BOFIT Forecast for China
28 September 2017

BOFIT China Team

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China's economic growth has picked up from last year. Official figures show GDP rose by 6.9 % p.a. in the first half of 2017, but with the expected slowing towards end of the year, growth for this year should come in at around 6.5 %. In 2018 and 2019, economic growth should keep slowing gradually as China pulls back from debt-financed stimulus policies to a more sustainable framework. This gradual slowdown is, above all, a natural evolution for China's economy that reflects on-going structural changes. The financial market risks are elevated and pose a risk to economic growth – and even more so if China continues to push the economy to the 2020 growth target with stimulus policies. Uncertainties related to Chinese statistical data have made it even more difficult to evaluate economic trends.

China's economic growth accelerated in the first half to an annual rate of 6.9 %. The pick-up in growth is expected to be brief, however. Growth has been slowing throughout the current decade and it is expected to continue also in coming years. BOFIT forecasts GDP growth of 6.5 % p.a. this year, 6 % next year and 5 % in 2019. Even with lower growth, Chinese economic growth will remain high relative to advanced economies and China continues to catch up with developed-world living and technology standards. Chinese economic growth will continue to rely on growth of China's domestic markets promoted by relatively brisk growth in real incomes, urbanisation and higher productivity.

The gradual slowdown in China's economic growth is natural, as major structural factors are curbing the growth. Five factors, in particular, are worth noting. First, China is already the world's largest economy when adjusted for purchasing power, and size in itself is sufficient to impose constraints on growth. Moreover, China's demographic structure is not growth friendly. The median age continues to rise and the cohort of working-age persons is shrinking. Third, the economy's structure is changing, which is reflected in rising domestic consumer demand and growing service sector, but also in falling rate of fixed investment. However, China's exceptionally high investment rate will decline only slowly. Fourth, productivity growth has slowed as the low-hanging fruits of productivity enhancement have largely been gathered and the share of services in economic output is increasing. Moreover, there is little evidence to suggest any significant productivity leap during the forecast period. Finally, China's massive environmental problems are already hindering growth.

Strict numeric growth targets expose statistical data to manipulation

The uncertainly related to China's official GDP growth figures has increased. In 2012, China set a goal of doubling real GDP from 2010 to 2020. Hitting this goal requires GDP growth of about 6.5 % a year. Indeed, China's official GDP figures have shown suspiciously stable 6.5–7 % growth for a couple years now. Even with economic growth supported by expansionary economic policies, the strict numeric growth target has exposed statistical data to manipulation. For example, officials revealed a massive statistical fraud in the Liaoning province at the start of this year. In June, officials announced that they were also looking into suspected instances of statistics manipulation in two more provinces. These cases reflect the pressure provincial leaders face in trying to hit their growth targets. Failure to deliver the right growth figures is toxic to their career advancement. Moreover, there is a contradiction between very stable official GDP growth figures and many other economic indicators. For example, consumer and enterprise confidence surveys conducted by the National Bureau of Statistics, the central bank and several private institutions point to exceptionally weak economic performance especially in late 2015 and early 2016, as well as a substantial rebound in growth thereafter.

The shift in foreign trade is similar to the picture of economic trends provided by the above-mentioned surveys. After a couple of lacklustre years, China's foreign trade has experienced grown rapidly since late 2016. The volumes of goods imports and goods exports are up by roughly 10 % y-o-y this year. Growth has been broad-based both by country and product category, and the mirror trade figures of China's trading partners bolster this view.

The rapid growth in Chinese exports partly reflects an uptick in global GDP growth, but exports have also been helped by weakness in the yuan's real effective (trade-weighted) exchange rate. Moreover, China is an important part of international production chains. Thus, rapid export growth encourages a recovery in imports as a third of exports are based on finishing or assembly of imported goods. Growth in imports is influenced by other factors, of course, including restrictions placed on domestic producers of certain commodities due to environmental reasons.

Stability – a top priority of economic policy

Opening the economy up to the world, improving opportunities for private businesses and adoption of market-based approaches have been cornerstones of China's economic reforms for nearly four decades. The reforms have helped China to develop rapidly, fostered an unmatched streak of economic growth and raised hundreds of millions of people from poverty. In recent years, however, Chinese efforts at opening up the economy, improving opportunities for private businesses and increasing the role market forces in the economy have not been as determined as earlier. Instead of reforms, excessively stable economic development has emerged as a top economic policy priority, which partly reflects political struggle before the important National Congress of the Communist Party in October. Moreover, in recent years China has been striving to increase the party's and state's grip of the economy. Citizens and companies room to operate has been restricted through e.g. stricter limits on internet use, establishing party committees within non-governmental organisations to scrutinise their activities and demands that universities should serve party interests and teach in accordance with party ideology. In addition, China has been trying to increase the role of party committees in firms, which are obligatory in all companies (including foreign-owned) operating in China.

China's exchange rate policy well reflects the priority now given to stability. The yuan's exchange rate weakened by about 8 % against the dollar from April to December 2016 as capital flight intensified. While changes of such magnitude are relatively typical for forex markets, China reacted heavily on capital outflows that weakened the yuan and fed expectations of further weakening. It defended the yuan's value with currency reserves, tightened capital controls on outflows and took measures to entice capital inflows. While stricter capital controls fly in the face of China's stated goal of increasing international use of the yuan, exchange rate stability apparently took priority. Indeed, the heavy-handed measures helped stabilise the yuan's exchange rate. In summer 2017, the yuan appreciated substantially, which lead to eliminating some earlier-imposed limits on currency trading and capital controls, and signal continuity in the policy of opening up to the world. Unfortunately, capricious regulatory and exchange rate policies are more likely to nourish uncertainty and complicate doing business in China.

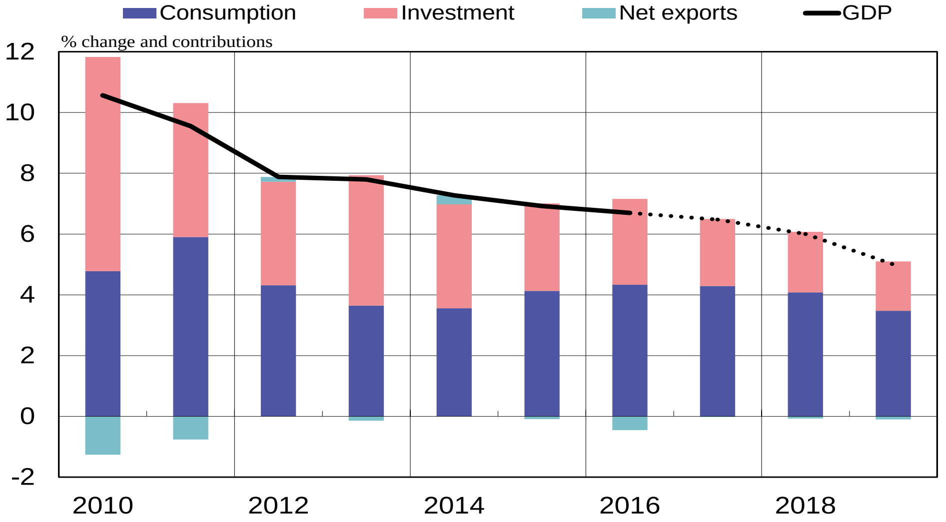
Heightened concerns over the state of financial markets

China has used economic stimulus and pursued expansionary policies to keep the country on track to meeting its official 2020 growth target. The accommodative monetary policy stance has been made possible by low inflation rates, even with swings in asset prices. The 2015 stock market bubble and collapse were followed by another asset bubble, this time in the form of skyrocketing housing prices. Official figures show housing prices continue to climb, even if the price explosion has ebbed in some of China's major metropolises.

The accommodative monetary stance has also fuelled indebtedness, which has continued to rise rapidly this year. Despite a slight slowdown in growth of China's debt-to-GDP ratio, the ratio stands at about 260 % compared to about 150 % a decade ago. Most debt is held by firms, but public-sector debt has also been mounting due to expansionary fiscal policies. The IMF puts the ratio of China's public-sector debt ratio at around 70 % of GDP. Taking the size of China's economy into account, its debt-to-GDP ratio is about double the average for other emerging economies. In other countries, similar multi-year rapid debt growth has almost always led to major crisis. If China continues to rely on debt-driven stimulus measures to meet its 2020 growth target, the likelihood of a messy unravelling of the financial market risks only increases. Thus, the possibility of a financial market crisis and major economic slowdown in the forecast period cannot be ruled out.

The top leadership now openly comments on the severity of financial sector problems. President Xi Jinping, for example, has stressed the importance of mitigating financial market risk. Despite the talk, however, no significant measures to rein in credit growth have been implemented. The upcoming National Congress of the Communist Party next month could be a turning point for Chinese economic policy, but hope for such change is diminished by the persistence of current economic policies focused on stability and propping up the role of state and party in the economy. External risks have also increased. Implementation of significant protectionist measures by China's main trading partners or an escalation of tensions on the Korean peninsula would dampen growth prospects.

China's realised GDP growth and BOFIT forecast 2017–2019



Sources: China National Bureau of Statistics and BOFIT.