China Briefing

2021 and beyond: Where China's economy is going

Executive summary

- China thinks its economy is back on track; headline economic growth will be well above 5% next year. There are still problems with rebalancing, a need for far greater levels of consumption, and concerns with SOE debt. However, on the plus side, there is also some scope for central fiscal stimulus packages.
- The recent annual meeting of China's leaders, focusing on the economy, outlined plans for technological upgrading, which leaders see as making China more self-reliant in case of access being cut off from foreign products, and allowing more "green growth". The plan is 'demand side' reform, focusing on housing policy and wealth redistribution as a way to grow domestic consumption.
- Globally, China expects a rocky road, no matter who is in the White House. It doesn't want to decouple, but it wants a two-track plan whereby it can maintain its own supply chains internally should it be shut off from the world. There will be considerable top-down support for green energy and tech companies.

Where China is going

COVID-19 hit China hard. While it didn't fully shut the economy down in the first quarter of the year, there was significant downturn and the government really only got back on track in May. The first "normal" Politburo study meeting happened in May this year, when normally there would have been six meetings, signalling that China only thought itself able to shift from a pandemic war footing then.

Even today, issues still remain. Post-May, investment growth was mainly in real estate and consumer spending is still down 6% year-on-year. This is flowing through to a tight jobs market.

But on the whole, China's government should feel pretty good. The second half of this year gave rise to a "V-shaped" recovery. China's economy grew at 4.9% in the third quarter of 2020, and may well exceed 5% growth in the fourth quarter. This sets the scene for a strong 2021. In this Briefing, we examine what China's 2021 economy might look like.

Twice a decade, China's leaders tell us where they want the nation to go. They outline their goals and economic targets. After that, the rest of China must fill in the blanks with various plans, comments, drafts, and decisions. China's importance to the world economy makes it vital to decode the signals from this data. And a major signal was the recent meeting of all of China's senior leaders (called a plenum) devoted to the five-year plan ("**FYP**"), the document that outlines exactly where the economy should go.

Each FYP acts as a top-level national blueprint for a wide range of policy goals. Originally a function of having the state plan all elements of economy and society, the FYP today sets the priorities, especially in areas like macroeconomic strategy, energy policy and major infrastructure.

While the final document with numerical targets and policy details only comes out in March next year, in the meantime, every local government and individual ministry will need to get busy making their responses. Targets will now be "indicative" (GDP, rate of urbanisation, health care goals) or "binding" (poverty, air improvements, reconstruction of slums). The binding targets are the ones to watch.

We discuss what the choice of binding over indicative targets mean below. But one further point before we get to that, is the question of local ability to fulfil the aforementioned plans. Right now, the local government is not where China has room to move. In the first three quarters of 2020, China's general public budget expenditure fell by 1.9%, but public revenue fell yet further — 6.4% for the first three quarters. Local governments were major contributors to this. When cash-strapped, they finance their deficits by issuing their own special project bonds; but they have already met this year's quota.

Rather, along with many high-profile Chinese economists, we think that China has a lot of room to increase central fiscal spending. There is dry powder. The core consumer price index was just 0.5% in October. Officially, public debt is 53% of GDP. Chinese pension funds entrusted for investment achieved a 9.03% return rate last year, the highest since 2016.

The problem is that, in theory, local debts will be repaid by revenues from the relevant investment projects, but that will be hard; see our last Briefing on China's Goldilocks Debt Problem. Should China solve this imbalance between centre and local government, it would have much more room to move. To us, this is the key battle facing China.

There is also a demographic problem. Michael Pettis' research shows that while there are currently 4.7 Chinese of working age for every equivalent American, by the end of the century there will be only 2.4. Beijing can boost consumption only by managing a massive redistribution of income to ordinary households.

Beijing's Five Year Plan solutions

The new FYP unveiled at the plenum is Beijing's response to these challenges. The key areas that they will have to cover are "quality growth" and "innovation and technology". China's leaders expect their economy to slow. They are now chasing a better type of growth: one of "innovation, efficiency, and environmental protection". (The Wall Street Journal thinks that the new goal for 2035 will be "per capita gross domestic product of about USD 30,000 a year…somewhere around the levels of South Korea and Spain". That will give China more flexibility to plot its economic course, although it will still mean a growth rate of around 5% per year.)

China sees technology as a way to avoid the "middle-income trap", whereby the industries that help rapid economic growth are not able to sustain another growth spurt. Innovation may allow China to shift to a more domestic, consumption-led economy and modernise agriculture and rural areas so as to boost crop yields as well as reduce some of the load on China's cities. In practice, that is likely to mean a huge amount of top-down investment in the following research priorities:

FYP research priorities

- Artificial intelligence
- Quantum information
- Integrated circuits
- Life and health science
- Neural science
- Biological breeding
- Aerospace technology

China has attempted to transition from an export-driven to a consumption-driven economic model before with limited success. This was the focus of the 13th FYP ("Everyone is an entrepreneur… using the creativity of the masses"). That is because China's issues — housing, regional inequality, SMEs, regulatory and food safety, improving community medicine post-COVID — cannot just be solved by technology. All of these issues, for what it's worth, are in the FYP. So why do we think this time might be different?

First, because much of China's investment can be funded top-down. China can make plans for bottom-up reform. But it struggles with the plumbing, the way to join everything together. For example: China's personal income tax is only 1% of GDP, making it hard to boost consumption through household tax cuts. Similarly, additional land market liberalisation would greatly help many goals. But that has been discussed as a measure since 1996; avoiding local incentive conflicts is just too hard.

China's leaders, to their credit, are very aware of China's incentive problem. The new FYP proposes to improve technology uptake through improving IP rights, and intriguingly through investing more in basic research (i.e. research without a specific target). Neither were traditionally strong points of the Chinese government. And they see "entrepreneurs" as the key to technological innovation, with firms footing the bill, aided by tax breaks for basic research. Technology has been put on a pedestal above all other concerns. According to the Minister of Science and Technology, Wang Zhigang, "Technological autonomy and self strength…has become the primary mission of all different plans."

But let us be clear as to why China is doing this. According to China's highest economic planner (Liu He), the ultimate objective to be achieved by the new strategy is to "increase the autonomy, sustainability, and resilience of economic development." The autonomy part of this sentence is crucial. If China cannot buy, it must make. China's stated goal is to become a "technology superpower". But the US and other developed countries are increasingly circumspect about China's technological development and want to prevent China from benefiting further from foreign technologies, including foundational and emerging technologies, which could have military uses. So investments in "quality growth" and "innovation" is defensive as much as expansionary.

Winners and losers

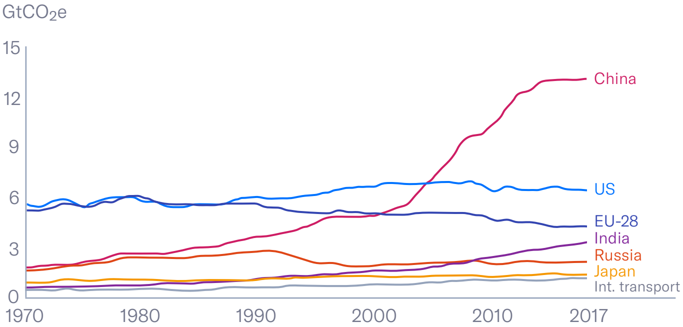
The new FYP comes at a particularly momentous juncture. China's relationship with the United States is being described as a new Cold War, as its technology firms are being given the cold shoulder by the US and its allies.

China's leaders think that the international environment is at the point of "100 year-type change". China's economic super ministry said that it expected this adjustment to last "a considerable time", exacerbating the already rising protectionism and shortening of global production chains. "The traditional global economic model of 'East Asia produce — US and Europe consume — rest of the world supply resources' is likely to be reshaped," potentially "weakening China's status as the world's factory".

But China does not wish for this to totally occur. "Complete decoupling is not realistic. And it is not good for China, the United States and the whole world," a Central Committee briefing argued. "The truth is very few would really want to see the two countries decouple. Most would want our two countries to cooperate and work together." China's main economic planners said: 'China-US will be the "biggest external uncertainty" that restrains China's medium- and long-term development but "time is on China's side"'. In other words, China-US relations are a matter of planning for the worst but hoping for the best.

The world in many ways needs to choose, too. For as attractive as it may appear to policy makers to quell China's technological innovation due to security fears, the world also needs China to go green.

That is because China is beginning to set increasingly ambitious zero carbon goals. By 2035, carbon emissions are to be "steadily declining after reaching their peak, and the ecological environment improved". As the world greatly needs China's emissions to reduce in order to reach any of the global goals, the government's success or failure in this task will be of global significance.



China's contribution to Global Greenhouse Gas Emissions without changing current behaviour (United Nations Environment Programme 2019)

These goals will be hard to reach. China's share of global emissions increased from less than 20% in 2010 to around 26% in 2019. Coal-fired power plants are China's single largest CO_2-emitting sector. China currently has approximately 130GW of excess coal-fired capacity, or more than 10% of the total capacity, and because these coal plants are fairly new, shutting them down would cost more than USD 300 billion. Let us be clear: there will be a lot of investment in green energy in China, and an enormous sum at stake.

Meeting a steady decline would require a few things. There would have to be a price on carbon. To achieve China's non-fossil power target of 50% by 2030, wind and solar need to at least double in comparison to the average over the past 10 years to achieve a share of more than 20% of all power generation by 2030. To compensate for the large probability of deceleration of hydro and nuclear power, 25% is a more robust figure. New sources such as hydrogen will need to be developed.

While this seems a bridge too far for some, we think that China might be able to do it. China is likely to focus on alternative energy sources where there is competitive advantages, so it can rely less on imported energy, including coal from countries such as Australia, where there is already a spat on political and cultural grounds that has affected economic relations.

Expect, also, some amazing progress and serious innovation coming out of China in this area. The British National Grid, for example, went from being 40% coal powered to 2% coal powered in eight years. World-leading companies are already developing to meet these green commitments. We are already talking with a number of new investors about these companies. Whatever happens to China's economy, the top-down impetus to go green will, alone, ensure considerable growth in the sector.

Can China go out?

The final part of this international outlook is that any technological innovation will invariably involve China developing a new tech giant, the same way that Alibaba and Tencent now run Chinese society. Xi's closest economics advisor Liu He, for example, said that Chinese firms were now working on core technologies their foreign rivals have a stranglehold on, and that is improving China's macro-economy, "Now, the bad things are turning into good ones," as he puts it.

The FYP is helping this due to including specific, new language on helping safeguard Chinese firms overseas. So this tech giant does not need to be based within China. Another FYP report noted that "the centre of global economic growth has accelerated its shift from developed economies to emerging markets…and emerging economies and developing countries are counting increasingly on China on major issues. There are growing expectations on us to better play 'China's role' in unleashing and leading a new round of globalisation."

What will China's role be?

This will grow through the impact of infrastructure. With the national 5G mobile broadband grid on track for completion by 2024, China will begin to lead the world in smart-city traffic management through 5G sensors and AI; through telemedicine; and finally, through farm 5G networks that measure fertiliser, pesticide, and water requirements, and direct delivery of inputs via drones and driverless vehicles.

Informed by our long experience with Akulaku, we see this as potentially even being a Chinese model of business (such as fintech) going out to a booming market (such as Southeast Asia) and making a go of it. The FYP is a clear green light for this. The best Chinese products, such as Ant, are highly competitive with best-in-class Western products such as Stripe, and China made around 50 times more online payments than the United States last year. We expect much investment in this area.

COVID-19 has shown that China's technology companies have the reach, speed, and capability to develop an array of new markets. Take for example the Alibaba system Health Code, which identified people at risk of COVID-19 by analysing their self-declared health status, travel history, and the people they have been in close contact with. It has since been applied to insurance payments. This trend of Chinese advances will continue.

For foreigners, this means a range of things. Credible foreign investors or entrants will be seen as boosting the economy, and policy changes aimed at helping these companies shall be introduced. But at the same point, there will be significant pressure from home to consider their dealings with China. Foreigners will need to be nimble, to expect greater frictions in dealing with China and with Chinese firms overseas, and finally, to be green. But, as this paper has shown, should that be possible, there shall be enormous opportunities.

What is less explored is that China's growth shall be somewhat lumpy, and will cut across multiple sectors. Take for example the much-lambasted SOEs. While there are many, many bureaucratic behemoths taking capital from better-deserving private counterparts, there are also some world-leading SOEs. These are already some of the biggest companies in the world, and they will have huge influence on listed companies through their activities plus funding. Some examples: State Grid and Ultra High Voltage (UHV) power SOEs and also clean energy, Railway Corp and high-speed rail equipment, PolyCorp and nano-tech. In all of these cases, SOEs will partner with private firms; bringing giant lumps of state capital and guaranteed government purchase contracts to China's many talented tech titans.

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