BOFIT China Team

BOFIT Forecast for China 2023–2025

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20 April 2023

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The Chinese government made a surprising reversal of its zero-covid policies late last year. Lockdowns ended and the economy was allowed to reopen. GDP growth is now on track to overcome the Communist Party of China's official target of about 5 % this year, thanks in part to the last year's low reference basis. The stabilisation of the real estate sector also fa-cilitates growth. As the recovery phase subsides, growth is likely to slow towards the end of our forecast period. A number of factors still restrain growth, including high indebtedness, a greying population, a shrinking working-age cohort, the absence of reforms to promote productivity and the CPC's ever-tightening grip on the economy. There is a possibility that growth exceeds our forecast due to stronger-than-anticipated consumer demand. However, risks of lower growth exist as well. The ever-growing debt could ultimately be disruptive for financial markets and the banking sector. There is also a danger that superpower relations deteriorate further.

China spent most of 2022 struggling with highly communicable covid strains. The government sought for months to keep strict zero-covid policies in place, with the result that large swaths of rolling lockdowns crippled life in many areas. Strict pandemic rules hobbled production, increased uncertainty about the future and reduced opportunities to consume. The problems of the real estate sector created an added drag on economic growth. The drive in export sector also stalled as global demand for services revived with the lifting of pandemic restrictions outside China. Towards the end of the year, rising inflation abroad eroded purchasing power and the energy crisis, particularly in Europe, reduced global demand.

In a stunning reversal of its covid policies, the government in December lifted most restrictions. The change seemed to be a concession on the government's part that lockdowns were insufficient to stem the spread of new highly contagious covid variants and a response to national dissatisfaction that had driven a wave of unprecedented public protests. With the opening of the economy, consumer confidence strengthened in the early months of 2023 and private consumption returned to the growth track. Officials were able to stop the collapse of the real estate sector by abandoning the restrictions they had imposed a couple years earlier to rein in soaring housing prices and rapidly mounting developer indebtedness.

This year's growth target within reach, but future growth prospects less certain

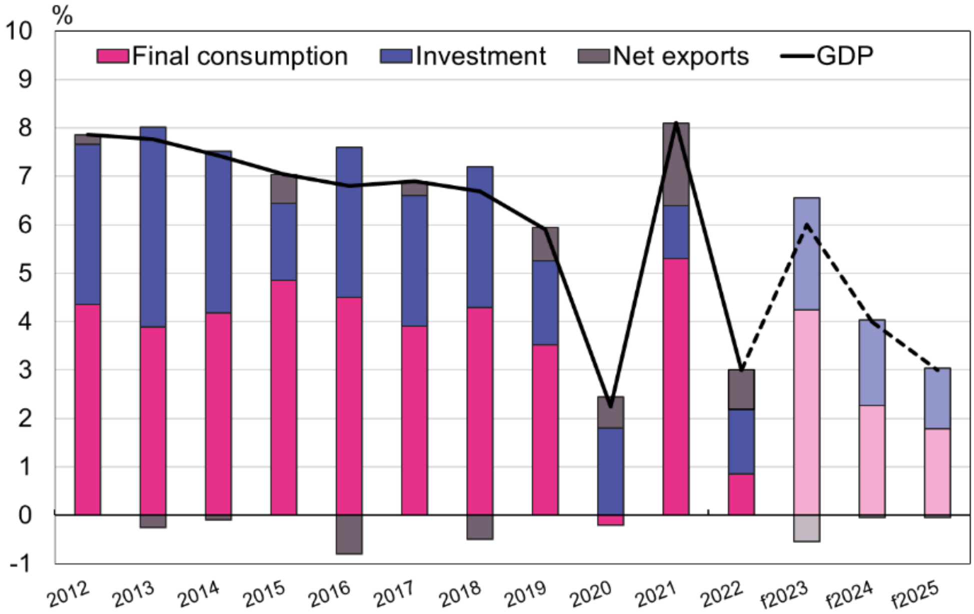
Even a modest recovery is sufficient for GDP growth to overcome this year's official target, which is "about 5 %". Much of this achievement is made possible by last year's low reference basis, which was revised even lower this year. In addition, we expect real estate investments to increase anew and support GDP growth by the second half of this year.

The factors limiting long-term growth, however, remain in place. China's labour force is shrinking, the population is ageing, political guidance has increased and indebtedness restrains corporate profitability and investment plans. Real estate investments are not likely to remain such a strong support to economic growth as they have been in the past, and most of people's wealth is tied up in housing that have now become far less reliable investments. This could hinder consumer demand growth.

Global demand is still clouded by the ongoing rise in living costs and interest rates. In such circumstances, China's export sector can hardly be a growth engine that it was in 2020–2021. Domestic inflation has been modest and clearly below the China's official 3 % ceiling. We expect inflation to remain modest throughout the forecast period, and thus country's monetary policy stance is expected to remain accommodative in order to support growth and keep financial conditions favourable.

We expect China's GDP growth to reach around 6 % this year due to the opening-up of the economy and last year's low reference basis. Recovery of the real estate sector should also help increase GDP growth next year to 4 %. After that, and in accordance with our forecast last October, we expect growth to slow to around 3 %. This modest overall growth figure naturally allows for higher growth in certain parts of the economy.

Figure 1. China's GDP growth, factors contributing to growth and BOFIT forecast for 2023–2025



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

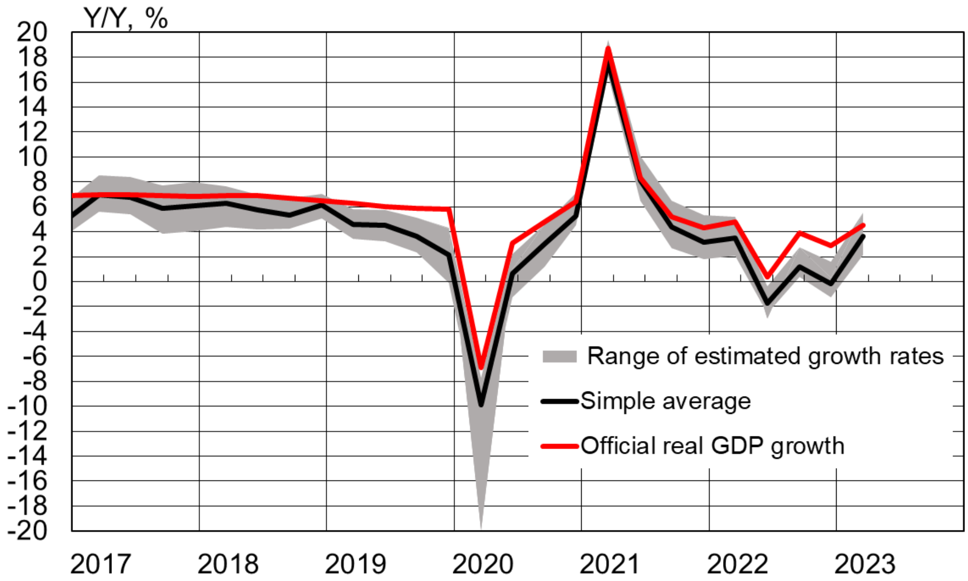
Official 2022 growth figures still suspect

Even if last year was objectively tough for the Chinese economy and the government abandoned its GDP growth target already in the summer, officially reported growth for the year was still 3 %. Most observers believe China's economic growth last year was actually lower. For example, BOFIT's alternative GDP calculations suggest that GDP growth last year was closer to zero.

Our alternative GDP growth estimate is based on official nominal growth figures at the sectoral and national level, as well as a broad sample of price indices published by the National Bureau of Statistics. Using deflators estimated on these price indices, we adjust nominal growth to obtain seven different measures of real growth. Our alternative GDP assessment is the simple average of these seven figures. China's official GDP growth figure began to depart from our alternative calculation at the start of 2022 and by the end of last year official GDP growth was considerably higher than any of our alternative growth rates.

China seems committed to burnish its GDP growth rates in the years ahead. At the CPC congress in March, this year's GDP growth target was set at about 5 %. Although the goal is modest under the circumstances, it is unfortunate that China still seeks to guide its economy with numerical targets. Necessary reforms and tackling the debt problem are difficult to make if decisionmakers fear they might impair economic growth over the short run and thereby harm their own career outlooks.

Figure 2. The gap between official growth figures and alternative calculations widened last year



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

Party grip on economy tightens; indebtedness continues to rise

The CPC's direct guidance of the economy appears to be increasing. This trend is embodied, for example, in the March decision by the plenary session of People's National Congress to establish new central commissions tasked with oversight and strategic policymaking in the financial and technology sectors. Also in March, the new political leadership was named to serve general party secretary and president Xi Jinping during his third term. At this stage, it is still possible that the new party leadership decides with a new energy to move ahead on some of the much-needed reforms.

However, the combination of the CPC's tightening political grip and the mandating of growth targets virtually guarantees that economic policies will remain supportive and the thornier issue of dealing with rising indebtedness remains on the back burner. For example, borrowing restrictions on developers have been lifted and borrowing rules even relaxed. Supports provided in the depths of the Covid-19 pandemic have been extended for several years and banks encouraged to lend.

The indebtedness of local governments and their off-budget financing vehicles exploded in recent years. The combination of increased spending to deal with covid and collapse in sales of land use rights, a major source of income for local governments, caused many to run large deficits. Local governments typically have strong links with the provincial banking and corporate sectors, so off-budget borrowing can be prodigious. In January, the IMF put China's 2022 augmented public deficit at about 17 % of GDP, noting that there was little evidence that that share would change this year. According to the Ministry of Finance, some cities and districts already face huge difficulties in servicing their debts.

External tensions unlikely to ease

All of the punitive and retaliatory import tariffs imposed by the US and China on each other since the start of the trade war in 2018 remain in place, and tensions have shown no sign of easing during the first two years of Joe Biden's presidency. The US now seeks to limit Chinese access to advanced microchips and sophisticated technologies needed to produce such chips. Other countries joining in the export ban include the Netherlands and Japan, both major manufacturers of equipment needed in advanced microchip production. Despite occasional conciliatory statements from both Chinese and American diplomats, we expect superpower relations to remain tense throughout the forecast period.

The fraying of geopolitical relations has also led to weaponization of trade policy and increased use of export restrictions in modifying trading-partner behaviour. As a result, dependency on China as the exclusive supplier of strategically important imports has become risky for many countries. If nothing else, the current public discussion on reducing China exposure and the dangers of export restrictions have caused foreign firms to rethink their future investments in China. Surveys made by foreign chambers of commerce in China show that many international firms operating in China are reconsidering their production chains and ways to reduce over-dependencies. Nevertheless, the breakup and re-establishment of production chains takes time and involves substantial transition costs.

Structural factors the largest hindrances to growth; plenty of downside risk

Intractable structural factors are the largest impediments to economic growth in China. The population is ageing rapidly, there are fewer people of working age and the birth rate continues to fall. Reforms are painfully needed. Reform of state-owned enterprises has been nearly non-existent, the operating environment of private firms become more constricted, transmission towards consumption-driven growth model has not progressed, regulations are tightened and the party's grip on many sectors of the economy increased. The ongoing growth in indebtedness and rise in debt-servicing costs ties up capital that might otherwise be used in more productive ways. The debt problem also presses on banking sector performance and increase risks in the financial markets.

Payment problems of firms in China's highly indebted sectors are a significant risk, and affect directly the profitability of the lenders, particularly the smaller banks. Opaque ownership connections and the lack of pricing risks could cause huge problems for excessively indebted local governments.

Moreover, geopolitical risks could slow growth further. If superpower relations continue to degrade, it could significantly affect China's investment and trade flows. Nearly a third of China's exports are produced by foreign firms.

There is room in our forecast for higher growth as well if household consumption demand strengthens more than we assume. For this to happen, however, would require a significant revitalisation of the housing market or government commitment to actually moving ahead with reforms that promote consumption.