BOFIT Forecast for China
16 September 2021

BOFIT China Team

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Stimulus spending on the corporate sector and fixed investment, together with a strong export performance, have helped China recover rapidly from a pandemic-induced slowdown in the first half of 2020. While rapid recovery and last year's low basis assure high on-year GDP growth figure this year, the speedy phase of economic recovery is over and lower growth lies ahead. China is struggling with a shrinking working-age population and high levels of debt that hinder deployment of capital to other uses. Moreover, there has been little progress in productivity enhancing reforms. While higher-than-expected growth is possible if consumer demand strengthens markedly, the risk of below-forecast growth has also increased during the pandemic. Growth could be severely impacted if debt becomes unsustainable, financial market disruptions generate uncertainty that spreads to the real economy or foreign relations hit an impasse.

Industrial output, construction and foreign trade had not just recovered from the pandemic-induced slowdown by the end of the first half of 2021, but actually surpassed pre-pandemic levels. In contrast, private consumption continues to be profoundly impacted by Covid-19, as households have increased their savings and lockdowns limit spending opportunities. Growth still lags pre-pandemic levels in retail sales and service industries. Given China's huge population, its infection rate has been quite low even with the delta variant. Over two billion covid vaccine doses have been administered throughout the country. Whenever small infection clusters have appeared, Chinese officials have moved quickly to impose restrictions on movement and gathering. If the current virus suppression strategy stays in place, it could be a long time before the ending of lockdowns and other restrictions.

This year's GDP growth target of "above 6 %" should be surpassed easily. The 2020 Covid Recession was relatively small in China due to its efficient suppression strategy and stimulus measures. Aggressive use of stimulus in many countries and an improving global economic outlook are likely to support export demand, thereby assuring Chinese industries stay busy in coming quarters. A high degree of capacity utilisation also predicts growth in industrial fixed investment. Under our revised forecast, on-year GDP growth rises to about 8 % this year, mostly due to last year's low basis. On-quarter growth should remain around 1 % next year, slowing a bit in 2023. On-year growth correspondingly falls to 4 % next year and to around 3 % in 2023.

Structural adjustment of the economy proceeds slowly; companies face regulatory crackdowns

Increased fixed investment helped sustain economic growth last year. The contribution of fixed investment relative to GDP, already high in China's case, rose even higher. Tepid consumer demand, the flipside of overemphasis on fixed investment, has manifested during the pandemic as increased household savings and growth in real disposable income below GDP growth. The structural change towards a consumption-driven economic model is not proceeding this year. Instead, we expect fixed investment's share of GDP to rise slightly with a corresponding decrease in consumption. The situation should eventually begin to correct, but the latest five-year plan (2021–2025) only places minor emphasis on structural reforms needed to move China to a consumption-driven model emphasising services. Notably, the plan calls for keeping stable the ratio of industrial output to GDP. In addition, the ambitious goal of carbon neutrality by 2060 would require a major overhaul of China's economic structures and growth engines. However, the impacts from such changes will not be apparent during the forecast period as China to date has taken very few concrete measures to reduce its emissions.

In August, president Xi Jinping highlighted again the need to deal with inequality through "common prosperity." Common prosperity could imply changes that have profound implications for growth and the structure of the Chinese economy if they would affect taxation, social security and social mobility. The reform urge recently has focused on corporate oversight, with regulatory crackdowns e.g. in the construction and financial sectors. Decision-makers have also moved quickly to pass stricter laws on data security and data handling, as well as greater protections for personal data. Cartel laws are now construed more rigidly. The regulatory updates for the platform economy, in particular, have large implications for China's giant tech firms. As regulations change and the operating environment becomes increasingly unpredictable, private actors suffer most. The overall result is lower productivity and lower economic growth.

With stimulus largely over, government focus shifts back to quelling debt

The broad-based 2020 stimulus left a large hole in China's public finances. Although certain pandemic-related support measures will remain in place through 2023, the major fiscal stimulus measures have ended. However, the fiscal policy will remain accommodative, and the IMF estimates that the public sector deficit over coming years will continue to be above 15 % of GDP. Figures from the Bank of International Settlements (BIS) put China's total debt-to-GDP ratio last year at 290 %. With the worst of the crisis behind, the government has pivoted to dealing with rising indebtedness. The central government has publicly demanded local governments to deal with their debt issues. The pandemic has made solvency more challenging for many firms, which could increase the stock of non-performing loans held by the banking sector. Eroding bank profits, particularly those of smaller banks, have already led to weaker bank balance sheets.

In the monetary policy sphere, officials are forced to balance the need to reduce financial market risk and indebtedness against the need to maintain macroeconomic stability and ensure that firms can service their debts. Monetary policy rates have remained unchanged this year and no anti-inflation measures are expected in the forecast period. Growth in the credit stock has been managed through direct window guidance to banks. The yuan's nominal exchange rate was last this strong in the first half of 2018. The yuan had appreciated by about 8 % in August from the start of 2020 against both the US dollar and a trade-weighted basket of major currencies. The dollar has been on a depreciating trend, which bolsters the external value of the yuan together with China's favourable economic development, increased trade surplus and capital inflows. China's real effective (trade-weighted) exchange rate (REER), which takes into consideration differences in countries' inflation rates, has been depreciating since March. As of August, the yuan's REER was just 2 % stronger than at the start of 2020. The yuan is not expected to appreciate further during the forecast period.

Rising external tensions still have little impact on China's real economy

Political tensions with Western countries continue to increase. The Biden administration has not taken steps to improve China-US relations and the trade-war measures implemented during the previous administration remain in place. In particular, technology export restrictions have complicated operations of certain Chinese firms, particularly with respect to manufacture of high-tech products and access to components. Western countries have imposed additional sanctions on China for dismantling of democratic institutions in Hong Kong and human rights violations in the Xinjiang region. China has responded to Western sanctions with countersanctions.

The struggle between superpowers, decoupling and increased political tensions, however, have yet to drive foreign firms out of the Chinese market. UNCTAD reports that China was one of a handful of countries last year that saw its foreign direct investment inflows increase. Exports have clearly grown faster than the global average, and China's share of global exports rose last year to 15 %. In our latest forecast, we see export growth remaining strong for the rest of this year. China will continue to increase its global market share, but growth will slow in coming years. While regulatory crackdowns and actions in the trade war have rocked share prices of Chinese firms and increased political risk, this year has still seen a record volume of foreign investment flow into mainland China stock markets.

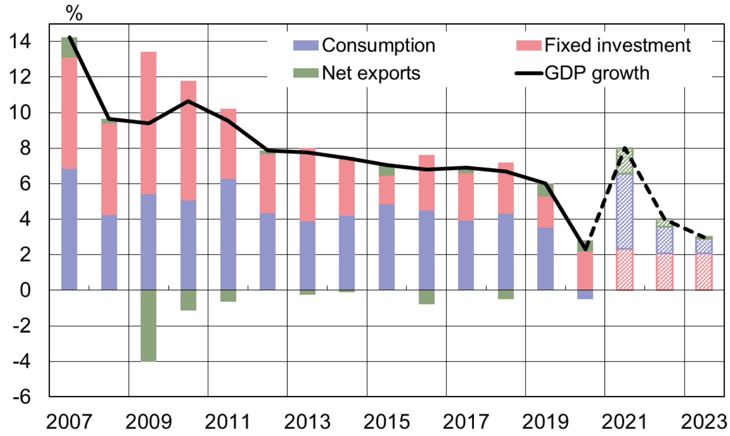
Slowing growth inevitable

Most of China's growth slowdown can be attributed to hard-to-tackle structural factors. The new census completed this year highlights China's demographic challenges. An ageing population, a declining number of working-age persons and a faster-than-expected drop in the birth rate all imply that China badly needs productivity-enhancing reforms to deploy capital and labour inputs more efficiently. Reform of state-owned enterprises has not progressed – instead the government has sought to improve SOEs' profitability through merger of laggard firms into ever-larger conglomerates. Firms owned by the central government or local governments tend to be less efficient than privately-held firms. Thus, this oversized role of state firms hurts productivity and economic growth. Tighter regulation has made operation of private firms even more difficult and eroded profitability in many branches. Moreover, the unbridled plunge into indebtedness of certain sectors has continued for years. Combined with rising debt-servicing costs, it becomes increasingly difficult to deploy capital investment to its most appropriate uses. Even if the government were to succeed in quelling the rise of indebtedness and applying consistent rules to the financial markets in a manner that reduces financial market risk, these measures would equally reduce economic growth, at least in the short-run.

Alternative indicators suggest that economic growth had already slowed to near 4 % p.a. before the pandemic. Official figures, however, continue to show GDP growth outperforming the low bar of set targets. China finds itself in an unusual situation as it currently has no official long-term GDP growth target. Perhaps the closest form of a target is president Xi Jinping's declaration last autumn that it is "completely possible" for China to double GDP between 2020 and 2035. If that declaration is used as a target, official figures would have to show average growth above 5 % p.a. over the next 15 years.

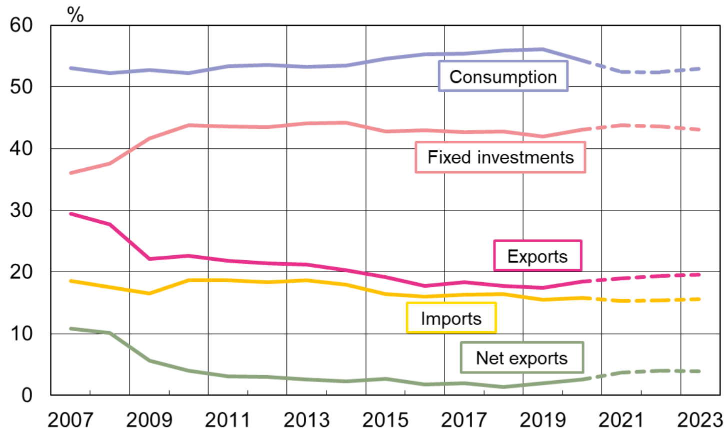
There is, of course, a possibility of higher-than-forecast growth if household consumption demand strengthens more than estimated. This could occur if the pandemic wanes faster than expected, restrictions are lifted and a semblance of normal life returns. Demand could also strengthen if the government embarks on reforms to support consumption under the auspices of a proposed common welfare scheme. Nevertheless, the familiar risks of lower growth have risen during the pandemic. Growth could weaken significantly if China's debt burden becomes unsustainable, uncertainty from a large financial market disruption spreads to the real economy or foreign relations hit an impasse.

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



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

Figure 2. Structure of China's GDP (BOFIT 2021–2023 forecast).



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