BOFIT Forecast for China
25 March 2015

BOFIT China Team

BOFIT Forecast for China 2015–2017

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Chinese economic growth slowed to just over 7 % p.a. in 2014. This widely expected slowdown in growth also comports with our view on China's long-term growth prospects. BOFIT sees GDP growth this year remaining near 7 % and then slowing to around 6 % in 2016 and 2017. China's decades of sustained high growth are now behind us, and maintaining conditions conducive to growth will become ever more elusive and require deliberate progress in reforms. Risks to the economy will rise with slowing growth.

GDP grew at 7.4 % in year 2014, which slightly exceeded our September 2014 forecast and just missed the official target of 7.5 %. The growth trend remains in line with previous BOFIT forecast. We maintain our view of a near 7 % GDP growth this year and slowing growth to around 6 % next year. Our forecast assumes China moves ahead with bold reform policies and large shocks to the economy are avoided, in which case China can achieve growth around 6 % in 2017.

China's official growth target this year has been set at "around 7 %". The latest official target, unlike earlier, is not set in stone and provides the government with greater flexibility in setting economic policy.

Moreover, lower growth is by and large a good thing for China. It enables a shift in China's growth paradigm in ways that increase the relative contributions of private consumption and services. It also announces the demise of the unprofitable, environmentally destructive investment projects on which high growth was sustained in earlier years. Chinese officials now concede that the massive credit expansion and investment-driven stimulus in the wake of the global financial crisis created a mountain of wasteful capital investment and excess supply in a number of industrial branches. China today struggles with excess capacity and indebtedness caused by unprofitable investments.

In 2014, the combined contribution of private and public consumption to GDP again surpassed the share of investment. The service sector's contribution to GDP also grew. Chinese GDP now exceeds $10 trillion a year, and structural change is slow for an economy that encompasses nearly 1.4 billion people. Private consumption presently only accounts for about 40 % of GDP, which is not just low by international standards but even by Chinese historical standards. Despite structural change, investment will long remain a significant driver of economic growth. While investment exceeds 45 % of GDP, official national accounts figures still likely underestimate the share of services in the economy and thus present an overly pessimistic image of progress in structural reforms.

Dealing with debt becoming even more important as economy slows

Getting China's mounting debt problems under control amidst cooling economic conditions constitutes one of the largest challenges facing the government in our forecast period. Not only does China's domestic credit stock now exceed 200 % of GDP, but there has been explosive expansion of credit in the more poorly supervised credit market outside the regulated banking sector. Companies have also piled on foreign debt in recent years.

Corporate debt in China is high. Firms involved in construction and real estate, in particular, have taken on copious amounts of debt. Problems in the building sector have gained wide public awareness recently with some major property developers having problems with debt repayments. By some estimates, the indebtedness of the real estate sector and construction firms accounts for 20–30 % of the total credit stock.

Indebtedness of local governments also continues to soar; estimates of the aggregate debt of local governments now reach 35–40 % of GDP. Local governments, previously required by law to show balanced budgets, got around the problem by creating local government financing vehicles (LGFVs) off budget. To enhance transparency and market discipline, China recently passed legislation enabling local governments to issue municipal bonds and thereby finance their investment projects at lower costs. Bond issues represent only a piece of the debt puzzle, however, as in themselves they are insufficient to offset mounting debt-servicing costs and amortise debt principal. China's central government debt, in contrast, is only about 20 % of GDP. In this respect, the government still has considerable leeway to deal with debt problems as they emerge.

12-month inflation was just 2 % on average in 2014, and inflation has continued to fall this year. Faced with slowing inflation and higher real debt-servicing costs, the People's Bank of China this year has lowered reference rates and bank reserve requirements. Rising indebtedness, however, limits flexibility in monetary policy to such extent that the central bank is likely to refrain from a broad-based monetary easing as long as the employment situation remains good.

Deregulation of financial markets and increased use of the yuan internationally

The value of China's exports in 2014 amounted to $2.34 trillion and imports $1.96 trillion. Lower prices for imported commodities helped drive the trade surplus to a record $380 billion. Notably, the goods trade surplus is now to some extent offset by a rising service trade deficit stemming from a boom in Chinese foreign travel. The current account surplus only rose slightly in 2014 to 2.1 % of GDP.

About a quarter of China's foreign trade is now conducted in yuan. Conditions permitting wider international use of the yuan improved last year with the establishment of yuan clearing banks for currency payments around the world, and with increasing number of foreign currencies with which the direct yuan trading is now possible (including the euro). Indeed, the yuan's share of international payments transactions has nearly doubled during the last year. The yuan is now poised to overtake the Japanese yen as the world's fourth-most-used payments currency with an over 2 % share. One interesting question in the forecast period is whether the yuan will become part of the IMF's currency basket that forms the basis of its supranational currency asset, Special Drawing Rights (SDRs).

China's financial market reforms seem now to be proceeding much as expected, unlike in many other sectors of the economy where reforms have not succeeded as well as had been hoped. The proposed rollout of a deposit insurance scheme this year should permit the phasing out of interest rate regulation altogether. Moreover, this would allow China to abolish an essential part of the remaining currency controls by the end of this year as planned before. A small step in deregulation of capital markets was taken at the end of last year with the launch of the "stock connect" experiment that enabled trading in shares listed on the Hong Kong stock exchange via the Shanghai exchange and vice versa. The partial opening of a similar share-trading arrangement between the Hong Kong and Shenzhen stock exchanges is also underway.

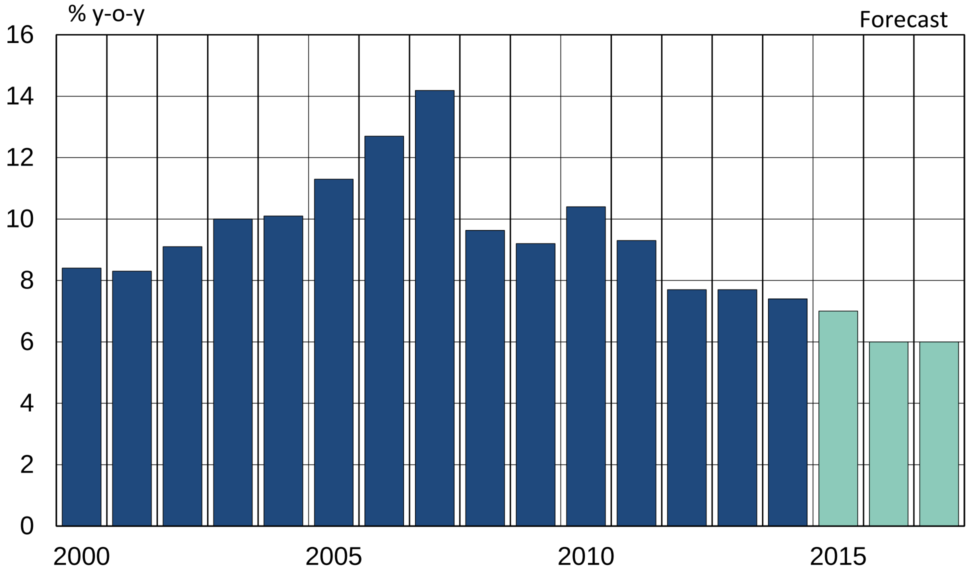
Large economic impacts expected, if problems in the real estate market deteriorate

The risks facing the Chinese economy are greater than in our earlier forecasts due to lower growth and higher indebtedness. In the forecast period, the biggest risks are a debt crisis that gets out of hand or a meltdown in the real estate sector. A real estate collapse, in particular, would cause harm throughout the economy. The real estate sector (including the construction industry) directly generates 15 % of GDP, and its indirect contribution is even larger. For example, the sale of land use rights traditionally provides a significant source of revenue for the central government and local administrations. A drop in demand for construction materials and raw material inputs would also directly impact global trade flows and global commodity prices.

Over the short term, the drop in world oil prices since summer 2014 is likely to benefit the Chinese economy and balance the growth outlook. Over the longer term, deregulation of financial markets could even carry some up-side surprises. Nevertheless, initial problems associated with the launch of deregulation measures can be expected. For example, the spike in share prices at the end of 2014 evidenced the lack of sophistication of China's financial markets. The opening up of the economy and greater international integration in the forecast period will also make China increasingly susceptible to swings in the global economy, and lower growth could bring new problems to the fore.

For China to achieve favourable economic growth in line our latest BOFIT forecast, the country must move ahead with implementation of broad-based economic reforms. The moment for reforms is auspicious: the employment trend is quite benign and inflation is running at very modest levels. Indeed, reforms could even be expanded to deal with China's thorniest economic policy issues such as reform of state-owned enterprises, taxation and landholding rights.

Realised GDP growth and BOFIT forecast 2015–2017



Sources: NBSC, BOFIT