PEOPLE'S REPUBLIC OF CHINA

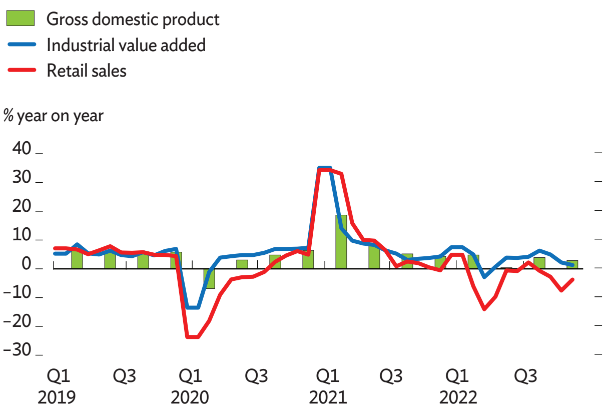
Economic growth is forecast to pick up in 2023 as household demand recovers following the lifting of COVID-19 restrictions, then moderate in 2024. Consumer price inflation is expected to stay subdued in 2023 and 2024 because pass-through from higher producer prices has become less likely. Boosting long-term potential growth is a policy challenge, calling for structural reform to allocate capital and credit more efficiently, address demographics, strengthen human capital, and raise productivity.

Economic Performance

Growth slowed to 3.0% in 2022 after strong economic recovery in 2021. Affected by COVID-19 lockdowns, GDP growth in the People's Republic of China (PRC) dipped twice in 2022: from 4.8% in the first quarter (Q1) to 0.4% in Q2, and from 3.9% in Q3 to 2.9% in Q4 (Figure 2.11.1).

Figure 2.11.1 Real Economic Growth

After strong recovery in 2021, economic growth slowed notably in 2022.



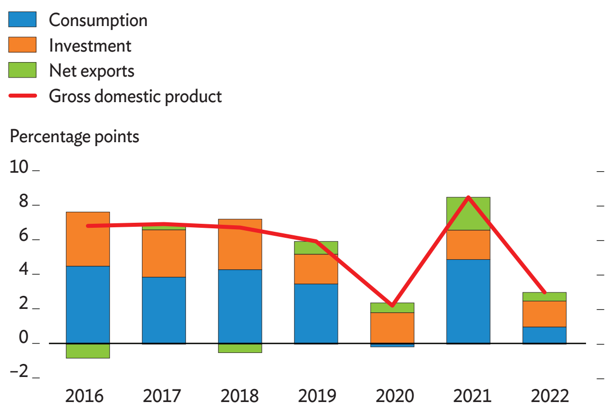
Q = quarter.

Sources: CEIC Data Company; Asian Development Bank estimates.

On the demand side, investment was the key driver of growth in 2022. Investment contributed 1.5 percentage points to the growth, 0.2 points lower than a year earlier (Figure 2.11.2).

Figure 2.11.2 Demand-Side Contributions to Growth

Investment was the key driver of growth in 2022, while the contribution of net exports moderated.



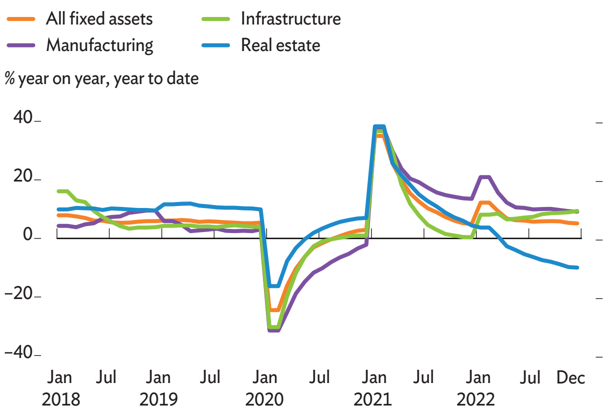
Source: CEIC Data Company.

Nominal fixed asset investment grew by 5.1%, up from 4.9% in 2021 (Figure 2.11.3). Contraction in real estate investment was offset by solid growth in manufacturing and infrastructure investment. Infrastructure investment surged on strong government support and expanded by 9.4% in 2022, up from only 0.4% in 2021. While manufacturing investment increased by 9.1%, a downturn in the property market brought contraction by 10.0% in real estate investment (see discussion in *Asian Development Outlook 2022 Update*).

This chapter was written by Dominik Peschel, former staff member of the People's Republic of China Resident Mission, ADB, Beijing; Wen Qi, resident mission staff; and Wenyu Liu, resident mission consultant.

Figure 2.11.3 Growth in Fixed Asset Investment

Infrastructure investment surged in 2022 while real estate investment contracted.

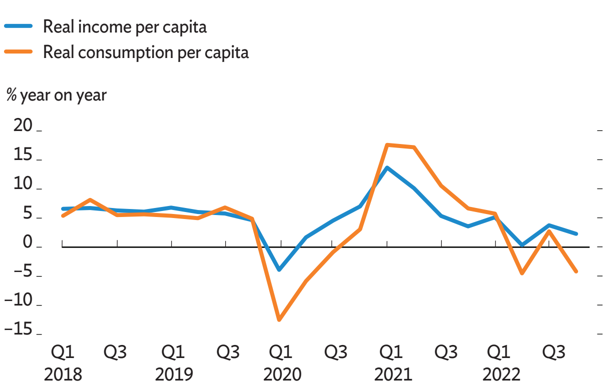


Source: CEIC Data Company.

Contributions to growth from consumption and net exports eased. COVID-19 lockdowns slashed the contribution of consumption to growth from 4.9 percentage points in 2021 to 1.0 point a year later, in line with weaker real household consumption and retail sales. While real growth in household income moderated from 8.1% in 2021 to 2.9% in 2022, household consumption plunged from 12.6% expansion in real terms in 2021 to 0.2% contraction in 2022 (Figure 2.11.4). Retail sales are estimated to have fallen in real terms by more than 10 percentage points for contraction by 2.8% in 2022. Meanwhile, net exports' contribution to growth eased from 1.9 percentage points in 2021 to 0.5 points in 2022, reflecting lower trade growth.

Figure 2.11.4 Growth in Income and Consumption Expenditure per Capita

Income grew slowly while consumption plunged in 2022.

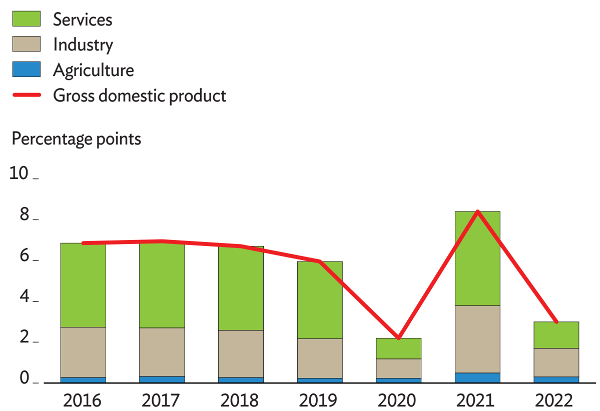


Q= quarter.
Sources: CEIC Data Company; Asian Development Bank estimates.

On the supply side, the secondary sector became the main contributor to growth. It increased by 3.8% in real terms in 2022, contributing 1.4 points to GDP growth (Figure 2.11.5). Growth in industry slowed from 10.4% in 2021 to 3.4% in 2022 as export growth slowed, while construction expanded by 5.5%, driven up from 1.1% a year earlier by high infrastructure investment.

Figure 2.11.5 Supply-Side Contributions to Growth

Reflecting renewed COVID-19 lockdowns, supply-side contributions to growth in 2022 resembled those in 2020.



Source: CEIC Data Company.

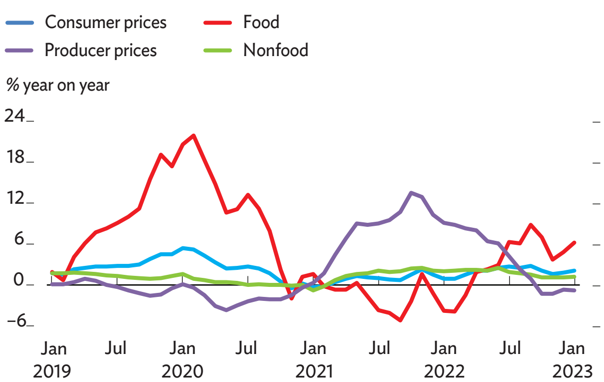
Services were hit hard by the pandemic. Growth in services decelerated from 8.5% in 2021 to 2.3% in 2022, contributing 1.3 percentage points to growth. Service growth was dragged down mainly by a 5.1% decline in real estate services and declines in accommodation and catering by 2.3% and in transportation by 0.8%, reflecting COVID-19 restrictions. Information technology, up by 9.1%, and financial services, up by 5.6%, were the main growth drivers. Agriculture growth moderated from an exceptionally high 7.1% in 2021 to 4.1% in 2022, contributing 0.3 percentage points to growth, which was 0.2 points lower than a year earlier.

The labor market weakened in 2022, particularly for youth. The labor market faced several headwinds in 2022: Frequent but unpredictable lockdowns and resulting economic downturns prompted firms to delay hiring. Tighter regulation of technology, education, and property enterprises also weighed on the labor market. While the surveyed urban unemployment rate retreated from its peak of 6.1% in April 2022 to 5.5% in December, the unemployment rate for youths aged 16–24 reached a record high of 19.9% in July 2022, decreasing to 16.7% in December. The number of rural labor migrants working in urban areas remained virtually unchanged at 172 million at the end of 2022, still more than 2 million fewer than at the end of 2019, before the pandemic.

Consumer price inflation and producer price inflation showed diverging trends. Consumer price inflation averaged 2.0% in 2022, up from 0.9% in 2021, as food prices increased by 2.9%, driven mainly by higher prices for fresh fruit (Figure 2.11.6). In contrast, producer price inflation averaged 4.2% in 2022 while on a declining trend, even reaching negative territory in Q4. Prices for newly constructed homes in the top 70 cities declined by 1.0% on average in 2022, with prices in tier-3 cities declining the most and those in top-tier cities remaining resilient (Figure 2.11.7).

Figure 2.11.6 Monthly Inflation

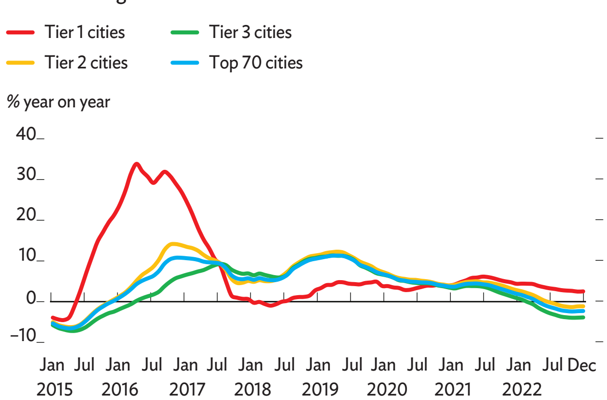
Consumer price inflation edged up, while producer price inflation came down.



Source: CEIC Data Company.

Figure 2.11.7 Prices for Newly Constructed Homes

Housing prices were on a declining trend in 2022, with prices in tier-3 cities declining the most.



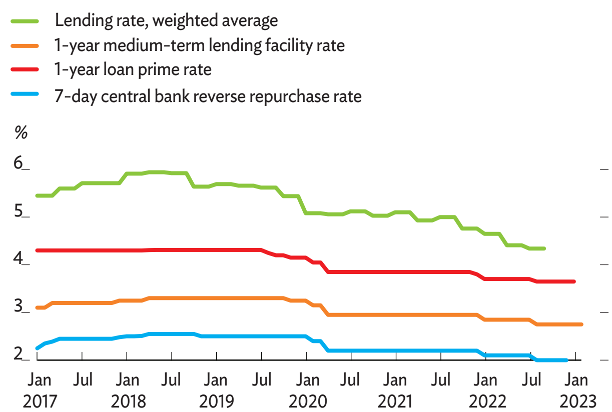
Note: Tier-1 cities are Beijing, Guangzhou, Shanghai, and Shenzhen; tier 2 has 31 provincial capitals and larger municipalities; and tier 3 has 35 other cities.

Sources: CEIC Data Company; Asian Development Bank estimates.

Monetary policy gradually eased as key policy rates were trimmed. The People's Bank of China, the central bank, cut the 1-year medium-term lending facility rate twice by 10 basis points each time to 2.75% in August 2022 (Figure 2.11.8). As a result, the 1-year loan prime rate moderated from 3.80% at the end of 2021 to 3.65% a year later. To support the stressed real estate sector, the 5-year loan prime rate used for mortgage pricing was reduced twice in 2022 by a total of 30 basis points to 4.30% in August. In addition, the required reserve ratio for commercial banks was cut twice to free up more funds for lending.

Figure 2.11.8 Banking Lending and Policy Rates

Monetary policy gradually eased as key policy rates were trimmed.

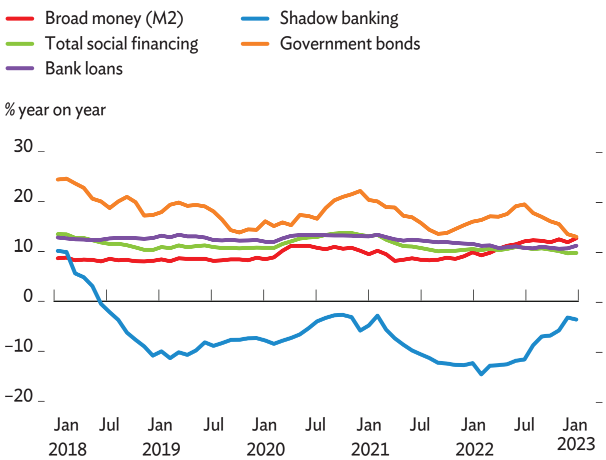


Source: CEIC Data Company.

Despite moderate monetary policy loosening, credit expansion softened. With the property market downturn, repeated lockdowns, and a surge in new COVID-19 infections toward the end of the year, growth in total social financing, a broad credit aggregate, slowed. The amount outstanding grew by 9.6% at the end of 2022, down from 10.3% a year earlier (Figure 2.11.9). Shadow bank finance outstanding declined by 3.2%, while bank loans outstanding increased by 10.6% and government bonds outstanding rose by 13.4% as the government stepped up infrastructure investment to support economic growth. Broad money (M2) increased by 11.8% in 2022, up from 9.0% a year earlier.

Figure 2.11.9 Growth in Credit Outstanding, Government Bonds Outstanding, and Broad Money

Despite some monetary policy easing, growth in bank loans eased in 2022.

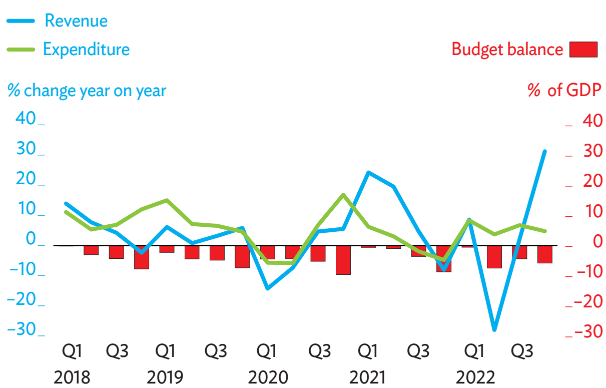


Note: Shadow banking comprises entrust loans, trust loans, and banks' acceptance bills.
Sources: CEIC Data Company; Asian Development Bank calculations.

Fiscal policy support for the economy increased in 2022. The annual budget deficit widened from the equivalent of 3.8% of GDP in 2021 to 4.7% in 2022 (Figure 2.11.10).

Figure 2.11.10 General Government Fiscal Revenue and Expenditure

Fiscal revenue growth fluctuated in 2022, while expenditure growth was comparatively steady.

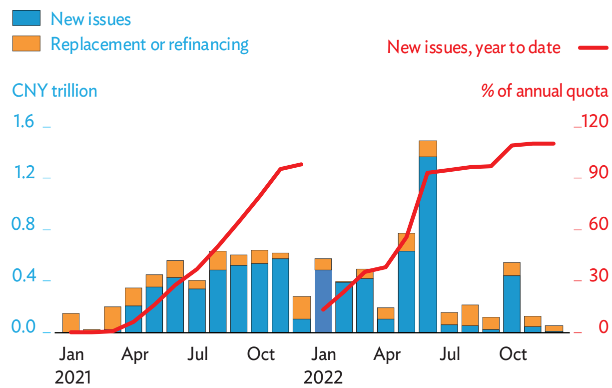


GDP = gross domestic product, Q = quarter.
Note: Public finance budget only.
Sources: CEIC Data Company; Asian Development Bank calculations.

Constrained by COVID-19 lockdowns and value-added tax credit refunds, which drove down tax revenue by 3.5%, general government fiscal revenue increased by only 0.6%, with nontax revenue higher by 24.4%. Meanwhile, fiscal expenditure grew by 6.1% as the government increased spending on health, which expanded by 17.8%, and on social security and employment, which grew by 8.1%. New local government special bonds issued amounted to CNY4.04 trillion by the end of 2022, exceeding the annual quota as the central government approved in August CNY500 billion in additional new local government special bonds (Figure 2.11.11).

Figure 2.11.11 Local Government Special Bond Issues

New special bond issues soared to finance infrastructure investment in 2022.

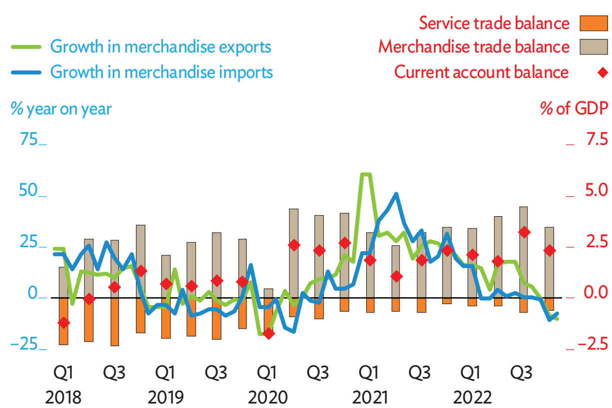


Sources: CEIC Data Company; Asian Development Bank calculations.

The current account improved notably in 2022. The current account surplus increased from the equivalent of 1.8% of GDP in 2021 to 2.3% in 2022 as the merchandise trade surplus expanded while the service deficit narrowed (Figure 2.11.12).

Figure 2.11.12 Current Account Balance and Merchandise Trade

Trade growth slowed notably as global demand weakened in 2022.



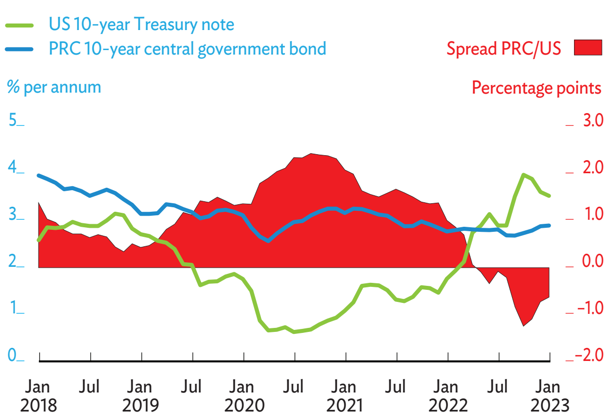
GDP = gross domestic product, Q = quarter.
Note: January and February data are combined to exclude the Lunar New Year effect.
Sources: CEIC Data Company; Asian Development Bank calculations.

Merchandise exports rose by 4.6% in US dollar terms after expanding by 28.1% in 2021, while import growth fell from 32.7% to 1.0%, reflecting weak domestic demand due to the pandemic and weakening export demand. Geographically, export growth to the PRC's major trade partners moderated in line with their growth slowdown and softening consumer demand. Following double-digit gains in 2021, export growth to the European Union moderated in 2022 to 8.3%, Japan to 4.3%, and the US to 0.9%, while exports to Southeast Asia grew by a solid 18.1%.

Net portfolio investment reversed direction, and net foreign direct investment (FDI) decreased in 2022. Under tightening US monetary policy, the 10-year US Treasury note yield rose sharply in 2022 (Figure 2.11.13), triggering non-FDI capital outflow from the PRC. In the first 3 quarters of 2022, net portfolio investment outflow reached $260.6 billion, reversing net inflow worth $14.4 billion during the same period of the previous year. In addition, the PRC attracted less net FDI in 2022 than in 2021 (Figure 2.11.14). Net FDI fell by a percentage point from the equivalent of 1.2% of GDP in 2021 to 0.2% a year later. Reserve assets decreased by $120.4 billion to stand at $3.31 trillion at the end of 2022.

Figure 2.11.13 Government Bond Yields

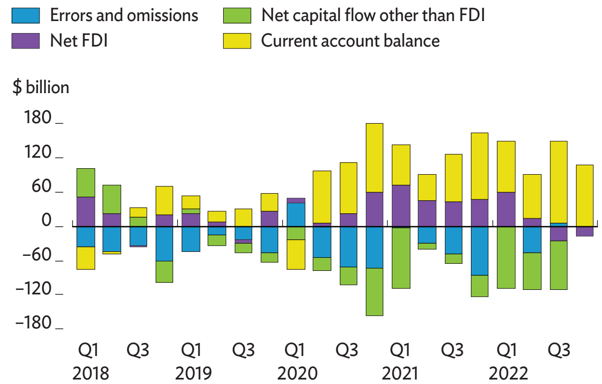
The tightening of US monetary policy saw the yield spread reverse in May 2022.



PRC = People's Republic of China, US = United States.
Note: Yields are monthly averages.
Sources: CEIC Data Company; Asian Development Bank calculations.

Figure 2.11.14 Balance of Payments

The current account surplus increased significantly, but net capital outflow was high in 2022.

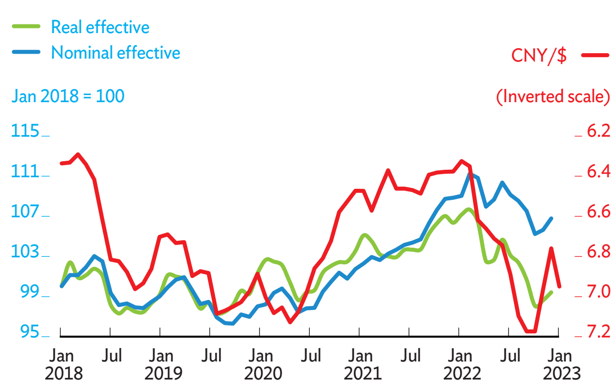


FDI = foreign direct investment, Q = quarter.
Note: Only current account balance and net FDI data available for Q4 2022.
Sources: CEIC Data Company; Asian Development Bank calculations

The renminbi depreciated against the US dollar in most of 2022 before recovering toward year-end. The renminbi depreciated by 9.2% against the US dollar over the course of 2022 (Figure 2.11.15). Besides the economic slowdown, renminbi depreciation reflected mainly US dollar strengthening as the US tightened monetary policy. The renminbi recovered against the US dollar toward the end of the year, after the government ended COVID-19 restrictions. In nominal effective terms, against a trade-weighted basket of currencies, the renminbi depreciated by 2.9% in 2022. In real effective terms, taking into account inflation, it depreciated by 7.9% in the same period.

Figure 2.11.15 Renminbi Exchange Rates

The renminbi depreciated against the US dollar in most of 2022 before recovering toward the end of the year.



Sources: CEIC Data Company; Asian Development Bank calculations.

Economic Prospects

Growth is forecast to recover in 2023. Consumer demand is expected to pick up after the lifting of COVID-19 restrictions in December 2022. At the same time, possible new spikes in COVID-19 infections after the end of pandemic restrictions could still undermine household demand. Consequently, ongoing fiscal spending, most notably infrastructure investment, will continue to be needed in the short run to catalyze economic recovery, particularly against the backdrop of a cooling global economy, which will suppress demand for PRC exports. Factoring in continued policy support, GDP is forecast to grow by 5.0% in 2023 on cyclical recovery in household demand before easing to 4.5% in 2024 as consumption fades (Table 2.11.1).

Domestic demand is expected to recover. Given the reluctance of households to spend over the past 3 years owing to pandemic-related uncertainty, it may take time for consumer demand to revive fully. Further, some households, especially those less well-off, may have drawn down their savings during the pandemic, which may draw out recovery in household consumption. At the same time, household deposits surged in 2022, increasing the potential for a revival in household consumption as consumer confidence recovers alongside higher economic growth. The government has already started loosening housing market policies to support economic recovery, but further relaxation may be needed to turn around the property market. This, together with continued growth in infrastructure investment, would support economic growth in the short run. At the same time, external demand may ease in 2023 as growth in advanced economies cools.

On the supply side, services are expected to pick up as consumer demand recovers. Accommodation and catering, transportation, and tourism will benefit from the lifting of pandemic restrictions. Given the likely weakening of external demand in 2023, manufacturing should expect to face headwinds from moderating exports, but construction will benefit from the recent loosening of housing market restrictions, and from further loosening likely to come. Improvement in the housing market will not only help retail sales by boosting demand for housewares, furniture, and home appliances but also boost consumer confidence, dragging up services in its slipstream. Agriculture, meanwhile, is expected to grow steadily.

Table 2.11.1 Selected Economic Indicators, %

Economic growth is expected to recover in 2023, while inflation should stay moderate.

	2021	2022	2023	2024
GDP growth	8.4	3.0	5.0	4.5
Inflation	0.9	2.0	2.2	2.0

GDP = gross domestic product.
Sources: CEIC Data Company; Asian Development Bank estimates.

The labor market should benefit from the lifting of pandemic restrictions. In addition, the tight regulation of technology, education, and property sectors that weighed on the labor market in 2022 will likely be finetuned, which should help the labor market. However, labor absorption remains a challenge as a record high of 11.6 million new college and university graduates are expected to enter the job market in 2023.

Consumer price inflation is expected to stay moderate. Pass-through from producer to consumer prices has become much less likely since producer prices started to ease in Q4 2022. Service prices look set to pick up, driven by higher household demand. Nonfood inflation may edge up as household consumption recovers in 2023, but from a low base. In sum, inflation pressure should stay low overall. Inflation is forecast at 2.2% in 2023 before easing to 2.0% in 2024 in line with lower economic growth.

Monetary policy is expected to ease marginally in 2023 to support economic recovery. The recent strengthening of the renminbi provides some room for policy easing. At the same time, though, any further tightening of monetary policy in advanced economies in 2023 would limit space for substantial cuts to key policy rates. Company profits have suffered during the past 3 years from pandemic restrictions, and many micro and small service businesses were hit hard. It will be crucial that banks support smaller businesses that stand to profit from a recovery in household consumption.

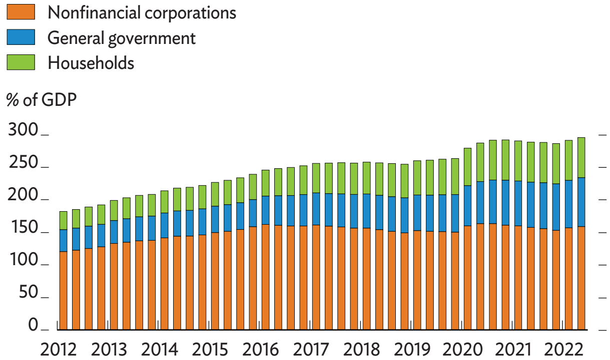
Slow credit growth may weigh on recovery. To generate momentum for economic recovery, bank lending will need to pick up. Further cuts to the reserve requirement ratio are likely as banks may otherwise struggle to provide sufficient credit to the economy. Credit demand from manufacturing will likely ease alongside weakening external trade, but credit demand from property should increase in light of loosening credit restrictions on developers. However, if credit flows to real estate pick up too much, this could come at a cost to other sectors and reemerge as a challenge for policy makers.

Fiscal policy is expected to remain supportive to growth in 2023. While the government set the 2023 GDP growth target at around 5%, it budgeted a 5.6% expenditure increase in the general public budget this year, slightly below 6.1% actual growth in spending in 2022. Fiscal revenue is planned to increase by 6.7% in 2023, up from 0.6% actual growth in 2022, which, however, was distorted by value-added tax credit refunds. Meanwhile, the annual quota for new local government special bond issues was set at CNY3.8 trillion, slightly below actual issuance of CNY4.0 trillion in 2022. While these budget figures would indicate marginal withdrawal of fiscal support, they do not provide a comprehensive picture of government spending. To support the economy, the government has ways of mobilizing additional off-budget spending, such as increasing policy banks' credit, and using central bank lending facilities and local government financing vehicles—all of which can be used as needed.

Fiscal policy should aim for fiscal consolidation once economic recovery has taken hold. Continuing weakness in the labor market and a cooling global economy justify ongoing fiscal support for now. At the same time, general government debt has increased in recent years, calling for deleveraging efforts once economic recovery has taken hold (Figure 2.11.16).

Figure 2.11.16 Debt Structure

Debt in the PRC has increased following the onset of the COVID-19 pandemic in 2020.



GDP = gross domestic product.

Source: Bank for International Settlements.

An additional challenge is to achieve sustainable local government financing, given that the local fiscal space has shrunk over the years as local government debt has increased.

External trade is expected to moderate, and capital flows may be more balanced in 2023. As demand from advanced economies softens, exports will likely decline, though from a high base. Weaker exports of consumer and investment goods should restrain merchandise imports, while trade in services should pick up as outbound travel from the PRC resumes. The current account surplus is expected to decline to slightly below the equivalent of 2% of GDP in 2023 and gradually ease further in 2024. On the capital account, higher GDP growth may attract capital inflow, reducing sizable net portfolio outflow in 2022 (Figure 2.11.14).

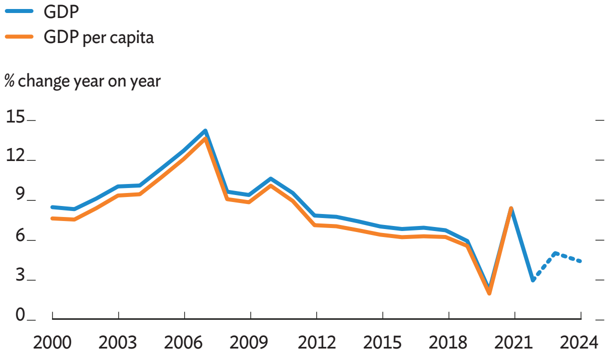
Risks to the outlook remain. They include the unpredictability of the COVID-19 virus as new variants could undermine recovery in domestic consumption. Another risk is that the recovery in consumption or in the housing market turns out slower than expected because of changed households' expectations about future economic growth and confidence in housing in lower-tier cities as a store of value. On the other hand, a recovery in consumer confidence that exceeds expectations could lift GDP growth above the forecast. An external risk is the global economy cooling faster or deeper than expected.

Policy Challenge—Declining Potential Growth

Even before the pandemic, economic growth was trending down (Figure 2.11.17). Critical questions are to which level of GDP growth the PRC will return and what the country's long-term growth prospects are given its rapidly aging society, the continued dependence of growth on investment, and a changed international environment. Long-term potential GDP growth can be estimated by fitting a production function. To obtain an estimate of future potential growth, the trends of all input factors—labor, human capital, financial capital, and total factor productivity (TFP)—are estimated separately and then combined into an estimate (Figures 2.11.18 and 2.11.19).

Figure 2.11.17 Real GDP Growth, 2000–2024

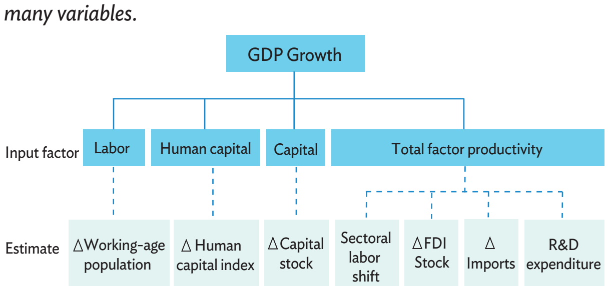
GDP growth has been on a declining trend for more than a decade.



GDP = gross domestic product.
Note: Values for 2023 and 2024 are forecasts.
Sources: CEIC Data Company and *ADO 2023* forecast.

Figure 2.11.18 Input Factors of the Production Function

Estimating long-term potential growth requires estimating the trend in many variables.

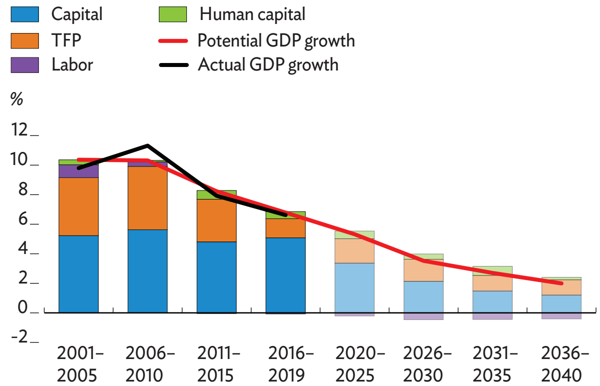


FDI = foreign direct investment, GDP = gross domestic product, R&D = research and development.
Note: Δ symbol means change in.
Source: Peschel, D. and W. Liu. 2022. The Long-Term Growth Prospects of the People's Republic of China. ADB East Asia Working Paper Series, No. 54. Manila: Asian Development Bank.

Potential GDP growth will likely decline. Potential GDP growth is estimated to be 5.3% on average in 2020–2025 and then to moderate to 3.5% in 2026–2030, 2.7% in 2031–2035, and 2.0% in 2036–2040. Capital and TFP are major contributors to potential growth in the long run. The contribution of capital is forecast to decline gradually from 3.4 percentage points on average in 2020–2025 to 1.2 points in 2036–2040. The contribution of TFP to growth is estimated to be smaller in the next 2 decades because of a decline in the contribution from the sectoral labor shift—i.e., people migrating from low-productivity

Figure 2.11.19 Decomposition of Contributions to Potential GDP Growth, 2001–2040

Despite remaining the main driver of growth, capital will contribute less to growth in the future.



GDP = gross domestic product, TFP = total factor productivity.
Source: Peschel, D. and W. Liu. 2022. The Long-Term Growth Prospects of the People's Republic of China. *ADB East Asia Working Paper Series*, No. 54. Manila: Asian Development Bank.

agriculture to higher-productivity industry and services—and lower returns to research and development (R&D). The shrinking of the working-age population will increasingly weigh on growth, but increases in human capital will moderately contribute to growth.

Structural reform is needed to increase potential growth. Reform is necessary in particular with respect to the country's capital and credit allocation, as are policy measures to address the shrinking labor force. Additional measures should be taken to increase TFP growth and the quality of education.

Changes to the allocation of capital and credit, including state-owned enterprise (SOE) reform are key to raising potential growth. Industrial SOEs tend to be less efficient than their private peers while profiting from superior access to credit. SOE reform should aim to clarify SOE scope and function, level the playing field for the private sector, separate social functions from SOEs, and improve SOE management. Moreover, credit allocation needs to be shifted in favor of the private sector, particularly micro and small businesses. To this end, banks need to strengthen their ability to assess credit risk, leading to higher operational efficiency.

Growth should be driven increasingly by domestic consumption. With a declining share of industry and a rising share of services in the economy, growth should be driven less by investment and more by domestic consumption. This would also be less capital-intensive. Developing the domestic service sector would require boosting household demand. To this end, basic public services and social security must be strengthened to reduce households' need for precautionary savings.

Demographics will increasingly weigh on economic growth in the coming 2 decades. The working-age population started to shrink about a decade ago. Policy action can mitigate how demographic aging affects the labor force. Measures include raising the retirement age, improving health care, raising female workforce participation rates, and increasing labor mobility. Shifting policy priorities to support families with children could spur the birth rate and thus improve demographics in the long run.

More and better education can raise human capital. The disparity in years of schooling between rural and urban areas in the PRC is significant, calling for efforts to increase years of schooling in rural areas. Moreover, better education would lift potential growth by raising workforce productivity. The quality and effectiveness of education can be improved by expanding early childhood development, enhancing the quality of tertiary education, strengthening technical and vocational education and training, and increasing on-the-job training.

Finally, measures are needed to boost TFP growth, which has declined over time. TFP growth benefits from sectoral labor shift, growth in imports and the stock of FDI, and higher R&D expenditure. The sectoral labor shift should be facilitated by relaxing residence permit restrictions and providing to labor migrants easier access to basic social services. Also, to make the country more attractive to FDI, restrictions on FDI and joint venture requirements should be loosened. In addition, advancing trade and investment agreements could engender openness and domestic reform. Finally, improving the country's R&D effectiveness requires more efficient R&D fund use and a higher share of basic research.