BOFIT China Team

BOFIT Forecast for China 2019–2021

Bank of Finland
BOFIT – Institute for Economies in Transition

Bank of Finland
BOFIT – Institute for Economies in Transition

PO Box 160
FI-00101 Helsinki
Phone: +358 9 183 2268
bofit@bof.fi

www.bofit.fi/en

BOFIT Forecast for China 2019–2021

BOFIT China Team

15 March 2019

BOFIT China Team

BOFIT Forecast for China 2019–2021

China's economic growth, which witnessed a slowdown last year, continued to deteriorate in the early months of this year. Although the government has responded with measures to support growth, an already lax fiscal stance and extremely high debt-to-GDP ratio highlight the limits to debt-driven stimulus policies. Adding to the mix, the trade war between China and the United States has exacerbated economic uncertainty. Business-cycle weakness is accompanied by structural factors that depress the growth such as demographic shifts and the government's failure to move ahead with economic reforms. While China's economic growth is expected to continue to slow during 2019–2021, it will still outpace growth of the global economy. The risk of a sudden slump of growth has increased significantly. Unreliable official GDP data complicate assessment of China's true economic conditions.

A cloud of uncertainty hangs over China's economy and its future prospects. The growing challenges confronting the domestic economy and the trade war that started last year depress growth. The situation is complicated by the fact official GDP growth figures have shown steady high growth for many years which contradict other available information. For example, government stimulus efforts, declining sales of cellphones and cars, rapid deterioration in the purchasing manager indices, increased corporate payment defaults, layoff announcements and shrinking exports of neighbouring countries to China paint a picture of a substantially weaker economy than the stable official GDP growth figures indicate.

In addition to the uncertainty created by the trade war and weakening external demand from business-cycle effects, structural factors continue to drag down growth. The Chinese population is aging rapidly. The headcount of working-age persons (15–64 years) has fallen since 2014, and absolute number of people in the workforce declined last year for the first time in the modern era. The dependency ratio continues to deteriorate at a disconcerting rate. The ongoing structural shift from industry to a services-based economy further limits possibilities for productivity gains. China's investment growth rate offers little room for increase as the investment ratio is already extremely high compared to other the world's large economies. Finally, China's environmental problems are so serious that they constitute a brake on growth. Looking at this totality of circumstances, we expect GDP growth to come in at around 5.5 % p.a. this year, then slow to 5 % in 2020 and 4 % in 2021.

Domestic factors largely responsible for decelerating growth

Official figures show that around five percentage points of China's 6.6 % GDP growth last year was generated by growth in domestic consumer demand. Growth in real disposable incomes slowed towards the end of 2018, however, falling below the pace of GDP growth. Wage growth this year is expected to remain modest. International recruiting and compensation specialists Korn Ferry and Hays plc estimate that nominal wages in China will rise an average of 3–6 % this year. China's consumer price index suggests inflation has remained around the 2 % level over the past five years, and currently there are no significant inflation pressures in sight. However, the actual price increases encountered by households might be higher than the CPI suggests. For example, the index has been criticised for its failure to track potential inflation drivers such as soaring rents.

Even if official figures report that registered unemployment continues to hold at the 4 % level as it has every month for the past 17 years, there is plenty of evidence that employment situation has deteriorated. In recent months, numerous firms have announced layoffs or extended the traditionally week-long Chinese Lunar New Year Holiday. Company surveys of industrial and service-sector firms reveal a severe weakening of the employment situation. Around the start of this year, the term "layoff" saw a record number of searches on the Baidu search engine. In December, the government announced support for small and medium-sized enterprises (SMEs) that promised to refrain from laying off their employees through such measures as lowering mandatory unemployment insurance contributions and subsidising the costs of training workers.

Even if growth in domestic consumer demand has outstripped growth in gross fixed capital formation in recent years, economic restructuring progresses slowly. Officially, China's ratio of fixed capital formation to nominal GDP still stands at 43 %, which is exceptionally high by any standard. The sky-high investment ratio, in turn, has been sustained by high savings rate and the government's policy of providing access to cheap finance, especially to state-owned enterprises, so that they would invest and drive up the pace of economic growth. The pace of fixed investment has slowed sharply from previous years and uncertainty from the trade war has caused firms, particularly in export sector, to re-evaluate their investment plans. Urbanisation, which helps sustain the high investment demand, is also slowing. While Chinese cities gained 18 million residents last year, the increase was the smallest in ten years.

The slowing of economic growth in China's main markets, increasing barriers to trade and rising uncertainty are reflected in the weakening of Chinese exports. Manufacturing export orders have decreased rapidly, suggesting further weakening in coming months. China's current account surplus shrank to less than 0.5 % of GDP last year. Even if China and the US manage to resolve their trade differences this spring, uncertainty will continue with the persisting threat of additional new tariff hikes.

Emphasis on debt-financed stimulus pushes structural reform off the agenda

China has stubbornly clung to its political goal of doubling real 2010 GDP by 2020 as announced at the 2012 CPC National Congress. Reaching the goal has required constant stimulus of the economy, with the result that debt has ballooned. The IMF estimates that the general government deficit in recent years has averaged around 10 % of GDP and that public debt now stands at 70 % of GDP. Corporate sector debt (150 % of GDP) is exceptionally high, especially for an economy as large as China's. State-owned enterprises, in particular, are deeply indebted. Household debt has also soared by about 20 % a year in recent years, and now corresponds to roughly 50 % of GDP. China's overall debt-to-GDP ratio exceeds 250 %.

The government's focus on supporting economic growth has left badly needed structural reforms on the back burner. Not only is there little political appetite for reform, but economic policy continues to favour state-owned enterprises at the expense of private sector firms in some branches. Moreover, some of the important reforms announced have only been partially implemented. For example, regulation of lending interest rates officially ended in 2013, yet commercial banks continue to grant loans tied to People's Bank of China reference rates, i.e. pre-reform practice. While measures designed to consolidate the party's position and control over society are at odds with many economic reforms, the trade war at least has forced China to move ahead quickly with some reforms related to opening up the economy. China has lowered import tariffs and is allowing foreign firms to operate more freely.

The Chinese government has responded to the current economic slowdown with more stimulus. In addition to further monetary easing, the government has declared tax cuts, reductions in government fees and increased spending on public services and infrastructure. The costs of announced fiscal policy easing and increased spending plans clearly exceed the framework of modest budget and planned amount of local government special purpose bonds to be issued this year.

On the monetary policy front, the PBoC has e.g. lowered reserve requirement ratios for banks and tried to improve access of SMEs to credit with several targeted measures. SMEs in China have traditionally resorted to the unregulated shadow banking sector for financing. With increased regulation and tighter supervision, the PBoC has managed to decrease shadow banking activity in recent years. Despite monetary easing, however, on-year growth in the stock of bank loans has remained quite steady.

China has limited room to manoeuvre in its economic policies. The fiscal deficit of about 10 % of GDP is already extremely accommodating, and the ability of local governments to deal with their debt has begun to raise red flags. The increase in corporate sector indebtedness is also worrisome in light of recent waves of defaults and the financial troubles of firms that went quickly into debt. The government is discovering the diminishing returns on debt financing as new borrowing often now goes to paying off old debt. Further monetary easing is limited by the narrowing of the interest rate difference between Chinese government bonds and US treasuries and bonds. This narrowing creates undesirable pressures that drive capital flight and yuan depreciation.

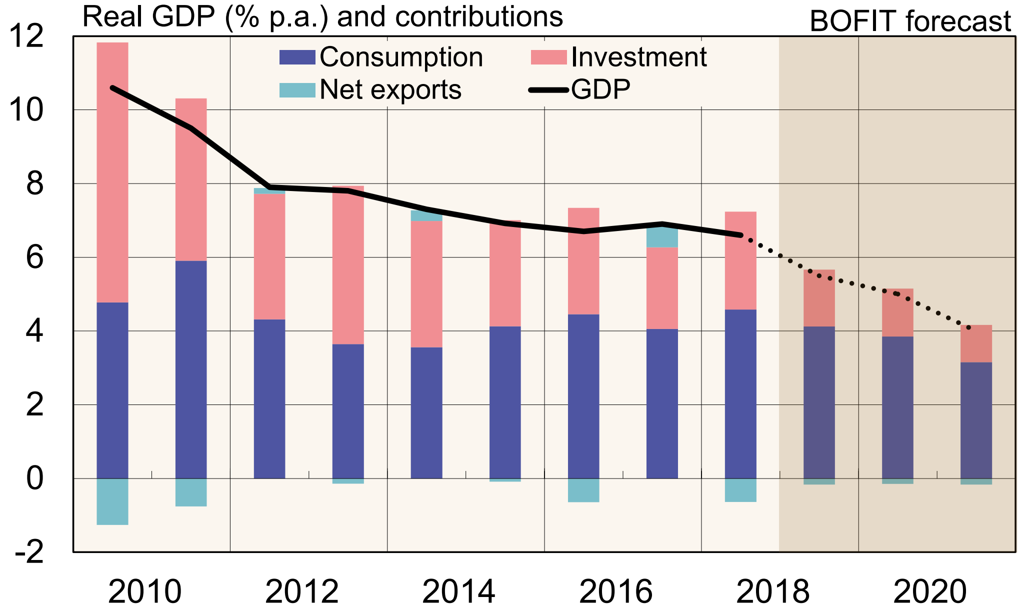
Sudden slump in growth possible

While financial market disturbances are a natural feature of developing economies experiencing structural changes like China, there is also a heightened potential for a sudden slump in economic growth. In nearly all historical cases where countries have rapidly accumulated debt in the manner of China, GDP growth eventually flamed out and precipitated a major financial sector crisis. Housing price growth has now stalled in China's major cities. Relative to incomes, housing prices have reached astronomical levels and speculators control a large swath of the apartment market. Many households and construction-related businesses find themselves awash in debt, so any substantial drop in housing prices would likely trigger a wave of defaults. Small and mid-sized banks increasingly find themselves struggling.

Large, difficult-to-resolve issues associated with the structure of the Chinese economy and government policies provide the backdrop to the current trade war. China's mighty state-owned enterprises, supported by industrial policies, present a particularly thorny problem. Even if the current the trade war is resolved amicably, competition between the United States and China will only to intensify. As it does, we may well see increased protectionism and a weaker outlook for Chinese growth.

It is also possible that China redoubles its stimulus efforts to sustain high growth for as long as possible. Such efforts would hasten the growth in the short term, but also it would worsen China's already serious debt problems and further heighten the risk of a sudden slump in growth. Distrust of China's official GDP growth figures has pernicious implications for officials attempting to set prudent policies, because measures based on distorted information could lead to improperly dimensioned economic policies. It is illustrative that president Xi Jinping called on the party cadres in January to be high alert to emerging risks.

Structure of Chinese GDP growth, realised and forecast



Sources: China National Bureau of Statistics and BOFIT.