BOFIT Forecast for China
4 October 2018

BOFIT China Team

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China's economic growth is slowing and the outlook has become more uncertain with the country's rising indebtedness and turbulence from trade policy disputes with the United States. The country's adherence to a GDP growth target further complicates economic policy as the stimulus needed to meet that target conflicts with government efforts to manage China's burgeoning debt problems and to move ahead with economic reforms. Acknowledging that problems with China' s statistical data make it hard to obtain a clear picture of economic conditions, we nevertheless hold to our earlier forecast that Chinese economic growth remains strong despite slowing to around 5 % p.a. in 2020, the final year in this forecast period. While China possesses resources to deal with many of the challenges it may encounter, the deterioration of economic conditions means that it is important to prepare also for a steeper slowdown in China's growth than predicted in our baseline forecast.

China's economic outlook has become increasingly uncertain as 2018 has progressed. While the biggest external factor driving uncertainty has been the escalating trade dispute between China and the United States, rising interest rates in the US and the narrowing of the interest rate gap between the two countries have also affected the outlook for the Chinese economy. Uncertainty is reflected in plunging prices on Chinese stock exchanges and yuan depreciation.

The intensity of market reaction, however, can be traced to China's domestic issues, particularly the slowdown in economic growth and rising indebtedness. Official figures show China's GDP growth, which was 6.9 % p.a. in 2017, slowed only marginally to 6.8 % in the first half of this year. China's quarterly reported GDP growth figures has fluctuated a mere tenth of a percentage point around the 6.8 % level for the past three years. Such extremely steady growth can hardly be a credible depiction of an economy undergoing massive structural adjustment. Indeed, many indicators suggest an economic slowdown is underway, with particular interest focusing on weak growth in fixed investment, a key driver of demand.

Erratic and contradictory economic policies

The latest stimulus measures, both fiscal and monetary, provide further evidence of government's worries over a slowing economy. The government's aspirational goal set forth in 2012 of doubling China's real 2010 GDP by 2020 has become the lodestar of Chinese economic policy. Hitting that goal requires annual growth rates of 6–6.5 % for the rest of the forecast period. However, even if economic growth were to fall somewhat below the level needed to stay on the official target trajectory, it would still be quite robust. Thus, the situation calls into question the desirability of current growth targets and debt-fuelled stimulus particularly as they intensify economic imbalances.

Higher public spending and implemented tax cuts increase the public-sector deficit in circumstances where, according to the IMF, the budget deficit already exceeds 10 % of GDP (official deficit 4 % of GDP). In addition, monetary stimulus implies taking on more debt. China's lax monetary stance has essentially erased the difference between Chinese and US interest rates – a situation that increases depreciation pressure on the yuan and encourages capital flight from China.

China's GDP growth target provides a stark contradiction to government efforts to rein in debt and reduce the associated risks. It has also made the country's economic policy direction increasingly unpredictable. In the first half of this year, there were still news about the central government's efforts to curb indebtedness by freezing local government infrastructure projects already in progress. By summer, however, local governments were being encouraged to hurry up and issue their own bonds in order to raise funds to complete their infrastructure construction projects to support growth and provide jobs.

China's debt-to-GDP in the first quarter of this year again exceeded 260 %, an exceptionally high level for an emerging economy. While most debt is domestically held and the public sector enjoys large reserves (the currency reserve, ownership of corporations and land rights) to help deal with emerging problems, virtually no country has managed to deal with similar explosive growth in debt without also experiencing some sort of crisis and growth impairment.

Postponing reforms only makes things worse

Economic reforms and sustainable growth policies have been side-lined by efforts to meet official growth targets and implement stimulus. Unfortunately, stimulus policies in the current environment tend to reinforce old structures, overcapacity and unprofitable operations. This, along with the lack of reform in opening up of the economy and assuring equitable treatment of foreign firms, is an important source of today's inflamed trade relations.

For years, China has offered various excuses for delaying needed economic reforms. With the problems on the trade policy front now spinning out of control, the government has finally chosen to move on some reforms. The Chinese market is now being opened to foreign banks and other companies operating in the financial sector. The government has also promised to lift restrictions on foreign ownership in such industries as automobile manufacture, aviation and ship-building. It has committed to broadening investment opportunities for foreign firms by reducing the number of sectors of the economy closed to foreign investment (negative list), and certain tariffs on imported goods have been reduced. The government has pledged to crack down in intellectual property theft and hinted about a possible accelerated schedule for joining the WTO's Agreement on Public Procurement. How well the reforms are realised and their practical significance remain to be seen as, in fact, many foreign firms have recently complained that officials are hamstringing their operations even more than earlier. Even so, some Western corporations have announced investment plans in the newly available branches.

There will be no better time than now for China to tackle reforms. The state, which is already over-involved in the economy, only appears to be increasing its presence when, for example, it seeks to limit indebtedness and environmental pollution with measures that affect private firms much more than state-owned enterprises. For China's economy to retain its dynamism, it needs deregulation and more market-based guidance in place of the current case-by-case "manual steering" approach that only kicks the can down the road. Real reform would mean, for example, faster overhaul of state-owned enterprises and more effective clean-up of branches suffering from overcapacity, as well as putting loss-making "zombie" firms out of their misery. Only then could vital firms and new engines of growth gain better access to financing and the benefits of a fair operating environment.

In addition to these practical challenges, reform policies are overshadowed by the current heightened emphasis on the Communist Party's importance and campaigns related to increasing its power. The present direction conflicts with market-economy reforms. It appears that the pragmatism of earlier economic and reform policies has been forced to give room to power politics. China's failure to deal with the unreliability of official statistical data partly reflects this policy trend.

Declining foreign trade surplus

The trade war with the United States has stimulated discussion concerning the importance of foreign trade in China's current growth model. With the rise of its domestic market, the ratio of goods exports to GDP has fallen over the past ten years from 34 % to 18 % (while imports have declined from 27 % to 15 %). Today, the impact of net exports on growth is quite small. China's foreign trade surpluses have shrunk with the rapid growth in China's domestic market and imports. The ratio of the current account surplus to GDP, an indicator of goods and services trade, has fallen to only about 1 %. Besides a shrinking goods trade surplus, the Chinese have developed an appetite for tourism that has significantly rebalanced foreign trade with a soaring services trade deficit.

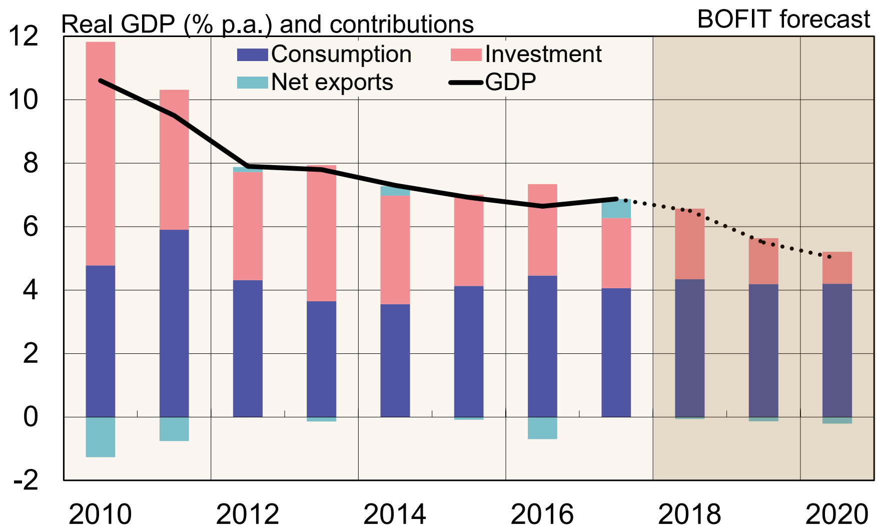
Despite the relative decrease in the significance of foreign trade, openness and access to global markets, as well as the enhancements to competition they bring, are still essential for Chinese firms and the country's development. China's decision-makers have sound reasons to be concerned about the rise of protectionism, but they have to take seriously also demands to open China's own markets and create a level competitive playing field for domestic and foreign firms. The growing criticism of foreign investments of Chinese firms and the Belt and Road Initiative clearly indicate the need for increased reciprocity and openness.

Growth slows, risks increase

Notwithstanding any official growth targets, China's growth rate is being dragged down by both domestic factors (indebtedness, the emerging dominance of services in economic output, demography, environmental problems) and external factors (trade war, reduced room to manoeuvre in monetary policy caused by a shrinking interest rate differential with the dollar). As in our previous BOFIT forecast from last spring, we see relatively strong growth continuing under our baseline scenario, even if GDP growth falls gradually to around 5 % in 2020. China's difficulties in reporting reliable GDP figures make it useless to publish more exact figures of output growth.

Examples of problems simmering in the economy include recent disruptions on financial markets and the financing problems encountered by certain major private Chinese firms. Although market disturbances are a natural part of China's economic evolution and the country has buffers for handling problems, the economic situation has been shifting in a disturbing direction. The pressures from pursuing conflicting goals lead to erratic reversals in economic policy, which, together with slowing growth, increased debt levels and the US-China trade war, suggest that the number of market disturbances could increase and one should prepare also for a more abrupt slowdown in China's growth than predicted in our baseline scenario.

The role of domestic consumption increases in China's economy



Sources: China National Bureau of Statistics and BOFIT