BOFIT Forecast for China
25 April 2022

BOFIT China Team

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China's economic growth slowed sharply towards the end of 2021. Despite subsequent stimulus efforts this winter, this year's growth trend will be determined by the major covid outbreak and strict efforts all over China to suppress the outbreak. Recent worsening of the covid situation has complicated government attempts at reviving growth and strikes hard at an already struggling real estate sector. As a result, we now expect considerably lower economic growth this year than indicated in earlier forecasts, while 2023 growth is bolstered by rebound in consumption demand and the stimulus efforts in the second half of this year. Uncertainty related to the covid outbreak and government policy to control it are substantial. A prolonged covid wave could easily lead to even weaker growth than expected. However, if the situation quickly improves with infection rates brought under control or adoption of covid policies similar to those of other countries dealing with current virus variants, the economic damage could be mitigated. Moreover, real estate developers' woes will continue to deepen, which might spill over more widely to the financial sector. The economic outlook would also be altered by further deterioration of relations with the West depressing growth, or conversely, a rapprochement with the West that boosts growth.

China's economic growth last year was exceptionally robust as it bounced back from the 2020 Covid slump and exports were boosted by the strong global demand. The final months of 2021, however, saw a steep slowdown in growth lead by the weakened real estate activity as new government rules constrained the borrowing of deeply indebted real estate developers. Official numbers show fourth-quarter GDP growth slowed to just 4 % y-o-y. Alternative GDP figures suggest an even larger downturn. Although economic growth gained steam in the first two months of this year, some of those gains were lost with the rapid increase in covid infections in March and the imposition of new covid lockdowns. The National Bureau of Statistics reports GDP growth of 4.8 % in the first quarter of 2022.

Covid outbreak and lockdowns drag down growth this year

This year's economic outlook will be heavily influenced by China's covid situation and covid strategy in the months ahead. Reported covid infections have skyrocketed in recent weeks and well exceed the daily numbers reported in the first wave of early 2020. During March and April, covid restrictions have been tightened around the country. Shanghai and some other cities have imposed strict lockdowns to curb the spread of the virus. China's zero covid approach interferes with normal business, disrupts logistical chains and reduces consumption. Even though public dissatisfaction with zero covid policies seems to be on the rise, there are no indications that China plans to shift away from its zero covid strategy to a different approach. We assume that newer variants of SARS-CoV-2 will spread widely this year, and that many cities will experience temporary lockdowns as zero covid policies remain in place.

Domestic consumption demand, which was flat during 2020, recovered strongly in 2021 and accounted for two-thirds of all economic growth. Increased covid infections and lockdowns now seem set to again depress consumption growth. The growth in real disposable household incomes will be muted. Real incomes have typically kept pace with GDP growth in recent years and this trend should continue. The uncertainty associated with the latest pandemic wave can cause households to save a larger share of their income as they did in 2020.

Surveyed unemployment in March approached levels last seen in early 2020. Because employment is high on the government's agenda, however, we expect officials to keep employment levels reasonably stable, even if it means resorting to blunt measures. We expect domestic consumption to recover as the covid situation eases towards the end of this year. In 2023–2024, consumer demand is expected to be the main driver of economic growth.

Not only have covid and lockdowns made it harder this year for the government to move ahead with investment projects, they have added to uncertainty about future endeavours. Lockdowns represent another blow to real estate sales and construction activity that started to contract last year due to tightened borrowing rules on developers. A slowing global economy and faltering domestic demand will dampen productive investments. Public sector investment will likely increase markedly this year, especially in the second half. While fixed investment in China remains at over 40 % of GDP – an exceptionally figure by any international standard – the economy seems nevertheless on track to a gradual rebalancing. Rebalancing and lower reliance on debt-fuelled investment should help reshape China's warped economic structures.

Global growth during the current forecast period is expected to be considerably than in 2021. Export growth, an important driver of Chinese growth last year, should fade and remain well below the 2021 level for the entire forecast period. The current covid outbreak and covid restrictions present a special set of challenges to export production and logistics, not to mention the structural factors hampering export growth. During the first two years of the pandemic, global demand soared for goods produced in China such as computers and electronic accessories needed for working remotely from home, as well as pandemic-related goods such as vaccines and personal protective equipment (PPE). Demand for such goods gradually fades, as the behaviour of consumers in China's main export markets will begin to adjust to an endemic-covid world. The distinct slowing of economic growth this year is reflected in China's reduced need for imported commodities, even if economic trends have previously had limited impact on imports of certain commodities such as crude oil.

Because the spread of covid and harsh measures to contain virus spread, we now expect Chinese economic growth to slow this year to just 2 %. This year's stimulus measures kick in in the second half of the year, which, along with strengthened domestic consumption, boosts 2023 GDP growth to 4 %, after which it again settles back to around 3 %. While these growth figures are rough estimates, they provide a picture of China's actual GDP growth trend. The gap this year between official numbers and the actual situation will likely expand as officials are under tremendous pressure to hit the official "about 5.5 %" GDP growth target.

Long-term economic growth will be affected by a familiar set of factors. Working-age population continues to shrink, dependency ratio continues to worsen, and decision makers continue to procrastinate over retirement age reform. We expect the migration of people from the countryside to cities, which has long sustained investment demand, to slow further. A new set of challenges also awaits policymakers as the country adjusts its growth paradigm from fixed investment and heavy industry to domestic consumption and services. Productivity gains have been modest in recent years as large critical reforms have either been postponed or progress in reforms has been slow. The land reform seems to be on back burner. Efforts to improve and extend public services and social safety nets have been minor. Despite relaxation of some *hukou* household registration system rules, many restrictions remain. China's long-awaited property tax reform was shelved this spring. A strategy for reducing China's internal barriers to trade proposed this month could boost growth, but all depends on its implementation. In any case, China's success in implementing critical reforms remains important especially from a long-term growth perspective.

Economic policies set to support growth

China's economic policy stance has for years been extremely growth supporting. The government increased its stimulus efforts during the winter, but currently seems focused on dealing with the covid outbreak. We expect that as soon as covid infection rates are under control and virus is no longer spreading, focus will shift back to stimulus measures. Investment-driven stimulus is the most tempting instrument in the decisionmaker toolkit. However, this kind of stimulus comes with the risk of displacing environmentally sustainable growth policies and complicating the country's efforts to hit its carbon reduction targets. Moreover, stimulus efforts have more and more constraints. The IMF notes that China's public sector deficit has been running above 10 % of GDP for years, and estimates that this deficit reached 16 % of GDP in 2021. As a result of persistent large deficits, general government indebtedness has risen to over 100 % of GDP. Local governments, usually the ones called upon to provide stimulus, account for the lion's share of this indebtedness. According to the finance ministry, some cities are already running pronounced deficits and struggle just to keep up with basic expenditures. We believe the willingness and ability of local governments to implement broad stimulus measures could fail to match Beijing's high expectations, particularly in the case of local governments that have already devoted considerable resources to the central government's zero covid battles. The cooling of the real estate sector will also hurt local government coffers as demand for land use rights continues to wane.

To support economic growth, the People's Bank of China eased its monetary stance in December by lowering the reserve requirements for commercial banks and cutting policy rates slightly in December and January. In January-March, central bank money market operations had a net tightening effect, and on-year growth in bank lending is now at its lowest level in two decades reflecting the subdued growth in loan demand. Even if the PBoC has said it is only waiting for the appropriate moment to act, it is under strong domestic pressure to ease. In late April, the reserve requirement was slightly cut again. As the rise in consumer prices has been modest so far, the central bank has some leeway for lowering rates. However, the central bank seems to be concerned on financial stability decreasing its eagerness to ease monetary policy. In addition to visible monetary policy easing, officials can resort to direct guidance of the large state banks. Chinese monetary easing is against the general trend to tightening seen in other major economic blocs. Indeed, rising US interest rates are already fuelling capital outflows from China. A Chinese decision to lower rates when other central banks are raising rates exacerbates this gap, increases capital outflows from China and puts depreciation pressure on the yuan. As seen in the past, China can resort to abrupt and drastic measures to stem large-scale capital flight.

Formulation of economic policy comes with its own challenges arising from the unreliability or incompleteness of critical economic indicators and data quality. Officials charged with setting policy suffer from the poor-quality statistical reporting on which they must base policy. In the worst case, bad data can create a false picture of the economic conditions that leads to inappropriately dimensioned policy measures or even completely incorrect policy responses. These data-quality issues continue to mount with no improvements on the horizon.

Uncertainty due to covid, China's struggling real estate sector and Russia's invasion

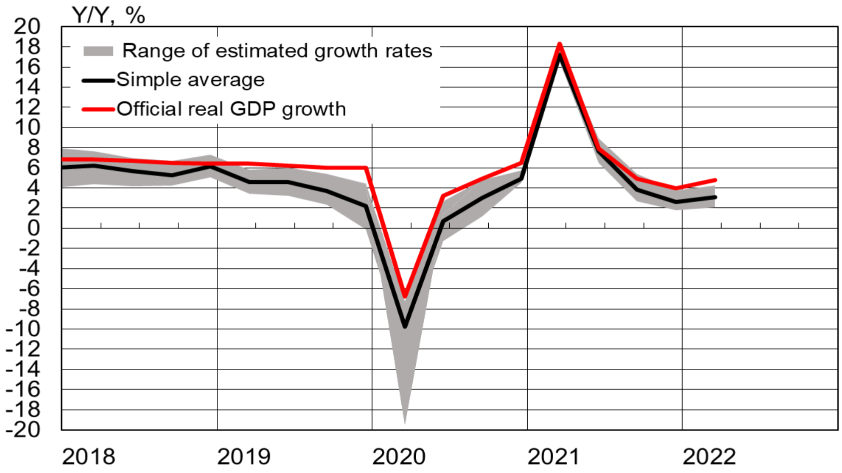
Large uncertainties persist from covid and covid restrictions. If lockdowns become more widespread or drag on, economic growth could be even much lower than our baked-in assumption of reduced growth. On the other hand, growth could pick up this year if covid infections are swiftly brought under control or covid measures are relaxed.

We expect that an ever-increasing number of builders and developers in the real estate sector will struggle to meet their debt obligations and find reasonably priced financing. If the current covid wave further depresses housing sales in an already-slowing real estate market, it would exacerbate the developer financing woes and drag out completion times for current projects. Bankruptcies of troubled major developers or a significant increase in non-performing bank loans could drive some small and medium-sized banks into insolvency, which in turn could lead to more bank collapses and an increased risk of systemic failure. China's real estate prices are extremely high relative to income levels, so any downward correction in housing prices would immediately weaken bank balance sheets.

Russia's invasion of Ukraine has yet to have much impact on the Chinese economy. Both Russia and Ukraine are minor export markets from a Chinese perspective, and the financial interdependencies between China and the countries are minimal. The increase in global commodity prices caused by the war, however, are reflected in the values of China's imports and domestic prices. China's response to the major economic sanctions imposed on Russia is likely to put even greater emphasis on national security and self-sufficiency. Both themes have been high on the Chinese political agenda since the trade war between China and the United States broke out in 2017 during the Trump administration. The realisation of country risk in Russia has also forced foreign firms operating China to re-evaluate the potential costs of staying in China against those of offshoring production. Chinese firms might intentionally or otherwise violate Western sanctions and find themselves subject to sanctions. Finally, China's current tightrope act of appeasing Russia and the West can be untenable over the long run. If China decides to support Russia economically and militarily, it must accept the resulting huge damage to relations with the West and the possibility that sanctions will be extended to China. If China condemns Russia, it loses an important geopolitical partner, but enjoys improved relations with the West that could bolster economic growth.

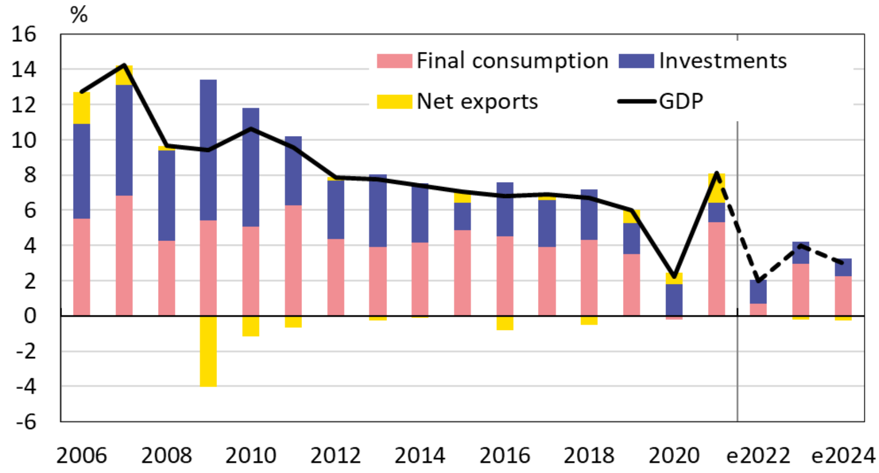
President Xi Jinping is set to be nominated for his third term as party leader and president in autumn 2022. Since Xi assumed office, the position of the party and the state on the economy and society in general has hardened. Decision-making has increasingly become concentrated in the hands of a single person. Greater government power and concentration of power can result in economically bad decisions. Moreover, long-standing practical approach to economic issues is being mixed more and more with political and ideological postures, which can produce poor economic outcomes or even damage the economy. China's economic policies continue to enshrine politically palatable notions of stability and overly ambitious GDP growth targets that leave little room for pushing ahead with critically needed reforms.

Alternative GDP calculations suggest actual economic growth has been lower than official numbers for years



Sources: Calculations made in Bank of Finland with figures from China's National Bureau of Statistics and Macrobond. Estimates based on Eeva Kerola (2019), "In search of fluctuations: Another look at China's incredibly stable real GDP growth rates," *Comparative Economic Studies* 61(3): 359-380.

BOFIT Forecast for China 2022–2024 and growth contributions



Sources: China National Bureau of Statistics and BOFIT.