

Navigating Uncertainty

China's Economy in 2023



Special Topic: Youth Unemployment — An Emerging Challenge

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List of Abbreviations

ASEAN	Association of Southeast Asian Nations
CAR	Capital adequacy ratio
CFETS	China Foreign Exchange Trade System
CIER	China Institute for Employment Research
COVID-19, COVID	Coronavirus Disease 2019
CO ₂	Carbon Dioxide
CPI	Consumer Price Index
EU	European Union
FDI	Foreign Direct Investment
FX	Foreign Exchange
G20	Group of 20
G-7	Group of Seven
GDP	Gross Domestic Product
H1	First Half Year
H2	Second Half Year
HP filter	Hodrick-Prescott filter
ICT	Information And Communication Technology
IP Royalties	Intellectual Property Royalties
ILO	International Labour Organization
LGFV	Local Government Financing Vehicle
LPR	Loan Prime Rate
MLF	Medium-term Lending Facility
MoF	Ministry of Finance
NBS	China National Bureau of Statistics
NPL	Non-performing Loan
OECD	Organisation for Economic Co-operation and Development
PBC	People's Bank of China
POE	Private-Owned Enterprise
PPI	Producer Price Index
PPP	Purchasing Power Parity
PSL	Pledged Supplementary Lending
q/q	Quarter-on-Quarter
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
RHS	Right hand side
RMB	Renminbi
RRR	Reserve Requirement Ratio
sa	Seasonally Adjusted
SAFE	State Administration of Foreign Exchange
SHIBOR	Shanghai Interbank Offered Rate
SLF	Standing Lending Facility
SME	Small and Medium-sized Enterprise

SML	Special mention loan
SOE	State-Owned Enterprise
SPRF	Special-Purpose Refinancing
TVET	Technical and vocational education and training
TMLF	Targeted Medium-Term Lending Facility
UN	United Nations
UNICEF	United Nations International Children's Emergency Fund
USD	US Dollar
VAR	Vector Auto-Regression
VAT	Value-added Tax
WBG	World Bank Group
y/y	Year-on-Year
ytd	Year-to-Date
3mma	Three-month Moving Average
12mma	Twelve-month Moving Average

Executive Summary

Activity in China continues to track the ups and downs of the pandemic—outbreaks and growth slowdowns have been followed by uneven recoveries. After a downturn caused by the COVID-19 outbreaks and stringent public health measures in April and May, activity picked up in the third quarter as infections receded. GDP expanded by 3.9 percent y/y in Q3, from 0.4 percent in Q2. High frequency indicators suggest another growth slowdown in the fourth quarter amid a return of high COVID-19 cases. Despite fiscal and monetary policy support, real GDP growth is expected to slow to 2.7 percent in 2022—1.6 percentage points lower than projected in the June *China Economic Update*.

In 2023 growth is projected to recover to 4.3 percent but remain below the potential rate. China has been moving quickly toward reopening since November 2022, with public health measures being eased rapidly. During the initial stage of reopening COVID infections will rise sharply and might lead to voluntary reduction in social interactions, which will weigh on consumer demand and may lead to continued disruption even after restrictions are lifted. These impacts of the initial exit wave are expected to be concentrated in the first quarter of next year followed by a rebound in subsequent quarters, as the economy transitions to living with COVID, consumer confidence improves and pent-up demand is released. Investment growth would also pick up, supported by continued infrastructure spending and improved investor sentiment. Meanwhile, external demand is expected to wane in line with weaker global demand growth. Amid the domestic demand recovery, consumer inflation is expected to moderately pick up as the economy reopens.

This baseline scenario is subject to significant risks. Recurrent COVID-19 outbreaks and renewed mobility restrictions to slow the spread of the virus could lead to longer-than-expected activity disruption, delaying the return to potential growth to 2024. Beyond the short term, these downside risks could also exacerbate the potential long-term consequences of the pandemic, resulting from more than three years of underinvestment by the private sector and labor force scarring from prolonged unemployment or underemployment. Persistent stress in the real estate sector could also have wider macroeconomic and financial spillovers. Risks related to climate change are growing, as demonstrated by this year's extreme weather patterns and the resulting disruption to economic activity. Externally, risks emanate from highly uncertain global growth prospects, sharper-than-expected tightening in financial conditions, potential trade fragmentation and heightened geopolitical tensions.

Confronted with the most widespread outbreaks since the beginning of the pandemic, the continued evolution of China's public health policies will be crucial, both to mitigate public health risks but also to minimize further economic disruption. Completing a primary series and first booster of the COVID-19 vaccine offers substantial protection against severe disease. In China, 69 percent of the over 60-year-olds had received a booster dose as of mid-November 2022, but the vaccination rate was just 66 percent for over 80-year-olds (latest data November 28, 2022). Strong efforts to encourage the uptake of all recommended vaccine doses, particularly for those at higher risk, such as the elderly and those with chronic diseases, could limit the impact of the rise in

infections and hospitalizations. In addition, increased access to effective COVID-19 treatments, changes to how cases are managed to preserve hospital capacity for severe cases and vigorous public outreach and communication could help enable a safer and less disruptive reopening.

Continued macroeconomic policy support is warranted, as the economy is expected to remain well below potential and the global environment is weakening. China has adequate fiscal policy space, especially at the central level, which could be deployed to bolster a stronger recovery. Directing these fiscal efforts toward social spending and green investment rather than traditional infrastructure would not only support short-term demand but also contribute to more inclusive and sustainable growth in the medium term. While continued monetary policy accommodation could also support the economic reopening, high household and corporate debt, in particular in the real estate sector, and the growing monetary policy divergence with other major economies constrain the central bank's room to maneuver.

Deeper structural reforms, put on hold by the pandemic, will have to be restarted to reverse the decline in potential growth and successfully achieve long-term development objectives. Reform priorities include creating a level playing field for the private sector by ensuring a predictable regulatory environment and reducing the implicit lending bias in favor of state-owned enterprises, allowing greater labor mobility by reforming the *hukou* (household registration) system, encouraging rebalancing toward consumption by strengthening social security, reducing inequalities in access to quality healthcare and education, and catalyzing the transition toward greener growth through more market-based instruments and investment in climate-smart infrastructure. Such reforms will raise productivity and lead to a more balanced, consumption-driven, and environmentally sustainable growth. Policymakers have in recent months reiterated their commitment to improving the enabling environment for businesses, providing support to develop domestic innovation capacity, and further opening China's market to foreign trade and investment. Following through on those reform commitments will be crucial as China confronts a complex economic transition toward more innovation-driven, greener, and inclusive growth.

<i>China Economic Outlook</i>	<i>2020</i>	<i>2021</i>	<i>2022f</i>	<i>2023f</i>	<i>2024f</i>
Real GDP growth (%)	2.2	8.1	2.7	4.3	5.0
Consumer Price Index (CPI) (% change, average)	2.5	0.9	2.0	2.3	2.4
Current account balance (% of GDP)	1.7	1.8	2.3	1.5	1.3
Augmented fiscal balance (% of GDP) *	-8.5	-4.4	-7.4	-5.7	-4.2

Sources: World Bank.

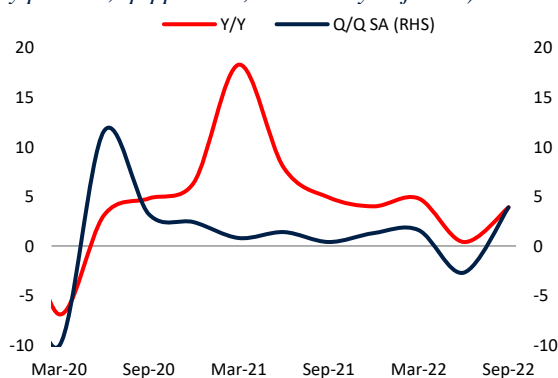
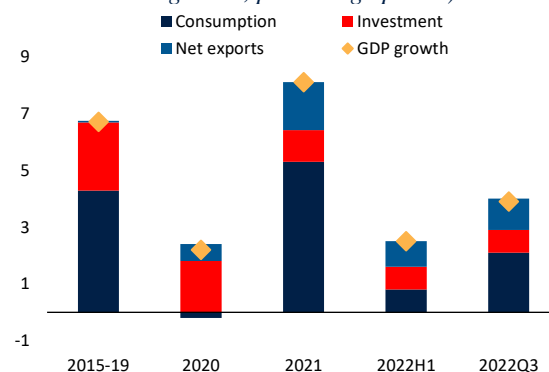
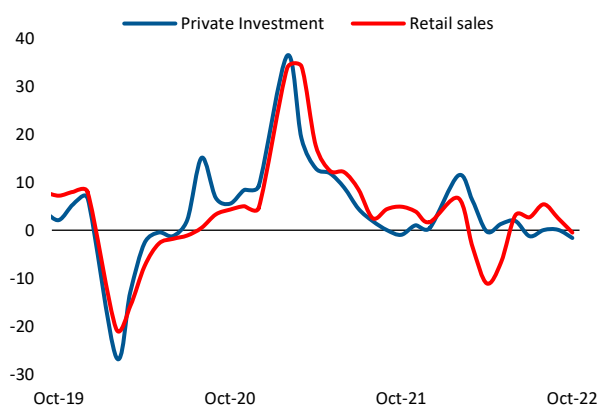
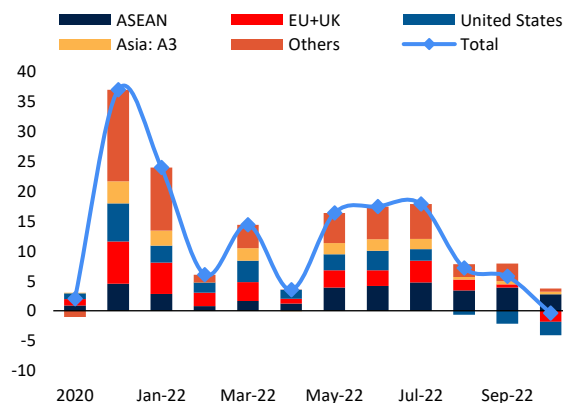
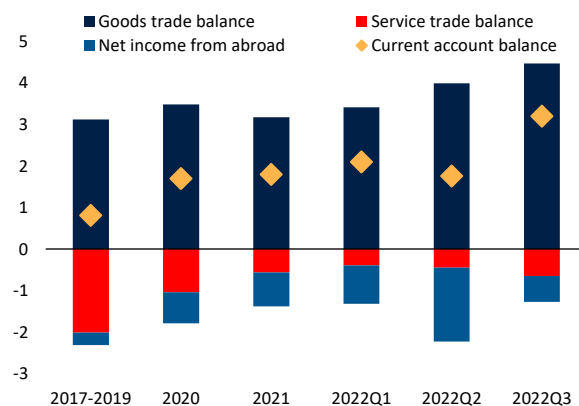
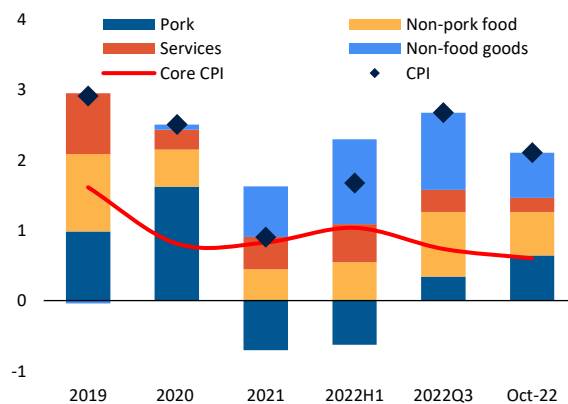
Notes: f = forecast. * World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the General Public Budget (excluding adjustment from the Stabilization Fund), the Government Fund Budget, the State Capital Operation Budget, and the Social Security Fund Budget. The primary balance is the difference between revenue and non-interest expenditures.

Focus Chapter: Youth Unemployment—An Emerging Challenge

Youth unemployment in China has risen, due to both short-term and structural factors. Youth unemployment rose disproportionately during the pandemic, standing at almost 18 percent in

October this year. Pandemic-related mobility restrictions have dampened job creation, in particular in the services sector—the largest employer of recent graduates. This decline in labor demand coincided with a spike in the number of graduates. Looking at longer-term trends, China will need a higher skilled workforce as it transitions to higher quality growth and high income, but the quality and relevance of higher education do not always match the requirements of the labor market.

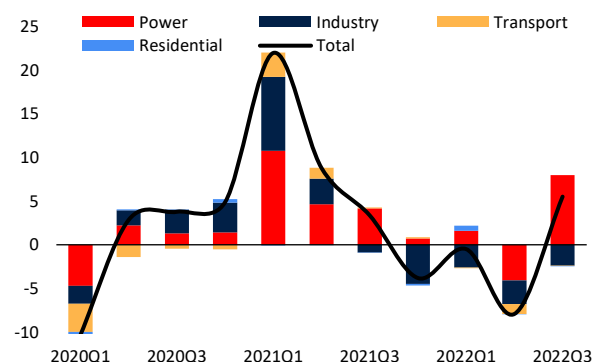
The government's policy response has largely relied on short-term support and could be complemented with more structural measures. To ease the adverse impact of the pandemic on the labor market, policymakers introduced employment subsidies and public works programs. International experience suggests that these measures can be effective in supporting labor demand during downturns, but they tend to be costly and typically generate small long-term impacts. To address the structural challenges, efforts will have to be made to strengthen the skillset of the youth through better coordination across training institutions, government agencies and employers, and through work-based learning opportunities such as apprenticeships. In addition, labor market mobility could be improved by pooling unemployment insurance funds at the national level to support coverage expansion, facilitate portability of benefits, and diversify labor market risks. Lastly, strengthening both labor market statistics and the monitoring and evaluation system of labor market programs could help improve evidence-based decision-making.

Figure 1. The China Economic Update at a glance*Activity has tracked the ups and downs of the pandemic***A. GDP growth***(y/y percent; q/q percent, seasonally adjusted)**... and aggregate demand has remained subdued***B. GDP demand components***(Contribution to growth, percentage points)**COVID-related measures continue to weigh on consumer and investor confidence...***C. Retail sales and private investment growth***(y/y percent)**... and export activity has slowed recently amid growing external headwinds***D. Goods export growth***(Contribution to growth, percentage points)**As domestic demand remains weak, the current account surplus has widened***E. Current account balance***(Percent of GDP)**... and inflation is subdued***F. CPI***(y/y percent)*

Carbon emissions have increased, mostly driven by the power sector

G. Carbon emissions by sector

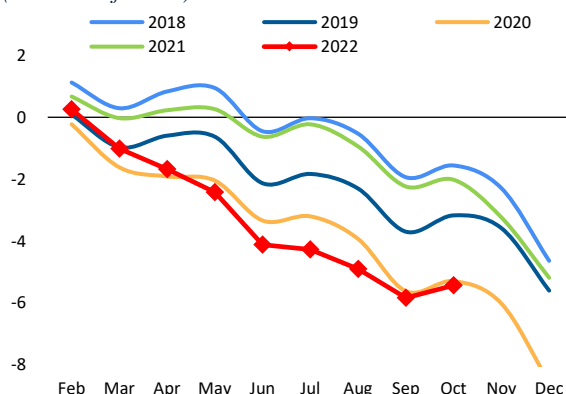
(Contribution to growth, percentage points)



Fiscal expansion has been on par with 2020

I. Fiscal deficit

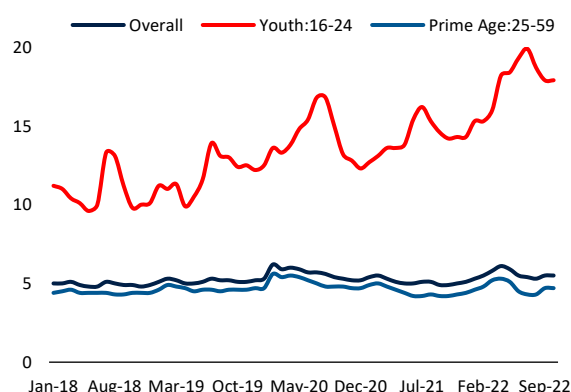
(Percent of GDP)



Youth unemployment has risen during the pandemic

K. Surveyed unemployment rate

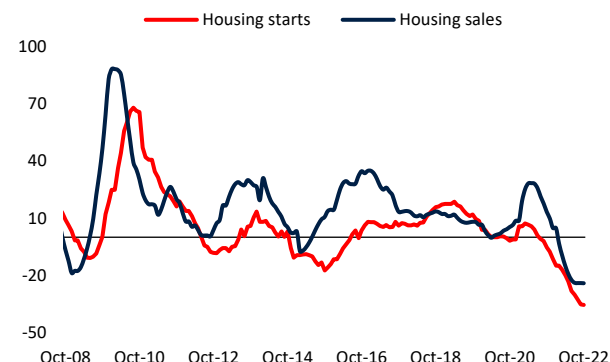
(Percent)



Despite policy support, the property market downturn persists

H. Housing sales and starts

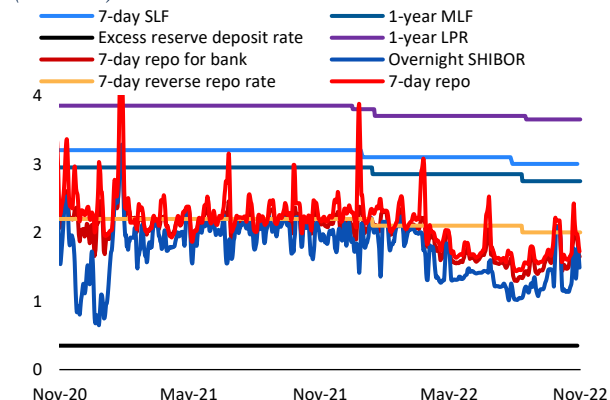
(y/y percent, 12mma)



Monetary policy has turned slightly more accommodative

J. Policy and market rates

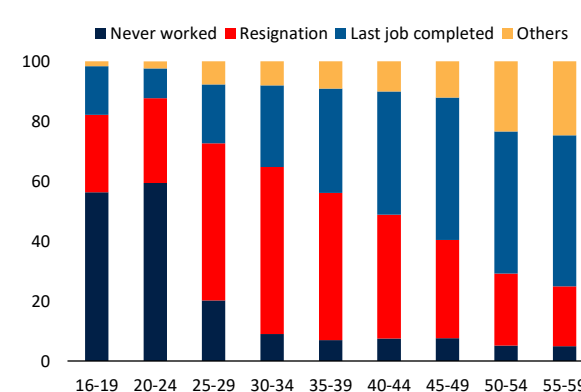
(Percent)



More than 60 percent of unemployed youth are new entrants into the urban labor market

L. Reasons for unemployment by age in 2020

(Percent)



Source: China National Bureau of Statistics (NBS); State Administration of Foreign Exchange (SAFE); Wind Information Database; People's Bank of China (PBC); Carbon Monitor; Ministry of Finance (MoF); World Bank.
Note: Figure H. 12mma refers to 12-month moving average. Figure I. Fiscal deficit adds up deficit from General Public Budget and the Government Fund Budget. Figure J. LPR = Loan prime rate; SLF = Standing lending facility; MLF = Medium-term lending facility; SHIBOR = Shanghai interbank offered rate.

I. Recent Economic Developments

Economic activity in China has tracked the ups and downs of the pandemic

COVID-19 outbreaks and growth slowdowns have been followed by uneven recoveries. After a downturn caused by COVID-19 outbreaks and stringent public health measures in April and May, economic activity picked up in the third quarter as the cases again receded. Aided by supportive fiscal and monetary policy and resilient external demand, GDP expanded by 3.9 percent year-on-year (y/y) in Q3, from 0.4 percent in Q2 (Figure 2.A). However, recent high frequency indicators suggest a renewed slowdown in the fourth quarter, with rising COVID-related disruptions across many provinces. As of end-November, 170 cities accounting for 72 percent of China's GDP were affected by COVID-19 outbreaks (Figure 2.B and C).

Growth in the third quarter of 2022 was broad-based across demand components. Consumption contributed 2.1 percentage points y/y to Q3, up from 0.8 percentage points in H1, thanks to an increase in household disposable income (Figure 2.D). Meanwhile, the growth contribution of gross capital formation remained broadly unchanged at 0.8 percentage points. Manufacturing investment on the back of a robust export performance and stimulus-led infrastructure investment supported growth, while real estate investment continued to contract. Despite a challenging global environment, the growth contribution from net exports improved to 1.1 percentage points in Q3 compared to 0.9 percentage points in H1, thanks to resilient exports and subdued imports.

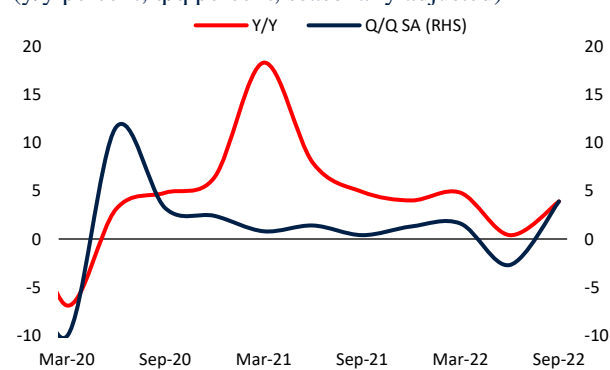
Nevertheless, domestic demand remains below potential, as recurrent COVID-19 outbreaks and related restrictions continue to weigh on consumer and investor confidence. On the demand side, both consumption and investment growth remain below pre-pandemic levels amid high COVID-related uncertainty. Recurring mobility restrictions, precautionary saving, and a negative wealth effect from the housing slump have held back services consumption. Retail sales also remain weak across a wide range of consumption goods. Meanwhile, weak investor confidence has suppressed private investment (Figure 2.E).

On the production side, industry expanded at a faster pace than services. The industrial sector contributed 1.9 percentage points to third-quarter growth, up from 1.2 percentage points in the first half of the year (Figure 2.F). Although the growth contribution of services increased to 1.7 percentage points in Q3, from 1.0 percentage points in the second quarter, retail, catering and real estate services were subdued as consumers remained cautious given the high uncertainty. The contribution from the agricultural sector remained roughly unchanged at 0.3 percentage points in Q3.

Figure 2. Growth improved following the sharp slowdown earlier in the year but is decelerating again in Q4 due to widespread COVID-19 outbreaks

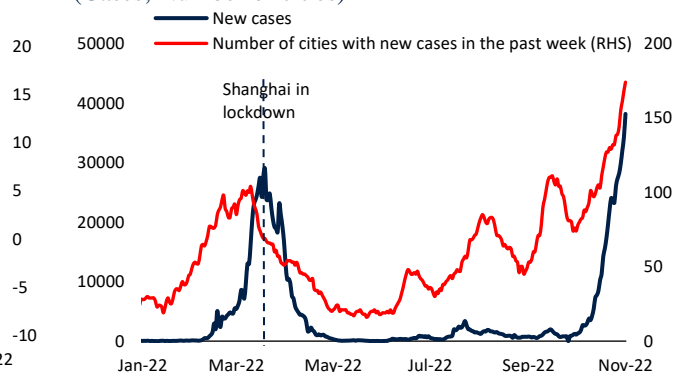
A. GDP growth

(y/y percent; q/q percent, seasonally adjusted)



B. New domestic cases and cities affected

(Cases; Number of cities)



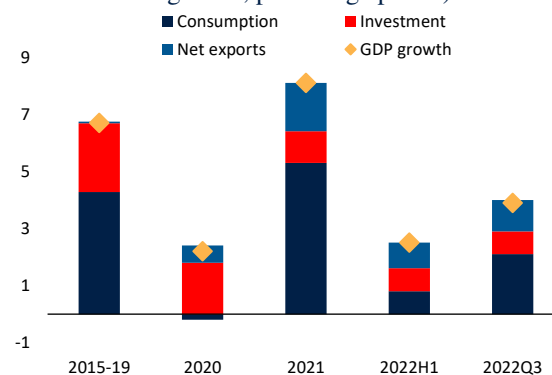
C. GDP impacted by COVID outbreaks

(Percent of national GDP)



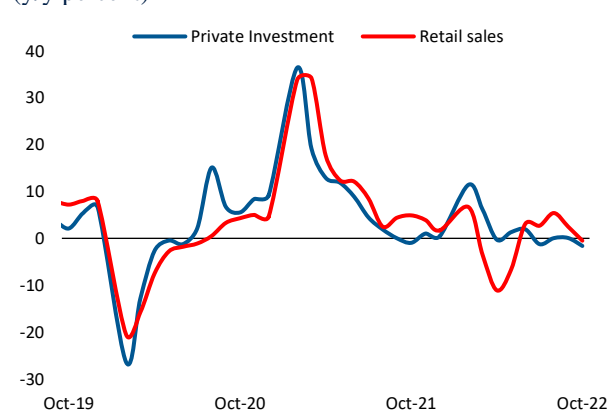
D. GDP demand components

(Contribution to growth, percentage points)



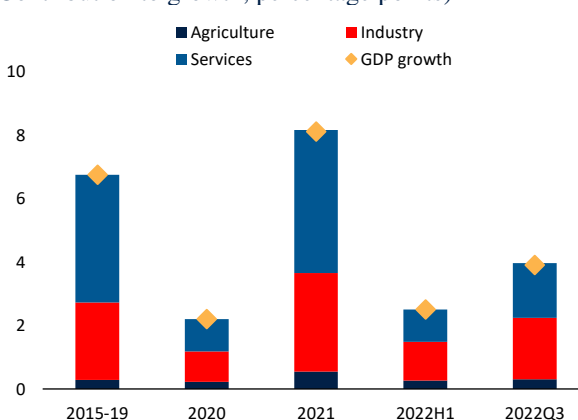
E. Retail sales and private investment growth

(y/y percent)



F. GDP sectoral decomposition

(Contribution to growth, percentage points)



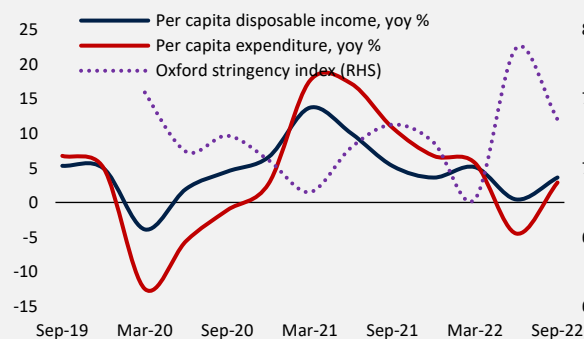
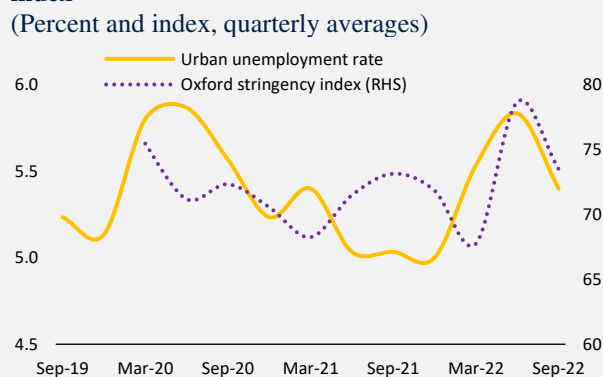
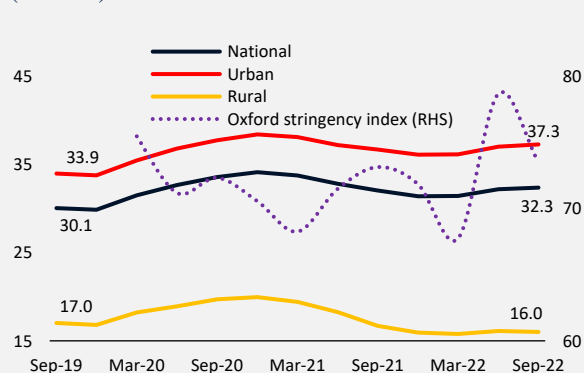
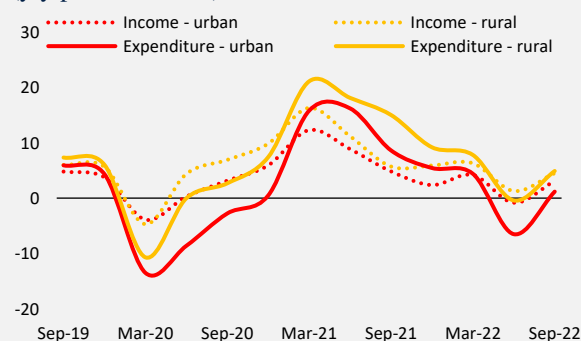
Source: NBS; World Bank.

Note: Figure A. RHS = right hand side; y/y growth of nominal private investment and nominal retail sales are reported in Figure E.

Box 1. Lower-income urban households have been affected more by the pandemic

Over the past three years, the evolution of household disposable income and spending has been affected by the COVID-19 containment strategy, with spending falling more sharply and recovering more slowly than income. Household employment, income, and spending growth suffered when stricter public health measures were implemented to control the pandemic (Figure 3.A and B). Conversely, the recovery was fast when restrictions were relaxed. Consumer spending fell more sharply than income, and its recovery, relative to the fall, was more subdued than that of income. As a result, the 12-month-average savings rate in urban areas reached 32.3 percent in 2022Q3, from a pre-pandemic average of around 30 percent (Figure 3.C), likely reflecting precautionary behavior as well as restrictions on face-to-face services.

During slowdowns, the contraction was more significant among urban households than rural ones (Figure 3.D). The largest declines in spending were in activities that required face-to-face interactions (such as entertainment or transportation), which represent a greater share of the urban households' budget compared to rural ones. Given higher dependence on jobs in services, business income and wage falls were more severe and long-lasting in urban areas. In addition, transfer income played more of a buffer role for rural households than for urban ones.

Figure 3. Policy stringency and household income and spending**A. Per capita disposable income, per capita expenditure, and Oxford Stringency index**
(y/y percent; index)**B. Urban unemployment and Oxford Stringency index**
(Percent and index, quarterly averages)**C. 12-month-average savings rate**
(Percent)**D. Per capita disposable income and per capita expenditure by area**
(y/y percent; index)

Source: NBS; World Bank.

Note: The Oxford Stringency Index is a composite measure of nine government response metrics, including school closures, workplace closures, cancellation of public events, restrictions on public gatherings, public transport closures, stay-at-home requirements, public information campaigns, restrictions on internal movements,

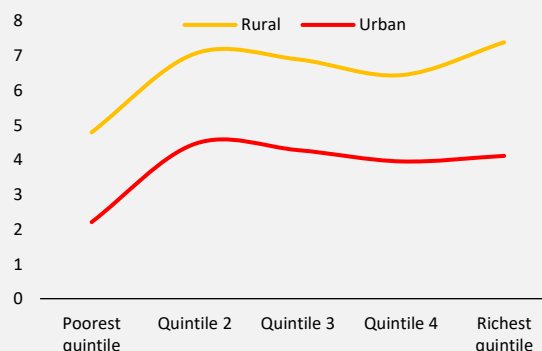
and international travel controls. The index takes values between 0 and 100, with higher values indicating greater stringency.

Disposable income growth since early 2020 was disproportionately lower for low-income households.

Despite household income losses at several points in time because of the pandemic, between 2019 and 2021, incomes still grew at an average annual rate of 4.2 percent in urban areas and 6.8 percent in rural areas. However, income growth was slower for households in the poorest quintile than for wealthier households in both urban and rural areas (Figure 4). For urban households, incomes of the poorest quintile fell by 1.9 percent in the first year of the pandemic, and while they recovered in 2021 as economic activity resumed, the two-year annualized growth was 2 percentage points lower than for all other urban quintiles. For rural households, the relatively strong two-year growth in disposable incomes also benefited the wealthiest households more than the poorer ones, growing 2.5 percentage points more than the former. The regressive growth of disposable income in 2019-21 contrasts with the changes in the pre-pandemic year of 2018-19, where the disposable income of urban households grew similarly across quintiles (around 5 percent), and the incomes of the poorest rural households grew six times faster than that of the wealthiest rural quintiles. The unequal impact of the pandemic found in China within urban and rural areas is consistent with findings in other countries (World Bank 2022a).

Figure 4. Per capita disposable income by quintile

(Average annual growth between 2019 and 2021, percent)



Source: NBS; World Bank.

Note: Quintiles are defined for urban and rural households separately.

Export activity has slowed amid growing external headwinds

China's export growth momentum has slowed in recent months on weaker external demand.

Although exports recovered swiftly from the severe COVID-related disruptions earlier in the year as supply chains normalized, export momentum started to slow in the second half of the year against the backdrop of weaker global demand. The growth rate of G-7 countries, China's main trading partners, moderated from 4.1 to 1.8 percent y/y during the first three quarters of 2022, which weighed on China's export performance (Figure 5.A). China's export growth in US dollar terms steadily decelerated and contracted by 0.3 percent y/y in October, despite higher export prices in US dollar terms.

Meanwhile, import growth remained sluggish throughout the year, owing to subdued domestic demand.

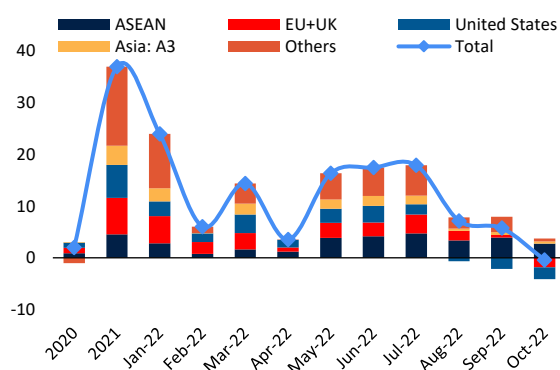
Imports expanded by only 3.5 percent in US dollar terms in the first 10 months of 2022, down from 31.4 percent in the same period last year (Figure 5.B). Excluding price effects, imports in volume terms contracted, reflecting weak domestic demand amid recurrent COVID-19 outbreaks and ongoing stress in the real estate sector.

Following a robust first half of the year, China's services trade experienced a broad-based slowdown, reflecting both a high base in 2021H2 as well as weakening demand. After a sharp expansion of nearly 27 percent y/y in 2022H1, services export growth has decelerated in recent months (Figure 5.C). Exports of transport services plunged partly due to weaker merchandise exports and partly on last year's high base. Meanwhile, growth in services imports also plummeted from the highs observed in the first half of the year, driven by base effects from last year and subdued domestic demand (Figure 5.D).

Figure 5. Slowing trade activity

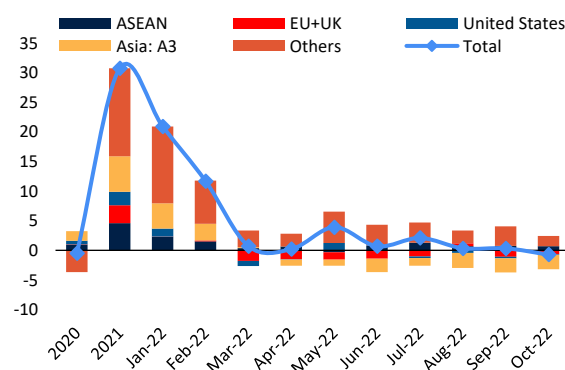
A. Goods export growth

(Contribution to growth, percentage points)



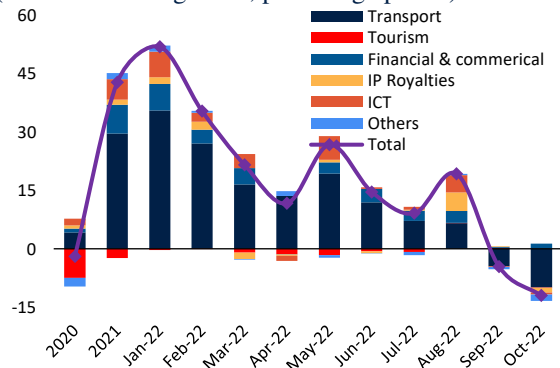
B. Goods import growth

(Contribution to growth, percentage points)



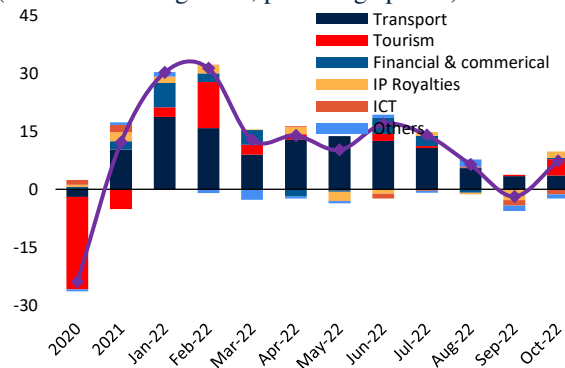
C. Service export growth

(Contribution to growth, percentage points)



D. Service import growth

(Contribution to growth, percentage points)



Source: China General Administration of Customs; SAFE; World Bank.

The current account surplus has widened amid weak domestic demand

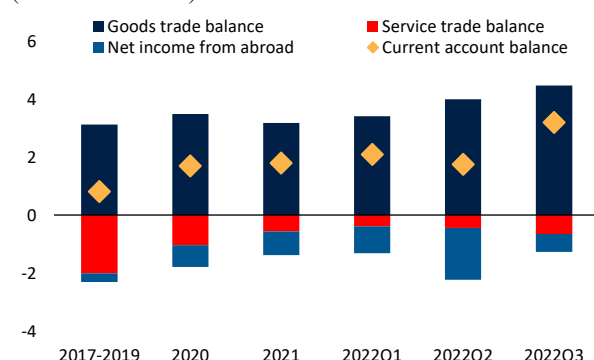
China's current account surplus surged in the first three quarters. With goods import growth decelerating faster than export growth, China reported a record high (in US dollar terms) merchandise trade surplus of US\$ 521.6 billion (4.0 percent of GDP) in the first nine months of 2022, up by 37.3 percent from the same period last year. The strong trade balance more than offset the services and income account deficits. As a result, the current account registered a surplus of 2.4 percent of GDP in the first three quarters of 2022, up from 1.6 percent of GDP in the same period last year (Figure 6.A).

China has experienced large portfolio outflows this year, driven by widening interest rate differentials with the US, higher uncertainty, and geopolitical concerns. Portfolio investments recorded net outflows of 1.8 percent of GDP in 2022H1, driven predominantly by outflows from the bond market. Rising net errors and omissions also signaled significant unrecorded capital outflows of US\$ 46 billion (1.0 percent of GDP) in the second quarter (Figure 6.B). Amid heightened global uncertainty, net Foreign Direct Investment inflows slowed to 0.9 percent of GDP in 2022H1 compared to 1.5 percent in the same period last year. However, China's overall external position remained firm, with foreign exchange reserves at US\$ 3.1 trillion (the equivalent of 13 months of imports) at the end of October (Figure 6.C).

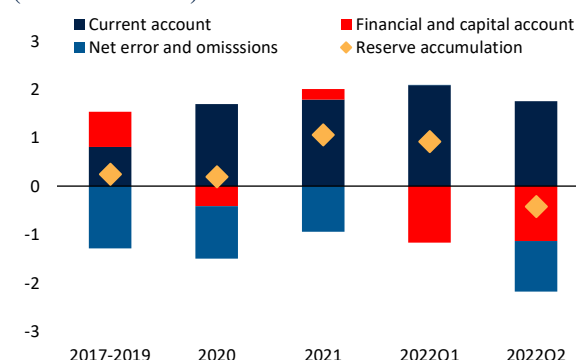
After steady appreciation in H2 2020 and 2021, the renminbi (RMB) remained broadly flat in trade-weighted terms, but weakened sharply this year against the US dollar, prompting policy measures to prevent disorderly depreciation. Capital outflows and broad-based US dollar strength led to a weakening of the RMB by 14 percent against the US dollar in the first 10 months of this year despite the large current account surplus. The RMB remained more stable in trade-weighted terms (Figure 6.D). To slow the pace of depreciation, the People's Bank of China (PBC) reinstated a 20 percent reserve requirement on bank FX forward sales. In October, the PBC eased macro-prudential restrictions on cross-border borrowing by domestic firms. The move was aimed at facilitating capital inflows and alleviating downside pressure on the RMB.

Figure 6. External imbalances have reemerged

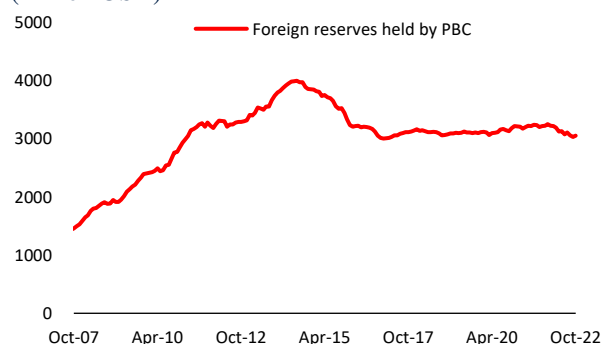
A. Current account balance
(Percent of GDP)



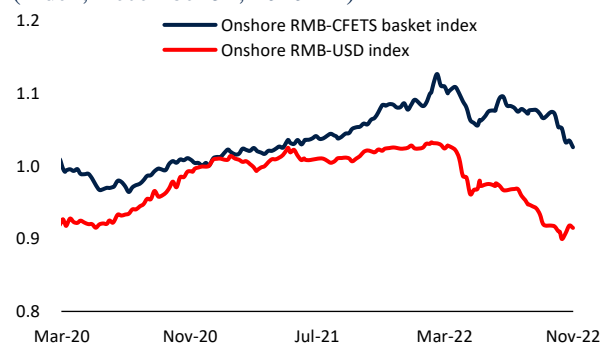
B. Net capital outflows
(Percent of GDP)



C. Foreign reserve accumulation
(Billion USD)



D. Exchange rate
(Index, December 31, 2020 = 1)



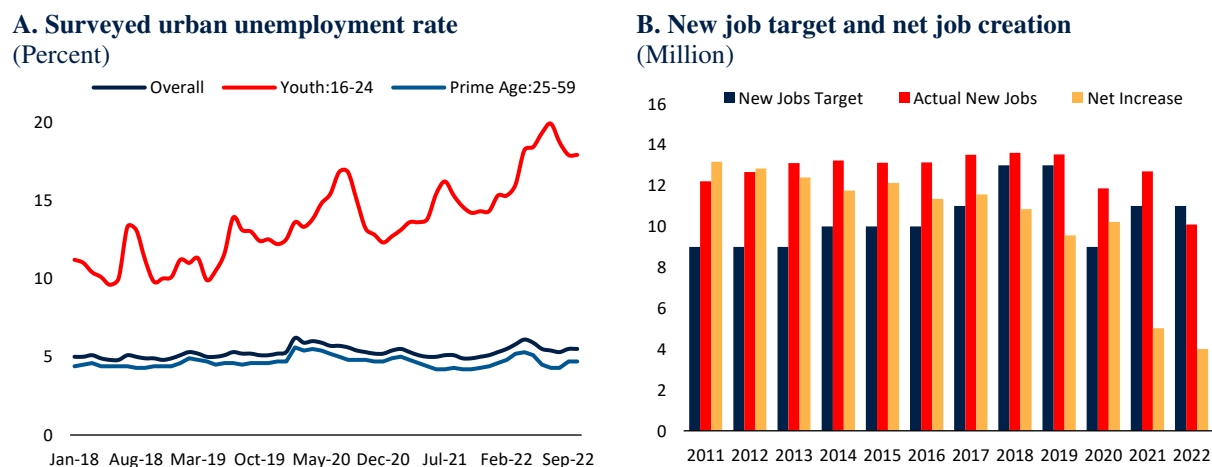
Source: SAFE; China Foreign Exchange Trade System (CFETS); Wind Information Database; World Bank.

Unemployment remains a concern due to frequent COVID-19 outbreaks

China's labor market has not fully recovered from the sharp deterioration earlier in the year. The surveyed urban unemployment rate increased from 5.1 percent at the start of this year to 6.1 percent in April, when the economy faced disruptions caused by large COVID-19 outbreaks (Figure 7.A). The labor market improved slightly in subsequent months as economic activity picked up, but broader COVID-19 flare-ups in recent months have again led to an uptick in unemployment.

Of particular concern is the sharper increase in the youth unemployment rate compared to previous years. Youth unemployment is typically seasonally high in June-July, when university graduates enter the labor force, and declines in the following months as graduates find jobs (see also Part III). Youth unemployment reached almost 20 percent in July 2022, an all-time high (Figure 7.A). More worryingly, the rate eased only moderately to around 18 percent in September, far above the pre-pandemic (2018-19) September average of 12.1 percent. Youth unemployment is also about four times higher than prime-age (age 25-59) unemployment (see also Section III). The government set a target of creating 11 million urban jobs (in gross terms) in 2022, the same as in 2021. While the economy generated about 10 million jobs in the first nine months, the net increase in urban jobs is significantly lower than before the pandemic due to higher job losses (Figure 7.B).

Figure 7. Labor market has not fully recovered



Source: NBS; Ministry of Human Resources and Social Security; World Bank.

Note: Actual new jobs in 2022 are the accumulative volume from January to September; net increase in 2022 is an estimate made by the World Bank staff.

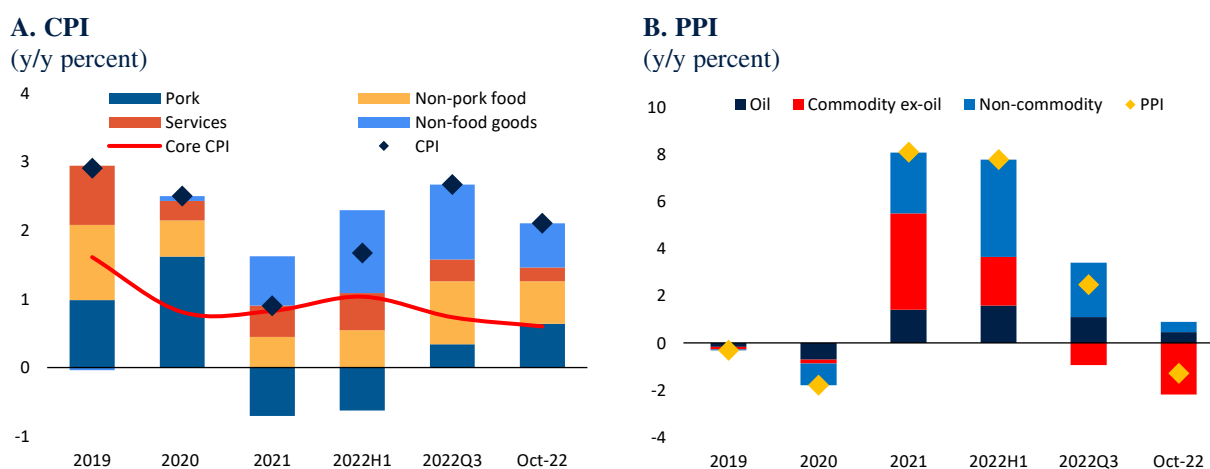
Weak consumer and housing demand have contributed to low inflation

Subdued domestic demand has kept China's consumer price inflation low. Core inflation remained below 1 percent y/y through most of the year and eased to 0.6 percent in October. Headline inflation ticked up from 1.7 percent in 2022H1 to 2.1 percent in October, owing mainly to higher pork prices (Figure 8.A). Despite the modest pick-up, headline CPI inflation has

remained below the official target of 3.0 percent and far below the levels observed in other countries. This can be explained by the limited pass-through of international energy prices to China's domestic prices, due to administered consumer energy prices and long-term fixed-price contracts for enterprises. International grain prices have not had a notable effect on domestic food prices either, as food security concerns have made self-sufficiency in grain production a priority for China. The self-sufficiency ratio for grain is as high as 93 percent.

Producer price inflation has trended down for most of this year on high base effects and, in the case of metal prices, due to the slump in the housing market. PPI inflation averaged 7.8 percent y/y in the first half of 2022 and fell rapidly in the second half (Figure 8.B). The sharp drop in PPI inflation was driven primarily by a high base due to high global commodity prices last year. PPI disinflation has extended into metal prices, as housing construction remains very weak. Lower global commodity prices in 2022Q3, together with an increased domestic supply of coal, also contributed to lower producer price inflation.

Figure 8. Disinflation pressure emerges

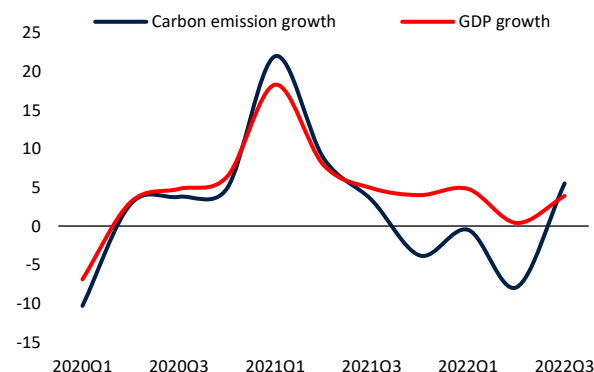


China's CO₂ emissions increased sharply

After contracting in the first half of 2022, China's carbon emissions are estimated to have increased sharply. Carbon dioxide (CO₂) emissions contracted by 4.3 percent y/y in the first half of 2022 (Figure 9.A). The decline was driven by China's ongoing real estate slump, relatively weak industrial and transport activity due to the large COVID-19 outbreaks and stringent containment measures, as well as stronger growth in renewable energy. In contrast, CO₂ emissions increased by 5.5 percent y/y in the third quarter, as economic activity temporarily improved. Higher CO₂ emissions were driven by the power sector. Droughts in some parts of the country reduced hydro-power output, which was replaced by increased coal-fired power generation. Record heatwaves led to higher electricity demand for cooling. In contrast, emissions from industry continued to contract, reflecting the continued weakness in the real estate sector (Figure 9.B).

Figure 9. Carbon emissions rose sharply in the third quarter**A. Carbon emissions and GDP growth**

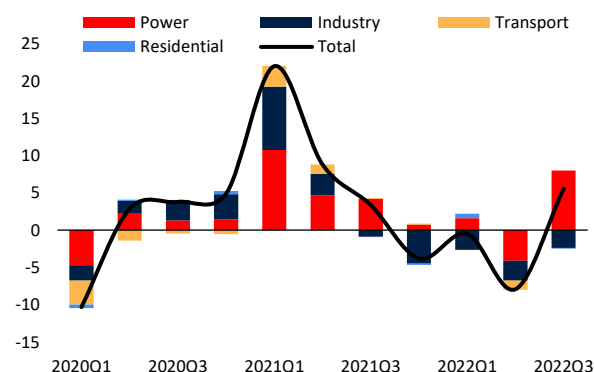
(y/y percent)



Source: Carbon Monitor; World Bank.

B. Carbon emissions by sector

(Contribution to growth, percentage points)

**Housing market weakness persists**

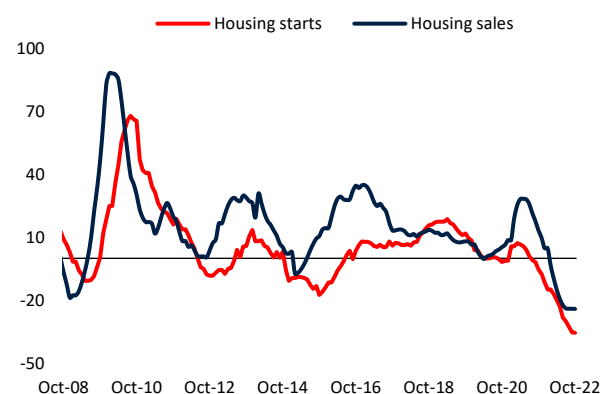
The weakness in the housing market has persisted longer than in previous downturns. The current housing downcycle, which began in the last quarter of 2020, has entered its ninth quarter. Regulatory tightening, intended to curtail excessive leverage, led to a rapid slowdown in credit to the property sector, constraining investments, land purchases, and construction starts. In addition, high COVID-related uncertainty and concerns over unfinished presold homes have weighed on the demand for real estate (Figure 10.A).

Policies to support housing demand have had a limited impact so far. The authorities have lowered the 5-year loan prime rate, offered tax breaks for some home buyers, and eased home-purchase restrictions (Figure 10.C). Both home sales and prices have continued to fall (Figure 10.A and B), and prices are now back to levels last seen at the start of 2021.

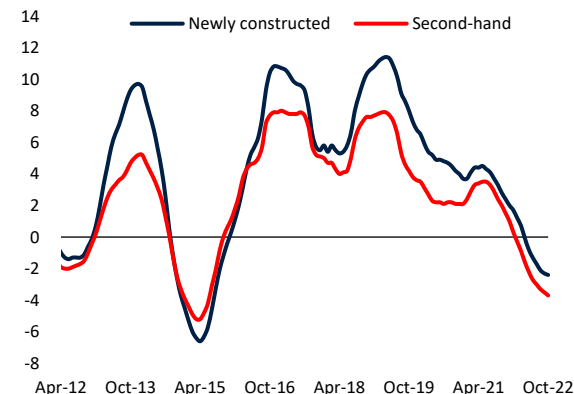
In November, financial regulators introduced additional measures to support the real estate sector (Figure 10.D). The new measures formalized previous window guidance to increase bank financing to the sector, but also introduced a new one-year moratorium on developer loans maturing in the next six months and extended the transition period for banks to comply with property sector exposure caps.

Figure 10. Housing market has yet to recover**A. Housing sales and starts**

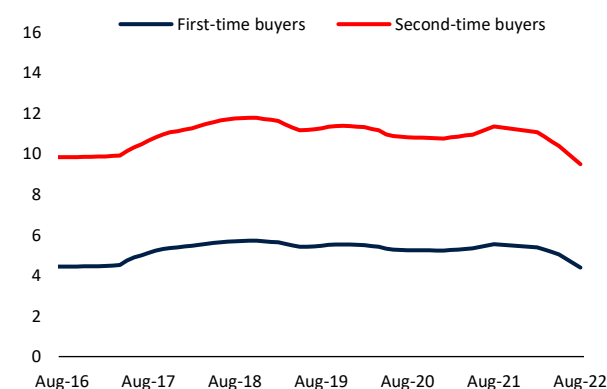
(y/y percent, 12mma)

**B. Housing prices**

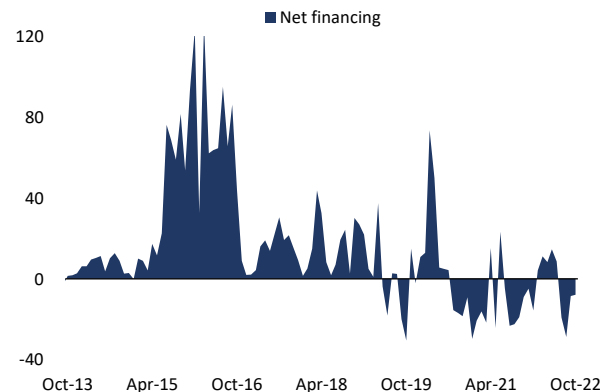
(y/y percent)

**C. Mortgage rates**

(Percent)

**D. Net financing for developers**

(Billion RMB)



Source: NBS; Wind Information Database; World Bank.

Note: Figure A. 12mma refers to 12-month moving average. “Second-time buyers” in Figure C refers to buyers who already purchased one residential property and are subject to stricter regulation by local policy. Figure D. Net financing (in the domestic bond market) refers to the difference between total issuance and payment.

Fiscal pressures have constrained stimulus efforts

To help stabilize economic growth, China has pursued expansionary fiscal policies. The consolidated General Public Budget and Government Fund Budget registered a deficit of 5.4 percent of GDP in the first 10 months of 2022, compared to a deficit of 3.2 percent of GDP during the same period last year (Figure 11.A). This broadly aligns with this year’s consolidated deficit target of 6.2 percent of GDP. Policy stimulus has focused on corporate support measures such as tax cuts and rebates, and infrastructure investment, with relatively limited fiscal transfers to households.

Following relatively slow growth in 2021, spending accelerated significantly and was front-loaded this year. Growth in the consolidated fiscal expenditure increased by 7.4 percent y/y in the first 10 months, the bulk of which was infrastructure investment. Health spending increased by 12.6 percent in the first three quarters of this year, up from 2.3 percent during the same period last

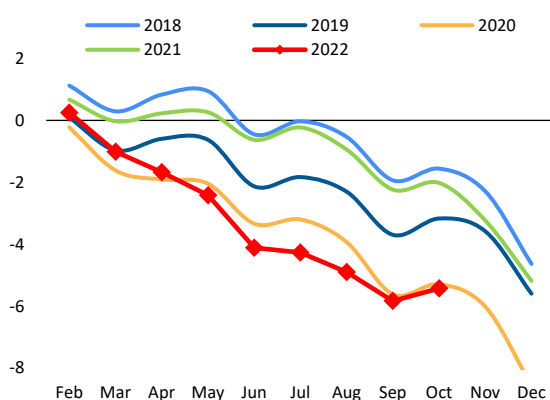
year, mainly due to efforts to contain more frequent COVID-19 outbreaks. Growth in social security spending also accelerated moderately against the backdrop of difficult labor market conditions.

Revenue out-turns deteriorated due to lower tax collection and land sales. The consolidated fiscal revenues contracted by 9.4 percent y/y in the first 10 months of 2022, owing to weaker tax revenues on the back of sizable tax cuts and rebates and subdued economic activity (Figure 11.B). Tax revenues improved in 2022Q3 with the completion of VAT refunds. Non-tax revenues (excluding land sales) increased, due to PBC's profit transfer, the sale or lease of mining and other state-owned assets, and intensified efforts to collect fees and penalties. In contrast, revenues from the sale of land-use rights contracted sharply, by 25.9 percent y/y in the first 10 months of the year, reflecting the lasting weakness in the real estate sector (Figure 11.C).

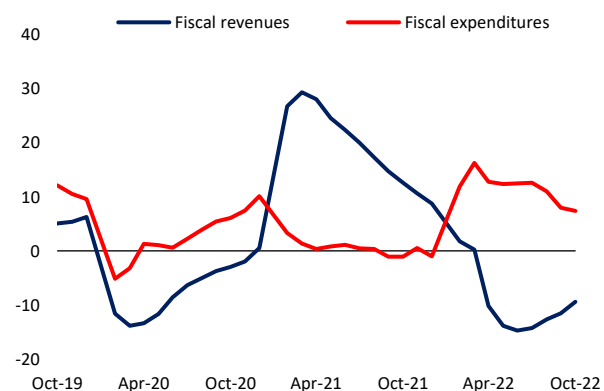
Sharply lower public land sales and tax cuts amid increasing spending needs have eroded the fiscal position of many local governments. Declining fiscal revenues and a smaller fiscal multiplier have severely reduced local governments' capacity to support the economy (see Box 2). In the first 10 months of 2022, China's 31 provinces reported a gap of RMB 11.7 trillion (13.4 percent of GDP) between fiscal revenue and expenditure in the combined General Public Budgets and Government Fund Budgets of subnational governments. This marks the largest fiscal shortfall since 2013, when the government first released these data. The shortfall in revenues has only been partly compensated by an increase in central transfers to local governments. Local governments front-loaded the issuance of special bonds to fill the financing gap this year (Figure 11.D), but the annual bond quota proved insufficient. The financing constraints of local governments prompted policymakers in Beijing to roll out additional measures, including an increase in the local government special bond quota of RMB 500 billion (US\$ 74.5 billion) on top of the original annual quota of RMB 3.65 trillion (US\$ 529.8 billion) and another RMB 300 billion in policy bank support to finance infrastructure projects.

Figure 11. Fiscal shortfall

A. Consolidated fiscal deficit
(Percent of GDP)

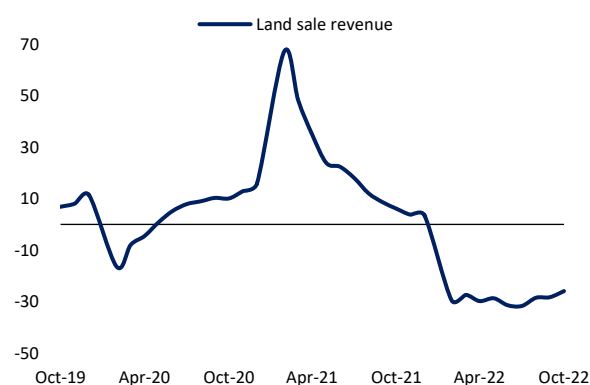


B. Growth in consolidated fiscal revenues and expenditures
(y/y percent, ytd)

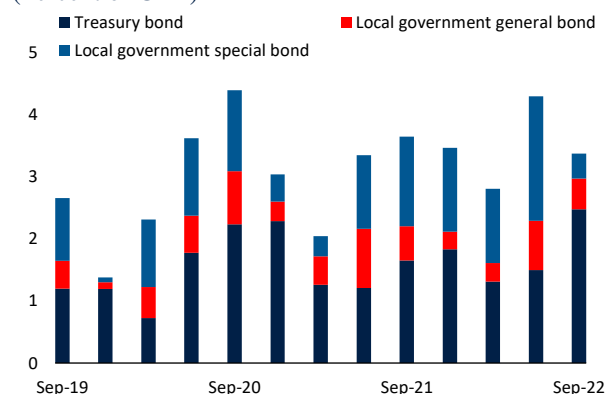


C. Land sale revenue

(y/y percent, ytd)

**D. Net financing from government bond issuance**

(Percent of GDP)



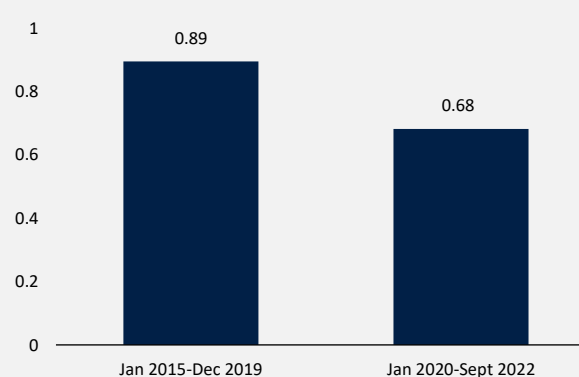
Source: Ministry of Finance (MoF); World Bank.

Note: Consolidated fiscal balance adds up the General Public Budget and Government Fund Budget.

Box 2. China's fiscal spending multiplier during the pandemic

Recent empirical studies have shown that fiscal multipliers declined during the pandemic. Kinda et al. (2022), using impulse response functions based on a sample of 91 countries, find that uncertainty reduced contemporaneous fiscal multipliers, but the multipliers increased as economies reopened. A rise in uncertainty could dampen the stimulative effect of fiscal policy as economic agents postpone hiring and investment decisions and also consumption. Guerrieri et al. (2022), using a theoretical model, find lower fiscal multipliers (below one) in presence of COVID-19-type shocks that lead to a shutdown of specific sectors in the economy.

This box assesses how China's fiscal spending multiplier has evolved during and before the pandemic. We estimate China's fiscal spending multiplier with a structural VAR model identified by sign restrictions, a method widely used in the literature (see, for example, Uhlig 2005 and Dedola and Neri 2007). Our model has four monthly variables included in the following order: consolidated fiscal expenditure, M2, inflation, and GDP.¹ All variables are seasonally adjusted, and the trend component is removed from the series by applying the HP filter. The sign restrictions are set such that fiscal expenditure and GDP should respond positively to the fiscal expenditure shock. We estimate the model over two samples: January 2015 to December 2019 and January 2020 to September 2022.

Figure 12. Fiscal spending multiplier estimates

Source: NBS; World Bank staff estimates.

We find that China's fiscal spending multiplier has been lower during the pandemic, as tightened public health measures and high uncertainty lowered the effectiveness of the fiscal stimulus. Our

¹ Monthly GDP is estimated using a mixed-frequency econometric model with quarterly GDP series and monthly indicators of economic activity such as industrial value-added, fixed asset investment, retail sales, and net exports.

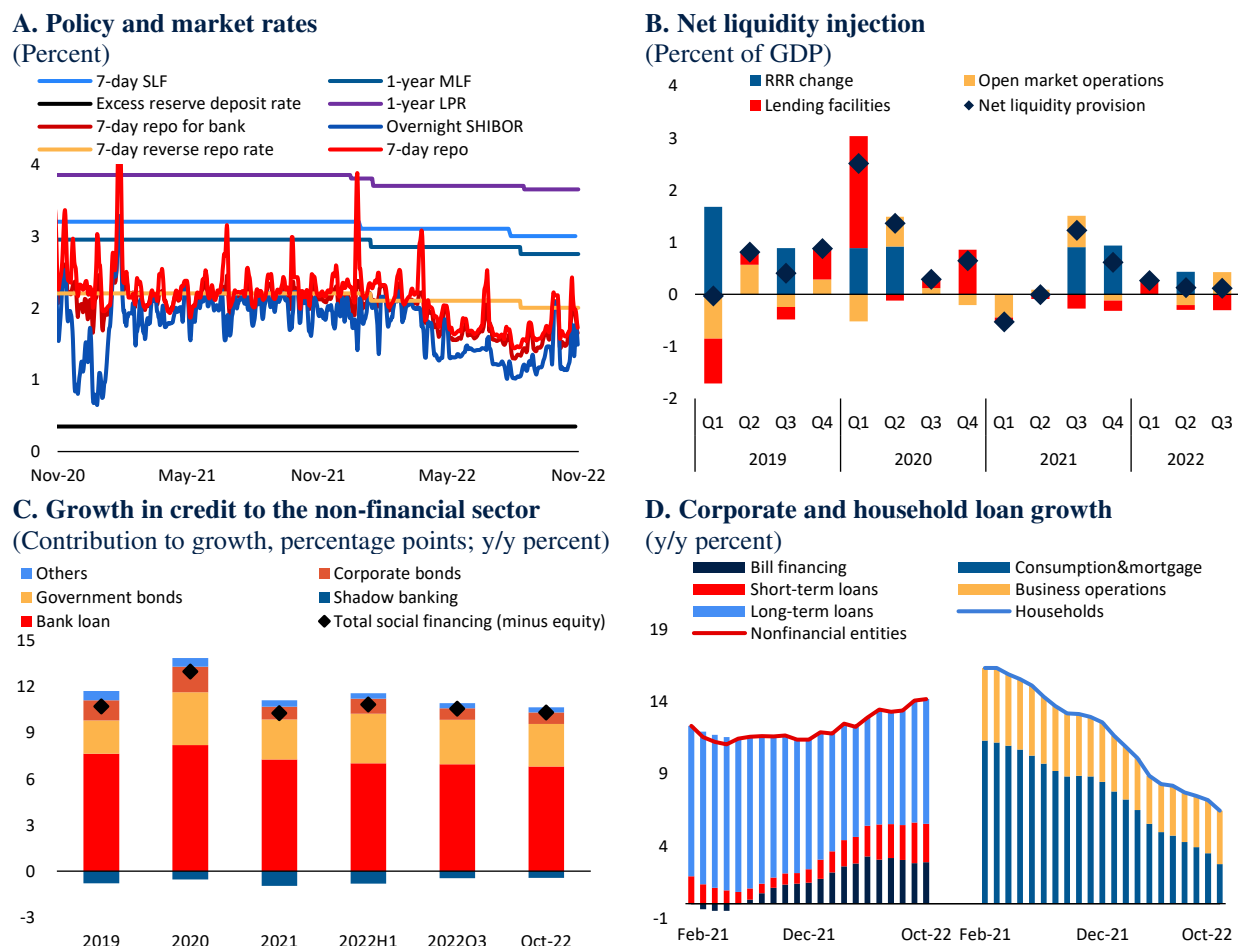
estimates show that China's fiscal spending multiplier has decreased to 0.68 since the start of the pandemic, compared to 0.89 in the five years prior to the pandemic. This implies that the estimated increase in fiscal expenditure of 0.7 percentage points of GDP in 2022 compared to 2021 is estimated to have contributed 0.5 percentage points to GDP growth in 2022. (These estimates are only for the growth impact of fiscal expenditure; stimulus on the revenue side is not included in this analysis.)

Despite modest policy easing credit demand remains subdued

The PBC has marginally eased monetary policy but maintained a cautious stance, reflecting concerns over capital outflows and financial stability risks. The central bank lowered the one-year loan prime rate by 5 basis points to 3.65 percent; the one-year medium-term lending facility rate by 10 basis points to 2.75 percent; the five-year loan prime rate, which influences the pricing of mortgages, by 30 basis points to 4.30 percent (Figure 13.A); and also cut the required reserve ratio for banks. The PBC has also maintained relatively tight liquidity in the banking system through its standard open market operations and lending facilities this year, but the PBC transfer of RMB 1.1 trillion of profits from foreign reserves holding to the Ministry of Finance in the first three quarters of 2022 added liquidity to the market (Figure 13.B).² Given high non-financial sector debt levels, the central bank has tried to balance short-term support to the economy with longer-term efforts to reduce leverage. Externally, the growing policy divergence with other major central banks that have started tightening has also constrained the PBC's room to maneuver due to concerns over capital outflows.

Credit growth has remained subdued, mainly on account of substantially weaker household loan demand. Credit growth to the non-financial sector slowed to 10.3 percent y/y in October 2022 from 10.9 percent y/y in June this year (Figure 13.C). The moderation was driven by considerably slower short-term and long-term household loan growth amid COVID-related uncertainty and weaker housing demand (Figure 13.D). The pace of government bond issuance, which was largely front-loaded, also slowed in the second half of the year. Meanwhile, corporate loan growth increased, largely in the form of short-term borrowing for working capital.

² Source: People's Bank of China (<http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4503994/index.html>); the Chinese central government's official website (http://www.gov.cn/xinwen/2022-04/20/content_5686297.htm).

Figure 13. Household credit demand has weakened substantially

Source: PBC; World Bank.

Note: In Figure A, LPR = Loan prime rate; SLF = Standing lending facility; MLF = Medium-term lending facility; SHIBOR = Shanghai interbank offered rate. Both repo rate and Overnight SHIBOR data are three-day moving average. In Figure B, net liquidity injection provided by the PBC through standing lending facility (SLF), the medium-term lending facility (MLF), the targeted medium-term lending facility (TMLF), the pledged supplementary lending (PSL), the special-purpose refinancing (SPRF), and the special relending or rediscounting facilities. RRR = Reserve requirement ratio.

Fiscal expansion has contributed to a rise in debt

China's debt ratio has risen to a new high, reversing last year's deleveraging efforts. The non-financial sector debt-to-GDP ratio, including external debt, increased by 10.4 percentage points from end-2021 to 289 percent of GDP by the third quarter in 2022 (Figure 14.A). Weaker economic growth, combined with higher borrowing to finance fiscal stimulus, pushed up the domestic non-financial debt ratio. Meanwhile, external debt remained low at 12.4 percent of GDP, up only by 0.3 percentage points from 2021.

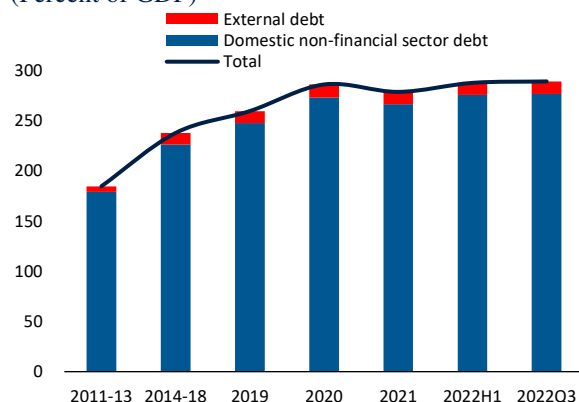
The infrastructure stimulus has accelerated subnational government debt accumulation. Local government debt rose by 2.2 percentage points between December 2021 and September

2022 to 28.8 percent of GDP, driven by special bond issuance in 2022H1 to finance infrastructure projects and to compensate for shortfalls in land sale revenues. In addition, the debt of local government financing vehicles (LGFVs) increased to an estimated 48.5 percent of GDP, 2.7 percentage points higher than at the end of last year (Figure 14.B). Meanwhile, central government debt has remained broadly stable at 20.6 percent of GDP.

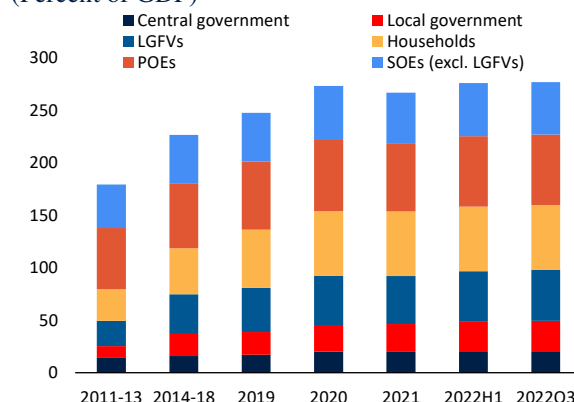
Household debt remained broadly flat on weak confidence, while corporate debt increased to meet short-term liquidity needs. Heightened uncertainty about future income and the slump in the housing sector slowed consumer loan and mortgage growth. As a result, household debt has remained broadly unchanged in the first three quarters of 2022 at about 62 percent of GDP. Meanwhile, corporate debt (excluding LGFVs) increased to nearly 117 percent of GDP, up 4 percentage points from last year, led by short-term borrowing by privately owned enterprises.

Figure 14. Debt has risen to a new high

A. Composition of total non-financial sector debt
(Percent of GDP)



B. Domestic non-financial sector debt
(Percent of GDP)



Source: PBC; Wind Information Database; CEIC Data; World Bank.

Note: Figure B. LGFVs = Local government financial vehicles; POE = Private-owned enterprise; SOE = State-owned enterprise.

While the banking sector generally remains sound, some rural banks are more vulnerable

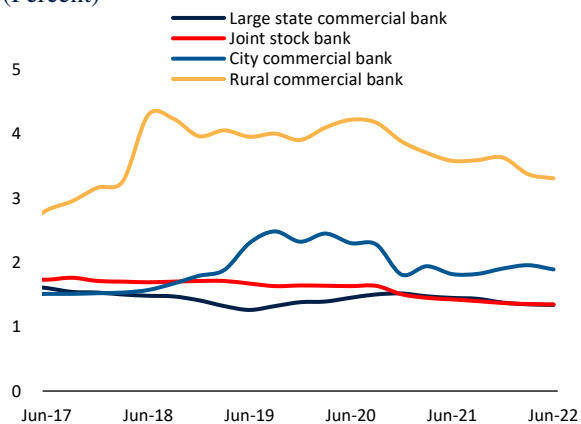
Reported non-performing loans (NPLs) have continued to decline, but NPL ratios for rural banks remain higher than for other financial institutions. The reported aggregate NPL and special mention loan (SML) ratios continued to decrease, standing at 1.7 percent and 2.3 percent, respectively, at the end of June 2022, both lower than pre-pandemic levels (Figure 15.A). Credit risk for rural banks remained significantly higher than for other financial institutions. Despite recent improvement, the NPL ratio for rural commercial banks was 3.3 percent. Moreover, ongoing regulatory forbearance may mask the underlying deterioration of credit quality.

Banking sector buffers appear adequate overall. The aggregate capital adequacy ratio (CAR) of commercial banks reached 14.9 percent at the end of June 2022, 39 basis points higher than a year ago and significantly above the Basel III minimum requirement of 10.5 percent. Large state

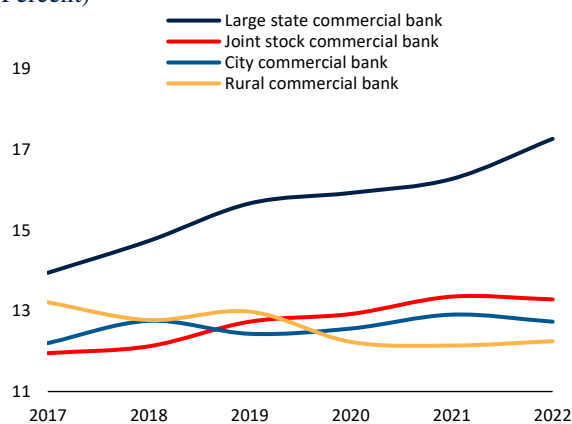
banks, which account for roughly half of total commercial bank assets, reported a significant CAR increase in 2022Q2, whereas rural commercial banks showed only marginal improvement and joint stock banks and city banks reported a deterioration in their capital adequacy (Figure 15.B).

Figure 15. The banking sector appears sound, with rural banks remaining most at risk

A. Non-performing loan ratios
(Percent)



B. Capital adequacy ratios
(Percent)



Source: PBC; World Bank.

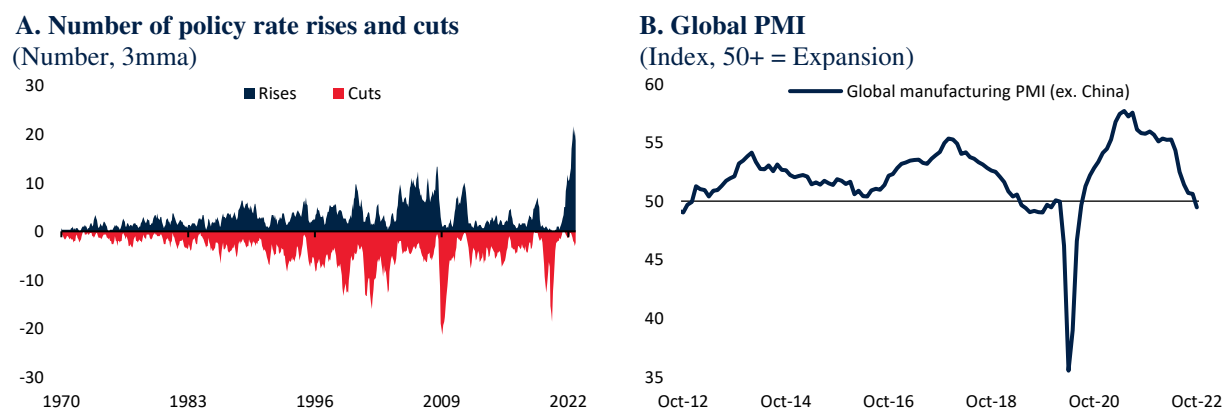
II. Outlook, Risks, and Policy Implications

Global outlook

China will face a difficult global environment in 2023. According to June 2022 World Bank projections, following a sharp deceleration in 2022, global growth is expected to be a subdued 3 percent in 2023, weighed down in particular by continued monetary policy tightening (Figure 16.A; World Bank 2022b). The global manufacturing Purchasing Managers' Index (PMI) has declined from its peak in mid-2021 to 49.5 in October 2022, pointing to a contraction in global activity for the first time since 2020 (Figure 16.B).

Significant downside risks surround the global outlook, including rising financial stability concerns and the possibility that central banks need to raise interest rates more than expected to quell inflation, as well as a protracted war in Ukraine. Greater than expected tightening accompanied by financial-market stress could push the global economy into recession (Guénette et al. 2022) and trigger significant capital outflows from emerging economies. Intensifying geopolitical tensions pose risks to trade and the global economy more generally (Brenton et al. 2022). Finally, prolonged severe energy disruptions present an additional substantial downside risk to the euro area outlook.

Figure 16. China will face a difficult global environment in 2023



Source: S&P Global; Haver Analytics; World Bank staff estimates; World Bank, 2022b.

Note: Figure A. 3mma refers to three-month moving average.

China outlook

After slowing to 2.7 percent y/y in 2022, China's growth is projected to recover to 4.3 percent in 2023, though the forecast is subject to unusually high uncertainty. China has been moving quickly toward reopening since November 2022, with public health measures being eased rapidly. During the initial stage of reopening COVID infections will rise sharply and might lead to voluntary reduction in social interactions, which will weigh on consumer demand and may lead to continued disruption even after restrictions are lifted. Some disruptions to manufacturing production and logistics are possible due to worker absenteeism. These impacts of the initial exit

wave are expected to be concentrated in the first quarter of next year followed by a rebound in subsequent quarters, as the economy transitions to living with COVID and pent up demand is released. This is consistent with the experience of other countries that rolled back COVID containment measures where Omicron had a relatively short-lived impact on domestic demand followed by a strong rebound.

The government is expected to maintain an expansionary policy stance, but less aggressively than in 2022. Following the significant fiscal expansion in 2022, the baseline scenario assumes a somewhat smaller fiscal deficit next year. The government will likely continue to rely on infrastructure investment, as well as health and social spending, to support the economy. The scenario also assumes that monetary policy will maintain an accommodative but relatively cautious stance, given capital outflow and financial stability risks. However, the PBC is expected to step in and provide liquidity if financial market stability risks materialize.

The structure of aggregate demand is expected to gradually shift in favor of domestic demand. Private consumption is likely to remain subdued earlier next year, with a recovery anticipated to take hold in the second half of the year, as consumer confidence improves and pent up demand is released. Investment growth would also pick up, supported by continued infrastructure spending and improved investor sentiment. Meanwhile, support from external demand is expected to wane in line with deteriorating global demand growth.

The current account is projected to narrow to 1.5 percent of GDP in 2023, reflecting a sharp decline in the trade surplus. China is likely to face a significant deterioration in external demand amid weaker global growth. Import growth is expected to pick up on the back of stronger domestic demand. With China expected to fully reopen later next year, the services trade deficit is likely to widen.

Headline inflation is expected to rise moderately as domestic demand improves. Pent-up demand supported by higher incomes and excess household savings could lift consumer inflation, as the economy reopens. Pork prices are expected to continue to rise and remain elevated in the first half of 2023, then gradually decline as supply recovers. Meanwhile, lower imported commodity prices amid weaker global demand could partly offset the upward domestic price pressures.

As growth is expected to pick up in 2023 and 2024, the pace of poverty reduction should accelerate. While rural extreme poverty by the national definition (US\$ 2.3/day per person in 2017 purchasing power parity (PPP)) has effectively been eliminated, about 19 percent of the population (273 million people) is expected to have consumption levels below the typical upper-middle-income poverty line of US\$ 6.85/day per person (2017 PPP) in 2022 (Figure 17.A).³ Using this threshold, an additional 15 million people are expected to be lifted out of poverty in 2022,

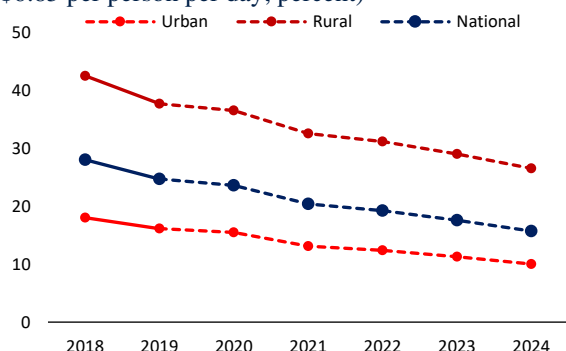
³ Note on the new global poverty lines: Poverty data are now expressed in 2017 Purchasing Power Parity (PPP) prices versus 2011 PPP in previous editions to reflect the most recent price levels and the value of national poverty lines worldwide. See <https://pip.worldbank.org/home>.

compared with 45 million estimated for 2021 (Figure 17.B). The pace is likely to accelerate in the following years, with 23 million and 26 million people estimated to be lifted out of poverty in 2023 and 2024, respectively, but that pace will still be lower than in the pre-COVID years. Among the remaining poor, around 40 percent reside in urban areas, suggesting that policies to improve the welfare of the most vulnerable would need to be directed to both rural and urban areas.

Figure 17. Poverty reduction will continue, albeit slower than in previous years

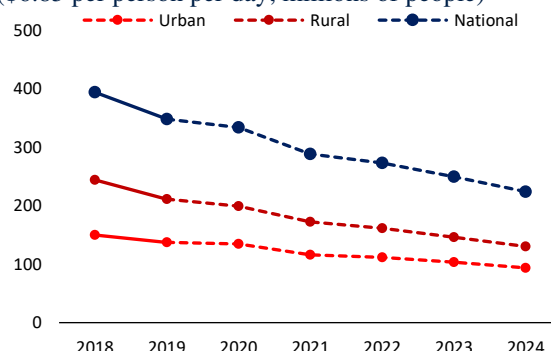
A. Poverty rate

(\$6.85 per person per day, percent)



B. Number of poor

(\$6.85 per person per day, millions of people)



Source: World Bank staff estimates using tabulated data from China's National Bureau of Statistics (NBS) and World Bank GDP growth projections.

Note: Last grouped data available to calculate poverty is for 2019. Projections based on per capita GDP growth estimates, using a neutral distribution assumption with pass-through 0.85 to per capita household consumption.

Table 1. China selected economic indicators

<i>Annual percentage change, unless otherwise indicated</i>	2019	2020	2021	2022^f	2023^f	2024^f
Real GDP growth, at constant market prices	6.0	2.2	8.1	2.7	4.3	5.0
Private consumption	6.5	-1.8	12.4	0.8	6.0	6.5
Government consumption	6.0	3.2	4.0	4.9	4.1	3.9
Gross fixed capital formation	5.3	3.2	2.3	1.6	3.3	4.6
Exports, goods and services	2.1	1.7	17.9	2.1	0.2	1.9
Imports, goods and services	-1.8	-1.4	10.7	-3.2	1.0	2.6
Real GDP growth, at constant factor prices	6.0	2.2	8.1	2.7	4.3	5.0
Agriculture	3.1	3.1	7.1	3.8	3.1	3.1
Industry	4.9	2.5	8.2	3.5	3.7	4.0
Services	7.2	1.9	8.2	2.0	4.8	5.9
Inflation (Consumer price index)	2.9	2.5	0.9	2.0	2.3	2.4
Current account balance (% of GDP)	0.7	1.7	1.8	2.3	1.5	1.3
Financial account balance, excl. reserves (% of GDP)	-0.1	0.4	-0.2	-1.1	0.5	0.2
Net foreign direct investment (% of GDP)	0.4	0.7	1.2	0.1	0.5	0.3
General public budget balance (% of GDP)	-2.8	-3.7	-3.2	-2.8	-3.2	-3.0
Augmented fiscal balance (% of GDP) *	-4.6	-8.5	-4.4	-7.4	-5.7	-4.2
Government debt (% of GDP)	38.5	45.4	47.1	51.7	54.4	55.1
Primary balance (% of GDP) *	-3.6	-7.5	-3.3	-6.2	-4.5	-2.9

Source: World Bank.

Note: f = forecast (baseline). * World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the General Public Budget (excluding adjustment from the Stabilization Fund), the Government Fund Budget, the State Capital Operation Budget, and the Social Security Fund Budget. The primary balance is the difference between revenue and non-interest expenditures.

Risks

Amid high uncertainty, downside risks to China's growth outlook prevail. On the downside, recurrent COVID-19 outbreaks, persistent precautionary behavior and renewed mobility restrictions to slow the spread of the virus could hold back the recovery in consumption and services, discourage private investment, and disrupt trade flows. On the upside, full-year growth could be higher than in the baseline if comprehensive public health measures help contain the spread of COVID-19 faster than expected in the baseline.

The stress in the real estate sector could also have wider macroeconomic and financial consequences. A prolonged housing market downturn can increase the risk of contagion through the balance sheets of households, local governments, and banks. Declining housing prices can have negative effects on household balance sheets, which in turn could lower household consumption expenditures. Prolonged weakness in the real estate sector could also exacerbate local government financial risks, which rely heavily on the sale of land-use rights. In addition, the protracted housing sector slowdown could adversely impact banks' balance sheets, especially those of small and rural lenders.⁴

The risks associated with climate change are growing. As experienced earlier in 2022, changing weather patterns contribute to increasingly disruptive events, such as heat waves and floods. These are associated with rising costs in terms of losses in economic activity.

Externally, risks emanate from highly uncertain global growth prospects, sharper-than-expected tightening in financial conditions, and heightened geopolitical tensions. Inflation remains high around the globe and could be pushed higher by renewed supply disruptions caused by Russia's invasion of Ukraine. Persistently high inflation could prompt major central banks outside China to tighten monetary policy further than anticipated, triggering a sharp tightening of global financial conditions with adverse spillovers to China's economy. Geopolitical tensions and trade fragmentation represents another risk, particularly if they constrain China's imports of critical technology, slow the transfer of productivity-enhancing innovations, and lead to a decoupling of high-tech supply chains.

Policy implications

Although policymakers stepped up macroeconomic policy easing in 2022, COVID-19 outbreaks and restrictions have limited the effectiveness of policy stimulus. The cycle of recurrent COVID-19 outbreaks and mobility restrictions has constrained economic activity and heightened uncertainty. This, in turn, has weighed on investor and consumer sentiment, constraining the impact of the stimulus measures. This also means that a relaxation of the COVID-19 policy—rather than additional fiscal or monetary policy stimulus—is likely to provide the

⁴ Around 40-50 percent of total bank loans are property-related if loans to real estate developers, mortgage loans, and other loans collateralized by land or property are summed up.

largest boost to the economy. The recent rapid adjustment in COVID-19 measures suggests that the authorities are quickly shifting toward reopening.

Strong public health preparedness, including more intensive efforts to increase vaccination rates among those most at risk of severe disease, rolling out a second booster campaign, and ensuring access to effective COVID-19 treatments could all lead to a safer reopening. Completing a primary series and first booster of the COVID-19 vaccine offers substantial protection against severe disease. In China, 69 percent of over 60-year-olds had received a booster dose as of mid-November 2022, but the vaccination rate was just 38 percent for over 80-year-olds (latest data July 7, 2022). Strong efforts to encourage the uptake of all recommended vaccine doses, particularly for those at higher risk, such as the elderly and those with chronic diseases, could limit the impact of the rise in infections and hospitalizations. Those at higher risk may also benefit from a second booster, as well as early access to treatments such as antivirals and monoclonal antibodies that can prevent the progression to severe disease. An effective system to identify and diagnose those at higher risk would also be needed.

Continued macroeconomic policy support is warranted since growth remains well below potential and the global environment is weakening. China has adequate fiscal policy space, especially at the central level, which could be deployed to bolster a stronger recovery, as COVID-19 related public health measures are eased. With a recovery in tax revenue following the completion of last year's one-off tax rebates, fiscal efforts could be redirected toward social spending and green investment rather than traditional infrastructure investment. This would not only support short-term demand but also contribute to a medium-term shift toward more inclusive and sustainable growth. High debt and growing fiscal strains at the subnational levels call for the national government to take on a larger role in financing such support measures. Concurrently, reforms to strengthen the revenue base of local governments (in a progressive manner) could help address fiscal sustainability concerns and mobilize resources to strengthen the provision of public services and the social safety net. Over the medium term, as the recovery becomes entrenched and the economy returns to potential, the fiscal policy stance could shift toward consolidation to rebuild policy buffers.

Unless inflation moves well above target and capital outflows intensify, monetary policy could maintain a moderately accommodative stance to support the economic reopening. With average inflation projected at 2.3 percent in 2023, further monetary policy easing may be warranted until growth in private demand has returned to pre-pandemic trends. However, policy easing should be data dependent and factor in interest rate differentials with other major economies to avoid disorderly movements in the RMB exchange rate. Over the medium term, further modernization of the monetary policy framework would strengthen the effectiveness and transmission of central bank policies.

The authorities also need to continue efforts to mitigate financial stability risks related to high corporate leverage, especially in the real estate sector. Careful monitoring of bank exposure to risks is warranted ahead of the withdrawal of forbearance measures. In the medium

term, strengthening insolvency and bank resolution frameworks would facilitate an orderly exit of weak or failing corporates and help businesses that are viable but need restructuring. This will facilitate the allocation of resources to more productive firms and support private investment.

Deeper structural reforms, put on hold by the pandemic, will have to be restarted to reverse the decline in potential growth and successfully achieve long-term development objectives.

Reform priorities include creating a level playing field for the private sector by ensuring a predictable regulatory environment and reducing the implicit lending bias in favor of state-owned enterprises, allowing greater labor mobility by reforming the *hukou* (household registration) system, encouraging rebalancing toward consumption by strengthening social security, reducing inequalities in access to quality healthcare and education, and catalyzing the transition toward greener growth through more market-based instruments and investment in climate-smart infrastructure. Such reforms will raise productivity and lead to a more balanced, consumption-driven, and environmentally sustainable growth.

China's policymakers have in recent months reiterated their commitment to market reforms and opening up; it will be important to follow through on those commitments as the effects of the pandemic fade.

The authorities have stated their commitment to improving the enabling environment for businesses (including the protection of property rights, market access, and competition), providing support to develop domestic innovation capacity, and further opening China's market to foreign trade and investment.⁵ Pursuing those reforms will be crucial as China confronts a complex economic transition toward greener and more inclusive growth against the backdrop of a challenging domestic and global environment.

⁵ See, for example, Xinhua, December 8, 2022, "Li Keqiang Meets with World Bank President Malpass," <https://www.chinanews.com.cn/gn/2022/12-08/9911218.shtml> [in Chinese].

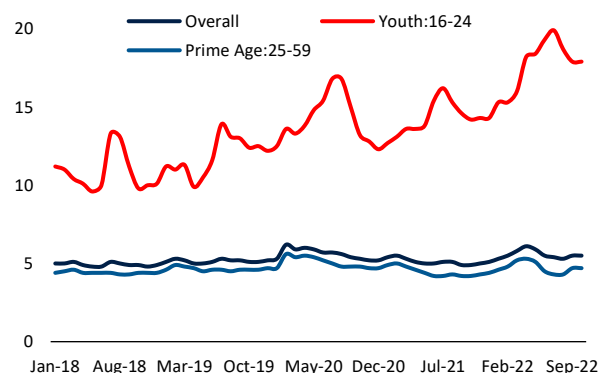
III. Youth Unemployment—An Emerging Challenge

China is facing high youth unemployment

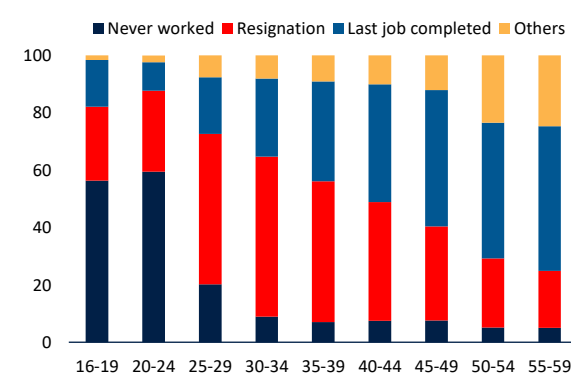
The overall labor market has struggled amid frequent COVID-19 outbreaks, but the youth unemployment rate has risen more rapidly (Figure 18.A).⁶ After a peak at 6.1 percent in April 2022, the overall surveyed urban unemployment rate declined to 5.5 percent in October. In contrast, the youth unemployment rate shot up to a record high of almost 20 percent in July. It has since moderated to 17.9 percent in October, after the usual June-July graduation season. Almost 60 percent of the unemployed youth are new entrants to the urban labor force and face difficulties finding jobs ((Figure 18.B).

Figure 18. Youth unemployment rate and international comparison

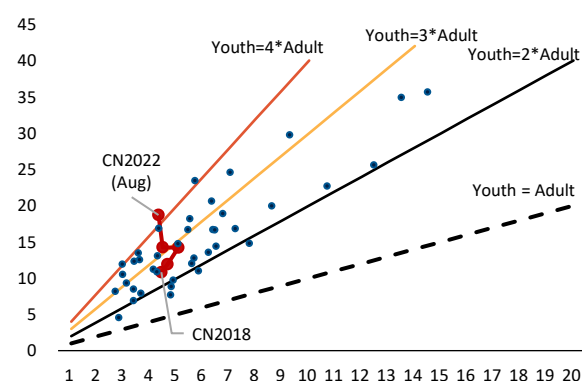
A. Surveyed urban unemployment rate (Percent)



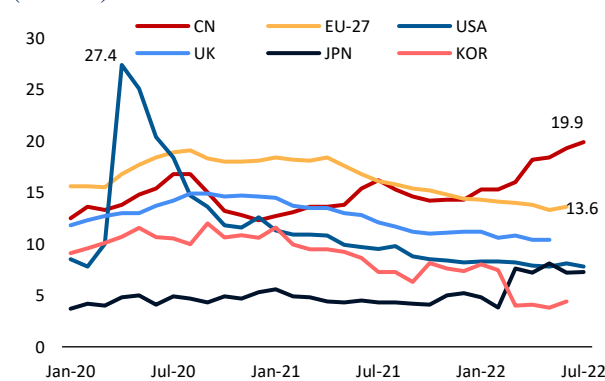
B. Reasons for unemployment by age in 2020 (Percent)



C. Youth versus adult unemployment (Unemployment rate of prime age = 1)



D. International comparison of youth unemployment (Percent)



Source: National Bureau of Statistics; OECD.

Note: In Figure C, red dots represent China, the others represent various OECD countries. The prime-age workers in China are those ages 25-59; for all other countries, prime-age workers are ages 25-54.

⁶ In China, youth unemployment refers to the share of the labor force ages 16-24 without work but available for and seeking employment. Working people between the ages 25 to 59 are typically referred to as “prime-age” workers.

Worldwide, the unemployment rate for youth is typically higher than for prime-age workers, although this varies depending on the country's education system and labor market. In most OECD countries, the youth unemployment rate (ages 15-24) is found to be two to three times that of prime-age workers (ages 25-54) (Figure 18.C). Countries' institutional arrangements to support the youth to gain work experience have been found to make a substantial difference (Pastore 2018). In Germany, for instance, a good dual education system allows young people to acquire work experience through apprenticeships.

Compared with OECD countries, the ratio of the youth unemployment rate to the prime-age unemployment rate was similar in China before the pandemic but has been much higher in 2022. The ratio in China was 2.5 in 2018; it increased to about three in 2020 and 2021 and has reached almost 4 as of October 2022 (Figure 18.C). In most OECD countries, youth unemployment is already at or below pre-pandemic levels (Figure 18.D).

Box 3. China's unemployment monitoring system

China publishes two official measures of unemployment.⁷

The **registered unemployment** series, established in the early 1980s, reports the number of urban workers (with local *hukou*) who lost their job and registered with the local labor bureau to receive assistance. By design, it excludes migrants and the self-employed.

The **urban surveyed unemployment rate** is based on a National Labor Force Survey and has been released monthly since 2018. The labor force survey collects information on those ages 16 and above, irrespective of their residential status (*hukou*). Unemployed migrants are included in the urban unemployment rate, as long as they continue to reside in the city. In addition, the China National Bureau of Statistics (NBS) also releases surveyed unemployment rates for local workers, migrant workers, the 16 to 24 year old population (youth), and those 25 to 59 years old.

The surveyed unemployment rate follows the ILO definition, requiring persons to be actively searching for a job within the past three months and be able to start work within the following two weeks. The short time series of national surveyed unemployment rates and its disaggregation by age groups limit the scope of empirical analysis on youth unemployment. In addition, since the household-level data are not publicly available, it is not possible to present a more comprehensive profile of unemployed workers.

Factors contributing to China's youth unemployment

There are three main types of unemployment—frictional, cyclical, and structural. Frictional unemployment occurs when workers move between jobs and people transition in and out of the labor force. Reducing the costs of searching and moving between jobs can lower frictional unemployment. Cyclical unemployment is short-term involuntary unemployment that is caused by changes in economic activities over the business cycle. Structural unemployment is long lasting

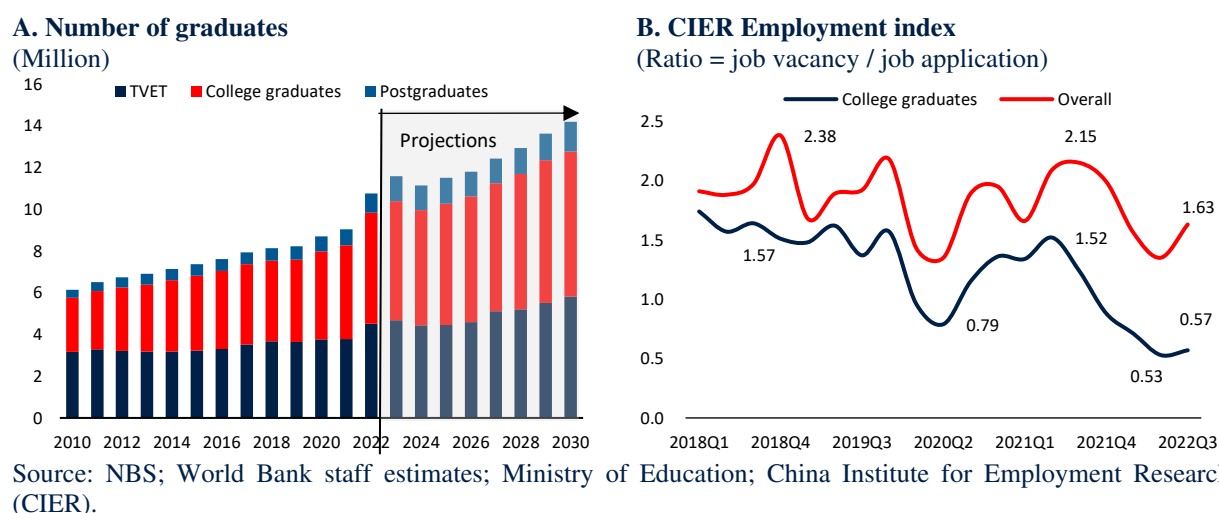
⁷ Source: Ning 2018; Li 2020.

and involuntary, reflecting a mismatch between the skills that workers possess, and the skills demanded by employers. It is typically caused by economic restructuring and technological change, which can make some skills obsolete.

Tightened mobility restrictions and regulatory changes in certain sectors have weighed on activity, reducing net job creation since 2020 and disproportionately affecting the young. The net job gains (job gains minus job losses) in the urban labor market are significantly lower than during the pre-pandemic period, largely due to more job losses (see Figure 7.B in Part I). As discussed in the first section of this report, frequent COVID-19 outbreaks have hit services harder than other sectors of the economy. As the largest employer of recent graduates, weak activity in the services sector has disproportionately affected the young. In addition, regulatory interventions, such as to reduce leverage in the property market, have contributed to a slowdown in certain sectors, including private tutoring and real estate. This has further limited the job opportunities for new entrants into the labor force since 2021.

From a labor supply perspective, a spike in the number of graduates in 2022 brought further pressures to the urban labor market. The number of college graduates has risen consistently since the expansion of higher education started in 1999. But in 2022, the number of graduates grew significantly more than in previous years, with 1.7 million more graduates than in 2021, equivalent to the total increment of graduates over the previous six years combined (Figure 19.A). The spike was likely due to a combination of increased enrollment in previous years and more students pursuing postgraduate studies due to weak labor market conditions. The new cohort of 10.8 million graduates in 2022 accounts for almost one-third of the youth labor force, putting greater pressure on youth employment in the context of weak job growth.

Figure 19. College graduates and employment index



The rise in youth unemployment also reflects long-term trends that disfavor young workers. Based on UN Population projections (United Nations 2022), the number of college graduates is estimated to keep increasing by over 0.36 million per year in the coming 10 years compared with

0.23 million per year between 2010-19 (Figure 19.A). With a larger number of universities, college enrollment has risen from 55.6 percent of the college-aged population in 1999 to 81.1 percent in 2022. In addition, technical and vocational education and training (TVET) has expanded since 2018 (Ministry of Education 2022). While college education and TVET have been increasing, the ratio of job vacancies to job applications for college graduates has been declining from an average of 1.6 in 2018-19 to 1.0 in 2020-22.⁸ In comparison, the same ratio when applied to all workers, has been higher and relatively more stable at 2.0 in 2018-19 and 1.7 in 2020-22 average (Figure 19.B). This suggests that there may be mismatches between the skills of recent graduates and those demanded by employers.

Sectoral job market data offer some evidence of a skills mismatch for college graduates.

Based on online job market data for the third quarter of 2022, the highest demand for graduates was in internet services and e-commerce, professional services, consulting, and real estate. These sectors accounted for two-fifths of total job postings. While these are also the sectors with the most job applicants, they accounted for only 24.2 percent of all applicants (Figure 20.A). By occupation, the highest demand for college graduates was for sales consultants and in customer service, while the applications of college graduates were more evenly spread across occupations (Figure 20.B). Moreover, using a random sample of job seekers of working age and recruitment listings from Zhaopin.com, an online recruitment company, Zheng et al. (2021) found that job seekers' intentions are largely concentrated in five industries—IT, education, real estate/construction, finance, and consulting—accounting for more than 90 percent of all job seekers. In comparison, the demand for workers was more diversified, with job listings in the same five industries accounting for about 50 percent of all vacancies.⁹

The skills mismatch may reflect not only a mismatch between the fields of college study and the needs of employers but also a variation in the quality of college and TVET education.

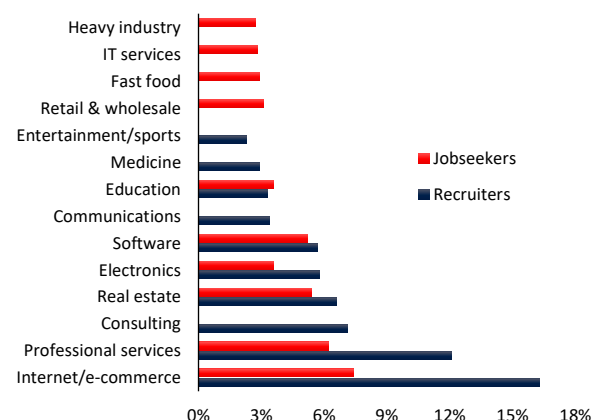
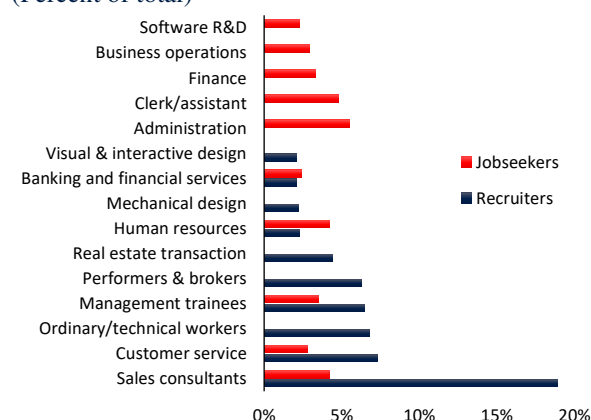
Based on the Ministry of Education's *Quality of Employment Reports for Graduate Students*,¹⁰ 67.1 percent of top four university graduates found jobs, 31.1 percent continued with post-graduate studies, and only 1.8 percent did not find jobs. In comparison, 52.4 percent of graduates from four lower-ranked universities found jobs, 39.0 percent continued with post-graduate studies, and 8.6 percent did not find jobs upon graduation in 2021.¹¹ The rapid expansion of TVET since 2018 has also raised concerns about the quality of lower-tier institutions due to inadequate funds and teaching capacities. Combining the information on college fields of 2019 graduates with a follow-up sample survey of their jobs, Jiang and Guo (2022) found that one quarter of their jobs are not related to their college specialties due to different types of mismatches. A lack of job-related skills and the unavailability of jobs in related fields are important reasons for the mismatch. Among mismatched college graduates, the skills mismatch is associated with lower probabilities of job satisfaction, promotion, and job stability.

⁸ China Institute for Employment Research, based on data from Zhaopin.com.

⁹ The projections took the enrollment rates of 2020 as a base, introduced a moderate increase based on historical trends and considered the size of age cohort populations.

¹⁰ See <https://www.ncss.cn/ncss/zt/2021jyzlbg.shtml>.

¹¹ The top four universities include Tsinghua University, Peking University, Fudan University, and Shanghai Jiaotong University; the four lower-ranked universities include Shandong University, Sichuan University, Zhongnan University, and Jilin University.

Figure 20. Labor market mismatch by industry and by occupation**A. Job vacancies and job seekers in top 10 sectors**
(Percent of total)**B. Job vacancies and job seekers in top 10 occupations**
(Percent of total)

Source: China Institute for Employment Research.

Policy implications

The explorative analysis presented above has highlighted China's emerging youth unemployment challenge. Labor demand and job creation in China have been sluggish in recent years due to both structural and cyclical reasons, especially in the labor-intensive service sectors, making it difficult for the youth to transition from education into active employment. On the supply side, pressures were compounded by an increased number of graduates entering the labor market. Moreover, while China will need a higher skilled workforce as it transitions to higher quality growth and high income, the quality and relevance of graduates do not always match the requirements of the labor market.

Table 2. International experience of youth employment programs

	Short term effect	Long term effect (best case)	Costs to Government
Private sector incentives (employment subsidies and start-up grants)	Positive	Small, positive	High
Job search assistance	Positive	Small, positive	Low
Training	Negative	Large, Positive	Medium/high
Public works jobs	Positive	Zero to small, positive	High

Source: Adapted from Kluge (2016).

The government's policy response to this challenge has largely relied on short-term measures and could be complemented with more structural measures. To ease the adverse impact of the pandemic on the labor market, the Government adopted various measures including employment subsidies and public works programs. International experience suggests that these measures are effective in addressing short-term youth unemployment challenges but are highly costly and typically generate small long-term impacts (Table 2). Going ahead, these short-term measures

could be complemented with structural measures to (i) strengthen the relevance and quality of skills; (ii) improve labor market mobility; and (iii) address information asymmetries and strengthen labor market statistics.

Strengthening the quality and relevance of skills. Fostering collaboration and partnership across job seekers, universities, training institutions, government agencies and employers can help the youth to build the required skills that are more responsive to labor market needs. A widely used instrument to support skill development is work-based learning which has been applied in three-quarters of OECD countries (OECD, 2021). Work-based learning opportunities which encompass a diversity of arrangements including apprenticeships and internship for young people have been found to enhance skills and ease the school-to-work transition and are also cost-effective (ILO and UNICEF 2019; Osborne, 2022). While China has started to implement and expand work-based learning opportunities, the rich international experience could offer China lessons on how to strengthen these programs and make them more valuable to both job seekers and employers.

Improving labor market mobility. First, easing constraints on labor mobility by reforming the *hukou*, China's system of household registration, for all urban areas, would enhance mobility, allowing job seekers to participate more easily in the most dynamic urban labor markets. Second, China could improve labor mobility by pooling social security systems, including unemployment insurance funds to support coverage expansion, facilitate portability of benefits, and diversify labor market risks. The unemployment insurance scheme covers only about 47 percent of urban employment, mainly formal sector workers with labor contracts. In 2022, the government started to cover unemployed college graduates which is encouraging. Pooling unemployment insurance funds from prefecture to province and finally at the national level will be crucial to diversify labor market risks across the country. In addition, an integrated national unemployment insurance system can facilitate labor mobility, allowing for portability of benefits and stronger social protection for workers.

Addressing information asymmetries and strengthening labor market statistics. At the micro level, China could further strengthen public employment services to address information asymmetries in the labor market. This can be done by combining job search assistance, such as individualized counselling and job seeker profiling, with the information from job boards where employers can post available jobs. At the macro level, this includes better statistics and information on labor market performance and increasing public access to labor market data to inform policies. While NBS has developed an integrated labor force survey to monitor urban and rural unemployment, the next step would be to make the (anonymized) labor force survey data publicly available. This would allow researchers to carry out in-depth analysis to better understand labor market dynamics. Lastly, strengthening the monitoring and evaluation system of labor market programs is essential to inform evidence-based decision-making and can help guide policymakers on when and where different programs are effective and how they can be improved upon.

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