Sonali Jain-Chandra:

So over the medium to long term, if you look ahead, we see China facing serious headwinds to its potential growth, and these headwinds arise from two primary factors. The first is from an aging population, and the second is from slowing productivity growth.

Bruce Edwards:

And as one of the largest economies in the world, what happens in China can have a significant impact on the global economy.

Thomas Helbling:

So in this year's report, we touch on three global issues: trade, climate, and debt.

Bruce Edwards:

In this program, the latest review of China's economy with two of the report's authors.

Sonali Jain-Chandra:

My name is Sonali Jain-Chandra. I'm the IMF Mission Chief for China.

Thomas Helbling:

I'm Thomas Helbling. I am a Deputy Director in the Front Office of the Asia-Pacific Department and I oversee the work on China.

Bruce Edwards:

China's severe COVID lockdown since the start of the pandemic no doubt contributed to an economic downturn last year not seen in decades, but there's more to it than that. And as China starts opening up again, what can we expect to see happen in China's economy?

Well, the IMF does economic reviews for each of its member countries every year, issuing reports known as Article IVs. Today, Sonali Jain-Chandra and Thomas Helbling walk us through China's latest Economic Review.

So how has this recent removal or the lifting of very strict COVID containment measures in China affected its economic outlook?

Sonali Jain-Chandra:

So the exit from Zero-COVID policy late last year in China is very welcome and it sets the stage for an improvement in economic conditions in 2023. Of course, the exit was very fast amid low population-wide immunity, so it's been a challenging situation for China given the human cost of the outbreaks.

However, now looking ahead, we see the economic situation as improving as mobility normalizes, the COVID waves subside, and natural immunity grows. All of this should provide a boost to private consumption in China. And also, the removal of COVID containment measures is expected to revive service sector activity and help with an improvement in rebalancing.

More specifically, we project growth to increase from 3% in 2022 to 5.2% in 2023 as mobility picks up. And of course, this is good for China, but it's also good for the global economy given the importance of China in the global economy. In fact, for this year, we project that China will contribute a quarter of global growth. So this is good, it's very good for the global economy as well.

Bruce Edwards:

And I assume that a recovery like that also comes with some risk.

Sonali Jain-Chandra:

Yes, absolutely. So even though we see the sharp rebound in China's near-term economic outlook, this outlook is also beset by downside risks.

Let me point to two headwinds that this outlook is subject to. First is the ongoing domestic property market stress amidst slow developer restructuring and the prevalent downward pressure on house prices.

The second headwind to Chinese growth is also weak external demand, which would weigh on Chinese exports and would constitute another downside risk. And I think in this context, we underscore in the report strongly the importance of domestic demand to play a greater role, particularly consumption as driving China's growth growing forward, both from a cyclical as well as a structural perspective.

Bruce Edwards:

And you mentioned there the property sector, and we've heard a lot about the property sector since one of its biggest developers, if not its biggest developer, essentially just fell apart a year ago. What is behind China's real estate crisis and how important is it to its economy?

Sonali Jain-Chandra:

Okay, let's step back and look at the importance of the real estate sector in the Chinese economy.

Real estate has been a very important driver of China's economic growth for much of the decade before the pandemic. The sector accounts for about a fifth of China's GDP and about three-quarters of this is related to construction services, and another quarter is real estate services. And it also employs a significant part of China's population. It has a significant share in employment.

Also, property is an important source of wealth and collateral for Chinese households, and it contributes to local government finances in a significant way.

So let me put some specific numbers around this. Almost 90% of urban households are homeowners and land sales account for about 40% of local government revenues. As well as the real estate sector plays an important role in the Chinese financial system with mortgages and developer loans, accounting for roughly about a third of bank loans.

All this to say that property has been an important driver of Chinese economic growth. And so going forward, how this sector evolves will have a bearing on the outlook for China.

Bruce Edwards:

But when we say China has a real estate crisis, what is it related to exactly?

Sonali Jain-Chandra:

So essentially, the Chinese authorities tried to limit the risks from the housing price appreciation in the past decade. I think the intention was to limit the risk and put in place measures to contain leverage in the sector. This was put in place in 2020.

However, as a result of this or following this, severe financial strains have emerged within the sector which have threatened housing market stability. New policies to limit financial risks emanating from the country's large property developers, essentially the impact of these policies was to expose fragilities in the risky business model of these sectors. And the business model of the sector relied significantly on pre-sales of unfinished housing as a key form of financing.

After that, as you mentioned, a large developer defaulted and this created liquidity pressures, which spread through the sector. As a result of this, banks cut funding to developers while at the same time households sharply slowed purchases of pre-sold homes.

As a result of this, nationwide home sales fell by about a third in 2022, and a large portion of developers have defaulted or are expected to default based on where their bond prices are trading. And a sizable stock of unfinished housing remains in China.

So given the situation, the authorities have taken very welcome steps to address the crisis. This has helped boost financing conditions for some of the large developers. So I think it's very welcome, the policy steps that have been taken, but as of now, we don't see signs of a significant turnaround and we see that property sales are still about a third below the earlier levels and mortgage growth remains muted.

Bruce Edwards:

Maybe I might ask you, Thomas, this. How would you compare the real estate crisis in China to the one that we experienced here in the United States in 2007 and 2008? Are the same elements at play there?

Thomas Helbling:

I would say there are important differences. There are common elements. I think house price appreciation was a big concern, say, in the United States in the mid-2000s. But if you will, there was an element of exuberance in the US housing markets and eventually, that exuberance ended and led to collapse, especially in financial markets with various housing-related financial market products.

The slowdown in China or the correction in China is different. I think it was much more policy-induced. It was not sort of an organic market development, if you will. So there was an element of policy induction, as Sonali mentioned, that the government tried to limit the risks from house price appreciation in trying to reign in leverage of developers, limiting credit to developers. That then, in the context of an economic slowdown during the pandemic, sort of led to a broader housing market correction.

And it's important to see the differences in the correction. There are common elements in the sense there are elements of overbuilding, of housing that cannot be sold. There's specific Chinese elements though. It's a large stock of unfinished housing that is a problem. So there's a commitment there, but that hasn't been delivered. On the other hand, we don't necessarily have the big adverse macro-financial loops. We don't have these toxic financial products in the mix that then led to this big market meltdown yet.

So there are important common elements, like in many housing market corrections, there is an element of pricing having risen too fast and leading to housing markets that became too big to be sustainable, but then in the specifics of the correction, there are many differences.

Bruce Edwards:

Okay. So you also, in this report, you talk a lot about the need for China to lift growth and productivity. What are the factors that weigh on its ability to do that, and how do you, in this report, suggest that they navigate their way through that challenge?

Sonali Jain-Chandra:

So over the medium to long term, if you look ahead, we see China facing serious headwinds to its potential growth, and these headwinds arise from two primary factors. The first is from an aging population, and the second is from slowing productivity growth.

First, in regard to its rapidly aging population, the Chinese economy will have fewer people entering the labor force and this will diminish growth prospects. There will also be more elderly outside of the labor force who will need to be supported through social transfers and from younger members in the labor force.

Secondly, productivity growth has also slowed significantly. As an economy develops and it gets closer to the technology frontier, slowing productivity growth is normal to some extent. However, what makes China unique is the additional pressure that's arising from diminishing returns of investment-led growth. In the past, investment driven out by record-high domestic savings have been channeled towards the real estate sector as well as the relatively less productive state-owned enterprises (SOEs). This pattern of investment has sped up the decline in aggregate productivity in China.

So going forward, we recommend structural reforms as well as rebalancing of China's growth towards more consumption-based growth paths, and this would help transition to high-quality growth. And what we mean by high-quality growth is balanced growth, it's growth that's inclusive as well as green.

To give you an example of the kind of reforms we are recommending, we recommend the implementation of state-owned enterprise reforms, which would help close the productivity gap between state-owned enterprises and private enterprises, and this would help improve resource allocation as well as increase economy-wide productivity growth. And also pro-market reforms to improve business dynamism with higher firm entry and exit would also boost economy-wide productivity.

Turning now to how to address challenging demographic trends, labor market reforms that gradually lift retirement ages over the long run would enlarge the potential workforce. Also, education reforms that increase access to and enhance the quality of education would boost human capital.

Bruce Edwards:

So in this Article IV report, you also discuss China's role in the global economy and its contribution in helping, even facilitating, multilateral cooperation and some of the more important global policy issues like trade and debt. How do you see China's role in all this?

Thomas Helbling:

So China is of course one of the largest economies in the world. By economic size, it's in the top three. And in the Article IV consultations, like for other countries, we discuss large country's spillovers to other countries of their economic policies. And we also discuss how countries can help or play a role in addressing global challenges, global problems with the notion that larger countries have a big influence and might be better placed to find solutions.

So in this year's report, we touch on three global issues: trade, climate and debt.

So to start with trade, I think a big concern at the moment is rising geo-economic fragmentation. And perhaps as a backdrop, we think that policymakers in China and other countries have legitimate economic and geopolitical security concerns, and such concerns can lead to restrictions on trade, on the movements in goods and services. But these restrictions or fragmentation also means that the current global division of labor is disturbed and that comes at a cost because it basically means the world is moving to a less efficient division of labor.

So we, in the IMF, tried to carefully look at the cost and benefits of these moves and we discuss also what this means for a country's policies.

In the context of China, not in this, but in a recent Article IV, we looked at the issue of technological decoupling.

Bruce Edwards:

And so explain technological decoupling?

Thomas Helbling:

Where you basically limit technology transfer from one country into another. That can be in various forms, but very often, it's in the form of restricting trades and goods, say, for example, trade in semiconductors.

So we have had some work that showed that this can lead to substantial income losses relative to a no-intervention trajectory, including in countries like China or the US. And so in the Article IV, we also emphasized that China and the United States and other large economies have an opportunity, or at the IMF we would also say a responsibility, to work together and try to find solutions.

At the same time in the report, we also know that like other major trading nations, China's ability to lead also depends on its own policies, how open it is to trade and how it lifts up to a commitment to openness and transparency. And so in this regard, we emphasize, again, in this Article IV, the reform of SOEs and the importance of level playing fields, level playing fields in various sectors between SOEs and the private sector, including some foreign entities.

So, that's on trade.

Maybe on that, China is now a large creditor in the global economy, and so it can play a solution in situations of debt distress when some form of debt relief is needed. So in the backdrop to the current discussion on debt is of course that 60% of low-income countries are now in acute or at high risk of debt distress. And then in the G20 to deal with this debt stress, the G20 has come up with the Common Framework, and China has participated and agreed to that Common Framework and it has been applied to some debt situations in low-income countries already.

And I think the priority now, the main issue, is to work on the process to make it work faster and make it more predictable. And that's one of the issues we discussed.

Bruce Edwards:

So you just explained China's role in terms of debt and the framework, but China is a huge greenhouse gas emitter, but it is also surprisingly a world leader in renewable energy. Do Chinese policymakers consider now, more environmental impact, do you think, and how does its policies play into this global push for green finance?

Thomas Helbling:

So yes, China is today the largest greenhouse gas emitter. And at the same time, it's also very committed to finding climate solutions and it is committed to reducing peak emissions before 2030 and to reach carbon neutrality before 2060.

If you look at China's emissions, they are partly the result of very rapid growth from a very low per capita income levels. Growth in these stages of development is typically more emissions-intensive. There is also China's specific factor in the sense that it has been very investment-led growth. So that investment-led growth has led to relatively higher emissions than it would have otherwise led.

So one of the issues we picked up in the consultation is in the context of the economic rebalancing towards consumption, also what this would mean for emissions and climate. If growth were more consumption-led, then growth, or the economy would be less emissions-intensive. So I think that's one of the broader policy objectives.

In terms of policies, I think there has been a sea change in policies. Two years ago when President Xi made a big announcement to the General Assembly of the United Nations in 2020 that China was committed to become a net zero emitter by 2060, which is a big commitment and would need big policy changes. And I think such policy changes would also be consistent with an international role of China in climate policy, taking the lead there, in the sense being a role model, but also showing solutions to the rest of the world and facilitating the transition to a greener global economy.

Bruce Edwards:

Great. Well, Sonali Jain-Chandra, Head of the China team at the IMF, and Thomas Helbling, Deputy Director in the Asia-Pacific Department. Thanks to you both.

Sonali Jain-Chandra:

Thank you.

Bruce Edwards:

China's latest Economic Review, or Article IV as it's known around here, truly takes a deep dive into the inner workings of China's economy and includes outlooks, risk assessments, and policy recommendations, and lots more! Check it out at IMF.org and look for more IMF podcasts wherever you get your podcasts.

I'm Bruce Edwards, thanks for listening.