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China Outlook 2021

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Forecast of key indicators

Real GDP. The estimated GDP growth rate in 2020 is 1.7% (the preliminary 2020 GDP stats will be released by the Bureau of Statistics on January 19th). We forecast GDP growth rate in 2021 to reach 7.5%, with the second half significantly slowing down from the first half due to the base effect in 2020. Our forecast is slightly lower than the market average, as we put high weight on the weak recovery of domestic consumption, which usually accounts for 60% of GDP growth. The economic drivers for 2021 will remain to be export and investment, not consumption. During the 14th Five-Year Plan period (2021-25), the annual growth rate is expected to reach 5%.

Exchange rate. We expect RMB to strengthen markedly in 2021, reaching an average of 6.1. It will be stronger in the first half and weaker in the second, with a high probability of breaking the 6 threshold temporarily in the first quarter. There are three main reasons to drive this trend: 1) The market is exceptionally optimistic about China's growth expectations in 2021, and the interest spread between China and the US remains high, and thus the pressure of capital inflow is high; 2) China-US trade surplus is expected to remain high; the US will need to rely on China for masks and medical devices, daily necessities and industrial inputs as it struggles to control the pandemic; 3) The US dollar will continue to be weak, possibly until 2023, depending on the pace of epidemic control. In the next five years, RMB is likely to continue the upward trend, albeit with fluctuations. China's technological investment and industrial upgrade will be faster than those of the US, which will drive up the real value of RMB.

Interest rates. We expect the loan prime rate (LPR) to remain at the current level in 2021. However, if the economic recovery in the first quarter falls short of expectations or there is obvious liquidity shortage, we do not rule out the possibility that the central bank may slightly reduce the LPR in the second quarter by about 5-10 basis points. The reserve requirement ratio (RRR) will likely remain unchanged in 2021, as its uplifting impact on real estate will be too strong. The yield of ten-year government bond will likely follow the trend of economic recovery, with the first half stronger and the second weaker.

Inflation. Inflation measured by the consumer price index (CPI) is forecast to fall to 1.6% in 2021, a sharp drop from the estimated value of 2.5% in 2020 (the actual 2020 CPI will be announced on January 11, 2021). The decline is mainly due to the downward hog price cycle and weak consumption. Inflation measured by producer price index (PPI) will go up, as commodity prices will rise in general, driven by infrastructure building and industrial production. China will increase investment in "new infrastructure" projects such as semiconductors and new energy, and strengthen environmental protection requirements, which will raise the prices of metals and coal. However, we expected the global GDP to return to the 2019 level in 2024, so the aggregated demand is insufficient to sustain high commodity prices throughout the period.

Export. Exports are expected to accelerate in 2021. In the first half, the export will be dominated by the growth of medical materials, while in the second half mainly coming from living and production supplies. Post pandemic, the global reliance on China's industrial supply chain has greatly increased rather than weakened. Global companies will continue to diversify their production lines away to reduce the risk of over-reliance on China, but this will have a limited impact on trade. Most of the firms that moved away produce lower-end final products to circumvent the tariffs and trade restrictions against China. Yet these firms will still rely on intermediate goods produced in China. More than 90% of global trade is intermediate goods, so the decrease of China's final product export will be partially offset by the increase of intermediate goods export.

Monetary policy. The Central Economic Work Conference held in December emphasized that monetary policy will not make a “sudden turn”. As such, the central bank, will remain cautious in tightening the policy and will adjust the policy according to the market liquidity and employment situation. With the industrial recovery, the demand for liquidity, especially from small and medium-sized firms, has greatly increased. Yet firms face even more difficulties when they seek for additional financing, because the risk of bad debts after the pandemic has greatly increased. The 2021 April meeting of the Political Bureau of the Central Committee will reassess the economic recovery. If there is a significant lack of liquidity, the LPR interest rate may be lowered.

Fiscal policy. The size of fiscal stimulus package in 2020 was about RMB3.6trn, accounting for 4% of nominal GDP. The fiscal stimulus will be smaller in 2021. Local governments will invest more in projects related to environmental protection and smart city, as well as expand medical and educational expenditures. The investment in traditional infrastructure projects will be reduced and tilted towards rural areas. There will be more measures to cut taxes and fees for firms.

Policy trend

Exchange rate policy. The rapid appreciation of RMB in 2020 has triggered several policy changes, including the adjustment of foreign risk reserve ratio to zero, phasing out the use of countercyclical factor, and the downward change of macro-prudential adjustment parameters of cross-border financing, which are signals that regulators want to prevent the market to form a unilateral expectations for RMB appreciation. However, due to the weakness of the US dollar, the increase of RMB is only moderate compared with other currencies. Except for Brazil, Turkey, India and Indonesia, all other currencies are appreciating against the US dollar. The euro and the Australian dollar were the strongest, rising by nearly 10% during 2020, while the annual increase of RMB against the US dollar was 7%. From the perspective of currency basket, the appreciation of RMB is less than 4%, whether it is measured against the currency basket of foreign exchange trading center or that of the Bank for International Settlements. Therefore, policy makers do not have a strong incentive to intervene the current position of RMB. In the coming years, the RMB is on track of further appreciation. The central bank wants to promote the internationalization of RMB and gradually open the capital account, so its tolerance for RMB fluctuation is rising.

Demand-side management. In contrast to the 2015 supply-side reform, the demand-side management focuses on improving income and income distribution, in particularly consumption. Long-term policies include the reform of social security, medical insurance, residence registration (hukou) and birth policy. In the short term, measures will mainly include direct government subsidies to low-income groups. The recent pilot programme of using central bank digital currency to boost consumption is one of such efforts. However, a fundamental change will require speeding up the reform of state-owned enterprises (SOEs), as their income does not enter the national income distribution, but is mostly used for investment and overseas assistance.

International relations. The investment in the Belt and Road Initiative (BRI) projects will slow down as national strategy turns inward, but the overseas medical aid expenditure will nonetheless increase, particularly in vaccine supply. The decoupling of technology between China and the US will continue, although the Biden administration may appear more collaborative in global issues such as climate change. China is actively seeking support from other countries. China has signed Regional Comprehensive Economic Partnership (RCEP) and a preliminary China-EU Investment Treaty by end-2020, and is considering joining Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Due to divergent positions on issues such as Huawei and the BRI, China's relations with Australia, Japan and India will stay tense in the coming few years.

Risks worthy of attention

Consumption. Despite the strong performance of high-end retail sales in big cities, including cars, the overall consumption remains weak. The weak job market has led to a decline in income expectations. Government subsidies are mostly targeting firms rather than individual families. The overdue and default rates of consumer loans are likely to rise sharply in the coming months. The driving force of economic growth in 2021 will be mainly from exports, real estate and infrastructure investment, rather than consumption.

Employment. In the coming years, ensuring employment will be the most important policy goal. Although the urban unemployment rate has improved towards the end of 2020, the unemployed migrant workers returning to rural areas and small counties have not been taken into account. The actual unemployment situation is worse than the headline figures. Post pandemic, firms had largely laid off workers or had headcount freeze, while rapidly adopted automation or digital solutions to replace labour. Although this trend is offset by aging to a certain degree, the number and quality of new jobs will not compare to those pre-pandemic. The growth rate of household income will also decline in the next few years.

Real estate. It’s probably the biggest "grey rhino" in 2021. The policy of "housing without speculation" will largely stay, and authorities will strictly control the growth rate of housing prices. However, in the spirit of "one city, one policy", areas with accelerated urbanization will probably gain more space in relaxing their home-buying restrictions. Destocking remains the major problem, with over 90% of the housing inventory outside the first-tier cities. It is difficult for small and medium-sized cities with net outflow of population to deplete the housing inventory by themselves, so there is the possibility of a sharp decline in housing prices for those regions. In contrast, the growth rate of housing prices in big cities is at a five-year low, while their demand soared after the pandemic, so their prices have strong pressure to go further up, particularly secondhand-housing.

Local financial risks. The perceived bond market risk is rising, triggered by several recent default of several SOE bonds. The risk of local government municipal bond is also rising. The bright side is that these defaults occur in the open market in an orderly manner so that they do not constitute systematic risks. However, similar incidents may lead to regional credit crunch. In some regions that lag in growth, SOE default may have severe domino effects. Financial institutions will become alerted when looking at other firms from the same region, which may lead to regional financial crisis.

Capital reversal. If the pandemic control in Europe and the US is far better than expected, it will lead to a global capital reversal away from emerging markets including China back to Europe and the US. This will cause great shocks in currency, foreign trade, stock and debt markets, and can potentially drag emerging markets into a prolonged economic recession.

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