BOFIT China Team

BOFIT Forecast for China 2021–2023

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In the second half of 2020, China witnessed a rapid recovery from the covid-19 outbreak. Growth was supported by robust exports and economic stimulus measures geared to boosting fixed investment. China's overall growth prospects, however, remain clouded by persisting structural imbalances further undermined by economic stimulus measures during the covid crisis. Due to the low base of 2020, the apparently strong economic growth this year will settle back to lower levels in the years ahead. Despite rapid recovery, the covid crisis has left the economy more vulnerable. Moreover, external uncertainties have increased, particularly with the efforts of the United States to lessen the interdependence of the two countries. China continues to postpone necessary policy reforms that would improve productivity. The latest five-year plan (2021–2025) calls for increased self-sufficiency and even more government intervention in the economy.

The covid-19 pandemic, which first emerged in China, had its biggest impact on the economy in first quarter of 2020. The government implemented severe lockdown measures and ramped up testing. By successfully reining in the coronavirus spread, the Chinese economy returned to growth in the second quarter of the year, just as the pandemic was advancing elsewhere in the world. By summer, the Chinese government had managed to quell the spread of the disease through targeted application of strict measures. The low rate of infection domestically partly explains the lack of urgency in China for a rush to vaccinate. Some regions still limit the size of gatherings and inhibit movement, and travel into China from abroad remains highly controlled. These measures will affect China's economic performance this year. As an example, Chinese citizens were encouraged to remain in their home districts this year during the normally peak travel weeks surrounding the Lunar New Year holiday.

Official figures show Chinese GDP grew by around 2 % in 2020, making it the only G20 economy to show positive growth last year. Despite a decade of growth-driven policy, China failed to achieve its target of doubling 2010 real GDP by 2020. As domestic consumption decreased last year, nearly all growth came from fixed investment. Robust exports also contributed to overall growth. Alternative indicators suggest that growth in recent years has been lower than official figures indicate. Nevertheless, they concur with official statistics in showing a rapid recovery by the end of last year.

GDP growth for 2021 should be quite impressive thanks to last year's low base and better-than-expected economic trends towards the end of the year. Although quarterly growth this year should be modest (about 3 % in annualized y-o-y terms, and in line with BOFIT October 2020 forecast), annual growth figure is expected to reach about 8 % this year, which is slightly higher than our previous forecast. Quarterly growth in the out years of this forecast is expected to remain roughly at this year's pace, i.e. GDP growth should slow in 2022–2023 to around 3 %, or close to the Chinese economy's long-term potential growth trend. Naturally, such low figures are unlikely to be reported in China's official statistics. By our estimates, the level of GDP at the end of the forecast period will be slightly lower than in our pre-covid forecast. In the light of the forecasted development, the government's official GDP growth target of "over 6 %" for this year would not require overly accommodative economic policies and should leave room to reduce stimulus spending.

Party's growing role in the economy; no significant progress in major reforms expected

External tensions continue to rise. The US-China trade war, which started in 2018, has now expanded to restrict the access of Chinese firms to US technology and financial markets. The restrictions have complicated the operations of many companies and impacted China's ability to manufacture high-tech products and components such as microchips. Joe Biden's presidency is not expected to alter US China policy to any great extent. Other countries, including the EU, continue to demand that China opens up its market to the world, increasing calls for China to level the playing field by ending practices that favour its domestic firms. China's tightened grip on Hong Kong and human rights violations in Xinjiang province have increased tensions with the international community.

As external tensions have risen, China has sped up its effort to become self-sufficient. The just-approved 14th five-year plan (2021–2025) highlights the importance of domestic production and demand alongside the export sector. China seeks to strengthen its domestic firms and increase self-sufficiency especially regarding high technology, as well as energy and food production. Technological self-sufficiency was already a cornerstone of the Made in China 2025 goals announced in 2015. This theme has been incorporated into the latest five-year plan along with the more recent China Standards 2035 strategy.

The state's role in the economy has grown. Direction of the economy by the party's leadership has increased, which has narrowed the operational scope of private firms. This trend will erode China's economic efficiency and increase the possibility of policy mistakes. China sees its centrally-led economic model as superior, reinforced by the fact that the country has weathered the covid crisis better than most of the world. Thus, the likelihood of a change in the direction of economic policy or any broad market-based reforms seems more remote than ever.

Neither the increase in geopolitical tensions nor the emphasis on self-sufficiency have yet to decrease the importance of the export sector or foreign direct investment to China. Indeed, there appear to be no significant changes in production chains located in China in the wake of the covid crisis. Exports performed surprisingly well in the midst of the pandemic, with China increasing its share of global goods trade. Foreign firms have not moved production out of China to any large extent, and businesses surveys suggest most have no plans to do so. Finding reasonable alternatives to China is also difficult. No other country possesses such a huge expanding market and China remains the most efficient production location for many industries. Moreover, the export sector is the most market-driven part of the Chinese economy. It will continue to be an important source of innovation and productivity gains, and thus important for the dynamics of the domestic economy.

Only modest growth expected over the medium term

Strengthening domestic consumption has long been a primary economic policy target. However, there has been little progress in rebalancing the economy from investment and exports to consumption-based growth. If anything, last year's trends suggest that the country is moving away from consumption-led rebalancing. Domestic consumption and retail sales were down from 2019 levels due to slowing income growth and increased uncertainty that made households more prone to save. Domestic consumption may not necessarily provide the hoped-for engine of growth in coming years.

The Chinese have grown accustomed to rapid income gains, but last year saw real disposable incomes in urban areas increase by just 1 %. Wage survey responses indicate a general expectation that there will be no major wage increases this year either. Not only does the lack of appropriate reforms restrain efforts to boost private consumption, but there have been no significant expansions of social security or increased spending on public healthcare and education. Households are thus forced to save a large chunk of their income. The ratio of household debt to GDP has also risen rapidly. Relative to the size of the economy, the ratio of just over 60 % of GDP is about the same as for countries in the euro zone.

Like in past economic downturns, China's response to slowing growth last year relied on investment stimulus. Local governments oversaw bulk of the investments largely financed through off-budget "special purpose" bonds which are supposed to pay themselves back on the proceeds from project returns. Stimulus policies have been necessary to meet China's high growth targets, which means the rate of investment has remained exceptionally high (over 40 % of GDP) for many years. This high rate of investment, in turn, reduces the potential profitability of new investments. Investment growth is expected to slow somewhat this year as economic policy normalises. China's current growth model, however, demands a high investment rate that sustains old economic structures and further increases imbalances.

Fiscal policy conditions have weakened rapidly. The IMF estimates that stimulus measures increased the augmented public-sector deficit last year by five percentage points to 18 % of GDP. The deficit is expected to remain large (over 15 % of GDP) in coming years. The IMF estimates that China's actual public-sector debt, which includes debts of the off-budget financial vehicles of local governments and state funds, rose last year to 92 % of GDP. The public debt-to-GDP ratio is expected to approach 110 % by the end of the forecast period, which still requires partial balancing of public finances through e.g. raising tax revenues. There is only limited room to increase public spending in coming years.

In monetary policy, the cost of stabilising the economy must be balanced against the need to reduce risks to the financial sector. The policy stance was relaxed in the first half of 2020 but was normalised towards the end of the year. Inflation is not expected to be a major monetary policy concern during the forecast period. Consumer prices have been driven by pork prices due to an outbreak of the African swine fever virus. The impact of pork prices on inflation is expected to wane this year. Interest rates in China are higher than in developed countries, which has increased capital inflows into the country and added to appreciation pressures on the yuan. The yuan has appreciated against the dollar since last summer. The real effective (trade-weighted) exchange rate has also appreciated, but less than the dollar-rate.

The current account surplus rose to 2 % of GDP last year on a growing goods trade surplus and shrinking service trade deficit caused by the drying up of Chinese tourism abroad. Current account surplus is expected to shrink as the effects of the covid pandemic begin to fade globally. At the same time, China's export shares, which grew temporarily during the pandemic, are expected to return to their earlier levels. The room to manoeuvre in monetary policy is restricted as monetary policy tightening to deal with rising indebtedness and financial sector risks could lead to a sharp rise in debt-servicing costs for the highly indebted corporate sector, which in turn could potentially set off a wave of defaults.

Rising economic imbalances due to the immediate fallout from the covid crisis and persisting structural defects lower China's long-term growth potential. The contraction of the working-age population is already affecting growth and its impact will accelerate in the years ahead. By our estimates, total debt-to-GDP ratio (excluding the financial sector) rose by nearly 30 percentage points last year close to 290 % of GDP. Even if the debt ratio were to stabilise, the debt servicing costs have increased, slowing the growth of consumption and investment.

Covid has exacerbated economic imbalances and risks

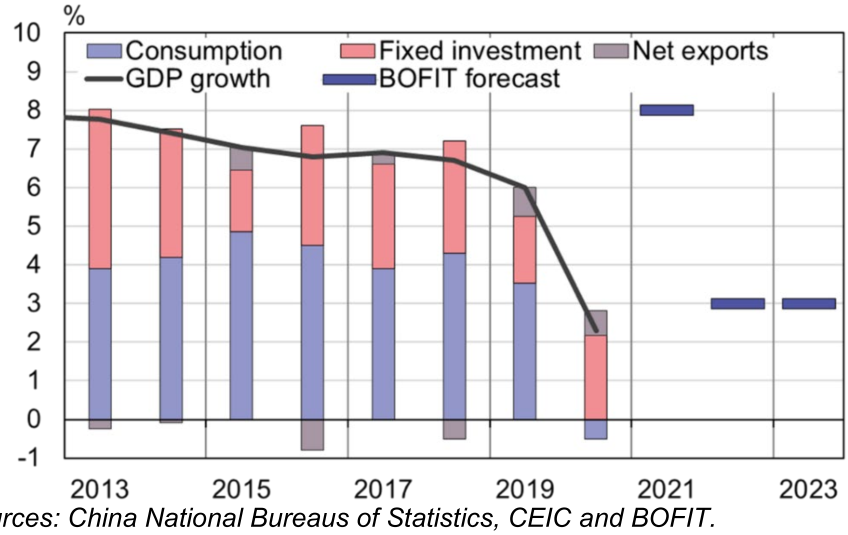
Rapid growth in indebtedness fuels risks. China experienced a similar debt surge in the wake of the global financial crisis, but economic growth at that time of around 10 % p.a. made it easier to deal with the debt-servicing challenges. In contrast, the deterioration of the financial condition of Chinese firms from the covid pandemic remains unclear. Companies have been allowed to postpone their loan repayments to this year. Banks have seen their profits shrink, and there have been a number of high-profile bailout cases of smaller banks in recent years.

Real estate developers in that heavily indebted sector have seen limits placed on their borrowing. Given the huge economic significance of the real estate sector, any disruptions in the housing market present major risk to the economy. Corporate bond defaults have been permitted in recent years, even if the default rates are still quite low. As China shifts to a more market-based financial system, defaults are expected to increase and financing costs should rise to better reflect corporate risks.

The continued stimulus policies may fail to leave sufficient room to address economic imbalances. Keeping growth at a level above forecast would require continuing the massive debt-funded stimulus. In such environment, much needed major productivity-enhancing reforms, which might briefly slow growth and possibly rock financial markets, are easily postponed hurting long-term growth prospects. President Xi Jinping declared late last year that China has all the means to double the size of its economy between 2020 and 2035. Many interpret this aspiration as an implicit growth target that requires GDP growth to average nearly 5 % a year over the next 15 years.

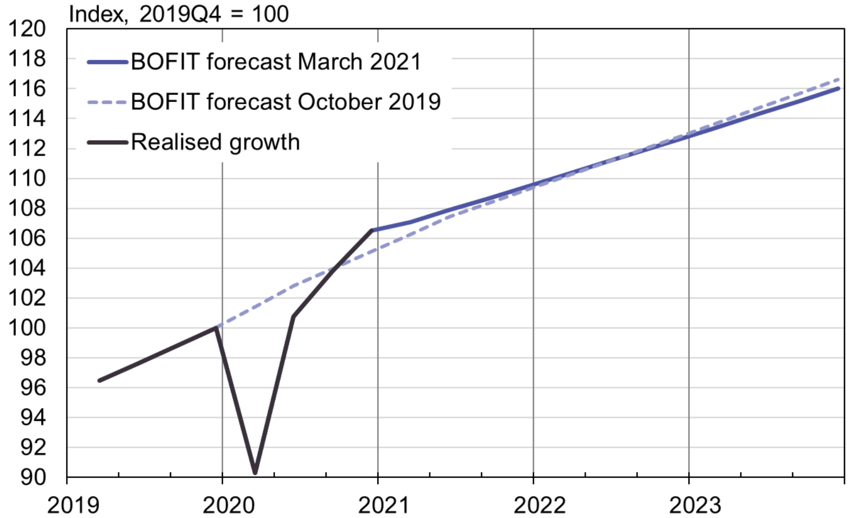
China's deteriorating foreign relations are already generating downside economic risk. The United States could step up measures to block Chinese expansionism. Anti-China measures could also be adopted by other countries that would significantly impact Chinese firms.

Figure 1. China's GDP growth, contributors to growth and BOFIT forecast for 2021–2023.



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

Figure 2. GDP growth trajectory under the new BOFIT forecast compared to our pre-covid forecast.



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