39. CHINA

Following a strong rebound at the beginning of this year, a more pronounced scarring effect from the pandemic materialised. Low confidence among households and private enterprises, amplified by the crisis in the real estate sector, is expected to unwind gradually over the next two years. At the same time, many local governments and state-owned enterprises find themselves financially strained, unable to provide their usual boost to growth through investment spending, while the central authorities focus on maintaining stability. Without implementing a more profound reform agenda, growth is projected to weaken further in 2024 and 2025, undermined by China's structural imbalances, geopolitical uncertainty and weakening demographics, but authorities are likely to support growth 'to the extent needed' to limit the fallout of the slowdown.

Pandemic scarring weakened growth in 2023

Following the abrupt abandonment of the zero tolerance COVID-19 policy in late 2022, China's economy started recovering rapidly in the first quarter of 2023. GDP exceeded expectations growing by 2.3% q-o-q, driven by recovering private consumption and state-owned enterprise (SOE) investment. However, the rebound was short-lived as pandemic scarring turned out more profound than expected, with households maintaining high precautionary savings. Furthermore, the uncertainty stemming from the ongoing real estate crisis continued to weigh on consumer and investor confidence. Growth weakened in Q2 (0.5% q-o-q), as households, private enterprises, and local governments actively deleveraged, before picking up again in Q3 (1.3% q-o-q).

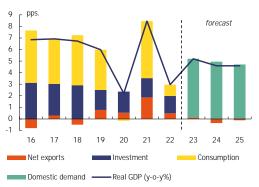
In 2023, China's economy is set to grow by 5.2%, surpassing the government target of 5%, despite weaker than expected domestic demand and worsening external environment. Household consumption is recovering and is projected to provide the largest contribution to growth as unemployment falls, especially among migrant workers. Still, labour market outcomes remain mixed, as youth unemployment hit an all-time high in June (the series has been discontinued thereafter). Lacklustre construction activity weighs on private sector investment growth (0.6% in the first nine months). Furthermore, local government investment spending, typically directed at infrastructure, remains subdued. Having underpinned growth during the pandemic, the contribution of net exports will likely turn negative in 2023, as import growth recovers.

Structural impediments to growth to become more binding

Growth is set to weaken to 4.6% in 2024 before stabilising in 2025. In both years it is expected to remain well below its pre-pandemic trend. As China's existing growth model based on high investment in real estate and infrastructure, financed by debt, is weakening, new drivers of growth are not sufficiently developed yet.

Household consumption recovery is projected to continue in 2024 and 2025. The household savings rate is set to gradually decline to its pre-pandemic level. Developments in the real estate market will certainly influence the pace of this adjustment. As real estate accounts for over





70% of total household wealth, movements in price expectations produce a sizeable wealth effect. Household disposable income growth is expected to remain relatively moderate, in line with weaker prospects in the labour market, especially for the youth.

Investment is set to remain subdued in both 2024 and 2025. Some local governments and SOEs are starting to feel harder budget constraints and are accordingly adjusting their business decisions. Without stronger central government intervention, their capacity to boost growth by

spending on new investment will be limited. While construction activity is expected to stabilise during the next two years, at a much lower level than before, growth will remain relatively low, in line with weakening fundamentals (e.g., demographics, urbanisation rate). The drop in economic activity during the pandemic left many private companies severely strained financially. Private sector investment is projected to remain subdued while companies repair their balance sheets. However, a positive contribution to investment growth is expected to come from green investments as banks are increasingly being incentivised to boost lending for green projects.

Net exports are not expected to provide a significant contribution to growth over the next two years. Export growth is forecast to remain subdued, as geopolitical considerations and management of trade dependencies become factors weighing on the demand for China's exports. Similarly, structurally weak domestic demand and the policy of pursuing self-sufficiency weighs on import growth. Overall, the current account balance is set to gradually decline to 1% of GDP in 2025 from the pandemic peak of 2.2%.

Authorities are expected to focus on managing risks

The authorities seem less insistent on delivering high growth rates and are focusing on managing existing risks and maintaining macroeconomic but also social stability. The weak fiscal situation at the local government level will limit policy options while the problems in the real estate sector will require more active engagement of the central authorities. So far policy support has largely come in the form of supply side support for businesses. Monetary policy is focusing on providing liquidity while fiscal interventions remain limited and targeted. A conservative fiscal stance is expected to remain in place over the next two years.

High debt is the most pronounced risk to China's economy over the next two years, further amplified by the real estate crisis which could potentially spill over to the financial sector (see also Box I.2.1 on how this process could play out and its relatively limited impact on the EU). At the end of 2023-Q1, total non-financial sector debt stood at 306% of GDP, almost 17 pps. higher than a year ago, and 40 pps. higher than in 2019. Servicing such massive debt, especially of corporates, is becoming increasingly difficult with the projected growth slowdown. Other risks arise from weak investor and consumer confidence, geopolitical uncertainties, and adverse demographics.

	2022				Annual percentage change					
	bn CNY	Curr. prices	% GDP	04-19	2020	2021	2022	2023	2024	2025
GDP		121020.7	100.0	9.0	2.2	8.5	3.0	5.2	4.6	4.6
Private consumption		44791.0	37.0	-	-	-	-	-	-	
Public consumption		19372.3	16.0	-	-	-	-		-	
Gross fixed capital formation		50795.8	42.0	-	-	-	-	-	-	
Exports (goods and services)		25041.3	20.7	10.5	2.1	17.7	-2.0	0.5	2.1	2.3
Imports (goods and services)		21092.0	17.4	9.7	-1.0	9.3	-5.0	-0.1	4.9	3.
GNI (GDP deflator)		-	-	-	-	-	-	-	-	
Contribution to GDP growth:		Domestic demand		-	-	-	-	-	-	
		Inventories		-	-	-	-	-	-	
		Net exports		-	-	-	-	-	-	
Employment				-	-	-	-	-	-	
Unemployment rate (a)				4.1	5.2	5.1	5.5	-	-	
Compensation of employees/head				-	-	-	-	-	-	
Unit labour costs whole economy				-	-	-	-	-	-	
Saving rate of households				-	-	-	-	-	-	
GDP deflator				3.8	0.5	4.5	2.3	0.1	1.4	1.4
Consumer price index (c)				2.7	2.5	0.9	2.0	-	-	
Terms of trade goods (b)				-	-	-	-	-	-	
Trade balance (goods) (b)				4.1	3.5	3.2	3.7	3.5	3.3	3.0
Current-account balance (b)				3.8	1.7	2.0	2.2	1.9	1.6	1.3
General government balance (b)				-	-	-	-	-	-	
Structural budget balance				-	-	-	-	-	-	
General government gross debt (b)				-	-	-	-		-	

Table 11.39.1:

Main foatures of country forecast CHINA