BOFIT Forecast for China
22 April 2024

BOFIT China Team

BOFIT Forecast for China 2024–2026

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BOFIT: Forecast for China in 2024–2026

China reported first-quarter GDP growth of 5.3 % year-over-year. As a caveat, the country continues to suffer from statistical shortcomings that make appraisal of the overall economic situation difficult. BOFIT's own assessment finds that China's official numbers have tended to somewhat overstate economic performance in recent years. In any case, this year's "about 5 %" GDP growth target will be harder to achieve than last year due to structural and cyclical factors, as well as the government's reduced room for stimulus. We see the Chinese economy growing by about 4 % this year, then slowing to around 3 % p.a. in 2025 and 2026. Beyond constraints on growth from the persisting real estate sector crisis and weak consumer confidence, tensions with China's main trading partners cloud the prospects of its export industries. Financial sector risks remain elevated. On the positive side, government efforts to redirect funding to specific industries, particularly those in high-tech fields, could boost productivity and rebalance economic structures. The move comes with the risk, however, that support flows into wasteful investments, adds to overcapacity and inflames relations with China's trading partners. Revived consumer confidence or significant improvement in the real estate market could support economic growth above our base scenario.

China's official figures show real GDP grew by 5.2 % last year as the economy recovered from the lassitude of covid lockdowns in 2022. Economic growth in the first three months of this year, officially 5.3 % y-o-y, reflects relatively strong manufacturing numbers. Growth in March slowed from January-February, and we expect the slowdown to continue for the rest of the year. Official figures do not necessarily give a true picture of the performance of the Chinese economy, however, as reporting good numbers is critical for political purposes and the high growth targets set by the party encourage overstatement. BOFIT's alternative GDP calculations suggest that actual economic growth has been somewhat lower than indicated by official figures for several years (Figure 2).

The overall economic outlook remains broadly unchanged from our previous forecast in October. Despite government support efforts, the downturn in the real estate market is entering its fourth year with no end in sight. Apartment sales in 1Q24 were down by more than a third from 2021 and new building starts were less than half their 2021 level. Apartment prices are dropping, although there is no reliable data on aggregate price trends. Scarred by their pandemic experiences, high youth unemployment, and real estate worries, consumers remain reluctant to spend. Export demand is also tepid.

Growth slows

China has set the same "about 5 %" GDP growth target for 2024 as last year. This year's target, however, will be harder to achieve due to a combination of structural and cyclical factors, as well as the lack of a technical boost from a low reference base.

The real estate sector's share of the economy has decreased sharply due to ongoing declines in apartment sales and new building starts. Government-supported efforts, however, have sustained construction activity aimed at completing unfinished housing projects and

state-led investments in affordable housing and infrastructure. Over the coming years, demand for new construction will likely be even lower than currently. We expect the contraction in real estate construction and housing sales to slow during the forecast period, but the sector will not serve as an engine for economic growth. In addition, experiences of other countries show that corrections in real estate markets typically take several years. The digesting of China's real estate excesses could be even more protracted given the large stock of empty apartments, relatively new real estate base, ageing population, and slowing urbanisation processes.

The real estate crisis has forced a shift in economic policy to support industry – particularly firms in high-tech fields. The Communist Party this year has given prominence to its "New Productive Forces" initiative led by President Xi Jinping. The initiative aims at accelerating technological innovation and making China a global leader through "revolutionary technological breakthroughs" in a range of emerging industries. Moving ahead with the long-awaited plan to improve productivity is welcome, but it is still too early to judge the implementation and efficacy of proposed measures. Part of boosting innovation and productivity would require that China also improve its business environment and treatment of private firms.

There is a further risk that government-led efforts to boost innovation activity results in waste and overcapacity. China has intensified its industrial policies in recent years, aiming to be the dominant player in several technology branches. As manufacturing accounts directly for over a quarter of China's economic activity (compared to 7 % for the construction sector), increased industrial production should translate into overall output growth. A key question, however, is where China will find markets for this increased production. We do not expect domestic consumption growth to accelerate in the forecast period. In addition, increased low-cost production capacity and competition for technological leadership could heighten tensions between China and its trading partners.

Household consumption has failed to revive as expected after the lifting of covid restrictions and despite income growth slightly outpacing GDP growth. Moreover, China's savings rate remains high, limiting spending prospects. The assessment of labour market conditions is challenging due to lack of reliable data, yet it is clear that youth unemployment remains elevated. The government is attempting to stimulate domestic consumption with a campaign that encourages households to buy replacement durable goods such as new cars and home appliances. The campaign is not expected to give a significant boost to consumer demand, however. A sustained increase in domestic consumption would require reforms and reallocation of public funds to such areas as improving the quality of social security and social safety nets in a manner that reduces the savings compulsion of Chinese households.

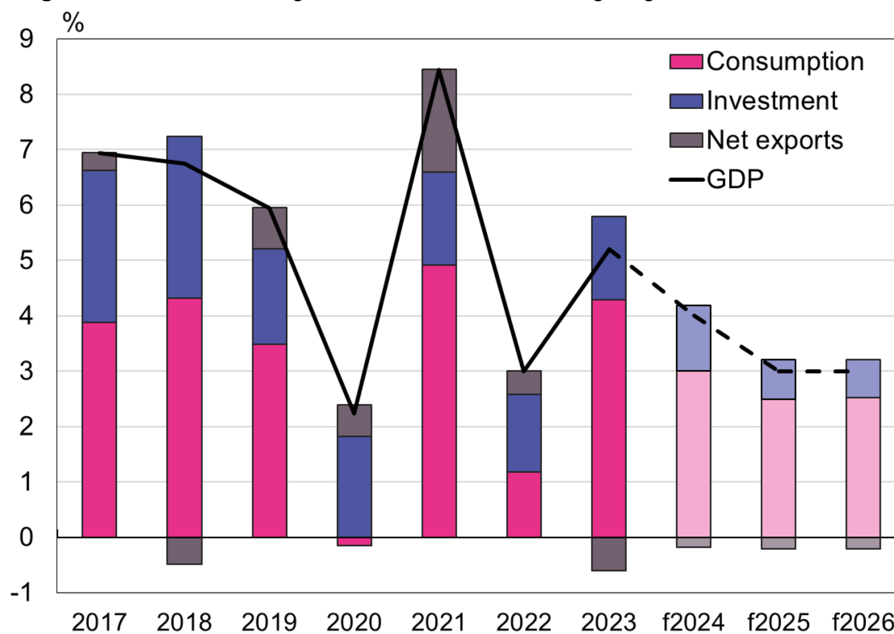
With the Communist Party's ever-tightening grip on the economy and business conditions, there is less political appetite for economic reform. The latest iteration of the anti-corruption campaign launched by President Xi targets the financial industry and healthcare, making people involved with those sectors particularly wary. With economic policies that strive for stability and maintaining state control, there is little room for implementation of market reforms. A good example of overlooking market principles was seen last year when state-backed actors were ordered to prop up share prices after Chinese stock markets slumped.

Structural factors such as the shrinking and aging population guarantee lower Chinese economic growth over the long term. Moreover, growth driven by fixed investment is unsustainable, so continuing to rely on such growth only exacerbates serious imbalances in the economy. Private consumption's modest economic contribution (38 % of GDP) has

remained unchanged in recent years as has China's stunningly high level of fixed investment (43 %).

We expect China's economy to grow by about 4 % this year. In 2025 and 2026, annual GDP growth should slip to around 3 %, which is close to China's long-term potential growth rate and global growth. China's headline GDP growth hides huge disparities in growth at both the provincial level and across sectors. Some emerging industries, for example, enjoy robust growth. In the forecast period, we expect consumption growth (including private and public consumption) to slow less than fixed investment growth. In other words, consumption should provide the bulk of GDP growth. We see Chinese imports rising slightly faster than exports, so the contribution of net exports to overall growth is small, but negative.

Figure 1. China's GDP growth, factors contributing to growth and BOFIT Forecast for 2024–2026.



Sources: China National Bureau of Statistics and BOFIT.

Fewer possibilities for economic stimulus

The government's efforts to sustain rapid economic growth has kept aggressive stimulus policies in place since the global financial crisis of 2008. The International Monetary Fund (IMF) notes that China's *augmented government deficit* (including central and local governments, local government financial vehicles, and government-guided funds) has exceeded 10 % of GDP in recent years, and expects it to hover around 13 % in 2024–2026. The IMF puts China's *augmented government debt* at 116 % of GDP last year, and expects government indebtedness to reach 133 % by 2026. The rapid rise in indebtedness has been accompanied by higher public debt-servicing costs.

Even if public entities still have considerable assets, their financial buffers have shrunk. Fiscal policy faces additional costs as the population ages. New revenue streams and higher tax revenues are therefore essential to balancing public finances. Generous corporate tax breaks have caused tax revenue growth to lag behind GDP growth for several years. Many covid-era tax breaks and exemptions remain in force (e.g., tax breaks to small firms were extended through 2027). According to the Organization for Economic Cooperation and

Development (OECD), Chinese tax revenues in 2021 corresponded to 21 % of GDP, well below the 34 % OECD average. The largest tax revenue streams in China are social security contributions and value-added taxes. Personal income taxes account for just 6 % of China's total tax revenues (OECD average 24 %). Adoption of a property tax has long been under discussion, but the idea was again shelved last year.

The situation at the provincial level is particularly difficult as local governments are responsible for providing most forms of economic support and account for the lion's share of public debt (80 % of GDP). Provinces must shoulder legacy costs from pandemic support and cover the costs of population ageing. The sale of land use rights, traditionally a major source of revenues for local governments, has been hurt by the reduction in new construction activity. The central government dictates the amount of debt local governments can take on, but official debt financing has been inadequate to cover their spending obligations, and many local governments have continued to resort to off-budget financing (sometimes referred to as "hidden" debt). The hidden debt situation has become so disconcerting that the central government has had to intervene to assist provincial governments in managing their debt problems. Banks last year were asked to restructure the debts of local government financial vehicles (LGFVs), and provinces were given the green light to issue special refinancing bonds earmarked for paying down high-interest hidden debt. Current measures target twelve of the most financially distressed provinces. These provincial governments must suspend some of their current infrastructure projects and limit new ones. The added scrutiny and varying financial conditions between provinces are likely to exacerbate differences in regional growth rates.

This year's budget anticipates low nominal revenue growth (3 %) due to the extension of corporate tax breaks. Spending growth (4 %) is also expected to be lower than the targeted nominal GDP growth, and provincial governments may only issue 3 % more debt than last year. As such conditions provide no room for broad-based fiscal stimulus, the government plans to allocate funds in a targeted manner. For example, the central government last year announced that it was issuing 1 trillion yuan (0.8 % of GDP) in off-budget special bonds to raise money for provincial support. Some of these bonds will be issued this year. In conjunction with the National People's Congress in March, the central government also announced plans to issue 1 trillion yuan in ultra-long special bonds this year along with a commitment to issue more ultra-long bonds in coming years. Finally, funding has been allocated to China's policy banks to support the real estate sector.

Increases in production capacity and moderate growth in domestic demand should restrain price pressures during the forecast period. Chinese inflation has been subdued in recent years, with consumer prices rising by just 0.2 % last year and not at all in the first quarter of 2024. Low inflation and pressure on the government to support growth would seem to justify more accommodative monetary policy. Indeed, after two cuts last year, China again lowered its reserve requirement ratio in February. Monetary policy rates and loan reference rates have also been slightly reduced. The possibility for broad easing, however, is limited by the yuan's weakening bias and capital outflow pressures. Thus, the People's Bank of China (PBoC) must rely on a range of targeted instruments to steer funding to desired sectors.

China's debt-to-GDP ratio has climbed above 310 % (includes government, household and non-financial firm debt). Nearly all Chinese debt is domestically held; just 5 % is foreign debt (15 % of GDP). The banking sector plays a central role in economic support efforts. Banks in recent years have been directed to provide financing to critical functions such as real estate and local governments. The banking sector's interest rate margins have narrowed and profitability eroded. Large state-owned banks appear to be solid, but problems could

lurk among smaller banks dependent on the real estate sector and local governments. In any case, it is difficult to provide a true picture of banking sector conditions and risks. Banks continue to practice the custom of helping struggling clients pay off their old loans with new loans, thereby disguising non-performing loans. Officials in recent years have also been forced to bail out some troubled smaller banks. Smaller banks are also merged together to improve profitability.

Uncertain directions in foreign relations

Measured in dollar terms, foreign trade fell last year from the peak pandemic years. The value of goods exports was down by 5 %, while the value of imports declined by 6 %. China's current account surplus last year corresponded to 1.4 % of GDP, a significant decline from the covid era. Low inflation and various forms of subsidies have lowered China's export prices, so trade volumes have fared significantly better. Indeed, export volumes last year rose by 3 % to historically high levels. China's share of global goods trade also continues to increase. Export competitiveness is expected to remain strong throughout the forecast period, which should help subdue inflationary pressures in countries trading with China.

The foreign trade outlook is dimmed by tensions between China and many of its trading partners. China recently appears to have adopted slightly more accommodating policies in an effort to mend differences and lure tourists and foreign companies back to China. Advanced economies, however, remain concerned about over-dependence on China and Chinese efforts in many branches to seize control of production chains. China's unfair production subsidies for electrical vehicles, for example, have caused the EU to consider new tariffs on Chinese imports. The ongoing trade war between the United States and China has directed trade flows through third countries to avoid tariffs. China's recent decision to put industrial policy at the heart of its economic plans only adds to pressures to increase exports. Increases in market share should become harder to come by.

To deal with depreciation pressure on the yuan's exchange rate over the past year, the PBoC has kept its daily dollar fixing rate relatively strong. On mainland China market participants are allowed to trade dollars within a 2 % band around the daily fixing rate. Commercial banks can also support exchange rates as needed. While the yuan's exchange rate has remained relatively stable thanks to these measures, capital continued to flow out of China last year. The flow of foreign direct investment out of China stayed roughly unchanged, while FDI inflows dwindled to negligible levels. It remains to be seen whether last year's drop in inward FDI was a reaction to strict covid lockdowns and closed borders that complicated investment projects or a signal of a broader move by foreign firms to diversify their investments away from China. Portfolio investment also showed a net outflow from China last year.

Upside and downside risks

As in recent years, our forecast comes with a litany of downside risks. Rapid indebtedness and public sector imbalances create risks to the financial markets. The massive financial struggles of developers could worsen and destabilise the banking system, spreading to the financial markets and causing harm to the real economy. Moreover, China's strained public finances limit the government's ability to tackle new challenges as they arise.

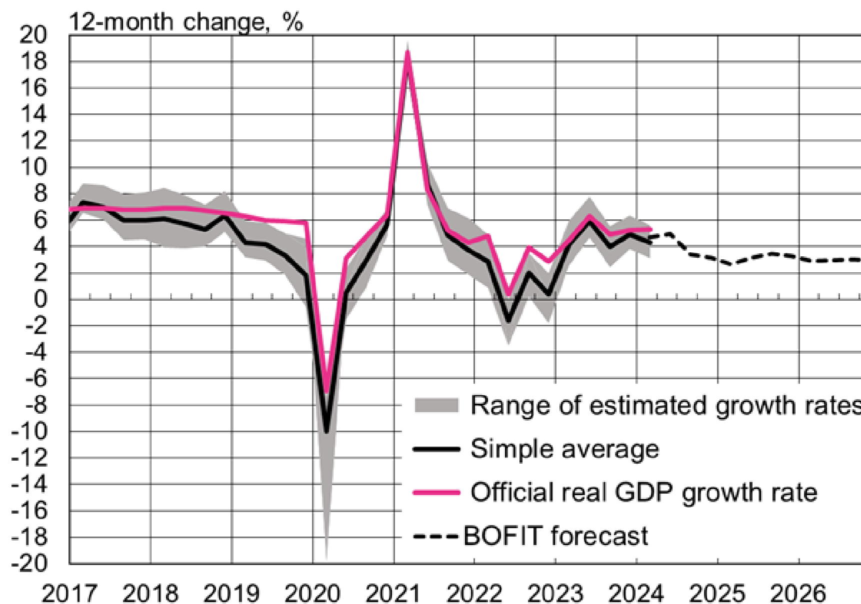
On the upside, successful industrial investment and technological advances could boost innovation and productivity, thereby increasing China's long-term growth potential.

Investment in emerging technology fields is risky, however, and there is a very real danger that funding goes to unprofitable investment, adds to existing overcapacity, or exacerbates foreign trade imbalances. Steering economic growth will be harder and more unpredictable as policymakers pursue productivity-enhancing measures rather than familiar infrastructure investments. Supported by a clear policy shift, conditions in the real estate sector and housing market could improve and help revive growth to levels above forecast. Such a change would boost consumer confidence and strengthen domestic demand and economic growth.

China's tense foreign relations persist and come with many geopolitical implications. Topping the list are relations with Taiwan, the situation in the South China Sea and the consequences of supporting Russia's war of aggression in Ukraine. The presidential election in the United States has also added uncertainty to a fraught bilateral relationship. Many branches of Chinese manufacturing are dependent on export demand and foreign technology. China has sought to calm its inflamed tensions with several countries. If this friendly approach leads to measures that improve the business environment for foreign firms and promote trade, it could have a favourable impact on the outlook for foreign trade and the economy as a whole.

Nevertheless, Chinese domestic policies increasingly stress national security and self-sufficiency, goals that do not comport with liberal, trade-friendly economic policies. There is a real risk the economy loses out to more immediate government priorities. China allows almost no public debate on economic issues, and publication of negative economic news is restricted. The release of some data series showing less-flattering performance have been suspended, while the quality of some other data sources has deteriorated. As mentioned above, it has become increasingly difficult to form an overall picture of the Chinese economy, which increase the margin of error in our forecast.

Figure 2. BOFIT's alternative GDP calculations and BOFIT 2024–2026 forecast.



Sources: China National Bureau of Statistics and BOFIT.