BOFIT Forecast for China
14 March 2013

BOFIT China Team

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Chinese GDP grew at nearly 8 % last year. This year China should still manage to grow at about the same pace. However, China's investment-driven growth model, which is heavily dependent on natural resource inputs, appears to have run its course. This implies that future growth will increasingly need to be sustained through consumer demand. Along with changes in the structure of the economy GDP growth will likely slow to around 7 % in 2014 and 2015. Beyond changes in the real economy, liberalisation of China's financial markets will add to uncertainty over our forecast period.

China's economic growth rebounded as expected in the final months of 2012 with GDP growth approaching 8 % for the year. Given that last year's weak numbers for the first half provide a fairly low reference point, GDP growth is likely to accelerate slightly in the first half of this year. For all of 2013, however, we expect GDP growth to match the previous year's performance of about 8 %. Chinese 12-month inflation is currently running at around 3 %. Given the uncertainty about price trends, there is little latitude (or need) for larger adjustment to the fiscal or monetary stance in the near term. Over the longer term, China continues to transition from a growth model driven by investment and goods production to one led by consumer demand and provision of services. We believe it is this structural change that will cause GDP growth to dip to around 7 % p.a. in 2014 and 2015. Contrary to our view, many other forecasting institutions still see last year's deceleration as cyclical in nature and expect Chinese growth to pick up a bit over the next two or three years.

Elements for continuing reform policies in place

The slowdown in growth is a positive sign if it signals a healthy transition in the structure of the Chinese economy away from investment-driven growth towards a more sustainable model driven by domestic consumption. This winter's ghastly smog episodes in Beijing and elsewhere provided concrete evidence on the limits of China's prevailing growth model and the need to upgrade to something better. Indeed, a managed deceleration in economic growth is appropriate under current conditions in the labour market. There are no alarming indications of rising unemployment, growth in the working-age population has ceased and average incomes continue to rise at around 10 % a year in real terms.

Also the political base for continuing reforms that support structural changes is again on a fairly firm footing after last year's political scandals and speculation about the upcoming leadership change. President Xi Jingping and prime minister Li Keqiang assume the reins of power at National People's Congress in March. The core of China's economic reforms, however, is going to be something quite different than the recent drum-beating in the state media about fighting corruption. We should see indications already this year as to the sincerity of the new leadership's commitment to continue reforms that will fundamentally change Chinese economy and society.

Financial markets generating risks

China's strategic goal is to increase the international role for the yuan. This goal drives financial market reforms together with the internal logic of the opening up process itself and actual needs of businesses. China should have a far higher profile in global financial markets by the end of our forecast period than at present. The opening up of finance and foreign currency markets has already broadened the selection of financial instruments available on both China's official and informal markets. This situation imposes greater demands on monetary policy and China's financial supervision authorities. The phasing out of China's highly regulated interest-rate regime will continue. The challenges of managing China's opening up, the heavy debt levels of some provincial and local administrations, as well as problems in the real estate sector are all potential threats to stability of financial markets and economic development during the forecast period.

Chinese imports and investment should support growth of the global economy

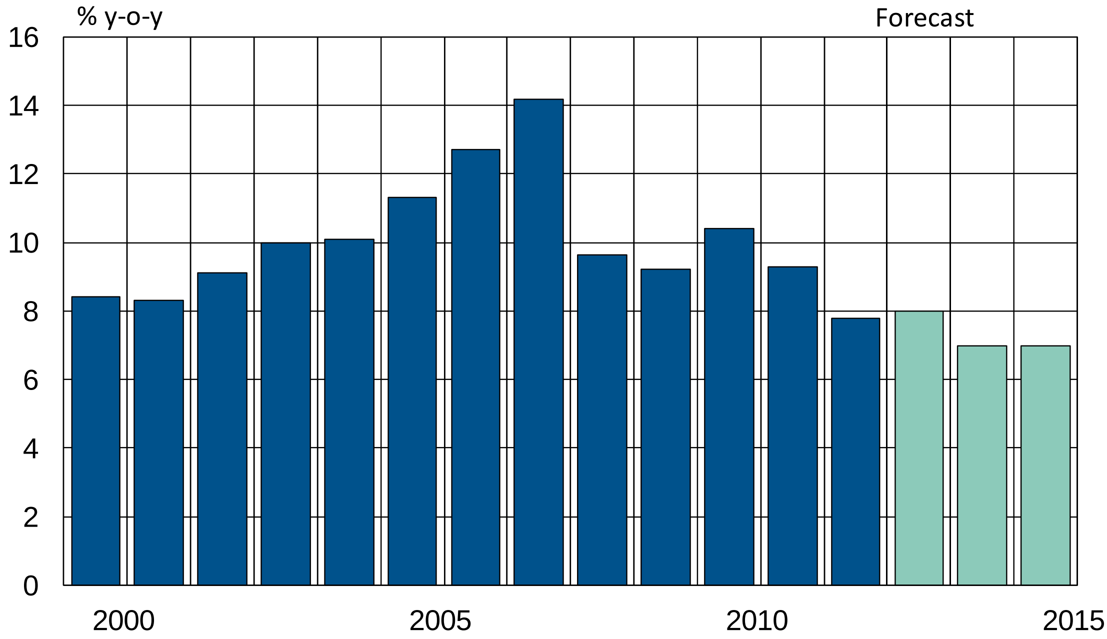
In terms of goods trade, China is a global giant on par with the United States. Nevertheless, the structural imbalances caused by China's massive foreign trade and financial surpluses in the past have caused trade policy headaches for many of its trading partners. China's surpluses, however, have shrunk since the global financial crisis. Although China's economic growth is expected to slow slightly, the volume of China's imports should increase at a faster pace than world imports on average and thereby support recovery of the global economy. Export growth should slightly lag import growth. Depending on trends in foreign trade prices, China's current account surplus could shrink a bit during the forecast period from last year's figure of 2.6 % of GDP.

Capital exports from China in 2012 were greater than capital imports first time since the late 1990s. A distinct shift is apparent in the financial account in China's balance-of-payments figures. The negative number partly reflects an explosion of investment abroad by Chinese firms. This could be good for the world as it likely supports development of the global economy more efficiently than investment of China's foreign currency reserves in treasuries and sovereign bonds of other countries. On a darker note, however, the financial account deficit also reflects a drying up of foreign direct investment inflows into China last year. This lack of growth in foreign investment inflows reflects financing problems facing Western firms and rising wage costs in China. The balance-of-payments figures also suggest that much of the pressure for yuan appreciation has abated. The People's Bank of China, in turn, has been able to allow greater fluctuation in the yuan's exchange rate than earlier. Due to China's robust economic growth, the yuan may still continue to strengthen, at least in real terms, over the forecast period.

Containment of political disputes critical to continued economic progress

Despite the lower growth outlook, our forecast is still quite favourable from the perspectives of both China and the global economy. The forecast assumes progress in liberalisation of China's financial markets, as well as the progress of other (possibly even political) reforms without insurmountable obstacles. Our forecast also assumes that simmering disputes with several of China's key trading partners, particularly Japan, remain on the back burner. This positive outlook would be jeopardised if the imbalances in the real estate sector that emerged in recent years or the debt problems of local administrations prove to be larger than thought.

Realised GDP growth and BOFIT forecast 2013–2015 (on-year change, %)



Sources: NBSC, BOFIT