BOFIT Forecast for China
31 October 2022

BOFIT China Team

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Bank of Finland
BOFIT – Institute for Emerging Economies

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PO Box 160
FI-00101 Helsinki
Phone: +358 9 1831
bofit@bof.fi

www.bofit.fi/en

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China's current modest economic growth will likely extend through 2024. For the third year in a row, China's strict zero-covid policies are hurting firms and crippling household confidence. The struggles of the real estate and construction sector will also continue with no quick fixes in sight. Lower global growth clouds prospects for Chinese exporters. With structural factors already depressing growth, China's long-term outlook has become even bleaker with intensified superpower competition and geopolitical tensions. There is also a risk from the shift to domestic policies emphasising ideology and nationalistic priorities as they may conflict with policies strengthening economic growth. Soaring indebtedness, possible contagion from the real estate sector to the wider economy and continuation of zero-covid policies have already heightened risk to financial markets. Lowered growth expectations increase downside risks and make it harder to tackle emerging issues. The economy is in a weaker position to apply countercyclical stimulus measures than in previous years. Geopolitical risks have also increased.

Helped by a rebound in private consumption and strong export demand, the Chinese economy recovered last year quickly from the covid slowdown in 2020. The situation this year has been quite different, however, as the spread of the omicron variant led to widespread lockdowns last spring. Strict covid measures continue at the local level to this day. While most of the world has moved on to living with the virus, China's tough suppression strategy remains in place. Travel within the country has yet to return to pre-covid levels and foreign travel is almost non-existent. Covid restrictions and uncertainty over future lockdowns have reduced consumer demand and consumer confidence, affecting the service sector in particular. Youth and internal migrant unemployment have increased, and the situation is not expected to change any time soon. During the past year, China has been slow to vaccinate its population against covid, and vaccination rates among the elderly are low. China's leadership has yet to indicate if or when it might modify or abandon its zero-covid policies. The financial difficulties of real estate developers continue to snowball and are clearly reflected in this year's economic trends. Apartment sales are down by about 25 % from a year ago, while construction starts are down by almost 40 %.

Weak growth in all forecast years

We now expect GDP growth to reach just around 2 % this year. Even though growth recovered somewhat from a weak second-quarter performance, alternative estimates suggest that the third quarter growth was significantly lower than the official figures. We expect fourth quarter growth to be sluggish. The Chinese economy should grow by around 3 % p.a. in 2023 and 2024. Our growth forecast for next year is slightly lower than in our April forecast as we now assume a delay in the positive impacts from the lifting of covid restrictions and the outlook for the global demand has significantly worsened. China's covid restrictions should largely remain in place until next year. Even if China is able to relax its restrictions in 2023, covid uncertainty extends over the entire forecast horizon.

China's growth over the forecast period should roughly match growth of the global economy. With China's long-standing role as one of the engines of global growth is now coming to an end, the country is no longer expected to grow its share of the global economy as in earlier years. The modest growth in aggregate demand, however, conceals vast differences across provinces and branches. Indeed, impressively high growth could be seen in some sectors and especially China's poorer regions.

The embellished GDP growth figures issued by Chinese officials complicate determination of the true economic situation in China and make it harder to scale economic activities appropriately. Most independent estimates suggest that China's actual economic growth this year has again been lower than official figures. While it is unlikely that official figures will fully express slowing growth, China's leadership made the exceptional concession this summer that the country would not reach its ambitious official 5.5 % 2022 GDP growth target. The decision to reduce the role of numeric growth targets in setting economic policy would be welcome as it would reduce incentives for politicians to fudge their GDP growth figures.

Reforms to support growth still essential

Nearly all GDP expenditure categories are subject to downward pressure. Covid restrictions and uncertainty about future earnings have driven people to save more and are slowing private consumption growth. Lower global growth should be reflected as a contraction in net exports. We expect the contribution of net exports to growth to turn negative next year. Investment plans have been dogged by problems in the construction and real estate sectors as well as rising corporate uncertainty. Although the biggest drop in construction activity will occur already this year, construction volumes are expected to remain permanently at lower levels. Public consumption accounts for 16 % of GDP, so any increase in public expenditures only has a limited impact on total demand. Consumption demand should contribute more to growth next year. The ratio of consumption to GDP should fall a bit this year from last year's 54 %. The ratio should then rise, albeit very slowly, in the later years of our forecast.

Economic policies should support structural reforms that move the economy toward a consumption-driven, rather than investment-driven, growth. Such a shift requires phasing out of zero-covid policies as fast as possible to revive consumer confidence and improve employment. Progress in long-needed social security reforms would allow households to shift part of their savings to consumption. Reforms should include hikes in unemployment insurance and pensions, as well as increased investment in public healthcare and education.

Reforms that boost productivity and improve the business environment are essential to higher growth. During the Xi Jinping era economic matters have taken a backseat, while ideology, party control and national security have become the top political themes. The state has expanded its role in the economy, and the operating environment has become harsher and less predictable, especially for private firms. Industrial policy steers investment to state-designated projects (e.g. high-tech), an approach unlikely to boost the overall economic productivity. In any case, productivity gains are essential to overcoming the structural challenges facing China – particularly the rapid ageing of the population. The UN finds that the median age in China has already surpassed that of the US. Raising the retirement age, again mentioned at the Communist Party National Congress in October, should ease the situation.

As tensions increase between major powers, China has found it important to stress self-sufficiency and supply chain security. Foreign companies are weighing decisions to invest in China much more carefully than earlier. The export controls on high-tech chips and semiconductor manufacturing equipment imposed by the US Department of Commerce on

Chinese firms directly affect firm operations as well as China's ability to manufacture technologically sophisticated products. In addition to its push for renewable energy, China's efforts to increase energy independence have led to increased investment in coal-fired power plants. China's inability to wean itself off coal makes it difficult for the country to cut its overall carbon emissions or meet its carbon-neutrality targets.

Debt detracts from stimulus possibilities

China's overall debt-to-GDP ratio (excluding the banking sector) already exceeds 290 %. The IMF estimates government sector indebtedness at 110 % of GDP. We expect China's debt-to-GDP ratio to rise during the forecast period. Although almost all Chinese debt is domestically held, rapid debt growth would increase financial market risks, particularly if corporate profitability declines. At minimum, a large debt burden is a drag on growth as the expenditure on large debt-servicing costs detracts from firms' and government's abilities to spend on more productive uses.

Although the government has so far refrained from large-scale developer bailouts, massive funding will be needed to rectify problems in the real estate sector. State banks, state-owned enterprises and local governments have been largely responsible for implementing support measures. Most support has gone to resolving the payment problems surrounding investment projects of private firms, which means that the real estate sector has come increasingly under state control. The real estate sector is a major pillar of the Chinese economy. By some estimates, it accounts for about a quarter of GDP when related businesses are included. Most Chinese household savings are invested in properties. A decline in apartment prices would thus impact household wealth and depress consumption. While at least official figures suggest that declines in apartment prices have been modest so far, resolution of real estate sector problems is essential to restoring apartment-buyer confidence. Even if current problems are resolved, real estate construction will no longer be the economic growth engine it once was.

Monetary policy easing to support the economy has been limited this year. In many cases the accommodative measures have been targeted and are not reflected in general measures of monetary policy stance, such as key policy rates. Banks have been instructed to increase their financing to different sectors, but at this point the issue is weak demand. Unlike in most countries, inflation is not currently much of a problem in China, with consumer price inflation remaining below 3 %. Moreover, we do not expect inflation to constrain monetary policy in the forecast period. On the other hand, rising interest rates outside China make it difficult for China to ease its monetary stance without inflaming fears of capital flight and yuan depreciation. Rates on long-term US treasuries now exceed Chinese rates for the first time since 2010. Due to the dollar's strong performance this year, the yuan has lost 14 % of its value against the dollar. At the same time, the yuan has appreciated against most other currencies, including the euro.

Spending on supports and subsidies will increase central and local government indebtedness at a time when government finances are already deeply in the red. The IMF puts the actual annual public sector deficits over the past five years in the range of 12–20 % of GDP. Local governments are particularly squeezed as they are responsible for implementing most stimulus measures. The cost of dealing with the covid pandemic and related economic support measures have boosted local government spending as cooling of the real estate sector has slowed construction activity and the sales of land-use rights, a major income source for local governments. Local governments have been allowed to issue more off-budget "special bonds" and continued borrowing via more opaque local government financial vehicles (LGFCs). The precarity of local government finances makes it nearly impossible for local governments to engage in stimulus measures without severely increasing their levels of indebtedness.

Greater risk than in previous forecasts

Increased risk has emerged in China's financial markets, its domestic economic policy and in the geopolitical arena. China's economy has been in a state of emergency since the outbreak of the covid pandemic, which has increased its vulnerabilities. A key message at the recent National Congress was that China wants to strengthen communist party ideology and consolidate its power. This has raised concerns that economic considerations will come second when economic matters conflict with ideology. The concentration of power in the hands of party general secretary Xi also increases the possibility of one-sided policy deliberations and misjudgements.

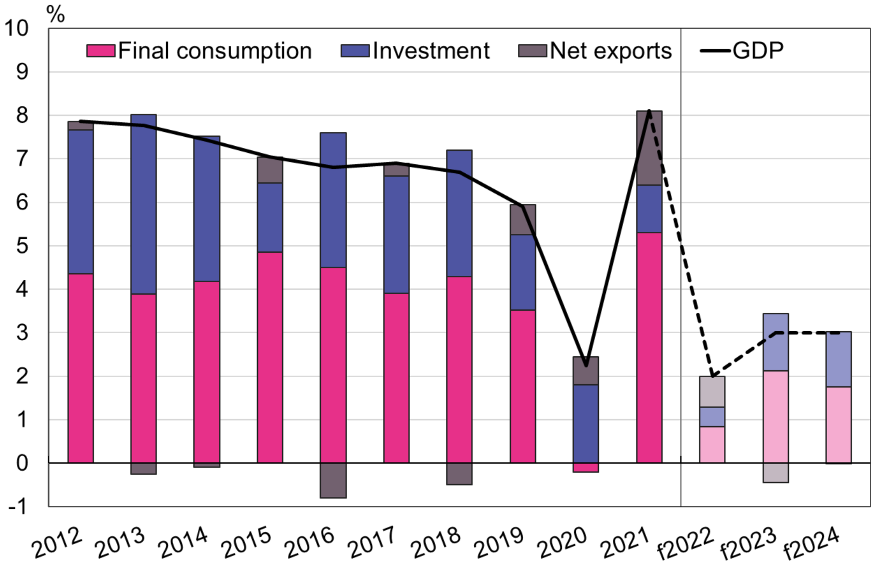
Officials, long aware of the risks lurking in the highly leveraged real estate sector, attempted in 2020 to put limits on developer indebtedness. The measures set off the current widespread financing difficulties facing the sector. Other branches face similar risks from sticking with a debt-fuelled growth model. The regulatory clampdown on big technology firms that started a few years ago was similarly seen as a way to reduce risk. All these measures, however, have been more or less abandoned as the economy slowed and markets expressed broad dissatisfaction. The underlying problems have been left unsolved.

Our forecast assumes that the Chinese government succeeds in preventing construction sector problems from spilling over to financial markets. The risk of a broader financial market meltdown with major negative impacts on the real economy cannot be ruled out altogether. The financial sector has seen a number of institutional failures in recent years, most involving bail-outs of smaller banks with government funds. Similar situations are likely to emerge in the future. Complex and opaque networks of ownership and financing links constitute a potential risk of unpredictable contagion in the financial markets.

Geopolitical risks have increased since Russia's invasion of Ukraine. China has sided in its political rhetoric with Russia, but from an economic standpoint China must tread a delicate path. Beyond its role as an energy-provider, Russia is an insignificant economic partner for China and the initial impacts of the war have been negligible for China's real economy. The war has, however, forced other governments and corporations to re-evaluate their China-dependencies and potential risks in a completely new light. Geopolitical tensions have heightened on China's oft-stated intent to integrate Taiwan with the mainland. Increased competition between superpowers and technological decoupling further increases the risks facing firms operating in or trading with China.

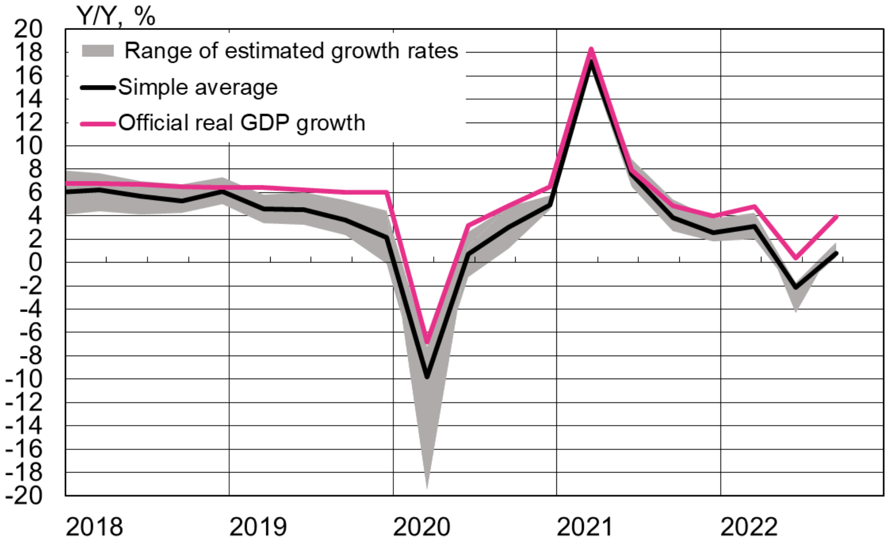
Our forecast comes with upside risks. Unpopular covid policies could be relaxed and borders reopened sooner than expected allowing for economic recovery. China could institute economic reforms that promote actual market opening and levelling the playing field for private and foreign companies. Moreover, any initiatives from China on reducing geopolitical tensions or increasing economic cooperation with the West would be seen as positive from an economic viewpoint.

BOFIT Forecast for China 2022–2024 and growth contributions



Sources: China National Bureau of Statistics and BOFIT.

Alternative GDP calculations suggest that actual economic growth this year has again been lower than official figures



Sources: China National Bureau of Statistics, Macrobond and Bank of Finland calculations.
Estimates based on method set forth in 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.