BOFIT Forecast for China
25 March 2014

BOFIT China Team

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Economic growth in China has gradually slowed in recent years, falling below 8 % p.a. over the past two years. China's resource-intense, investment-driven model is slowly being replaced with a more sustainable and environmentally responsible model based on private consumption. This implies lower economic growth ahead. We now expect economic growth to hover just around 7 % this year and next year, and then slow to about 6 % in 2016. Rising debt and worrisome financial market trends, however, could have destabilising effects. Thus, the situation calls for strong, focused reform policies to prevent problems from building up and creating a crisis that harms the entire Chinese economy. Progress in market reforms inherently alters the rules of the game, so participants in the Chinese economy need to act with the awareness that transition ushers in new types of risk.

China's economy grew 7.7 % in 2013 which is in line with our previous forecasts. However, we find it somewhat perplexing that investments driven by last year's fiscal mini-stimulus contributed more to growth than consumption. In this respect, the long-awaited evidence of a shift in the structure of the Chinese economy had yet to manifest itself. Fixed capital investment still accounted for 46 % of GDP last year. Nevertheless, these figures in themselves do not necessarily imply structural change is not occurring.

The overall picture of trends in the Chinese economy matches our earlier projections, and we continue to expect slower economic growth in the forecast period. During 2014–2015, GDP will grow at around 7 % a year, then settle to about 6 % in 2016. While China's official GDP growth target for 2014 remains 7.5 %, it is clear from the leadership's recent comments that China is not as committed to hitting a particular target figure as earlier.

Reforms critical to further development

Many factors explain China's decelerating growth. For starters, the number of working-age people has begun to decline. Moreover, after sustaining over three decades of historically unprecedented economic growth, rapid urbanisation and catching up, Chinese productivity simply can no longer be expected to keep rising at the same pace. Growth is constrained by the limited availability of natural resources and the immense costs of environmental degradation that are forcing China to adopt a growth model that puts sustainability ahead of high growth. China's rapidly increasing indebtedness constitutes an immediate drag on growth. Dealing with debt requires relatively tight fiscal and monetary policies, which means that both the public sector and enterprises are likely to curtail investment moving forward.

Of course, even at 6–7 %, Chinese economic growth remains impressive by any measure. The conditions for favourable economic development are in place as the reform policies announced at the end of last year suggest the leadership is committed to deep and far-reaching economic reforms. The view that reforms are likely to be implemented is supported by the fact that market conditions demand additional reforms to bring systemic risk under control. Items on the leadership's "to-do" list include implementation of a deposit insurance scheme, deregulation of deposit interest rates and enhancing the role of interest-rate policy. China's healthy employment situation and an inflation rate holding at around 2–3 % also gives the leadership breathing room to move ahead with reforms.

Main elements of reform policies

- Relaxation of one-child policy rules
- Dismantling of *hukou* household registration system
- Allowing the lease and transfer of land use rights in rural areas
- Reforming public sector administration
- Deregulation of the private sector
- Dismantling of price controls
- Further liberalisation of the financial sector

Although private consumption is expected to rise during our forecast period, it will still amount to less than 40 % of GDP and the ratio of fixed capital investment to GDP will decline only slightly. However, the basic structure of the economy may change faster than these figures suggest. A look at the production side shows that the relative contribution of services to economic output continues to increase steadily. Services last year generated 46 % of GDP, the first time that the contribution of services was larger than the combined contribution of manufacturing and construction (44 % of GDP). Agriculture continued to account for about 10 % of GDP.

Foreign trade shifts suggest structural change is happening

The evidence of structural change can also be seen in China's foreign trade figures. The volume of imports rose nearly 10 % in 2013, while exports grew just 7 %. As a result, China's current account surplus shrank to 2 % of GDP. Thus, the global economy no longer had to deal with so large Chinese current account surpluses as earlier. Rapid growth in imports may allow a further decline in China's current account surpluses, although this depends crucially on price changes in foreign trade. An interesting aspect of shrinking trade imbalances is the explosive growth in Chinese tourism. A big change has also occurred in international production chains; the share of China's exports based on component assembly has fallen over the past six years by ten percentage points to less than 45 %. The picture of structural change in the economy is thus more complex than investment figures alone suggest.

The yuan was a popular currency last year. The direction of net capital flows was into China, driven in part by higher interest rates in China and persisting expectations of yuan appreciation. The People's Bank of China let the yuan appreciate 3 % against the US dollar last year, but intervened to slow the rate of appreciation by buying currency and building up its reserves. At year's end, China's currency reserves exceeded $3.8 trillion. Given the market's strong belief in the inevitability of yuan appreciation, many observers are convinced the PBoC deliberately induced yuan depreciation in the first three months of this year to disabuse market participants of this belief and to prepare enterprises for further reforms in the exchange-rate system and wider swings in the yuan's value than earlier. The yuan's trading band was widened in mid-March to 2 % on either side of the central bank's daily fixing rate. International use of the yuan is expected to increase with freer markets and the rapid growth of China's economy. In other words, the long-term appreciation trend of the yuan has hardly broken yet.

Another notable aspect of this forecast period is that it includes the phasing out of capital controls. Most of these measures should be finalised by the end of 2015. The change is likely to boost gross capital movements in and out of China, although the net impact will depend on trends inside China and opportunities available in global markets.

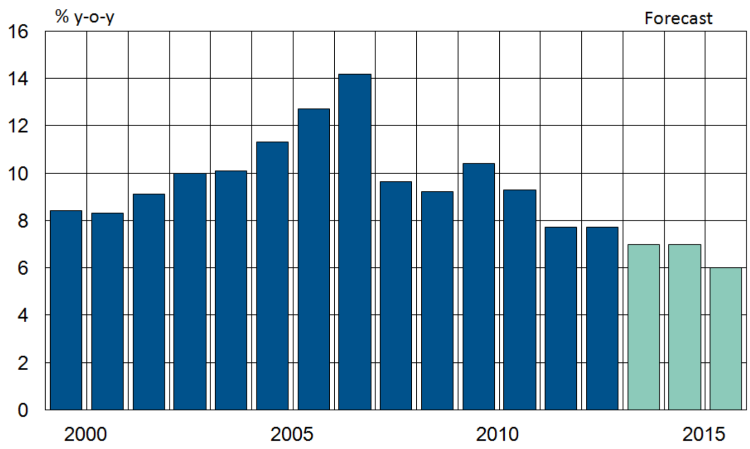
Problems ahead call for preparation

Uncertainty on Chinese financial markets has been heightened by the gradual deregulation and diversification of financial markets, poor supervision of the "shadow" banking sector and high amounts of debt. Rising risk is reflected in sporadic tightening of financial markets and a general rise in interest rates. The world awakened in January of some of the dangers of Chinese shadow banking when a bankrupt mining company threatened to default on trust loans issued via informal banks. Although the authorities saved investors from major losses this time around, new problems emerge. China's domestic bond market saw investors hit in early March by unprecedented losses in the corporate bond arena.

It is clear that as market reforms progress, we will also see realised losses and bankruptcies in the financial sector. Our basic forecast assumes that the financial buffers of banks and other businesses – and ultimately the ability of the government to bail out troubled banks and businesses – are sufficient to prevent contagion. Part of this confidence reflects the facts that the Chinese public sector controls vast assets it can sell to raise money and that Chinese firms have not borrowed extensively on international markets. As before, rapid growth itself remains a prerequisite for China to manage emerging problems.

Measured in euros, capital investment in China is substantially higher than in the euro zone or the United States. Financial difficulties could quickly undercut investment plans and lead to sharp reductions that could not be offset by higher consumption or exports. Consequently, given the nature of China's current problems, the risk that China's growth underperforms is much bigger that an upside risk that growth would be significantly stronger than forecast. This view draws on experiences with credit bubbles and financial market liberalisation seen elsewhere. A number of these symptomatic financial market trends are already well established in China. If this dark scenario materialises, it would directly impact commodity markets of other emerging economies and ultimately the global economy.

Realised GDP growth and BOFIT forecast 2014–2016



Sources: NBSC, BOFIT