ASG Update on the Chinese Economy

March 2, 2021

Monthly Economic Snapshot

- China's economic recovery appeared to slow in February, as the Lunar New Year holiday and virus restrictions weighed on the manufacturing Purchasing Managers Index (PMI), which fell to 50.6, and the service sector PMI, which fell to 51.4 – their lowest levels in nine months.
- Government restrictions on Lunar New Year holiday travel helped fuel domestic consumption, as auto, retail, and entertainment expenditures all increased. Consumption at major retail and restaurant outlets, for example, increased by 29% year-on-year (yoy) during the February holiday, as many migrant and white-collar workers heeded government calls to avoid travel.
- High household savings growth propelled by the pandemic appears to be buoying China's property sector despite efforts to cool the market through mortgage lending limits and restrictions on developer financing. Sales for new homes in China's 70 major cities rose in January.
- China's central bank has had to assuage market concerns about a rapid tightening in monetary policy, after an unexpected reduction in liquidity caused a credit crunch when short-term lending rates skyrocketed ahead of the Lunar New Year holiday.
- Over the last two months, China's regulators have issued a raft of new fintech regulations, anti-monopoly rules, and commercial requirements which will slow the growth of Alibaba's fintech arm Ant Group. Ant's competitors are rushing in to fill the market void created by Ant's shrinkage.
- Tensions persist in U.S.-China relations. While the U.S. government predicts agricultural exports to China will grow in 2021, the Biden administration is also considering new technology and supply chain policy restrictions which could impact trade flows.

ASG BUSINESS TAKEAWAY: During this month's annual National People's Congress, the Chinese government will release its much anticipated 14th Five Year Plan (FYP) and a new, longer-term industrial development strategy called "Vision 2035," laying out China's economic growth and industrial policy objectives for the next five to fifteen years. Companies should look for industry-specific policy guidance and be prepared to adapt corporate messaging to align with relevant priorities set in these plans.

China's economic recovery appeared to slow in February. Domestic pandemic travel restrictions boosted consumption, but manufacturing and service sector activity slowed. China's restrictions on domestic and foreign travel during the Lunar New Year holiday from February 11-17 shifted consumption patterns by diverting disposable income from travel to entertainment and retail purchases. According to the State Council, holiday travel restrictions caused travel volumes to plummet 76.8% compared to the 2019 pre-Covid holiday, and were 34.8% lower than last year when lockdowns began. Sales at China's largest retailers and restaurants grew by double digits during the holiday, and China's Lunar New Year movie box office hit a record RMB 7.78 billion ($1.2 billion), beating 2019's high of RMB 5.9 billion ($910 million). Courier companies also saw a package boom, with 130 million packages delivered during the first two days of the holiday, a 223% increase yoy according to the State Post Bureau. Although activity slows are typical during the holiday, China's manufacturing and services sectors slowed more than expected in February, despite reports that manufacturing resumed normal production faster than usual as many workers took shorter (or no) holiday vacations.

China's annual Nation People's Congress will set out China's macroeconomic policy priorities as well as longer-term development plans. China's "two sessions," the annual convenings of China's legislature—the National People's Congress (NPC)— as well as the Chinese People's Political Consultative Conference (CPPCC), will begin with the CPPCC convening on March 4 and the NPC convening on March 5. Instead of the traditional 10-day session from the pre-Covid era, this year's gathering will be abbreviated and is likely to conclude by March 11. At the 2020 NPC meeting, China broke with precedent by not setting an official GDP growth target in the wake of the Covid-19 pandemic. No target is expected again this year. The absence of a hard GDP growth target could be viewed as a win for reform-minded economists who have long argued for abolishing the fixed target as China's economy evolves and emphasis shifts to quality over speed of growth. The Chinese government is likely to announce tightening of stimulus policies, but will closely monitor economic performance to avoid pulling back too quickly. According to the World Bank and other sources, the Chinese economy has resumed its pre-pandemic growth trajectory and could expand by nearly 8% this year. Fiscal policy is expected to contract in 2021, as the official budget deficit target is forecast to fall from last year's record 3.6% of GDP to around 3% of GDP. Similarly, Chinese officials have signaled that, as conditions permit, they intend to resume efforts to deleverage China's economy after public and private sector debt ballooned dramatically from already-high levels last year.

Chinese leaders will unveil the 14th Five Year Plan (FYP) during the NPC session, which will lay out their new medium-term development plan for China's economy. The FYP will set quantitative macroeconomic and industrial targets for the next five years and could include a goal to double GDP by 2035, as well as new metrics for gauging economic development such as total factor productivity, government debt ratio, and the Gini coefficient (to measure income inequality). The "dual circulation" strategy that Chinese leaders have emphasized since last year is expected to be the bedrock principle undergirding the 14th FYP. Chinese President Xi Jinping first introduced the dual circulation concept in May 2020, explaining that it was a new growth model that would reduce China's reliance on external demand, shifting instead toward domestic production, distribution, and consumption – all supported by domestic innovation. Included in the dual circulation model is an effort to adjust the Chinese economy away from its reliance on high levels of investment by expanding the role of household consumption. The 14th FYP will also lay out the government's choice of industrial policy tools to help China to achieve greater technological self-sufficiency, including ambitious R&D spending targets and other support measures. Other core policy goals could include expanding China's "rural revitalization" initiative, maintaining the size of China's manufacturing sector to be around 26% of GDP, and setting new carbon reduction targets to meet President Xi's pledge to achieve net-zero carbon emissions by 2060.

Policy Landscape

MONETARY POLICY

China's central bank signals "neutral" and "prudent" monetary policy after sparking a liquidity crunch in January. In January, the People's Bank of China (PBOC) began to make gradual withdrawals in liquidity through open market operations ahead of the Lunar New Year holiday. Unfortunately, this modest net RMB 6.34 billion ($983 million) reduction in liquidity caused financial markets to tighten and sent the overnight repo rate, which is the price of loans on the interbank market, skyrocketing to a six-year high of 3.34% at the end of January, from around 0.65% at the beginning of 2021. In November 2020, PBOC Vice Governor Liu Guoqing stated that, "Exit [from monetary stimulus] is a matter of time and also necessary, but the timing and method of exit need to be carefully evaluated, mainly based on the status of the economic recovery." As a result of such policy signals, markets have become increasingly vigilant for indications that the Chinese government has begun to tighten monetary policy in earnest, as it refocuses on addressing asset bubbles in the financial and property markets. This sensitivity likely caused market players to misinterpret the measured withdrawal of liquidity that began in January as a major policy shift. Following the spike, the central bank has tried to reassure markets, emphasizing its intention to maintain a largely "neutral" and "prudent" monetary policy without sharp changes. The short-term spike in overnight repo rates did not reflect a broader tightening of credit conditions, however, as banks extended a record RMB 3.58 trillion ($555 billion) in new loans in January, an increase from RMB 1.26 trillion ($194 billion) in December. The broad M2 money supply increased 9.4% yoy in January, decelerating by 0.7 percentage points from December. The PBOC continued to take modest steps to reduce liquidity in February by allowing hundreds of billions of yuan worth of reverse repo and MLF loans to mature, while balancing this with smaller short-term liquidity injections and rolling over RMB 200 billion ($31 billion) of one-year MLF loans. While the overnight reverse repo rate cooled to 2.12% as of February 26, it remains higher than the beginning of the year. The PBOC also kept the loan prime rate — the country's benchmark lending rate — unchanged for the 10th consecutive month.

FISCAL POLICY

China has already begun to tighten its fiscal stance as local government revenues show signs of post-Covid recovery and the release of funding for new infrastructure projects has slowed. The Ministry of Finance (MOF) has yet to release local government bond quotas for 2021. The delay could be because the government is reassessing what fiscal support may be necessary in light of the ongoing economic recovery. This year, the quota for special purpose bonds (SPBs) – a policy tool traditionally used as infrastructure stimulus – is projected to be cut to RMB 3 trillion ($463 billion), down from last year's record RMB 3.75 trillion ($579 billion). In February, over 20 provinces and cities announced major infrastructure projects worth a total of RMB 25 trillion ($3.86 trillion) for 2021. Separately, a majority of localities reported fiscal revenues began to recover in January, with some reporting double digit growth. The growth reflects a steady economic recovery as well as base effects following last year's 0.9% yoy decline in local receipts.

INTERNET ANTI-

China tightens oversight of the tech sector through release of anti-monopoly rules for internet platforms. China's State Administration of Market Regulation (SAMR)

MONOPOLY RULES

released the final version of the *Anti-Monopoly Guidelines on Internet Platforms* on February 7. Taking effect immediately, the speed of the release – less than three months after the initial draft – demonstrates the government's urgency to tackle regulatory challenges from China's tech juggernauts (see "fintech sector" below). The *Guidelines* seek to curb anti-competitive practices that discriminate against small market players, such as providing services below cost to keep competitors out of the market. The guidelines also ban the sharing of sensitive user data to protect consumer privacy. The final version diluted language on some platform common practices such as differentiated pricing for different consumers of the same product. However, it also provided more detailed measures on how to define and remedy problematic behaviors such as monopoly agreements, abuse of dominant market positions, and abuse of administrative power to prevent competition. December's Central Economic Work Conference indicated greater enforcement of the *Anti-Monopoly Law* in 2021 as the government seeks to rein in "disorderly capital expansion."

RURAL REVITALIZATION

Government spotlights rural development strategy through new agency and policy measures. The National Administration of Rural Revitalization (NARR) made its formal debut at the end of February, replacing the leading small group office for poverty alleviation under the State Council. It will sit under the management of the Ministry of Agriculture and Rural Affairs (MARA). An extension of President Xi's poverty alleviation goals, the government announced in 2017 that it would prioritize "rural revitalization" by expanding economic development in rural areas through agricultural and land reforms. Even after urban migration reduced China's rural share of the population from 74% in 1990 to only 40% by 2019, raising the standard of living in rural areas remains an essential component to meeting China's poverty alleviation targets and transitioning the Chinese economy to a consumption-driven growth model. Rural development is expected to feature prominently in the upcoming 14th FYP. On February 1, the State Council released the *No. 1 Document* for 2021 – the government's first policy document of the year. Like No. 1 Documents released for almost two decades, it focused on rural development, announcing over 20 measures to build on earlier progress made through China's poverty alleviation campaign and transitioning to a long-term rural revitalization strategy. In line with the timeframe of the upcoming 14th FYP, this document declares that China will "achieve major progress" in agricultural and rural village modernization by 2025.

Key Industry Updates

FINTECH SECTOR

New regulatory restrictions on fintech expected to slow sectoral growth. Over the last two months, the PBOC and the China Banking and Insurance Regulatory Commission (CBIRC) issued a raft of new regulations on online lending, online insurance, online credit reporting, and mobile payments. In February, regulators also finalized anti-monopoly rules for internet platforms (see "Internet Anti-Monopoly Rules" above) and released the final guidelines for internet loan operations of commercial banks, which will slow the growth of a major business line for Alibaba's fintech arm Ant Group. Released on February 20 by CBIRC, the new rules state that online lending partners of commercial banks must contribute no less than 30% of the funds for a loan, closing a loophole exploited by online lenders that allowed them to generate revenue from loans while limiting their own leverage risks. The rules also ban cross-regional online deposits and lending, which will curb the scope of platform operations. The new restrictions will curtail growth for Ant Group and other lending platforms, primarily by increasing their capital needs. After Ant's IPO suspension, the government's anti-trust probe, and a new restructuring plan that will turn Ant into a financial holding company, Ant has been forced to reduce its operations, allowing rival online lenders to rush to fill the vacuum.

RETAIL SECTOR

Pandemic travel restrictions boost consumption as Chinese citizens are forced to stay home and spend locally. China's Ministry of Commerce reported that offline and online consumption at major retailers and restaurants rose by 29% to RMB 871 billion ($127 billion) during February's seven-day Lunar New Year holiday compared to last year. However, consumption during last year's holiday had already been impacted by pandemic lockdowns and travel restrictions. Compared to 2019, consumption still increased by 4.9% this holiday season. Instead of buying train and plane tickets, consumers redirected disposable income towards gifts, food, and entertainment, which had been hit hardest by last year's pandemic lockdowns. Jewelry sales rose by 160.8% yoy and apparel rose by 107.1% yoy due in part to base effects. Sales of communications devices at major retailers rose by 39% yoy, and home appliances and digital device purchases increased 29.9% yoy.

Geopolitical Trends with Business Implications

U.S.-CHINA TRADE

U.S. agricultural exports forecast to reach record levels in 2021 even as China falls short Phase One trade agreement purchase commitments. The U.S. Department of Agriculture estimated in the most recent quarterly forecast that U.S. agricultural exports to China will reach an estimated $31.5 billion in 2021, increasing its forecast by $4.5 billion compared to the USDA's predictions last November. By the end of 2020, China had imported $99.9 billion of U.S. products covered under the U.S.-China Phase One trade agreement, only about 58% of the $173 billion it committed to purchase last year, according to estimates made by the Peterson Institute of International Economics. During her Senate confirmation hearing last week, USTR Nominee Katherine Tai reiterated that the Biden administration would maintain tariffs on over $350 billion worth in Chinese products for the foreseeable future, as the administration assesses the trade relationship over the coming months.

SUPPLY CHAINS

Biden administration launches review of U.S. supply chains for critical and essential goods and signals it will move forward with Trump-era rule that expands power to block business transactions that pose national security risks. On February 24, U.S. President Joe Biden issued an executive order directing U.S. federal departments and agencies to initiate a comprehensive evaluation and risk assessment of America's supply chains for critical goods and sectors. Besides requiring 100-day reviews of four specific product areas (semiconductors, rare earth minerals, high-capacity batteries, and pharmaceuticals), the order also requires year-long reviews in six sectors: defense, public health, information and communications technology, energy, transportation, and agriculture. The executive order does not specifically mention China. However, reducing American reliance on China for critical goods is clearly an intended aim of the comprehensive review. The White House fact sheet further states that America must guarantee "…potential actions by foreign competitors and adversaries never leave the United States vulnerable again." The Biden administration reportedly also plans to allow a new Commerce Department rule on technology supply chains to take effect in March. The rule, which was drafted by the Trump administration last year, provides the U.S. Commerce Department with the authority to review and potentially prohibit business transactions involving ICT technologies with “foreign adversaries,” including China and Russia, it assesses could pose a national security threat. A number of U.S. business organizations have urged the Biden administration to abandon or significantly curtail the rule, arguing that it could threaten innovation and significantly expand compliance costs. The Commerce Department is accepting comments on the rule until March 22. At that point the Department may allow the rule to enter into force, or issue a modified final rule.

Economic Indicators

The Chinese government’s National Bureau of Statistics has issued only limited January/February data as of March 2, 2021. As per China’s normal practice, remaining data for January and February will be combined and released in March following a delay due to the Lunar New Year holiday.

Output and Investment (yoy)

MANUFACTURING PMI	50.6	The official manufacturing Purchasing Managers Index (PMI) dipped lower than expected to 50.6 in February from 51.3 in January, indicating slowing in factory activity due in large part to the Spring Festival holiday, but remained above the 50-point mark that demarcates contraction.
SERVICES PMI	51.4	The official non-manufacturing PMI slowed in February to 51.4, its lowest since last spring, from 52.4 in January, indicating a deceleration in service sector activity likely spurred by both the holiday and localized Covid-19 outbreaks throughout the country.
HOUSING PRICES	0.28%	Prices for new homes in China’s 70 major cities rose 0.28% in January compared to December, after increasing 0.12% month-on-month for the last two months.

Prices (yoy)

CONSUMER PRICE INDEX	0.3% decrease	Consumer prices deflated in January after returning to marginal 0.2% growth in December. The fall was in line with expectations, driven by a base effect distortion since the high-consumption Spring Festival holiday happened in January of last year, but fell to later in the calendar this year.
PRODUCER PRICE INDEX	0.3% increase	Producer prices finally returned to growth in January, after falling for 11 consecutive months and decreasing 1.8% overall in 2020. Price increases were driven by rising costs for raw materials and growing demand.

About ASG

Albright Stonebridge Group (ASG) is the premier global strategy and commercial diplomacy firm. We help clients understand and successfully navigate the intersection of public, private, and social sectors in international markets. ASG’s worldwide team has served clients in more than 110 countries.

ASG's China Practice has extensive experience helping clients navigate the Chinese market. For questions or to arrange a follow-up conversation please contact Marika Heller.