China Economic Insight 2021

China Economic Insight

Executive Summary

- Despite a sharp but short-lived contraction, the Chinese economy was resilient to the Covid-19 shock. Activity was supported by an effective public health response to the virus, extraordinary policy support and strong exports. With an estimated 2.3% GDP growth in 2020, China was the only major economy that expanded last year

- The Chinese economy is expected to accelerate further, growing by 8.5% in 2021, before moderating to grow at 5.5% in both 2022 and 2023. Growth drivers are likely to shift from public-sponsored infrastructure investments to private domestic consumption and high-end technological development

- A multi-trillion renminbi (RMB) package was announced to stimulate the Chinese economy in 2020, including discretionary measures on the expenditure side, revenue side and semi-fiscal side. With a deficit of 11.4% of GDP in 2020, China produced a powerful fiscal impulse but a record general government deficit

- Fiscal policy is expected to tighten moderately as the economy normalizes and the government gradually reverts back to supporting the re-balancing of the economy towards consumption and the private sector

- A more accommodative monetary policy was also key to support the Chinese recovery in 2020, including policy rate cuts, liquidity injection, expansion of special credit facilities, and government relief measures to local banks

- Monetary policy is expected to remain accommodative, especially as fiscal support is withdrawn. Both CPI and PPI inflation are expected to hover around 2% over the coming years

- China’s current account balance registered a surplus of 2% of GDP in 2020, due to strong exports, weak imports and low commodity prices. Massive capital inflows have also produced an appreciation of the RMB

- China’s current account surplus is expected to moderate gradually with imports growing faster than exports. But the RMB is expected to remain stable over the 2021-23 period as positive capital flows more than offset a deterioration of the current account

Contents

Economics Team
economics@qnb.com

James Mason
Senior Economist
james.mason@qnb.com

Luiz Pinto*
Economist
luiz.pinto@qnb.com

* Corresponding author

Editorial close: 2nd of June 2021

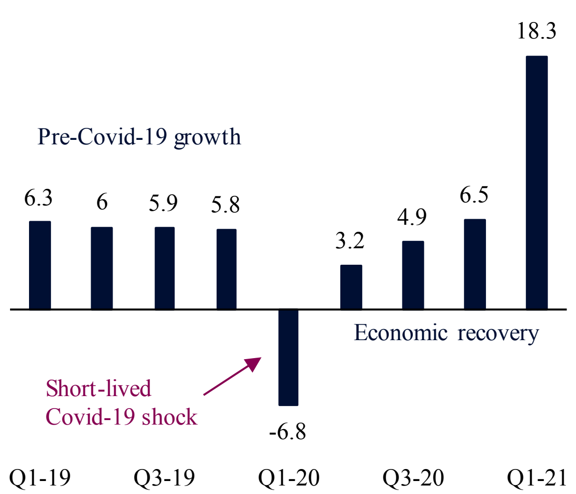
Real Gross Domestic Product

Background

Last year started on a positive note for China. This came after more than two years of economic deceleration, when both external and domestic headwinds prevailed. Domestically, government-induced financial deleveraging was preventing faster credit growth. Externally, weak demand for manufactured goods, the US-led financial tightening and tariff wars with Washington created significant setbacks. But in late 2019, all of these negative trends started to reverse, pointing for an incoming economic expansion in China. Tailwinds included less regulatory restrictions for domestic credit growth, an uptick of global demand for physical goods, more accommodative policies by the US Federal Reserve and a comprehensive trade agreement with the US.

However, conditions took a dramatic turn with the outbreak of the Covid-19 pandemic. A rare "once-in-a-century" event, the pandemic led to the imposition of lockdowns and social distancing measures across all continents. This produced the largest economic shock since World War II.

Chart 1: China's GDP growth
(quarterly, y/y, %)



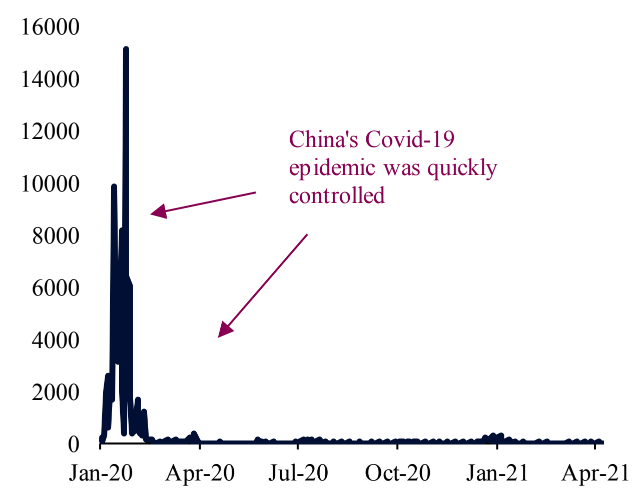
Sources: Haver, China Natl. Bureau of Stats., QNB analysis

The Covid-19 outbreak started in China. At the height of the domestic epidemic, in Q1 2020, social distancing measures and lockdowns were enacted across several large provinces. As a result, both supply and demand were brought to a virtual halt, with the economy collapsing. In fact, China's GDP contracted by 6.8% on a year-on-year (y/y) basis in Q1 2020, the sharpest and deepest downturn in decades.

However, the Chinese economy proved to be resilient to the Covid-19 shock, despite a short-lived sharp contraction, with activity re-igniting in Q2 2020 and gaining momentum thereafter. Three factors explain China's quick recovery.

First, Chinese authorities showed an outstanding capacity in handling the health crisis through mass testing, virus tracking and effective social distancing measures. This was also supported by high levels of compliance and accountability of the general population to the preventative guidelines. Therefore, new Covid-19 cases dropped precipitously in a matter of weeks, allowing for economic activity to gradually "normalize."

Chart 2: New Covid-19 cases in China
(total number of new cases per day)

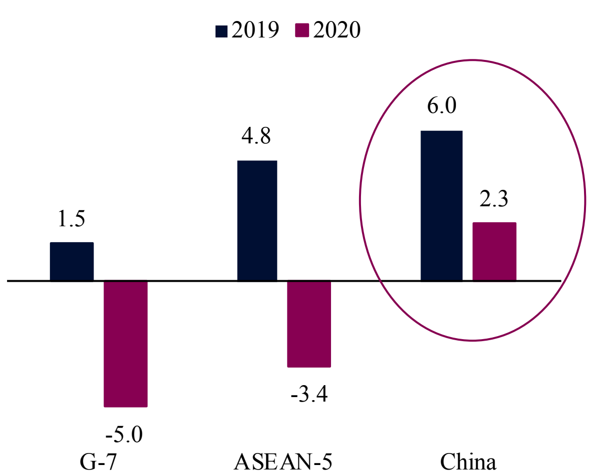


Sources: Haver, John Hopkings University, QNB analysis

Second, extraordinary fiscal and monetary policy support were also essential to propel the economic recovery. Authorities stimulated the recovery through interest rate cuts, financial support to companies and infrastructure investments. The government decided to promote real estate growth and invest in public infrastructure in order to offset the negative effects of the Covid-19 crisis on household consumption and private investments.

Third, the external sector also proved to be supportive to the Chinese economy. After an initial sudden collapse of China's exports to the rest of the world, when economic activity in most major economies virtually froze, new trends and changes in global spending patterns emerged during the pandemic, favoring an export boom in China. As the world adapted to less face-to-face interactions, more work-from-home and longer periods of social distancing, households adjusted their consumption behavior, spending less in "experiences" or services and more on physical goods. This created a strong demand for Chinese exports, including of personal protective equipment (PPE) such as masks and sanitizers, software, electronics and communication equipment.

Chart 3: GDP growth compared
(growth rates, y/y, %)



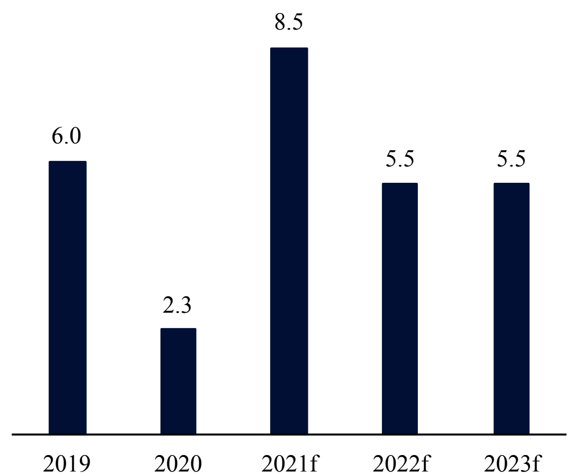
Sources: Haver, IMF, QNB analysis

China is estimated to have been the only large economy to present positive GDP growth last year. The last few quarters have presented some positive momentum. China has therefore not only outperformed the major economies of the G-7 (US, Japan, Germany, France, UK, Italy and Canada) in 2020, but also the dynamic emerging market economies of the ASEAN-5 (Indonesia, Thailand, Malaysia, Philippines and Vietnam).

Outlook

The Chinese economic recovery is set to accelerate this year, before moderating in 2022 and 2023. We expect a GDP growth of 8.5% in 2021 and 5.5% in 2022 and 2023.

Chart 4: GDP growth projections for China
(growth rates, y/y, %)



Sources: Haver, China Natl. Bureau of Stats., QNB analysis

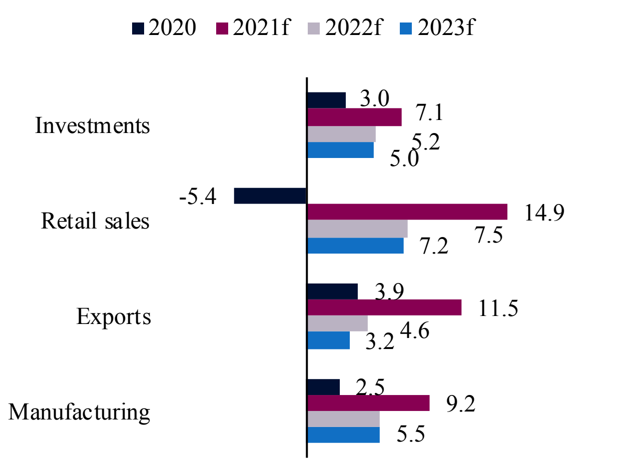
Importantly, however, the drivers of growth will likely change as activity normalizes and economic authorities move away from "fire-fighting" support to more long-term policy targets.

So far, the post-Covid-19 recovery has been over-reliant on state-induced, credit-intensive infrastructure and real estate investments. While public investments may have been important to support the economy during the pandemic, they are not expected to be a sustainable source of long-term growth. China's infrastructure is already highly developed and additional investments in the sector tend to be less efficient, often contributing to create inadequate levels of indebtedness and overcapacity.

Chinese authorities aspire to accelerate the transformation of the country's economy, pivoting away from public investments in infrastructure. The aim is to strengthen the role of domestic consumption and high-end technology in China's growth model. Hence, growth in investment should slow, on the back of continued reduction in excess capacity in old industries, such as steel, coal, and plastics. But this impact should be partially offset by private investments in "frontier sectors," such as artificial intelligence, quantum computing, semi-conductors, medical technology and space exploration, which includes satellite development and fundamental research. This should take place as urbanization continues within five planned mega-city clusters across the country, where services as well as high-end tech should dominate. The five mega-city clusters include the Beijing-Tianjing-Hebei area in the north, the Shanghai-Zhejiang-Jiangsu-Anhui area around the Yangtze River Delta in the east, the Chengdu-Chongqing area in the west, the Changsha-Zhuzhou-Xiangtan area in the center, and, finally, the Guandong-Hong Kong-Macau greater bay area of the Pearl River Delta in the South.

Moving forward, for this year and the next couple of years, as government support is gradually withdrawn, we expect to see three main drivers of growth in China.

Chart 5: GDP growth drivers in China
(growth rates, y/y, %)



Sources: Haver, China Natl. Bureau of Stats., QNB analysis

First, retail sales and general household consumption are expected to rebound more strongly and gain momentum, becoming a leading sector for growth. With Covid-19 and the imposition of more restrictions on intra-provincial traveling, the flow of China's almost 300 million migrant workers got partially interrupted, preventing low-income rural workers to go back to or search for higher-paying urban jobs. This had a negative effect on household consumption as migrant workers are not covered by urban social welfare programs, having to save more in difficult economic times. Associate insurance programs from the central government are limited or not available for most migrant workers. As Covid-19 restrictions are lifted and domestic traveling between Chinese provinces fully resumes, domestic consumption will slowly recover. This should take place as disposable incomes rise and households feel less of an urge to save. In addition, the ongoing mass vaccination campaign will be supportive for the domestic services sector, particularly consumer-facing activities, such as accommodation, catering, tourism and offline retailing.

Second, as the world "opens up" post-pandemic, Chinese exports will pick up further. The global economy is expected to grow by almost 6% in 2021 and above 3.5% in 2022 and 2023, increasing the demand for Chinese goods and services. Rising demand for general consumer products and capital goods should more than offset any decline in demand for PPE and electronics.

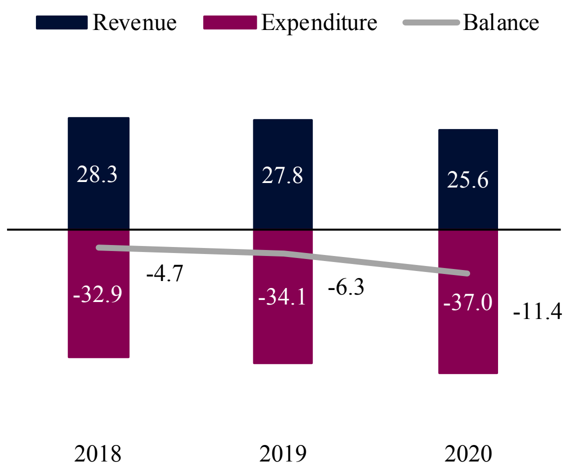
Third, manufacturing is expected to receive a boost and to be a beneficiary from the new domestic and global environment. As mass vaccination campaigns accelerate across the globe, creating the conditions for a more sustained "re-opening," demand will pick up, filling Chinese manufacturers with new export orders. This will also be supported by the recovery in domestic consumption, as migrant workers and the Chinese middle class start to spend more in manufactured goods again. Furthermore, "strategic competition" with the US in frontier industrial technology will likely lead to more allocation of public resources to the manufacturing sector, instead of infrastructure or real estate.

Fiscal Policy

Background

Fiscal policy was paramount for China in 2020. An estimated 4.8 trillion of renminbi (RMB) or 4.7% of total GDP were announced as discretionary fiscal measures to stimulate the economy.

Chart 6: China's general government balance
(as a % of GDP)



Sources: IMF, QNB analysis

On the semi-fiscal side, which includes sovereign credit guarantees as well as spending and investments from state-owned companies (SOEs) and public funds, the government mobilized resources aggressively. This encompassed more support for credit guarantees, the direct issuance of bonds for infrastructure projects, higher levels of investments from SOEs and significant drawdowns of public funds.

On the expenditure side, this included new public investments to spur activity, accelerated disbursements of unemployment insurance, special support facilities for migrant workers, and additional spending on epidemic prevention and control.

On the revenue side, this included a substantial tax relief program as well as waivers for social security contributions.

The end result of such measures was a strong fiscal impulse but the largest general government deficit in recorded history.

Outlook

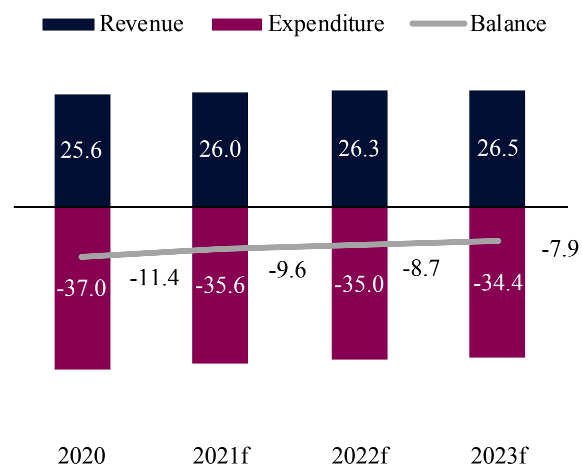
Fiscal policy is expected to tighten as the economy normalizes and the government partially reverts back to supporting the re-balancing of the economy towards consumption and the private sector.

On the semi-fiscal side, we expect a normalization of the issuance of credit guarantees and less mobilization of public and semi-public funds for investment projects.

On the expenditure side, we expect less extraordinary benefits and social transfers as well as more moderate spending and support for public investments.

On the revenue side, we expect the expiration of relief measures and the expansion of the tax base with the economic recovery.

Chart 7: Projections of general government balance
(as a % of GDP)



Sources: IMF, QNB analysis

Therefore, while the fiscal stance is still expected to remain accommodative in 2021 and in the next couple of years, the overall fiscal impulse will be softer, with more contained deficits. As demand for fiscal support gradually decreases, we project a general government deficit of 9.6% in 2021, 8.7% in 2022 and 7.9% in 2023.

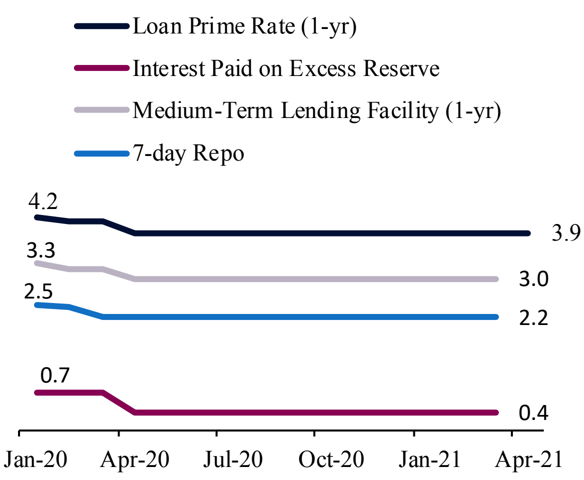
Monetary Policy

Background

During the Covid-19 crisis, China had also relied on monetary policy to support the economy. This included both traditional monetary policy measures carried out by the People's Bank of China (PBOC) and regulatory measures to offer relief or support to the domestic banking system.

Traditional easing measures included the reduction of all major policy rates by around 30 basis points (bps), the reduction of interest on excess reserves from 72 to 35 bps and liquidity injection into the banking system via open market operations (OMO). The PBOC had also expanded the re-lending and re-discounting facilities by RMB 1.8 trillion at lower rates, targeting non-financial firms that were either vulnerable or considered critical for pandemic mobilization. Moreover, policy banks (China Development Bank, Export-Import Bank of China, and Agricultural Development Bank of China) extended additional credit lines to the private sector.

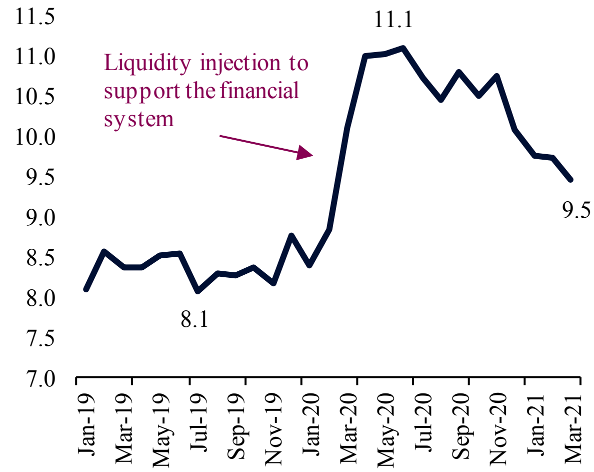
Chart 8: China's interest rate corridor
(policy rates, %)



Sources: PBOC, QNB analysis

Government relief measures affecting the banking sector included support to uncollateralized loans to small and medium enterprises, delays for loan payments, and tolerance for higher non-performing loans (NPLs) with reduce NPL provision requirements.

Chart 9: Money supply growth (M2)
(y/y, %)



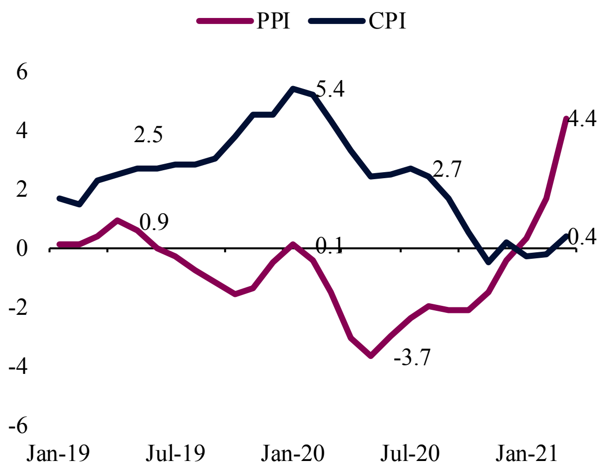
Sources: PBOC, QNB analysis

Monetary policy measures were adequate to insure ample liquidity, ease financial conditions and support credit growth without producing domestic imbalances.

Despite the significant amount of liquidity injection, reflected in the expansion of money supply (M2), there was no sign of ultra-excessive monetary financing of domestic activity. This comes in contrast to what other major economies experienced in 2020. In fact, while China's M2 to nominal GDP increased by 7.4% in the year, the same metric expanded by 27.2% in the US and 14.4% in the Euro area. This is relevant because excessive monetary financing is an early indicator of future financial instability or potential capital misallocation. Importantly, China's M2 expansion already started to moderate to close to normal levels in Q4 2020.

While headline Consumer Price Index (CPI) inflation was high just before the pandemic, running above the 3% policy target/ceiling, this was a rather temporary phenomenon. This was mainly caused by the African Swine Flu supply shock, which pushed food inflation up due to soaring meat and poultry prices. Headline CPI inflation peaked in February 2020 and the negative shock from lockdowns and the global pandemic added to deflationary pressures that were already visible in the producer price index (PPI), which measures the price change of inputs for domestic producers. The PPI is especially affected by supply chain constraints from lockdowns and closer borders as well as higher commodity prices.

Chart 10: Inflation in China
(y/y, %)

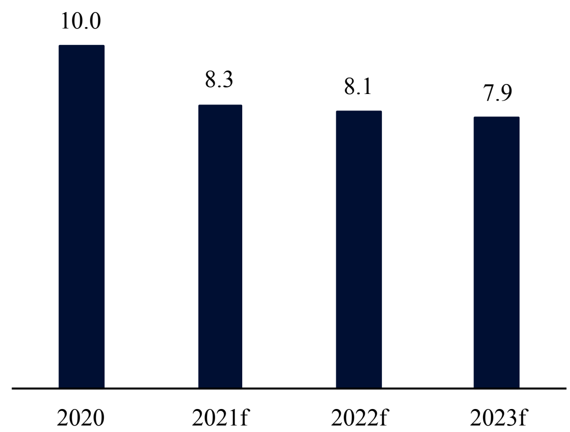


Sources: PBOC, QNB analysis

Outlook

Accommodative policy rates are expected to remain in place as government relief measures phase out and liquidity injections moderate further. M2 is expected to grow by 8.3% in 2021, which is less than nominal GDP, pointing to some financial discipline. The ratio (M2 to nominal GDP) is set to remain broadly balanced in 2022 and 2023. We expect this ratio to increase further in other major economies, where central banks are more prone to finance activity by expanding the money supply.

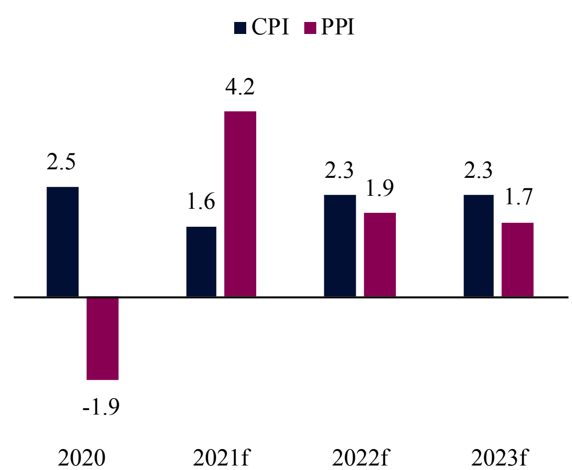
Chart 11: Projections for money supply (M2)
(y/y, %)



Sources: PBOC, QNB analysis

CPI prices are expected to drop further in 2021, due to more tamed food prices and the lack of wage growth pressures in a context of higher levels of unemployment. The PPI, however, is expected to spike in 2021 on higher commodity prices and a tighter market for key inputs and services for producers, such as semiconductors. However, imbalances are expected to normalize in 2022 and 2023, with both consumer (CPI) and producer (PPI) prices back towards more normal levels around the 2% mark.

Chart 12: Projections for inflation
(y/y, %)



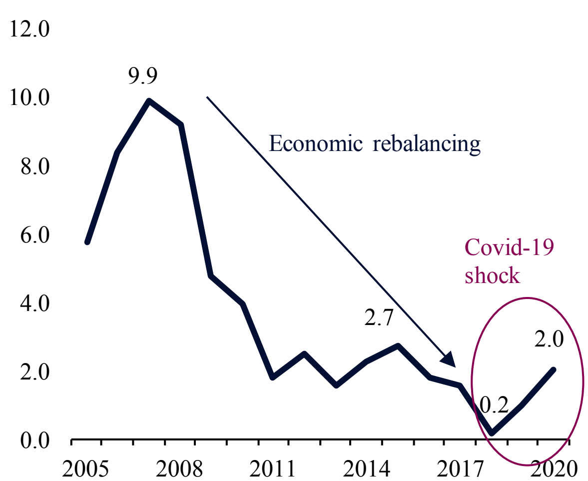
Sources: PBOC, QNB analysis

External Sector

Background

China is often known for running current account surpluses. However, over the last several years, as the economy initiated a long process of re-balancing from investment to consumption, the surplus was shrinking. With less savings and more consumption, and by growing more than the rest of the world, China's overall level of imports increased substantially. This trend was reversed in a meaningful way for the first time with the pandemic last year.

Chart 13: Current account balance
(as a % of GDP)

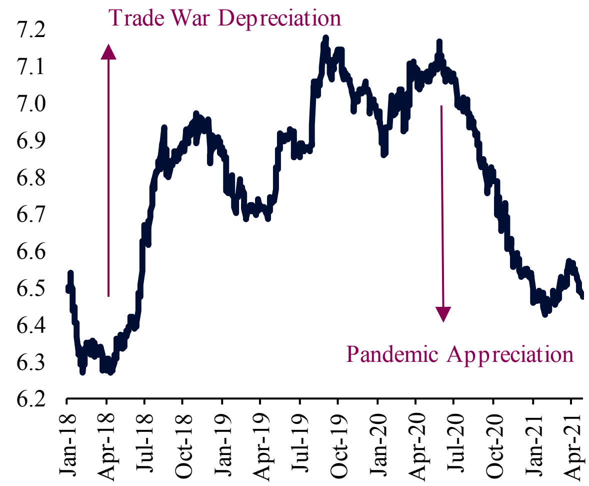


Sources: IMF, QNB analysis

Two main factors explain the 2020 current account surplus. First, China's exports performed well during the pandemic, due to high demand for electronics, personal protective equipment and work-from-home materials or other pandemic-related goods. Second, imports contracted significantly, due to a slowdown in consumer demand, lower commodity prices and the collapse of Chinese tourism overseas.

When it comes to the financial account, which covers claims on or liabilities to non-residents, specifically with regard to financial assets, last year was also remarkable. The current account surplus, along with China's relative market stability, appealing yields and strong economic performance, attracted a large amount of capital to the country. According to the Institute of International Finance (IIF), portfolio inflows from non-residents to China amounted to a record of USD 277 Bn in 2020, up from USD 123 Bn in 2019. Capital inflows to China represented more than 75% of the total capital inflows to emerging markets in 2020.

Chart 14: FX movements
(USD:CNY)



Sources: Haver, Wall Street Journal, QNB analysis

As a result, the RMB reversed its multi-year downtrend, that was driven mostly by trade conflicts with the US. As the pandemic hit and China outperformed the rest of the world, the RMB appreciated significantly against the USD in 2020.

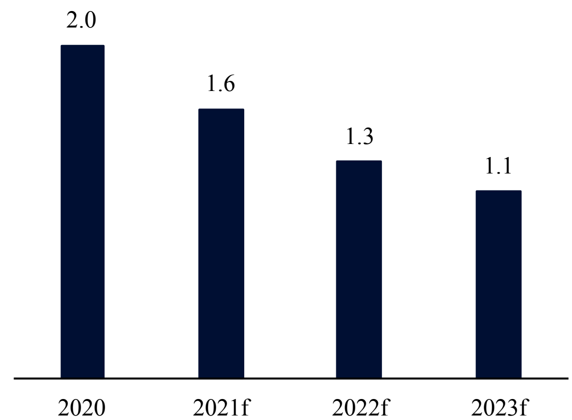
Outlook

Moving forward, however, China's external surplus is set to moderate gradually, with the current account returning to more balanced levels despite continued export growth. Three factors are expected to contain the surplus over the next few years, with import growth likely outpacing export growth.

First, the acceleration of domestic consumption is expected to make imports grow at a faster pace than exports. Second, the recovery of commodity prices will further increase China's commodity-intensive import bill. Third, the partial re-recovery of Chinese tourism overseas will weigh on the service balance, with imports spiking as tourism spending increases. Taken together, these factors will produce a gradual deterioration of China's current account balance, with the overall surplus moderating.

Despite such external developments, we expect the RMB to hold up around current levels against the USD over 2021-23. Relatively high nominal and real yields in China are expected to attract more capital flows into the country, more than offsetting the negative changes of the current account.

Chart 15: Projections of current account balance
(as a % of GDP)



Sources: Haver, IMF, QNB analysis

Key Indicators

	2016	2017	2018	2019	2020e	2021f	2022f	2023f
Real sector indicators								
Real GDP growth	6.8	6.9	6.7	6.0	2.3	8.5	5.5	5.5
Nominal GDP (USD Bn)	11,227	12,265	13,842	14,341	14,723	16,642	18,013	19,423
GDP per capita (USD, PPP)	13,525	14,254	15,519	16,659	17,192	18,931	20,392	21,945
CPI inflation	2.0	1.6	2.1	2.9	2.5	1.6	2.3	2.3
PPI inflation	-1.4	6.4	3.6	-0.5	-1.9	4.2	1.9	1.7
General government balance (% GDP)								
Revenue	28.2	27.8	28.3	27.8	25.6	26.0	26.3	26.5
Expenditure	31.9	31.6	32.9	34.1	37.0	35.6	35.0	34.4
Fiscal balance	-3.7	-3.8	-4.7	-6.3	-11.4	-9.6	-8.7	-7.9
External sector								
Current account balance (% GDP)	1.8	1.6	0.2	0.9	2.0	1.6	1.3	1.1
Exports (y/y, %)	-6.9	10.5	9.1	-0.8	3.9	11.5	4.6	3.2
Imports (y/y, %)	-3.0	13.9	15.9	-2.5	-5.5	13.4	5.5	4.7
Monetary indicators								
Money supply growth (y/y, %)	11.4	9.1	8.1	8.8	10.0	8.3	8.1	7.9
Exchange rate USD:RMB (eop)	6.94	6.50	6.87	6.96	6.53	6.45	6.45	6.45
Memorandum items								
Population (Mn)	1,414	1,421	1,428	1,434	1,439	1,444	1,448	1,452
Population growth (% change)	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.3
Unemployment (%)	4.0	3.9	3.8	3.6	4.2	3.8	3.7	3.6

Sources: IMF, China National Bureau of Statistics, PBOC, UN and QNB analysis

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