BOFIT Forecast for China
16 September 2014

BOFIT China Team

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Chinese economic growth, which has been below 8 % p.a. already for two years, will slow further in coming years. We retain our earlier view that GDP growth will remain around 7 % this year and next, and then fall to around 6 % in 2016. Success in China's soft landing, however, will depend largely on the government's ability to rein in indebtedness of businesses and local governments, as well as implement bold reform policies that foster new growth engines and appropriately manage risk. Due to changes in China's growth model and structural reforms, occasional market disruptions are likely.

GDP growth slowed from 7.7 % p.a. in 2013 to around 7.5 % in the first half of 2014. This slowing trend is expected to continue with economic output increasing about 7 % this year and next, and then gradually falling to about 6 % in 2016 at the end of our forecast period.

While economic policy discussions have focused on whether China would hit its official GDP growth target of 7.5 % this year, the voices that have long demanded stimulus measures fail to acknowledge that there are no signs of rising unemployment even with the economic slowdown. Moreover, with price inflation likely to remain at a 2–3 % over the medium term, the government hardly has motivation to embark on large-scale policy easing beyond narrowly targeted stimulus measures. If the indicative data showing a relatively good employment picture are credible, even growth lower than forecast here may be sufficient to satisfy the needs of the Chinese society. China's traditional official growth targets, crystallised in a single number, have outlived their purpose. They fail to guide market expectations and policies in a way that reflect economic fundamentals.

Slowing growth and progress in structural reforms

The current slowdown in growth is quite natural given the size of China's economy, its resource demands and increased level of development, but there are also other factors contributing to the slowdown. In the wake of a decade-long investment boom, new investment no longer delivers the same "bang for the buck" it did earlier. A corollary to China's aging population is the decline in the number of work-age people. Vast environmental degradation comes with hefty costs that are already eroding growth. Finally, short-term growth will be subdued by high indebtedness that limits the government's room to manoeuvre in the fiscal and monetary policy spheres.

Perhaps the clearest signs of a slowdown can be seen in fixed-asset investment (FAI) in urban areas, which slowed in the first half to 16 % y-o-y (20 % in 1H2013). Slowing investment growth is gradually modifying the overall structure of demand in China. The share of private consumption will increase from the current 36 % of GDP and the share of investment will fall from 46 % of GDP to levels closer to those found in other economies. As the production structure evolves to meet demand, services should increase their current share of 46 % of GDP, while manufacturing and construction (44 % share at present) will play diminishing roles. Statistical shortcomings continue to complicate attempts to get a clear picture of structural adjustments in China and, in fact, actual changes in the Chinese economy are likely to be faster than suggested by statistics.

The yuan's expanding international role

Growth in volumes of exports and imports of goods faded in January-July to around 2 % (goods trade increased about 10 % in the same seven-month period in 2013). Despite the rise in value of goods trade surplus in recent months, the services trade deficit, driven by growth in Chinese tourism, will hold the overall current account surplus to around 2 % of GDP.

The decision by the People's Bank of China to allow the yuan again to appreciate will also help in rebalancing China's trade surpluses. The PBoC apparently permitted a brief weakening of the yuan early this year to make investors aware that yuan strengthening was not inevitable. The yuan's daily fluctuation band was also widened in March from a 1 % to a 2 % departure from the PBoC's daily reference exchange rate. The widening of the fluctuation band is part of an effort to liberalise the yuan trade and establish the yuan as a major international currency. As of July, the yuan had become the world's seventh most-used currency in international payments, up from 20th position at the start of 2012. Despite uncertainty about exchange rate trends caused by the yuan's greater volatility from band widening as well as China's domestic economic issues, the yuan's strengthening trend is unlikely to have been abated as yet – the yuan continues to find increased acceptance internationally and China's growth figures remain significantly higher than the world average.

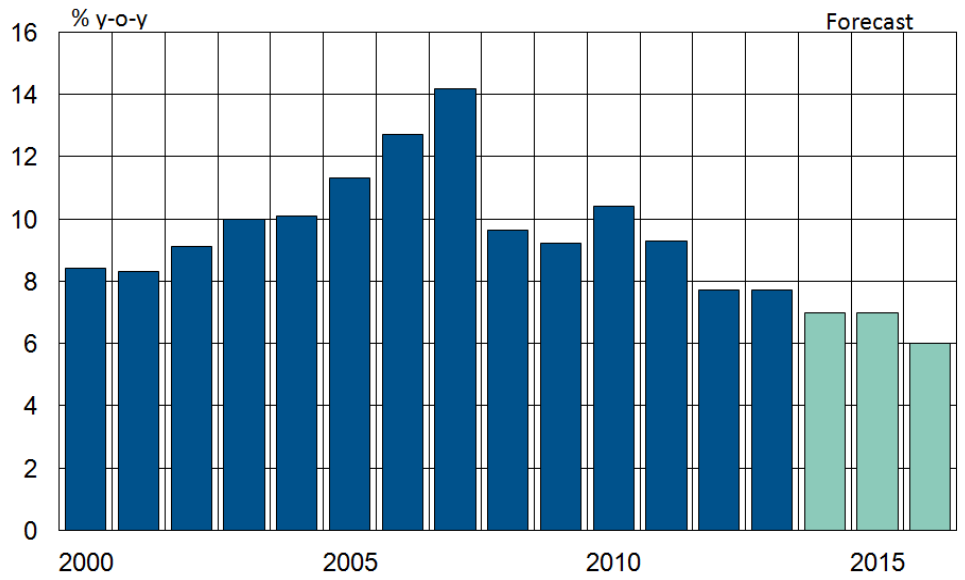
No way to avoid market disruptions altogether

A controlled "soft landing" for economic growth is by no means a given at this point. Remaining on the appropriate glide path will require strong economic and reform policies. The rising indebtedness of firms and local governments remains a top challenge for China's multi-tiered economic policy matrix. Worryingly, the credit boom in China this decade tracks several earlier credit booms in other countries that ended in crisis. Darkening the mood further is an impending correction in the real estate sector. While Chinese financial markets have been relatively calm in recent months compared to a year ago, the shadow-banking sector continues to grace the headlines with stories of defaults and other problems.

Reducing exposure to risk and reinforcing new growth engines will require extensive reform of China's financial markets, state enterprises, the public sector and social security safety nets. Reforms are moving ahead at the moment, but many have raised concerns about the slow pace of reform. Foreign firms complain about the degraded operating environment. The government has yet to specify how it will deal with deposit insurance and deregulation of deposit rates which are linked to capital controls supposed to be largely lifted by the end of 2015. China's eagerness to move ahead with actual reforms should be on display at the upcoming fourth plenum of the Communist Party in October.

Given the nature of China's problems, comprehensive management of economic policy has become more challenging than earlier. This means the downside risks associated with our forecast are significant. Even in the best-case scenario, it is unlikely China avoids occasional market disruptions. The knock-on effects witnessed in financial markets in recent years offer a hint of things to come.

Realised GDP growth and BOFIT forecast 2014–2016



Sources: NBSC, BOFIT