Analysis

China develops, growth slows

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As projected in earlier forecasts, Chinese economic growth continues to slow. 2015 GDP growth overall should average around 7 % p.a., and then the growth is expected to fall to around 6 % p.a. in 2016 and 2017. China faces the challenge of creating new engines of growth and managing its existing problems. This calls for determined reforms that inevitably will also bring about various kind of disturbances in the economy. Given decelerating growth and rising indebtedness, the risk that the Chinese economy underperforms this forecast is rising.



Slower growth pace in coming years

China's GDP growth slowed to 7.3 % in 2014. GDP growth this year was 7 % in January-June, and the July-August figures indicate growth will continue roughly at that level particularly if already-implemented stimulus measures produce their intended effect in the second half. Despite exceptionally weak performances in both exports and imports, the slowdown in GDP growth

closely matches our forecast of late last winter.

China has proceeded with wide-ranging financial market reforms. Sticking to implementation of reforms is critical in order to create new engines for growth and to resolve existing problems. In line with the Bank of Finland's earlier forecasts, our new forecast sees China's GDP growth averaging around 7 % this year and slowing to the 6 % range in 2016–2017.

Changing structures

The slowdown is a natural consequence of economic development and rising living standards in China. In terms of nominal GDP, China is already the world's second largest economy after the United States. Using GDP measured in terms of purchasing power parity (PPP), which captures better the actual use of resources, China's economy is already as large as the US economy. Given the huge size of the economy and the sheer amount of resource inputs needed to sustain current growth rates, a slower pace of growth is inevitable. Moreover, many of the factors that once drove high growth have vanished. The working-age population is shrinking, the available workforce in rural areas is diminishing and China has reached the point where it can no longer ignore environmental degradation.

The slowdown in growth reflects the transition from a growth paradigm driven by fixed-asset investment and goods manufacturing to a growth paradigm crowned by robust consumer demand and a large service sector. Evidence of this shift has been visible for some time now and can be seen in every part of the economy. One obvious area affected by the new growth model is the structure of Chinese imports. Import volumes of numerous commodities used in construction have already fallen. Similarly, low value-added component assembly work ineluctably continues to trickle away from China to countries with lower labour costs.

For the first time since 2006, private and public consumption last year accounted for more than half of GDP. Fixed investment in excess of 40 % of GDP is still phenomenally high, suggesting China has plenty of room for further structural realignment for many years to come. On the supply side, service sector output has increased rapidly and now generates nearly 50 % of GDP. Moreover, services now play the lead role in supporting job creation. Based on available information, it appears that China's labour markets withstand an economic slowdown. China's poor labour market statistics, however, makes accurate assessment of this situation difficult.

Current account surplus and stimulus bolster short-term growth

Due to the tightening labour supply and the sky-high investment ratio, growth in China must

increasingly be based on productivity gains. Both China's urbanisation process and technological advancement strongly support this trend. Development in the technical sphere is already apparent in that China has been the world's top purchaser of industrial robots for some years now, even if there are still few robots relative to the number of workers.

Growth over the short run is supported by two factors: fiscal and monetary policy stimulus measures and the positive terms-of-trade effect stemming from the drop in global prices for oil and other commodities. Despite a remarkable boom in Chinese international tourism that moderates China's current account surplus, it could still reach 3 % of GDP this year.

In the years ahead, current account surplus will begin to shrink. Chinese incomes and consumption will continue to rise significantly faster than the global average and, consequently, import growth is expected to outstrip export growth. China's foreign currency reserves, while prodigious, have shrunk to less than $3.6 trillion reflecting e.g. the recent surge in capital outflows. These factors in combination suggest that China's trade and capital flows are no longer feeding the global imbalances seen in the last decade.

With modestly rising consumer prices at the moment, policymakers do not seem overly concerned with threats of higher inflation or deflationary risks. Producer prices, in contrast, have entered their fourth consecutive year of decline. This reflects both the slide in world commodity prices and overcapacity problems that continue to plague many sectors.

Yuan spearheads reform policy

Measures to open financial markets provide the clearest examples of progress in policy reforms. Reform policy pursues the strategic goals of promoting international use of the yuan and strengthening China's presence in the global economy. At a practical level, this can be seen in China's efforts to have the yuan included in the IMF's SDR basket of the key currencies. China has recently moved ahead with the dismantling of capital controls, revised its mechanism for setting exchange rates to a more market-driven approach, continued with deregulation of deposit rates and launched a deposit insurance scheme. All these measures increase competition on the domestic market and support international acceptance of the yuan.

In many other sectors of the economy, the progress in reforms has been slower than hoped. State-owned enterprises still enjoy an array of competitive advantages denied their private counterparts, and reform of the service sector would be important to pull structural reforms ahead. Foreign firms operating in China have expressed concern over the worsening business environment due to slow progress in reforms.

Nevertheless, reforms have already altered the business environment considerably but policymaking and related communication have not kept up with changes. For example, inconsistent and confused policy by authorities this summer with regard to stock markets and foreign currency markets implied significant costs for the government and added to market uncertainty. While visible inconsistencies in policymaking could indicate differences among decision-makers over reform policy, they also demonstrate the fact that China's decision-makers find themselves operating in unfamiliar territory. This is part of a natural learning process. What counts is that China has stuck with its financial market reforms in spite of market turbulence.

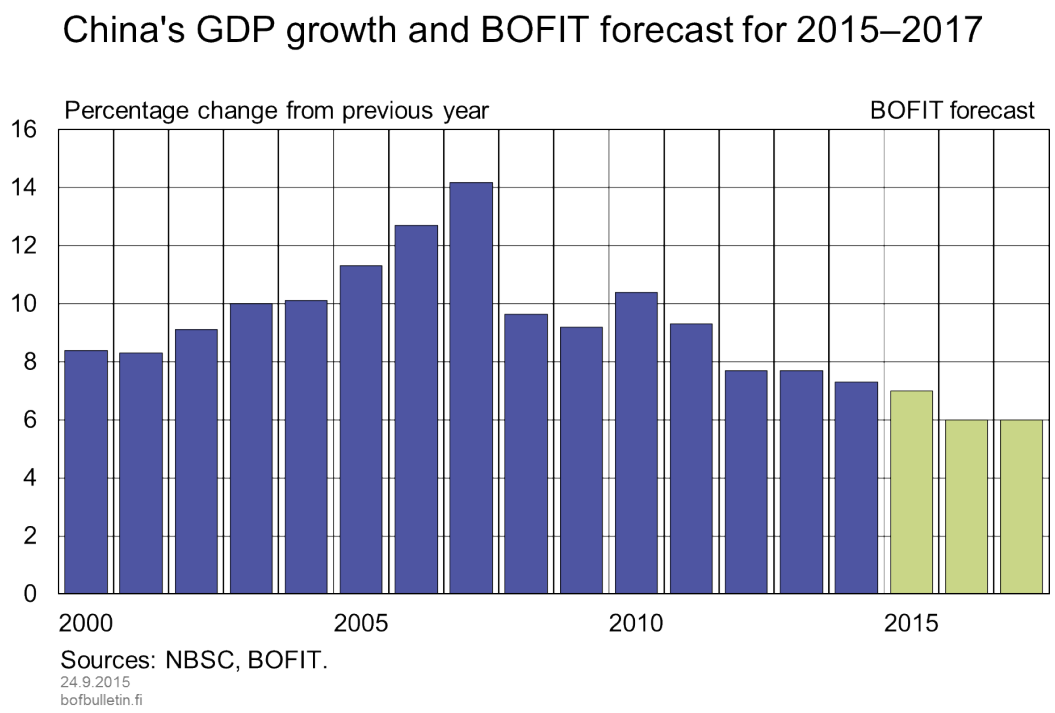
Market uncertainty should not be downplayed

Slower growth of China's economy, falling share prices and weak export/import trends have made markets increasingly jittery in recent months. It now seems apparent that markets have clung too long to overly optimistic views about China's economic growth and that disturbances in the financial markets have been interpreted too literally as a sign of dramatic weakening in the real economy. Given the scale of systemic and structural changes in China, it is clear that the process involves adjustments that bring about disturbances of varying degrees in the economy. In fact, such disruptions are at least partly a sign that things are developing in the desired direction.

Although shocks are natural at this phase of China's development, problems and the seriousness of the risks they entail cannot be treated lightly. In themselves, the poor statistical data, the lack of transparency in the system, and the huge differences among China's regions already create the situation where nobody has a clear picture of the economy. Debt levels in the country are rising, which means that this major sore point of economic policy continues to fester and related risks increase.

At their worst, severe market disturbances could trigger a situation where economic reforms come to a halt. Signs of impeded reform processes have already been seen following the recent turmoil in the stock markets and foreign exchange markets. If policymakers give in to pressures to suspend reforms and Chinese policy becomes inward looking, a reassessment of China's development trajectory and growth outlook would definitely be in order.

Chart 1.



Keywords

BOFIT, China, forecast, gross domestic product