BOFIT Forecast for China
30 October 2023

BOFIT China Team

BOFIT Forecast for China 2023–2025

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China's economic conditions deteriorated over the summer on sluggish exports, a nosediving real estate sector and an unimpressive pick-up in consumer spending. The government has in recent months announced a number of minor stabilisation measures sufficient to sustain GDP growth of about 5 % in 2023. Economic growth over the medium term, however, will be dampened by structural factors, so we expect growth to slow to 4 % next year and 3 % in 2025. China is dealing with a rapidly ageing population and a shrinking working-age cohort. Moreover, the government has made marginal progress in shifting away from a growth paradigm driven by fixed investment to a consumption-based model. Overall productivity growth remains tepid. China is unlikely to make needed major structural reforms during the forecast period as the leadership remains focused on promoting self-sufficiency, national security and party ideology. The government has limited room for stimulus and traditional forms of stimulus have lost their effectiveness. Geopolitical tensions complicate China's foreign relations and financial sector risks continue to mount.

At the time of our April forecast this year, China's economic rebound from 2022 still looked relatively good. The government's swift lifting of covid restrictions in December 2022 had allowed the normal rhythms of Chinese life to resume. The uncertainty surrounding covid infections and quarantines due to possible exposure quickly vanished and the feared economic fallout from the omicron variant proved modest. Hope briefly returned to the struggling real estate sector, inspiring claims that the collapse in housing sales had bottomed out in accordance with the government's economic targets set forth at the end of last year.

As summer wore on, however, economic conditions deteriorated. Problems in the real estate sector flared and the long-awaited resurgence in household consumption fizzled. Consumer spending went to services such as domestic tourism and dining out – activities severely restricted during the covid years. Little help was forthcoming from the export sector due to the global slowdown in economic activity. Growth slowed especially in China's main export markets in North America and Europe. During the third quarter of 2023, on-year GDP growth fell to just 4.9 % y-o-y.

Lower growth ahead

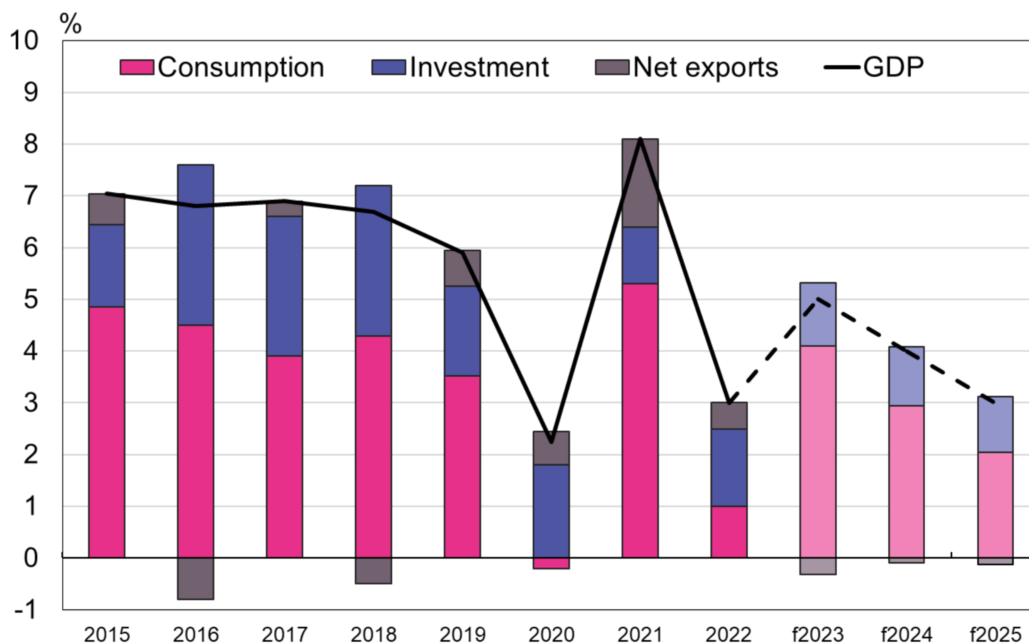
Officials have announced an assortment of measures to support the economy in recent months. In real estate sector, administrations have been encouraged to ease rules on the purchase and sale of apartments by e.g. lowering the downpayment requirement or redefining the term "first-time buyer." Monetary policy was also relaxed a bit through rate cuts and reductions in the reserve requirements for commercial banks. There has been some action on the fiscal policy side too, as the central government decided to issue 1 000bn renminbi worth bonds to increase government spending. The government has also increased certain household tax deductions. The measures should stabilise growth for a while. Our April forecast, which saw the Chinese economy growing by about 6 % this year, fell short as the assumed return of modest growth in the real estate sector in late 2023 never materialised. Given

the weak performance of the economy in recent months and ongoing struggles of the real estate sector, we have lowered our outlook for Chinese GDP growth this year to around 5 %.

Even if the slowdown in growth is partly due to cyclical components such as the real estate sector, the looming obstacles to long-term growth are structural factors the government has yet to address. In addition to China's rapidly ageing population, the cohort of working-age people continues to shrink. The shift away from an investment-driven growth paradigm to a consumer-driven model has not progressed. Resources have been squandered on unprofitable projects and productivity gains in recent years have been unimpressive. There are still no signs that the government will embrace the broad-based structural reforms needed to correct the situation.

Economic development has topped the agenda of the Communist Party of China (CPC) for decades. Indeed, allowing citizens to accumulate wealth rapidly and sustained high economic growth strengthened the party's position. During the presidency of Xi Jinping much more emphasis has been given to ideological considerations, state-control, national security and self-sufficiency leaving less room for pragmatic wealth-building policies. We thus expect China's economic growth to slow during the forecast period with GDP growth falling to around 4 % next year and 3 % in 2025. The differences in growth rates across branches should remain large.

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



Sources: China National Bureau of Statistics and BOFIT.

Caution remained the hallmark of household consumption behaviour in the first half of 2023 with Chinese households saving an even larger chunk of their income than in pre-pandemic times. Beyond the pain of falling housing prices that have substantially decreased household wealth (most household wealth is tied up in housing), erratic enforcement of zero-covid policies has left Chinese consumers traumatised and scarred. Thus, we expect household spending to normalise gradually. Official figures suggest that the rise in disposable household income this year has roughly kept pace with China's economic growth overall. There is uncertainty over future income trends, however, as some local governments and

companies struggling with financial problems are reported to have slashed employee benefits such as annual bonuses. Moreover, solutions to China's burgeoning youth unemployment problem have yet to be found.

Fixed investment growth should remain low. With investment in commercial and residential construction on the decline, the role of public investment in infrastructure and state-owned enterprises has become all the more important. With the government explicitly committed to stabilising the situation in the real estate sector, we expect the contraction in the sector to end at some point next year. The level of industrial capacity utilisation is quite low by historical standards, which limits incentive of industries to move ahead on capital investment projects. The branch-specific differences are quite large, however. While fixed investment growth during the forecast period is expected to slightly lag overall economic growth, China's gross rate of capital formation will remain above 40 % of GDP, an astonishingly high level for a developing economy.

Net exports are not expected to significantly support economic growth in coming years. The growth of demand in China's main export markets in North America and Europe should remain quite modest. Tensions between China and the West are unlikely to subside. A significant deterioration of public perceptions about China in Western countries could hurt demand for Chinese goods. Foreign firms are re-evaluating their China risk and isolating their China operations from international production chains. Chinese firms will continue to shift their production to third countries to circumvent challenges to value chains and cut costs. On the other hand, exports should get a boost from the improved price competitiveness of Chinese exports with the significant drop in the yuan's real effective (trade-weighted) exchange rate, or REER. With certain industrial branches (construction material production, in particular) struggling with overcapacity issues, there is a possibility the excess production will find clients from international markets. The slowing growth of the Chinese economy and weak yuan should dampen demand for imports, so we expect the volume of imports to grow at about the same pace as the economy overall. China's foreign trade surplus reached historic heights during the first years of the Covid-19 pandemic. We expect China to continue to post large trade surpluses throughout the forecast period.

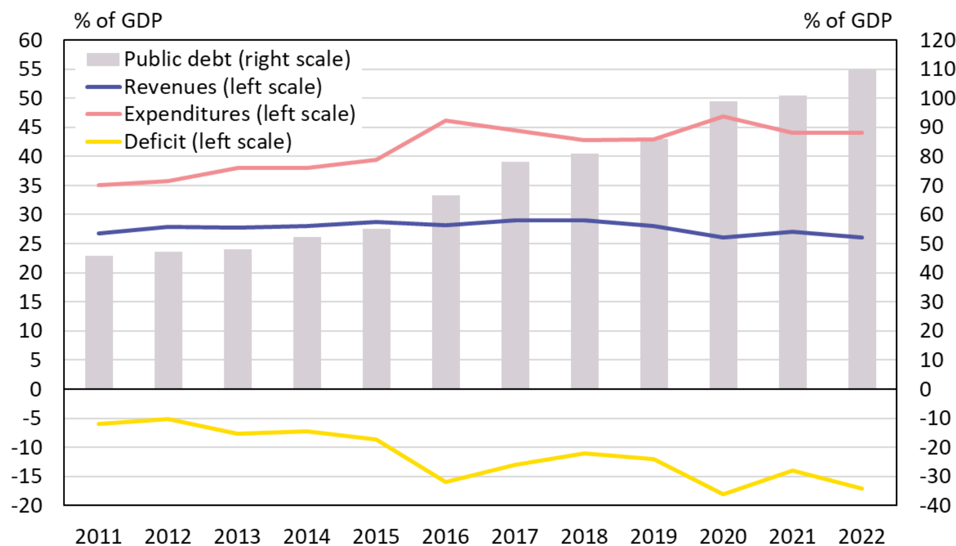
Limited stimulus options

China has run very large public sector deficits for years. The International Monetary Fund (IMF) put China's general government deficit last year at the equivalent of 17 % of GDP when public sector is defined in internationally comparable terms and includes the hidden indebtedness of local governments. This huge deficit reflects the central committee's long-standing imperative to hit economic growth target as well as the extremely costly burden of trying to maintain high growth amidst lockdowns, testing and tracing during the first two years of the Covid-19 pandemic. The IMF notes that the Chinese government's decade-long borrowing splurge lifted China's augmented public debt (includes general government debt, off-budget local government financial vehicles and state funds) to 110 % of GDP as of end-2022.

Local governments in China have traditionally been responsible for implementing the lion's share of stimulus measures. In addition, provincial and local governments were largely left holding the bag when it came to paying for covid measures, even as they also had to cover the costs of bailing out businesses such as local banks. The blow was made all the harder with the drying up of sales of land-use rights, a major revenue stream for local governments. A considerable amount of local government debt is hidden by off-budget local

government financial vehicles (LGFVs). The IMF estimates that local governments at the end of last year had declared debts amounting to about 29 % of GDP and undeclared debts of roughly 47 % of GDP. Although the situation varies considerably from region to region, this combination of large existing deficits and rising debt burdens limits the possibilities of local governments to invest in growth. In addition, local decision-makers may be less enthusiastic about taking risks and using the old tools to support economic growth. While the career paths of local Chinese decision-makers are still tied to local economic successes over short time horizons, central government anti-corruption campaigns have recently given much greater scrutiny to local decision-makers and the off-balance-sheet indebtedness of local governments. An unresolved question hanging over fiscal policy is whether the central government assumes a larger role in paying for economic stimulus.

Figure 2. IMF estimate of China's augmented public debt and fiscal performance.



Sources: IMF and BOFIT.

The increase in consumer prices has been modest in recent months with 12-month headline inflation running close to zero and core inflation (excludes energy and food prices) running below 1 % p.a. We expect inflation to remain moderate throughout the entire forecast period. Despite slowly rising prices and low economic growth, the People's Bank of China has relaxed its monetary stance only cautiously through minor cuts in its main policy rates and reduction in reserve requirements for commercial banks. We expect the PBoC's current cautious monetary stance to remain in place as officials seem concerned about the emerging risks indebtedness poses to the financial sector and the yuan's exchange rate. While interest rates have generally gone up in advanced economies, the PBoC has slightly lowered rates. This has widened the rate spread between China and the rest of the world, thereby increasing pressure to move capital out of the country. Capital flight leads to yuan depreciation, feeding a vicious circle of capital flight and further yuan depreciation. In winter 2016–2017, the last time China had to defend the yuan's exchange rate, the PBoC was forced to use extremely heavy-handed measures to stave off excessive capital flight. The reapplication of harsh measures cannot be ruled out if conditions dictate.

Forecast uncertainties

The uncertainties related to politically important official statistical figures are on the rise. Officials are under pressure deliver economic performances in line with set targets, even as underlying growth is expected to slow. It is likely that the discrepancies between official reported figures and various alternative measures of China's economy will widen. Moreover, slowing growth will likely reveal various kinds of problems, many linked to past capital allocation as fixed and portfolio investment have been dimensioned for higher growth environments. One question is how China will try to solve the rising acute and structural problems. Will the country resort to restrictions, bans, imperatives and increasing the role of the government or will it seek out market-based measures? The traditional fall-back to a debt-fuelled investment stimulus programme would boost the growth over the short term but exacerbate the economy's structural fragilities.

While our basic forecast scenario assumes the downturn in the real estate sector stabilises during 2024, there remains a possibility of the sector's troubles persisting. The real estate sector's problems are also reflected in the financial sector. Banks already report increases in the amounts of non-performing real estate loans on their books. Small and mid-sized banks have been hit hardest by declining profitability and balance-sheet solidity because a larger share of their lending goes to the real estate sector. This could create an increased need for bail-outs and other rescue measures by the state or local governments. The risks facing the financial sector are increased by local government struggles to deal with the vast amounts of off-budget debt set to mature by the end of 2025.

Further deterioration of China's foreign relations with Western countries could have profound economic consequences. Increased superpower competition might take surprising forms beyond current efforts to curb trade or promote national self-sufficiency. Disputes over Taiwan, for example, could precipitate a crisis in China's foreign relations that has major international implications. Taiwan is the world's largest producer of advanced microchips, and disruptions in production or logistics chains broadly affect global high-tech production, including high-tech production in China. China could also face severe major economic consequences if it provides arms or military support to Russia's war on Ukraine or efforts to enflame conflicts elsewhere.

Chinese households can surprise positively, as they have built up vast savings during the pandemic years. They could readily increase their consumption levels if confidence about the future strengthens. The release of pent-up demand would give a big boost to domestic consumption in particular. Moreover, economic policy reforms that strengthen social safety nets would significantly reduce the need of households to save.