economy rebound quickly. Official figures show GDP growth of 3 % y-o-y in 2Q20, up from a 7 % contraction in 1Q20.

The Chinese economy has overcome the coronavirus crisis faster than we anticipated in our March forecast. We now expect positive GDP growth this year (about 1 % p.a.). An ageing population, shrinking workforce, as well as the need to balance public finances and restructure the economy will restrain growth in coming years. Slow progress in structural reforms will keep productivity gains at modest levels. Even so, growth next year will be impressive (about 7 %) due to the exceptionally low reference point provided by this year's growth figure. In 2022, growth will stabilise around 3 %. Even if the economy has mended quickly and growth will continue in coming years, the Covid-19 crisis will leave a permanent scar on the long-term GDP level. We expect the economy at the end of our forecast period to be about 1 % smaller than it would have been without the pandemic. Our forecast assumes China will succeed in keeping the coronavirus in check domestically.

The poor quality of Chinese statistical data makes assessment of economic conditions challenging. Many alternative estimates of China's economic performance, including those made in BOFIT, suggest that real GDP growth has been lower than official figures for several years. This issue has persisted in 2020. Nevertheless, alternative estimates point to a strong economic recovery in the second quarter, which comports well with official figures.

Covid-19 crisis aggravates economic imbalances

China's economic policy was very accommodative even before the pandemic to help in the pursuit of politically-set growth targets. Stimulus has been increased further this year to support employment and firms, while infrastructure and other investment projects have been launched to bolster economic growth. Due to the support measures and weak revenue streams, the public sector deficit (central and local government budgets, off-budget activities and social funds) should approach 20 % of GDP this year, while public-sector debt approaches 100 % of GDP. Even if many of this year's measures are temporary in nature, measures to balance public finances are needed in coming years in particular, as the government needs to deal with an increasing number of distressed corporations and troubled banks.

One of the characteristics of China's economic model is its inability to allocate resources efficiently. This has been highlighted during the coronavirus crisis. Companies controlled by the state or local governments, often unviable, continue to receive support and are commandeered by politicians to fulfil political goals such as protect jobs or even adding workers on the payroll. Even then, unemployment is higher than it was before the crisis, while real incomes have fallen from last year. This will continue to weigh on private consumption in the months ahead. Thanks to stimulus measures, investments in infrastructure and construction activity are expanding rapidly, even as there are major profitability concerns on the vast level of investments China has been running for years. The share of fixed investment to GDP is on the rise again, thereby putting on ice any hopes of transitioning to an economy that stresses consumption and services. Needed large reforms such as improvements in social security, raising the retirement age and reform of state-owned enterprises are on hold.

While the pandemic has caused the global economy and international trade to contract, Chinese exports have been remarkably vibrant. Chinese industry has been able increase output of products much needed abroad such as equipment for remote work and education, facemasks and other protective gear, as well as medicines and healthcare appliances. When the pandemic eases, global demand for such products will decline, but the global economy will also return to growth, which will help exports of other goods manufactured in China.

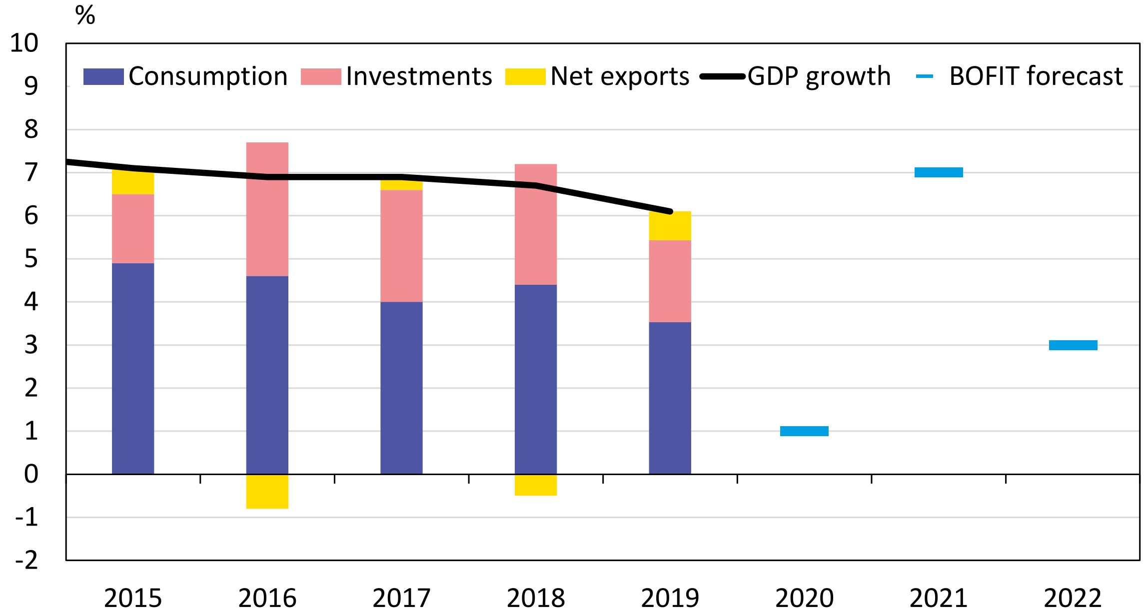
Uncertainty is increased by heightened tensions between China and other countries. China has become more aggressive on its borders and beyond, and has imposed stricter controls on citizens domestically and in Hong Kong. Relations with the US continue to deteriorate – even with the signing of Phase 1 of a US-China trade agreement in January. US-China relations are unlikely to improve in coming years as the competition between superpowers is unlikely to subside. Restrictions and other measures to isolate Chinese technology firms for cybersecurity and intellectual property theft have caused significant harm. The on-going decoupling is expected to weigh down China's growth prospects.

Indebtedness and financial market risks on the rise

Although the pace of indebtedness had moderated slightly in recent years, the Covid-19 crisis has kicked borrowing back into high gear. Similar lengthy borrowing binges in other countries have often ended in crisis. Concerns about the indebtedness and the health of financial sector have limited China's room to manoeuvre in monetary policy. For example, the monetary stance was only relaxed slightly last spring even when inflation pressures were moderate and there was no indication of capital flight leading to major yuan depreciation.

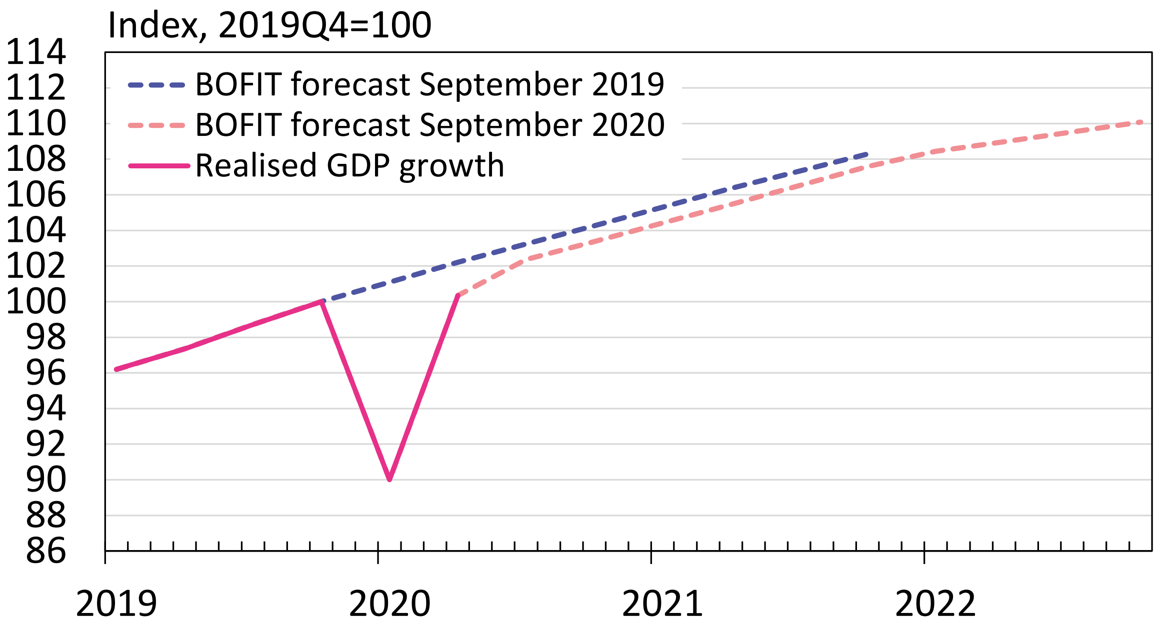
Most debt is held by the corporate sector. It became difficult in many branches to conduct normal business during the coronavirus crisis, with the result that many firms are today struggling to service their debts. China's banking supervision authorities have already warned that commercial banks' non-performing loans are likely to soar. Many real estate developers are deeply indebted, apartment prices are very high relative to incomes and many apartments are purchased for investment purposes. A correction in housing prices would put developers and those with housing loans in great distress. The government has already had to rescue a number of small and mid-sized banks, and more operations are expected. The risk of a major disturbance in financial markets has grown. A new major wave of Covid-19 would slow economic growth and significantly increase financial market risks.

China's GDP growth, contributors to growth and BOFIT forecast for 2020–2022



Sources: China National Bureau of Statistics, CEIC and BOFIT.

Even with a rapid recovery from the crises, the level of China's GDP will remain lower than we fore-casted a year ago



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