BOFIT Forecast for China
29.9.2016

BOFIT China Team

BOFIT Forecast for China 2016–2018

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Growth of the Chinese economy this year has slightly exceeded our expectations, largely due to the government's stimulus policies. We now expect GDP to grow about 6.5 % p.a. this year. However, China's growth outlook has not changed. We project growth to slow to 6 % in 2017 and 5 % in 2018, and consider the slowdown as a natural aspect of the China's economic development. As structural adjustments proceed, the role of consumer demand and services in the economy will become more pronounced. Concerns over economic development have increased, and the possibility of a rapid deceleration in growth during the forecast period cannot be ruled out.

Growth in China's economic output this year has been boosted to levels slightly higher than our previous forecast as a result of the government's stimulus policy. Thanks to a strong first half performance, GDP is now expected to increase 6.5 % p.a. this year in real terms (previous forecast 6 %). The overall outlook of a gradual slowdown in economic growth, however, remains unchanged from our previous forecasts. Growth should fall to 6 % in 2017 and 5 % in 2018.

The slowing of economic growth is a natural feature of China's economic development, and several important structural factors underlie the slowdown. The Chinese economy is so large already that high-paced growth has become increasingly difficult to achieve. Demographic trends are unfavourable to high economic growth as the number of people in the labour force has begun to decline. Productivity gains have become harder to come by as Chinese performance begins to approach that of the world's most productive economies. Finally, China's structural shift to more consumption-driven growth creates slowdown pressure to economic growth in coming years.

Growth in consumer demand remains strong; growth in fixed investment continues to slow

China is gradually moving towards a consumer-driven economy. Real wages of Chinese workers and disposable household income have risen faster than economic growth, thereby significantly raising the purchasing power of Chinese. Signs of greater consumption are seen, for example, in the strong growth in retail sales and the service sector. Services now account for slightly over 50 % of economic activity, even if this share is still lower than in other countries with similar income levels. In coming years, rapid and stable growth of domestic consumption is expected to continue and hold up economic growth. Thus, the share of services and consumption in the economy should move towards levels similar to that of other middle-income countries.

The rate of growth in fixed capital formation has slowed in recent years, however, its share of 43 % of GDP is still exceptionally high by international standards. As structural change proceed, investment growth is expected to slow further and the investment ratio (capital formation to output ratio) should decline. Fixed capital formation growth is expected to slow rather evenly during the forecast period, but the forecast trend is clouded by couple of

factors. Notably, investment this year has been largely state-led and on-year growth in real private fixed asset investment has been tepid. Due to the high investment rate, a slowdown in investment growth substantially larger than forecast would severely depress economic growth.

Growth in Chinese goods exports and imports should be moderate, a few per cent annually in coming years. Net exports will thus contribute little if anything to economic growth. Growth of demand in Europe, China's largest export market, is expected to slow due to the Brexit. On the other hand, weakened exchange rate of yuan has improved the price competitiveness of Chinese products, which supports exports. In goods trade, China has sought to shift to export of products with ever-higher value-added and increase the domestic-degree in exports. At the same time, the importance of exports based on traditional assembly of components imported from abroad has diminished significantly. From the standpoint of foreign trade, perhaps the most interesting development involves services. Chinese tourism abroad has increased rapidly, rising last year already to a level equivalent to 12 % of the total value of China's goods and services imports. The brisk growth of Chinese international tourism is also expected continue in coming years.

Progress in financial sector reforms; worries over mounting debt

Chinese price trends have long been quite modest. The rise in consumer prices in the past three years has largely remained in the range of 1–3 %. In recent months, the rise in prices has slowed to just above 1 %. At the same time, the danger of deflation appears to have abated, as the drop in producer prices that began in 2012 has nearly come to a halt. Price pressures are expected to remain modest in coming years, allowing the continuation of monetary policy geared to supporting economic growth.

China's reform policies in recent years have emphasised development and opening up of the financial sector. A deposit insurance scheme has been put in place, while lending and deposit rates have been deregulated. China has adopted a more flexible exchange rate formation mechanism and some restrictions on capital flows into and out of China have been lifted. One indicator of just how far China has come with its financial reforms is the fact that the IMF will incorporate the yuan into its SDR basket on October 1, 2016. The yuan thus joins an exclusive club of only four other SDR currencies: the US dollar, euro, Japanese yen and British pound. The adding of the yuan to the SDR basket, however, to unlikely to have much impact on Chinese economic growth.

China's efforts to implement of a broad spectrum of major financial market reforms and the nature of emerging economies makes it almost inevitable that market disruptions will arise. Last year, the stock market rally ended with a crash in the summer. Thereafter, capital outflows from China increased substantially, putting depreciation pressure on the yuan. Real estate prices have soared this year in many cities, while other markets have remained relatively stable. More market disruptions should be expected in coming years.

In particular, concerns have increased over conditions in China's financial sector. Even with the debt-to-GDP ratio currently judged to be over 260 %, indebtedness continues to rise. Companies continue to pile on debt, even as lower economic growth and structural adjustment have eroded the profitability of many firms. Debt also happens to be concentrated in those parts of the economy where the outlook is poorest, i.e. inefficient state-owned enterprises, businesses owned by local governments and firms operating in overcapacity branches. As a result, an increasing number of firms devote an inordinate share of their earnings to debt-servicing costs. The number of firms struggling to handle their debts has also

increased. To calm the excessive borrowing, Chinese officials will need to restrict the access of enterprises owned by the state and local governments credit that is under-priced in relation to default risk.

The problems in the corporate sector also afflict the banking sector. Non-performing loans (NPLs) of Chinese banks have grown, and the reserve buffers set aside to deal with NPLs have shrunk. The situation of banks is expected to weaken further in coming years. China's experience in the first half of the 2000s involved extensive bailouts of troubled banks and major balance sheet clean-ups. Today, however, there is a much denser interlinkage of financial sector participants, so the possibility of spill-over of one company's problems to others has increased. In addition, the large shadow banking sector makes it difficult task to assess state of the financial sector, which makes supervision difficult for officials and complicates risk assessment for all market participants.

In other countries with similar experiences of rapid growth in indebtedness, the typical outcome has been a banking crisis and a rapid slowdown in economic growth. China may be able to avoid some of the pain seen elsewhere, however, as the lion's share of Chinese debt is domestically held. Moreover, the state has exceptionally large buffers. China's foreign currency and gold reserves are the world's largest, the state's holdings of land and corporations is prodigious, central government's debt is internationally still rather low, and despite reduction bank buffers are still large.

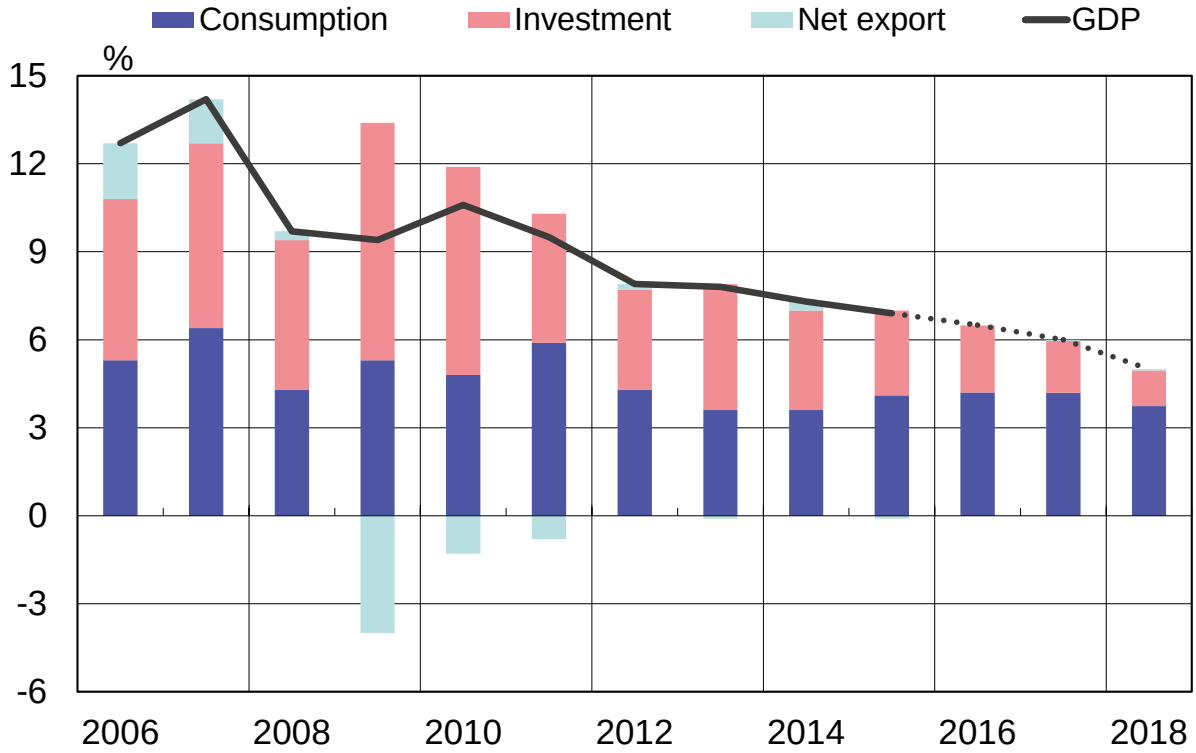
Tighter internal controls and economic opening on collision course

Several risks have appeared on the political front that could eventually have significant economic impacts. During recent years, China has heightened media censorship, on-line monitoring and imposition of restrictions, and surveillance of citizen groups. This tightening of internal controls directly conflicts with efforts to promote transparency and open up the economy. China must stick with economic reforms if high economic growth is to continue. If officials start to compromise with the opening up strategy and with reforms to facilitate the transition to a market-driven economy, the conditions that foster high growth will erode. Moreover, China still suffers from a tendency to steer the economy as in the days of a full-blown command economy, even if current circumstances demand more modern guidance mainly through the pricing mechanism. This creates confusion and uncertainty that interfere with long-term corporate planning and investment. Needless to say, international business groups have raised concerns about these issues.

It seems that even China's leaders are not unanimous about economic policy focus and any significant changes the focus can have large impact on economic growth in coming years. In May, an "authoritative person," who many believe is part of the president's inner circle, criticised the government's debt-driven economic policies in an open letter published in the *People's Daily*, the main party newspaper. It appears that some of China's leaders to want to stick with official growth targets, even if clinging to the party's declared target of doubling 2010 GDP by 2020 will only create unneeded economic imbalances and add to China's problems by increasing indebtedness further. Others want to proceed with reforms that would most likely slow growth in the short term and miss official targets, but lead to better and more sustainable economic growth over the long term.

Foreign policy risks are also rising. Of immediate concern are the territorial disputes in the South China Sea. Southeast Asia is one of China's most important export markets. If the situation escalates, it would weaken the export outlook, increase uncertainty and shake up at least regional financial markets.

China's GDP growth, growth contributions and BOFIT forecast



Sources: China National Bureau of Statistics, CEIC and BOFIT.