# AT A GLANCE | China

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## "Beyond the Eyes of China"

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When an economy recovers from the coronavirus disaster, the track of economic recovery often becomes the subject of debate. Various recovery paths are being discussed, from the prolonged stagnation of "L-shape," and the rapid recovery of "V-shape" to the gradual recovery of "U-shape," which shows slow but gradual acceleration. Recently, some have proposed the view that, in China, it is a "K-shaped" recovery, indicating the polarization of society.

Against the backdrop of the global economic resumption after the first wave of infection and the subsequent decline in the incidence of serious infections and mortality, the likelihood of the global economy recovering with an L-shaped path has decreased, but it is unlikely that the V-shaped recovery will be achieved.

However, when we look at individual countries, there are differences depending on the extent of damage from the coronavirus pandemic and the industrial structure. At the very least, the recovery of the Chinese economy is close to a V-shaped one as far as we can confirm the economic indicators that are at present available.

In the first part of this report, we review the latest economic situation in China, and in the latter part, we discuss China's exchange-rate policy, fiscal policy, and risk factors.

### Monetary Easing in Response to the Crisis Has Ended, and Interest Rates Have Risen Markedly

First of all, we would like to examine the financial situation.

Since March of this year, the total social financing, which indicates the state of fundraising in a whole society, has grown rapidly, mainly in CNY-based loans (Figure 1). The growth rate has stopped rising since July, but has remained high.

The breakdown of loans from banks to corporations shows that the overall growth in loans has also remained high (Figure 2). In addition, the components have been changed, and demand for funds required for working capital, which has expanded rapidly since the beginning of this year, leveled off around May and June, while demand for medium- and long-term funds required for capital investment, etc. has expanded.

This is due to the fact that the tight cash flow caused by the coronavirus disaster at the beginning of the year has gradually improved, and the demand for investment in anticipation of future growth is currently expanding. In particular, demand for infrastructure investment backed by large-scale fiscal policies and production expansion to meet recovering overseas demand have led to increased demand for capital investment funds.

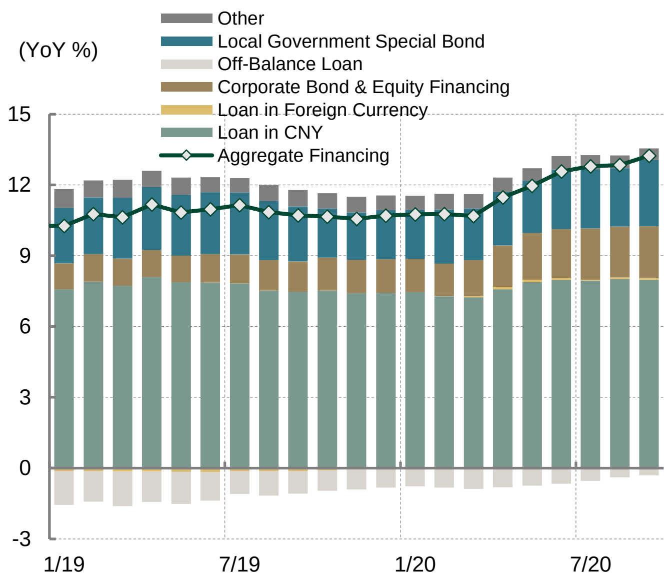
In response to these developments, China's central bank, the People's Bank of China (PBOC), temporarily halted the expansion of liquidity provision in May in response to the crisis caused by the coronavirus pandemic (Figure 3). Of course, since the recovery of the economy is not robust, the PBOC needs to remain accommodative and carefully adjusts its liquidity supply in its daily operations to prevent excessive monetary tightening.

However, the rise in interest rates is conspicuous (Figure 4). In China, where the spread of the novel coronavirus (COVID-19) infection was contained in March, demand for funds increased as economic activities resumed. On the other hand, the PBOC absorbed the liquidity of CNY, which was supplied on a large scale as a countermeasure against COVID-19, by 1 trillion yuan from June to July. As a result, the yuan's interest rate, which had been on a downward trend until March, gradually rose. Government bond yields on all maturities have recently exceeded the level at the end of 2019 before the coronavirus disaster, and super-long-term interest rates are approaching the level at the end of March 2018 (just before the escalation of trade frictions between the U.S. and China). This will increase the cost of raising working capital for small and medium-sized private companies, which have relatively low creditworthiness, and may put pressure on their management.

The authorities have not withdrawn their attention on reducing the funding costs of small and medium-sized enterprises (SMEs), and therefore have not raised the prime loan rate (LPR), which is the standard for interest rates on general loans, in line with the recent rise in market interest rates. However, interest rates on note loans used to raise working capital, etc. tend to be linked to market interest rates, which may lead to an increase in firms' funding costs. Although the nominal GDP growth rate in the July-September quarter of 2020 increased by 5.5% from the previous year, we feel that the pace of increase will be somewhat faster if it approaches the level of interest rates in the first half of 2018, when the growth rate increased by more than 10%.

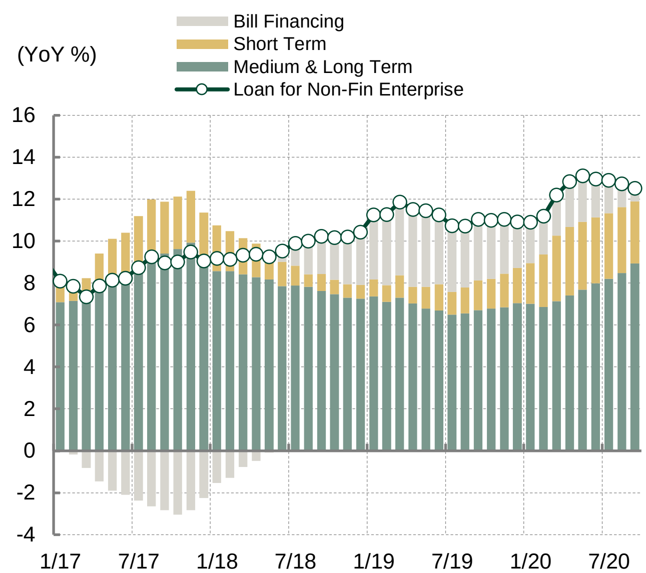
The PBOC will increase its liquidity supply, particularly in the money markets, if there are signs that this increase in interest rates will not only cool down the buying frenzy of real estate but also hinder corporate fundraising.

**Figure 1: Total Social Loans (compared to the previous year)**



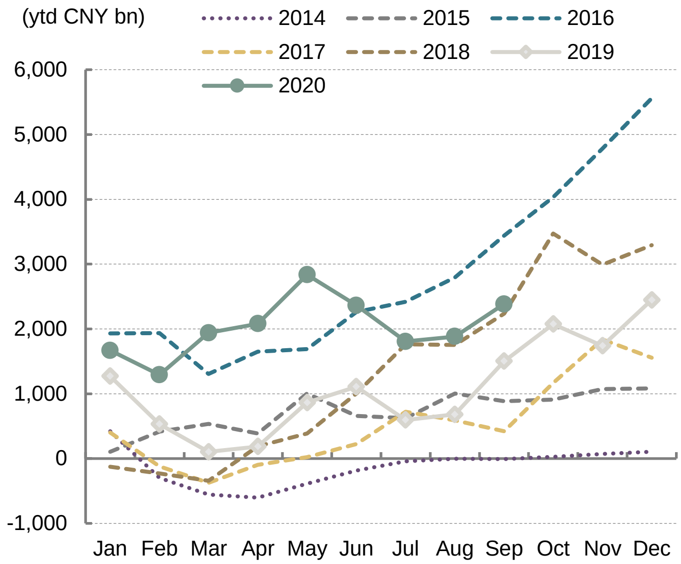

Sources: PBOC, CEIC

**Figure 2: Breakdown of Loans to Non-Financial Corporations (compared to the previous year)**



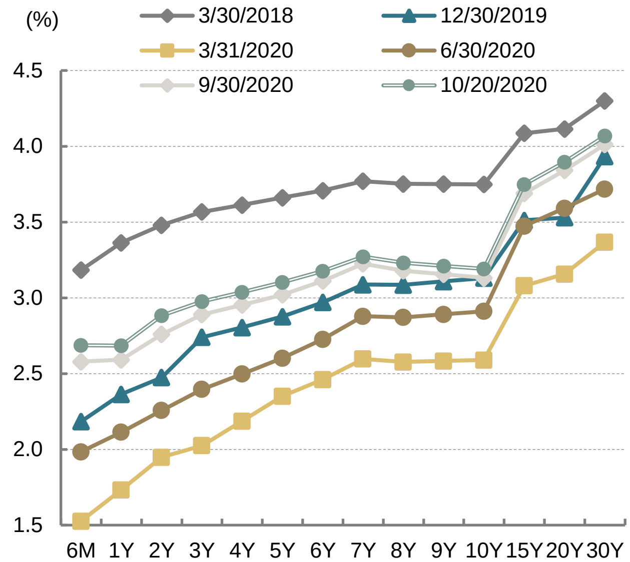

Sources: PBOC, CEIC

**Figure 3: PBOC Liquidity Provision (year to date)**




Sources: NBSC, Bloomberg

**Figure 4: Yield Curve of Chinese Government Bonds**




Sources: PBOC, Wind

## Strong Macroeconomic Indicators Show China's V-Shaped Recovery

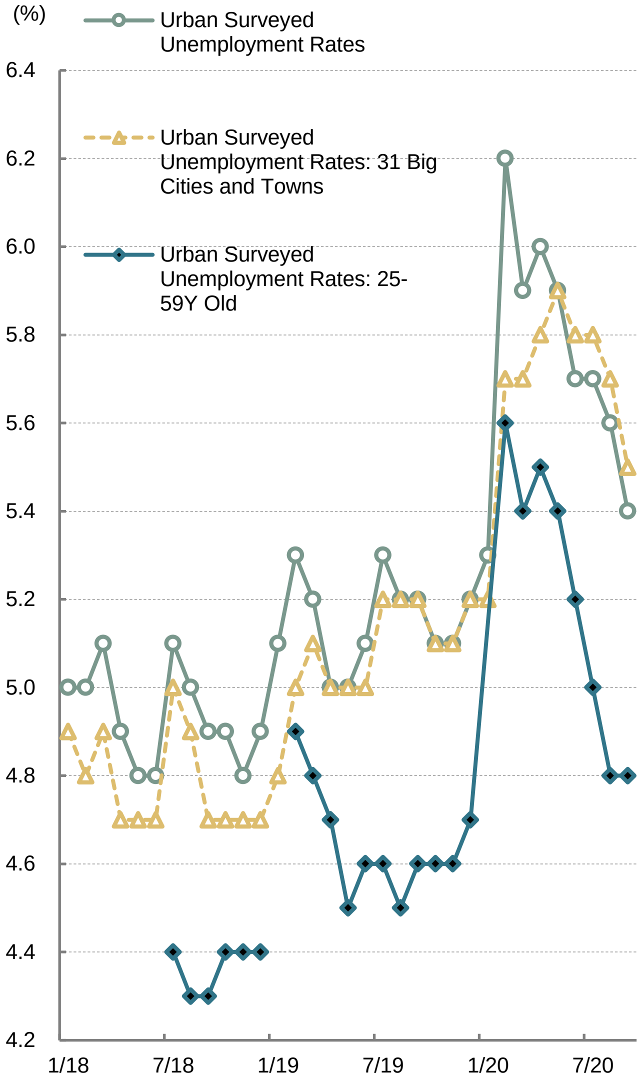
China's key economic indicators, including its GDP growth rate, released by the authorities on October 19, once again confirmed the continued recovery of the Chinese economy (for more information, see China Economic Comment (October 19, 2020)).

Industrial production and fixed investment far exceeded market expectations, and consumption, which seemed to be lagging, showed signs of recovery. Production growth remained firm on the back of expansion of domestic demand resulting from the government's large-scale fiscal policy and an increase in foreign demand. As for investment, real estate investment was robust, and in addition to state-owned enterprises and infrastructure investment supported by fiscal policy, there was also a recovery in capital investment by private enterprises and the manufacturing industry, which led to autonomous economic growth.

Along with these economic recoveries, the employment environment continues to improve. The September urban unemployment rate (sample survey) was 5.4% (market expectations: 5.5%; August: 5.6%), which was better than the market expectation (Figure 5). With the unemployment rate at age 25-59 leveling off, the overall unemployment rate has improved, and the number of new jobs created in September per month has improved to the average level (Figure 6).

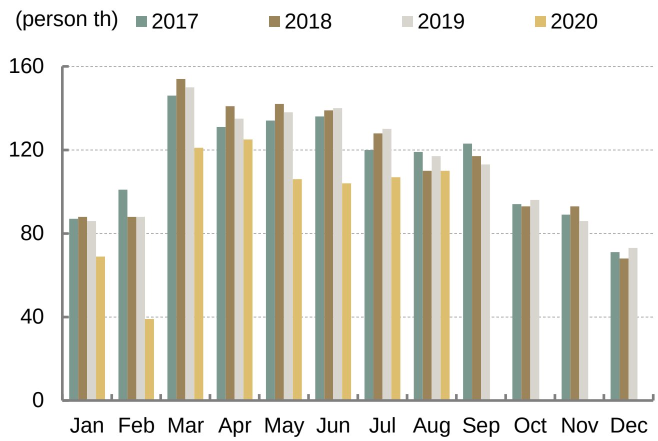
People's incomes have begun to improve as employment improves (Figure 7), and the slowdown in personal spending has narrowed accordingly. If the employment situation improves further, consumption is expected to increase further.

**Figure 5: Urban Unemployment Rate (sampling basis)**



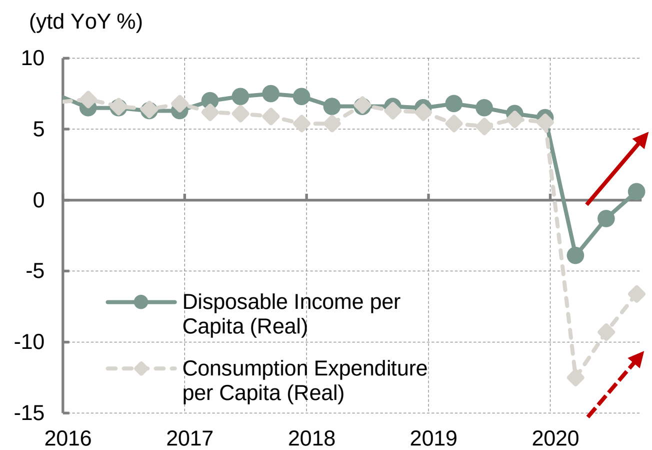

Sources: NBSC, CEIC

**Figure 6: Creating New Jobs (monthly)**




Sources: NBSC, CEIC

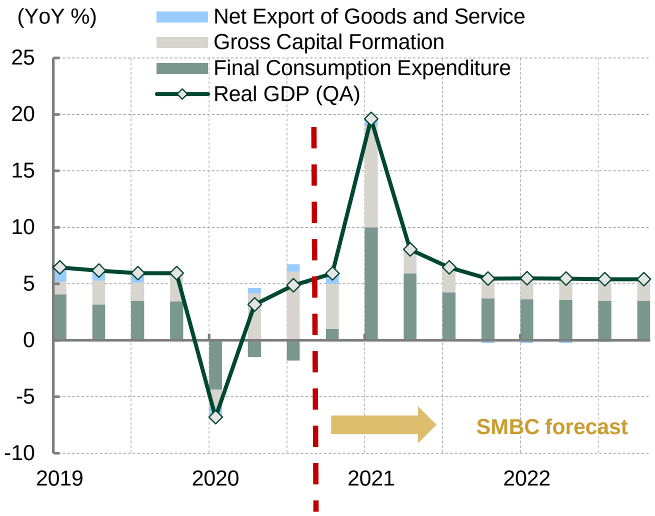
**Figure 7: Real Disposable Income and Personal Expenditure per Capita (compared to the previous year)**




Sources: NBSC, CEIC

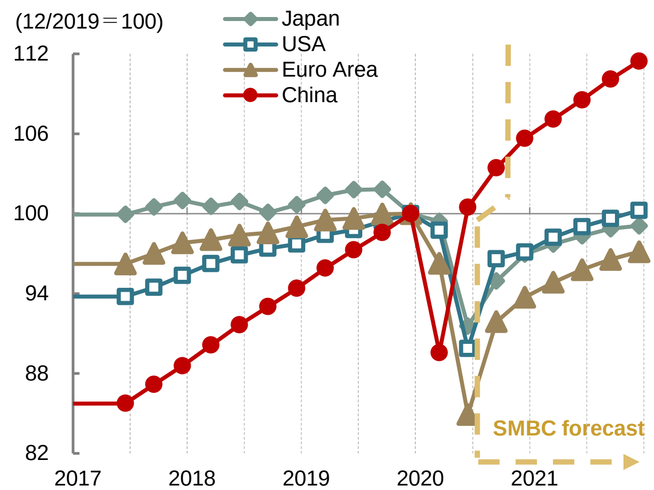
It is true that economic assistance measures implemented in the first half of this year were the key to solving economic stagnation caused by the coronavirus disaster. At present, however, private companies and individuals are gradually expanding their economic activities, which will lead to autonomous economic growth driven by private investment and consumption in the first half of next year (Figure 8). The recovery path for the Chinese economy is already in a V-shape (Figure 9).

**Figure 8: Actual and Projected Real GPD Growth Rates (compared to the previous year)**




Sources: NBSC, CEIC

**Figure 9: GDP Recovery Path in Japan, the U.S., Europe, and China**




Sources: Bloomberg, CEIC

## Future Direction of the Chinese Authorities

(1) Exchange Rate Policy

As the yuan continues to appreciate, the PBOC has allowed the nominal effective exchange rate "yuan index" of the yuan to rise (Figure 10). The index, which was around 93.0 in early September, has risen to over 95.5, up about 2.7% in about one and a half months, and has risen about 2.1% against the U.S. dollar.

In response to the rapid rise in the value of the yuan, the central bank would have restrained the value of the yuan through statements by key figures and the setting of daily CNY standards, and intervened in foreign exchange markets as necessary. However, PBOC Governor Yi Gang recently remarked that "exchange rates should be left to market decisions" and daily operations show no signs of slowing down and stopping the trend.

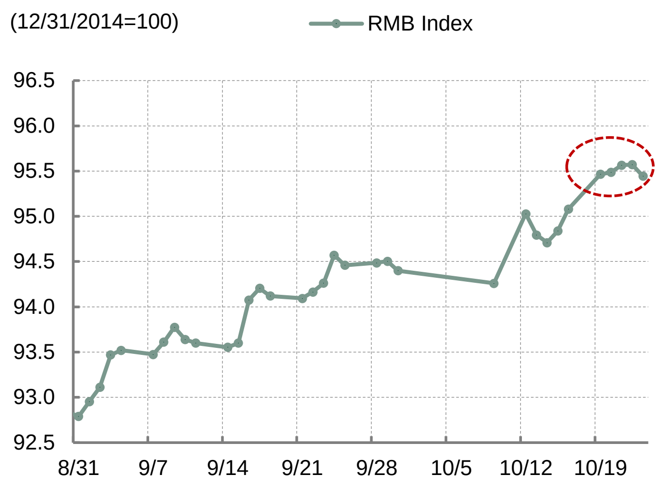
If the authorities leave the exchange rate level to market decisions, the yuan will continue to appreciate against the backdrop of China's economic recovery ahead of the rest of the world and the expanding trade and current account surpluses.

Looking around the world, low interest rates are expected to continue for the time being, as the U.S. and other countries have maintained their monetary easing measures in response to the crisis caused by the coronavirus disaster. While the excess liquidity created by this easing policy is seeking higher yields from investors around the world, capital inflow into the Chinese bond market, where interest rates are relatively high, continues (Figure 11). The inclusion of Chinese government bonds in the global bond index also boosted investment funds from overseas into Chinese government bonds, which would also exert strong pressure on the government.

Therefore, as long as the authorities acquiesce, it is highly likely that the yuan will continue to appreciate.

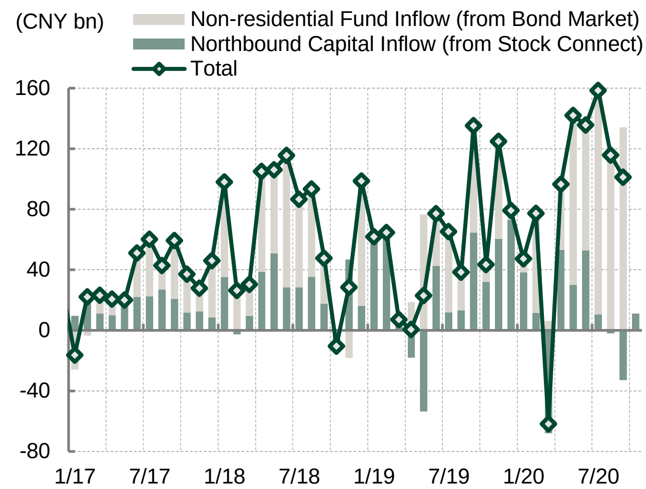
In view of the PBOC's long-term vision of promoting the internationalization and liberalization of the CNY, and the current position of the PBOC, it would not be surprising if (as early as this year) the allowable intraday volatility of the CNY (reference value ± 2%) were abolished in the near future.

**Figure 10: Recent Trends in the Yuan Index**




Sources: PBOC, Bloomberg

**Figure 11: Investments in Stocks and Bonds by Non-Residents**




Note: Data section bonds: by the end of 9/2020; stocks: up to 10/20/2020

Sources: SSE, SZSE, HKEX, China Bond, Wind, Bloomberg

(2) Fiscal Policy

Against the backdrop of a slowdown in economic growth caused by the U.S.-China friction that began in earnest in 2018, China had already expanded its fiscal policy from the latter half of 2018 to 2019, before the coronavirus disaster occurred.

As countries around the world aggressively expand their fiscal budgets in the wake of the coronavirus disaster in 2020, China is also forced to implement fiscal expansion measures, and the ratio of the general fiscal deficit (exclusion from special account) to GDP is expected to increase to nearly 7% this year (Figure 12).

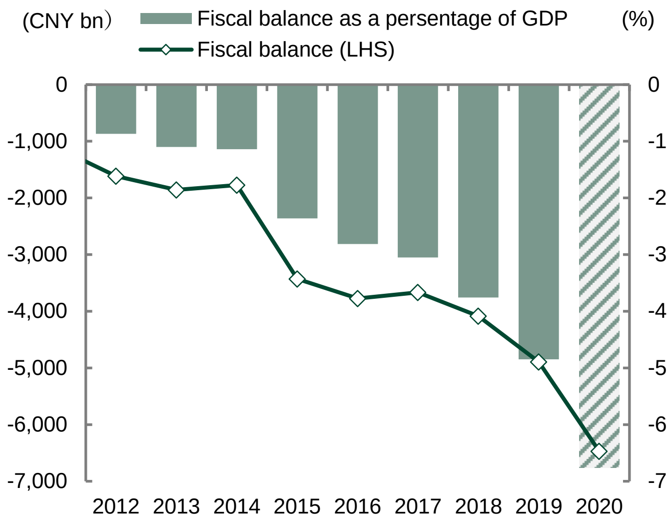
In China, even if the deficit in the general account expands, the government's budget deficit target has generally been held to less than 3% of GDP by combining the budget deficit with the surplus in the special account (sale, etc. of land use rights) and carried over funds. In May 2020, however, the National People's Congress targeted a deficit of more than 3.6% for this year. Against this background, in addition to the scale of fiscal expansion this year, it is highly likely that the amount of money carried over to date has been almost depleted.

Looking at the state of government funds, which account for the majority of the special accounts, the deficit increased in 2018 and then in 2019. Moreover, in 2020, as of August, the deficit was already close to 2 trillion yuan, and it is highly likely that this year will also end with a large deficit (Figure 13).

Therefore, there is a high possibility that the government will start fiscal consolidation during the next fiscal year. In particular, as foreign investors have been pouring money into Chinese government bonds since last year, the focus on China's fiscal discipline is expected to increase more than ever.

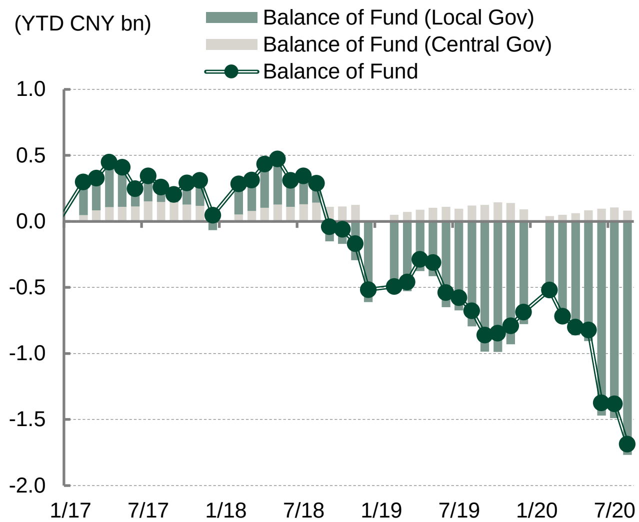
Autonomous economic growth is essential for fiscal consolidation, but the ratio of the fiscal deficit to GDP will shrink next year unless the current economic recovery trend collapses due to major shocks.

**Figure 12: General Account Budget Deficit and Ratio to GDP**




Sources: MOF, CEIC

**Figure 13: Income and Expenditure of GSEF (accumulation at the beginning of the year)**




Sources: MOF, CEIC

## Risks in the Chinese Economy

We would like to consider two risks faced by China, which has achieved solid economic growth.

Of course, the biggest risk is the escalation of the U.S.-China conflict. Although a confrontation with the U.S. is inevitable in the struggle for supremacy, the direction of the U.S. hard-line policy toward China will largely depend on the outcome of the U.S. presidential election in November, so we would like to limit this article to domestic rather than external factors.

At present, what we are concerned about as domestic risks in China are “credit uncertainty” and “social destabilization” and events of that kind have already been identified.

First, we would like to discuss what can be labeled “credit uncertainty”. This is a risk common to many countries, including developed countries, but nonperforming loans have been increasing due to the coronavirus disaster. In China, the number of nonperforming loans has been increasing rapidly, but companies that should have gone bankrupt have been rescued by the massive liquidity supply and temporary bailouts. Many service companies, which have been hit hard by the coronavirus disaster, have also been temporarily bailed out by policy effects.

With the end of the coronavirus disaster, China has stopped easing its monetary policy to deal with the crisis, and the number of corporate bankruptcies is likely to gradually increase. This is illustrated by the sharp increase in the number of defaulted corporate bonds.

As of the end of September, the outstanding amount of corporate bonds defaulted was 502.0 billion yuan, more than 3.3 times the amount in 2019 (151.6 billion yuan). However, this includes the large-scale default (345.4 billion yuan) of the Beijing Founder Group, which collapsed in February of this year due to political reasons. Excluding this figure, the total amount stood at 150.4 billion yuan, but in this year’s first nine months, it has risen to almost the same level as the annual default in 2019.

Although many firms are in the manufacturing sector, defaults in corporate bonds in the real estate sector have recently become conspicuous. Corporate bonds are normally issued by companies with relatively strong financial strength. Still, the number of defaults is increasing.

Therefore, there is no need to mention small, medium and micro enterprises (SMMEs). In the wake of the coronavirus crisis, the government provided generous support to small and midsized companies. At present, therefore, the authorities' monetary policy from the beginning of the year seems to have stabilized the financial situation. However, it is undeniable that problems may arise when the PBOC rolls its working capital, etc., as it is already moving toward eliminating large-scale monetary easing. Banks are suffering from a credit crunch because of bad loans to companies that failed to take advantage of the V-shaped economic recovery.

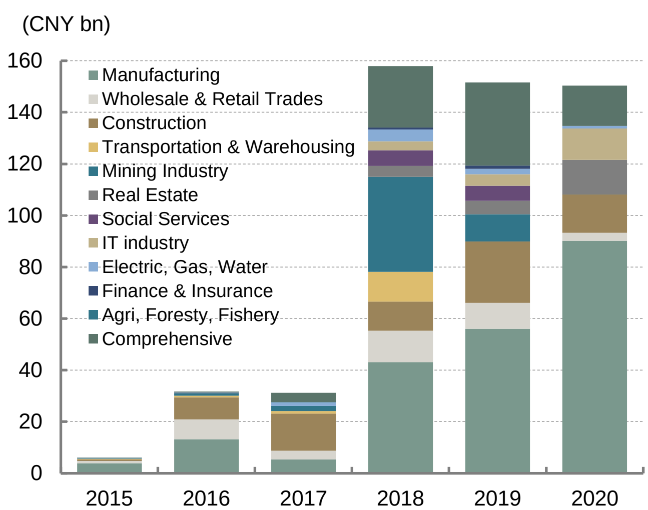
The seed of the "social destabilization" is the widening gap between the rich and the poor. For many years, China has pursued a policy of curbing the widening gap between the rich and the poor, especially between rural and urban areas.

However, due to the coronavirus disaster, this gap may be widening among different industries.

While the number of wealthy Chinese IT entrepreneurs has been reported to be at an all-time high, the income of workers in the service sector, which has been adversely affected by the coronavirus disaster, and the manufacturing sector, which is a labor-intensive industry with cheap labor as its source of competitiveness, will not recover quickly. There are indications that manufacturing companies, which have been forced to raise wages due to labor shortages, will be able to secure labor at lower wages than usual this year, and it cannot be denied that low-skilled workers are in a more severe situation than before the coronavirus pandemic.

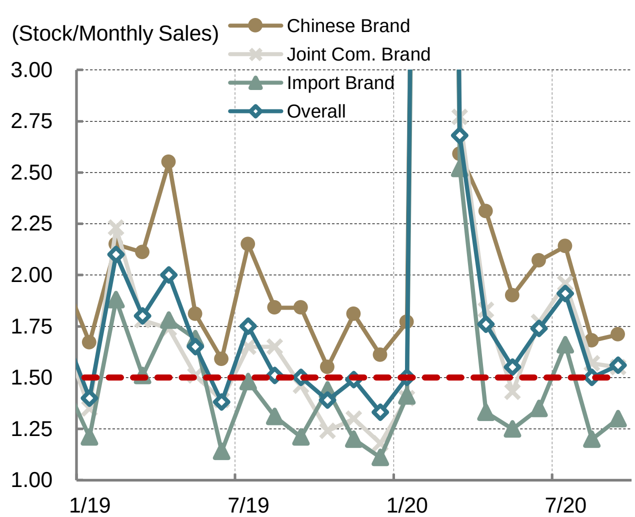
Although there are no hard data available, signs of this can be seen in automobile inventory (Figure 15). Although automobile sales appear to be brisk on a macro basis, inventories of imported cars, which are relatively expensive, as well as those of foreign-affiliated joint ventures, have declined significantly. The gap between the average and median per capita disposable income has also widened this year, indicating the widening income gap.

**Figure 14: Default Bond Balance (excluding Beijing Fangzheng Group)**




Note: Data for 2020 are up to the end of September.
Source: Wind

**Figure 15: Automobile Inventory Index (inventory/monthly sales)**




Source: Bloomberg

Amid the medium- to long-term slowdown in the growth of society as a whole, increasing dissatisfaction—particularly among the poor, due to factors such as widening income disparities and persistently high food prices, particularly for pork—is considered to be the root cause of “social destabilization”.

# Economic Outlook: 2020-2021 Forecast

## Figure 1: Forecasts for Economic Growth, Inflation, and Unemployment Rates

| | | 2019 | | | 2020 | | | | 2021 | | | | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | | |
| US | Real GDP | 2.0 | 2.1 | 2.1 | −5.0 | −31.4 | 33.6 | 2.1 | 4.6 | 3.3 | 2.5 | 2.5 | 2.9 | 2.3 | −3.6 | 3.9 |
| | Inflation | 1.6 | 1.7 | 1.6 | 1.7 | 1.0 | 1.5 | 1.6 | 1.6 | 2.0 | 1.8 | 1.8 | 1.9 | 1.6 | 1.5 | 1.8 |
| | Unemployment | 3.6 | 3.6 | 3.5 | 3.8 | 13.0 | 8.8 | 7.6 | 7.2 | 6.9 | 6.7 | 6.5 | 3.9 | 3.7 | 8.3 | 6.8 |
| Euro Area | Real GDP | 0.2 | 0.3 | 0.0 | −3.7 | −11.8 | 8.2 | 2.0 | 1.2 | 1.0 | 0.8 | 0.6 | 1.9 | 1.3 | −8.1 | 4.8 |
| | Inflation | 1.3 | 0.9 | 0.9 | 1.1 | 0.2 | 0.0 | 0.2 | 0.4 | 1.0 | 1.1 | 1.2 | 1.9 | 1.2 | 0.4 | 0.9 |
| | Unemployment | 7.6 | 7.5 | 7.4 | 7.2 | 7.8 | 8.2 | 8.8 | 9.0 | 9.0 | 8.9 | 8.8 | 8.2 | 7.6 | 8.0 | 8.9 |
| Japan | Real GDP | 1.6 | 0.2 | −7.0 | −2.3 | −28.1 | 15.6 | 8.8 | 3.2 | 2.6 | 2.2 | 0.9 | 0.3 | 0.7 | −5.4 | 2.9 |
| | Inflation | 0.8 | 0.5 | 0.2 | 0.6 | −0.1 | −0.2 | −0.7 | −0.4 | 0.3 | 0.3 | 0.2 | 0.8 | 0.7 | 0.1 | 0.2 |
| | Unemployment | 2.4 | 2.3 | 2.3 | 2.4 | 2.8 | 3.0 | 3.2 | 3.2 | 3.2 | 3.1 | 3.0 | 2.4 | 2.4 | 2.8 | 3.1 |
| China | Real GDP | 6.2 | 6.0 | 6.0 | −6.8 | 3.2 | 5.3 | 5.6 | 19.4 | 7.8 | 5.8 | 5.6 | 6.7 | 6.1 | 2.2 | 8.9 |
| | Inflation | 2.6 | 2.9 | 4.3 | 5.0 | 2.7 | 2.4 | 2.2 | 2.0 | 2.2 | 2.3 | 2.4 | 2.1 | 2.9 | 3.5 | 2.2 |
| | Unemployment | 5.0 | 5.2 | 5.1 | 5.9 | 5.9 | 5.6 | 5.5 | 5.5 | 5.4 | 5.4 | 5.4 | 4.9 | 5.2 | 5.7 | 5.4 |

Real GDP growth is in QoQ annualized for U.S. and Japan, QoQ for euro area and YoY for China and India. Inflation rate is in YoY%. Inflation rate is YoY, % of core index (ex. fresh food) for Japan, YoY % of PCE deflator for U.S., and total YoY% for the rest.

## Figure 2: Forecast for Rates

| Interest rate | | 2019 | 2020 | | | | 2021 | | | | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| US | Policy rate | 1.50 ~ 1.75 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 0.00 ~ 0.25 | 1.50 ~ 1.75 | 0.00 ~ 0.25 | 0.00 ~ 0.25 |
| | 2yr | 1.57 | 0.25 | 0.15 | 0.13 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 1.57 | 0.10 | 0.10 |
| | 10yr | 1.92 | 0.67 | 0.66 | 0.68 | 0.60 | 0.75 | 0.90 | 1.20 | 1.50 | 1.92 | 0.60 | 1.50 |
| Germany | Policy rate | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| | Deposit rate | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 | −0.50 |
| | 2yr | −0.60 | −0.69 | −0.69 | −0.70 | −0.70 | −0.65 | −0.60 | −0.60 | −0.60 | −0.60 | −0.70 | −0.60 |
| | 10yr | −0.19 | −0.47 | −0.45 | −0.52 | −0.55 | −0.50 | −0.40 | −0.30 | −0.20 | −0.19 | −0.55 | −0.20 |
| Japan | Policy rate | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 |
| | 2yr | −0.13 | −0.14 | −0.13 | −0.13 | −0.10 | −0.10 | −0.10 | −0.10 | −0.10 | −0.13 | −0.12 | −0.10 |
| | 10yr | −0.01 | 0.02 | 0.03 | 0.02 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | −0.01 | 0.04 | 0.05 |
| China | Policy rate | 4.15 | 4.05 | 3.85 | 3.85 | 3.85 | 3.85 | 3.85 | 3.85 | 3.85 | 4.15 | 3.85 | 3.85 |
| | 2yr | 2.46 | 1.95 | 2.24 | 2.76 | 1.80 | 1.75 | 1.75 | 1.70 | 1.70 | 2.46 | 1.80 | 1.70 |
| | 10yr | 3.14 | 2.59 | 2.85 | 3.13 | 2.70 | 2.70 | 2.65 | 2.60 | 2.55 | 3.14 | 2.70 | 2.55 |

## Figure 3: Forecast for FX and Oil Price

| | | 2019 | 2020 | | | | 2021 | | | | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| USD/JPY | Range | 106.48 ~ 109.73 | 101.19 ~ 112.23 | 105.99 ~ 109.85 | 104.00 ~ 108.16 | 99.00 ~ 112.00 | 102.00 ~ 112.00 | 102.00 ~ 115.00 | 105.00 ~ 115.00 | 105.00 ~ 115.00 | 104.46 ~ 112.40 | 99.00 ~ 112.23 | 102.00 ~ 115.00 |
| | End of quarter | 108.61 | 107.54 | 107.93 | 105.48 | 105.00 | 106.00 | 108.00 | 109.00 | 110.00 | 108.61 | 105.00 | 110.00 |
| EUR/USD | Range | 1.0879 ~ 1.1239 | 1.0636 ~ 1.1495 | 1.0727 ~ 1.1422 | 1.1185 ~ 1.2011 | 1.1300 ~ 1.2500 | 1.1200 ~ 1.2400 | 1.1200 ~ 1.2400 | 1.1300 ~ 1.2500 | 1.1400 ~ 1.2600 | 1.0879 ~ 1.1570 | 1.0636 ~ 1.2500 | 1.1200 ~ 1.2600 |
| | End of quarter | 1.1213 | 1.1031 | 1.1234 | 1.1721 | 1.1800 | 1.1700 | 1.1700 | 1.1800 | 1.1900 | 1.1213 | 1.1800 | 1.1900 |
| EUR/JPY | Range | 117.08 ~ 122.65 | 116.13 ~ 122.87 | 114.43 ~ 124.43 | 120.26 ~ 127.08 | 119.00 ~ 129.00 | 120.00 ~ 130.00 | 122.00 ~ 132.00 | 124.00 ~ 134.00 | 126.00 ~ 136.00 | 115.87 ~ 127.50 | 114.43 ~ 129.00 | 120.00 ~ 136.00 |
| | End of quarter | 121.77 | 118.64 | 121.24 | 123.65 | 123.90 | 124.02 | 126.36 | 128.62 | 130.90 | 121.77 | 123.90 | 130.90 |
| Crude Oil Prices (WTI) | | 56.87 | 45.86 | 28.00 | 40.92 | 42.00 | 45.00 | 50.00 | 52.00 | 50.00 | 57.04 | 38.47 | 49.25 |

※Crude oil prices are averages for each period. Source: SMBC.