

China's Economic and Financial Outlook

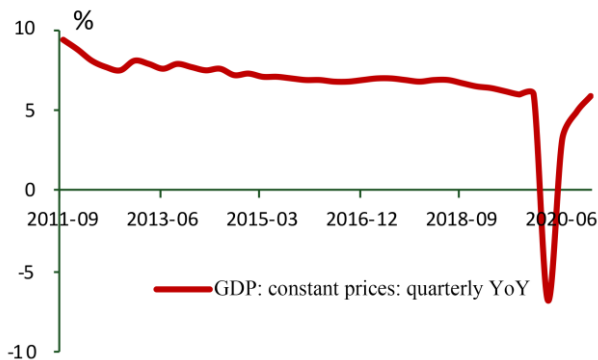
Annual Report 2021 (Issue 45)

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Highlights

- 2020 witnessed profound changes in the global political and economic landscape amid the global COVID-19 pandemic. The Chinese government's ongoing efforts to contain the coronavirus, which is well-coordinated with economic and social development, has delivered major strategic results. As the government is progressively reopening the economy and implementing the policies ensuring stability on six fronts and maintaining security in six areas, the Chinese economy has become the first to get back on the growth track. GDP growth for the first three quarters turned from negative to positive and reached 0.7%, up 2.3 percentage points from H1, expected to hit around 2.1% for the year.
- 2021 marks the first year of China's 14th Five-year Plan. In spite of an external environment remaining largely unstable and uncertain, there are many favorable factors for China's economic growth. The domestic coronavirus situation may have a lesser impact on the economy. The Chinese government will continue to boost domestic demand, support innovative development and improve business environment. Taking into account a low comparison base, China's economic growth is estimated to recover to a normal level of about 7.5% in 2021.
- With COVID-19 contained more effectively, macro policies will focus on creating a new development pattern featuring dual circulation, which takes the domestic market as the mainstay while letting domestic and foreign markets boost each other, to boost economic transformation and upgrading. First, the proactive fiscal policy will continue to be employed in an effort to directly fund the real economy and improve the bond issuance system. Second, the monetary policy will be more targeted and flexible. Structural monetary policy instruments will remain the priority. Third, the business environment for market entities will be further improved to boost domestic demand in both consumption and investment terms. New development modes of foreign trade will be created to better coordinate innovation with industry.

Chinese Economy Recovers Steadily



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Create a New Development Pattern to Usher in High-quality Development in the 14th Five-year Plan Period

– China's Economic and Financial Outlook (2021)

2020 witnessed profound changes in the global political and economic landscape amid the global COVID-19 pandemic. The Chinese government made ongoing efforts to coordinate COVID-19 containment with economic and social development. On the one hand, China has delivered major strategic results in pandemic control, realizing a dramatic decline in new local infections. On the other hand, as the government is progressively reopening the economy and implementing the policies ensuring stability on six fronts and maintaining security in six areas, the Chinese economy has become the first to get back on the growth track. GDP growth for the first three quarters turned from negative to positive and reached 0.7%, up 2.3 percentage points from H1, expected to hit around 2.1% for the year. 2021 marks the first year of China's 14th Five-year Plan. In spite of an external environment remaining largely unstable and uncertain, there are many favorable factors for China's economic growth. The domestic coronavirus situation may have a lesser impact on the economy. The Chinese government will continue to boost domestic demand, support innovative development and improve business environment. Taking into account a low comparison base, China's economic growth is likely to recover above the normal level, expected to reach about 7.5% in 2021. With COVID-19 contained more effectively, macro policies will focus on creating a "dual circulation" development pattern to boost economic transformation and upgrading. First, the proactive fiscal policy will continue to be employed in an effort to directly fund the real economy and improve the bond issuance system. Second, the monetary policy will be more targeted and flexible. Structural monetary policy instruments will remain the priority. Third, the business environment for market entities will be further improved to boost domestic demand in both consumption and investment terms. New development modes of foreign trade will be created to better coordinate innovation with industry.

I. 2020 Economic Review and 2021 Outlook

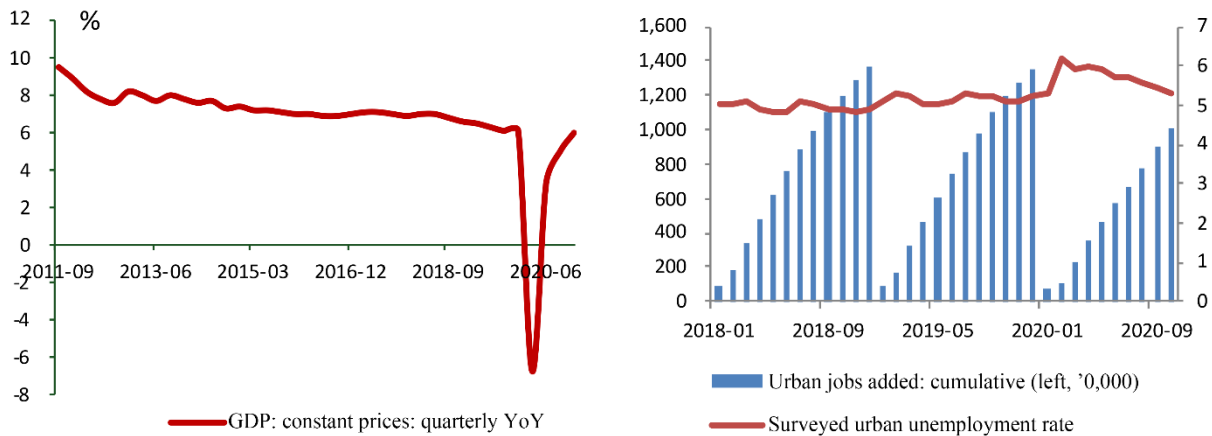
2020 witnessed profound changes in the global political and economic landscape amid the global COVID-19 pandemic, and the Chinese government has made ongoing efforts to coordinate coronavirus containment with economic and social development. GDP growth in the first three quarters returned into positive territory, standing at 0.7%, up 2.3 percentage points from H1. Specifically, GDP growth fell by 6.8% in Q1 and rose by 3.2% and 4.9% in Q2 and Q3 respectively (Fig. 1). The annual GDP growth is projected to be around 2.1% for the year.

First, main economic indicators showed continued improvements, suggesting faster recovery in efficiency and stable job market. The coronavirus outbreak took a heavy toll on the Chinese economy in early 2020, on either supply or demand side. The value added of industrial enterprises above the designated size and value added of the service sector in the first three months fell by 8.4% and 5.2% respectively, with investment and consumption down 16.1% and 19% respectively, all hitting a record low since China's launch of reform and opening-up. Industrial capacities took the lead in the recovery, in an accelerating pace, as the pandemic got effectively contained and a series of policies were introduced to reopen the economy. The industrial value added of enterprises above the designated size turned positive in April, rising to 3.9%. Services, consumption and investment indicators gradually improved. The services production index returned into positive territory in May, the monthly growth rate of consumption returned into positive territory in August and the accumulated growth rate of fixed asset investment returned into positive territory in September.

Despite the sustained pressure from the outside world, China's exports showed strong resilience due to its full-fledged industry system and strong ability to organize production. Exports grew by 9.5% on average from July through October, much better than expected.

As the economy gradually moved back on track, enterprises improved their profitability continuously. The profits of industrial enterprises fell by 2.4% YoY in the first three quarters of 2020, an improvement of 34.3 percentage points and 10.5 percentage points from Q1 and H1 respectively. China's public revenue fell by 5.5% YoY in the first ten months, an improvement of 8.8 percentage points and 5.3 percentage points from Q1 and H1 respectively. The per-capita disposable income of Chinese residents grew by 0.6% in the first three quarters, up 1.9 percentage points from H1. The job market was stable in general, with 10.09 million urban jobs added in the first ten months, meeting the annual target of 9 million ahead of schedule. The surveyed urban unemployment rate gradually dropped to 5.3% in October from the February high of 6.2% (Fig. 2).

Fig. 1: Chinese economy recovers steadily Fig. 2: Job market is stable in general



Source: Wind, BOC Research Institute

Second, the coronavirus pandemic accelerates the development of new industries and new forms and models of business. While having a big impact on China's economy, the COVID-19 outbreak also has accelerated industrial transformation, giving rise to new demands and new forms and models of business. Intelligent and digital transformation in manufacturing has gained pace. The emerging demand for mobile office and remote medical services are mushrooming. Traditional catering and retail businesses pursue an online-offline combination to reshape the business pattern. Online retail sales of physical goods grew by 16% YoY in the first ten months. As the intelligent tourism emerged as a new form of business, museums and tourist attractions launched online tour services.

Third, China opened wider to the outside world. China unswervingly supports the economic globalization by widening its opening-up in the face of an increasingly complicated external situation. China's 2020 version of "Negative List" for foreign investment reduced the number of prohibited sectors from 40 to 33. The "Negative List" for foreign investment in pilot free trade zones reduced the number of prohibited sectors from 37 to 30. Such reductions have further expanded the scope of permitted foreign investments and opened the service, manufacturing and agricultural sectors wider. The *Overall Plan for the Construction of Hainan Free Trade Port* and the *Comprehensive Plan on Implementing Pilot Reforms in Shenzhen to Build the City into a Demonstration Area of Socialism with Chinese Characteristics (2020-2025)* were issued for implementation. The second China International Import Expo (CIIE) was successfully held. The

Regional Comprehensive Economic Partnership (RCEP) was officially signed.

2021 marks the first year of China's 14th Five-year Plan. The external environment will still be the largest uncertainty in China's economic development. The global COVID-19 pandemic shows the risk of resurgence and the Sino-US power game will continue over the long term. Domestically, the countercyclical regulation will soften, COVID-19 containment efforts will be more reasonable and effective, and the economic growth is likely to recover above the normal level. First, in creating a "dual circulation" development pattern, the Chinese government will continue to boost domestic demand, support innovative development and improve the business environment. New investment and new consumption will keep growing fast. Second, China will open up wider in every respect to boost reforms and development, unleash the leading role of free trade zones and ports, promote reform and innovation in the liberalization and facilitation of trade and investment and continuously improve the business environment for foreign investors. Third, the comparison base in 2020 is low. In particular, in 2020Q1, there was a sharp contraction in economic activities, such as industrial production, transportation and logistics, trade and investment, consumption and tourism, which would herald a significant rise in the 2021Q1 economic growth. GDP is projected to grow by about 7.5% in 2021.

I.1 Infrastructure and real estate investment will keep growing fast to drive a continuous economic recovery.

Infrastructure and real estate investment recovered fast in 2020, a major driver of investment bounce-back. Total fixed asset investment (excluding rural households) rose by 1.8% accumulatively during the first ten months, showing a V-shaped pattern. By category of investment: **First**, infrastructure investment was major carrier of the countercyclical regulatory policy amid the pandemic. Infrastructure investment (including electric power) from January through October increased by 3% accumulatively, with the growth rate representing 92% of that recorded a year ago, the strongest recovery among the three categories of investment. **Second**, real estate development investment recovered gradually from month to month as the recovery in sales accelerated cash inflows and the industrial prosperity index was restored continuously. From January to October, real estate investment increased by 6.3% accumulatively, down 4 percentage points YoY. **Third**, the contraction in manufacturing investment slowed down gradually due to demand rebound and profit improvement, yet still in negative territory. Manufacturing investment fell by 5.3% accumulatively from January to October, a YoY improvement of 7.9 percentage points.

Looking into 2021, infrastructure and real estate investment will keep growing fast to drive a continuous economic recovery. Driven by infrastructure and real estate investment, investment will continue to accelerate in 2021 and become the main engine of economic growth for the year. **First**, rapid growth will be sustained in key fields of infrastructure investment including transportation, energy and water conservancy as well as new infrastructure investment, such as 5G and artificial intelligence (AI). **Second**, property developers will feel their cash flows further strained under the guiding principle that "houses are for living in, not for speculation" and classified regulatory policies, including the "three red lines" that shall never be crossed. Given the stable overall demand in the real estate sector in 2021 and the low comparison base in 2020, real estate development investment is expected to remain stable. **Third**, the manufacturing investment will continue to recover and turn from negative to positive by virtue of demand rebound and profit improvement. In general, the annual growth in fixed asset investment is projected to be 6.5% or so in 2021.

I.2 Sustained recovery in consumption will contribute markedly more to economic growth

Consumption took a big hit from the COVID-19 outbreak in early 2020. Backed by the policies

launched to ensure the stability on six fronts and maintain security in six areas as well as consumption stimulus packages, however, consumption growth started to recover in March and returned into positive territory in August. Total retail sales of consumer goods fell by 5.9% accumulatively from January to October, down 14 percentage points YoY. **First**, sales of commodities associated with consumption upgrading kept growing. From January to October, the retail sales of cultural and office supplies, cosmetics and telecoms devices grew by 4.5%, 5.9% and 7.3% respectively. **Second**, driven by sustained economic recovery, stronger consumer confidence and consumption stimulus packages, the automobile demand was released continuously and double-digit growth was recorded for four consecutive months.

Looking into 2021, sustained recovery in consumption, coupled with the low comparison base in 2020, will contribute markedly more to economic growth. In the context of sustained economic recovery, household income will improve when compared with 2020. In addition, more consumption stimulus packages will be launched as China is moving faster forward to create a new development pattern featuring dual circulation, which takes the domestic market as the mainstay. All these factors will give a boost to the sustained recovery and upgrading of household consumption. Consumption will continue to upgrade in terms of clothing, food, housing and transportation. As for the low comparison base in 2020, consumption was hardest hit by the coronavirus in the year among the three categories of demand. So consumption will stage the strongest relative growth in 2021, especially in 2021Q1. Overall, consumption growth is projected to be around 10% in 2021.

1.3 External uncertainties and high comparison base will be a drag on foreign trade growth

From January to October 2020, exports (in USD) grew by 0.5% YoY accumulatively, an improvement of 1.3 percentage points from Q1-Q3. Imports (in USD) dropped by 2.3 percentage points YoY accumulatively, an improvement of 0.8 percentage point from Q1-Q3. Stronger-than-expected growth in exports amid the pandemic was a prominent feature of 2020 foreign trade. The main reasons are as follows: **First**, the foreign coronavirus battle and the “stay-at-home” economy triggered a surge in demand for COVID-19 supplies and household consumer goods. The exports of medical apparatus and instruments grew by 27.3% YoY in the first ten months of 2020. **Second**, China led the global economic recovery from the pandemic, partially substituting other countries’ shares in exports. With regard to the share of Chinese exports in other countries’ imports, as of August 2020, the Chinese products as a share in US imports rose from 16.63% to 21.35%, and the share in Japanese imports rose from 20.1% to 24.7%. **Third**, foreign demand picked up on the recovery of overseas economies. JPMorgan Global Composite PMI was 53.3% in October. The US and EU manufacturing PMI stood at 59.3% and 54.8% respectively, both representing a recovery for six consecutive months. With regard to imports, the low commodity prices in H1 weighed on imports growth. Given the domestic demand bounce-back and RMB appreciation in Q3, the slowdown in accumulated YoY growth of imports softened continuously.

Looking into 2021, China’s exports will be under big pressure. **First**, the drastic coronavirus resurgence and re-lockdowns in Europe and the US will dent the recovery of China’s foreign demand in the short term. **Second**, the de-globalization tides, Sino-US trade conflicts and developments in other countries’ trade policy with China bring about uncertainties. **Third**, the high comparison base of exports in 2020 will turn into pressure on exports in 2021H2. Over the long-term, however, the signed RCEP will reduce trade barriers and costs, helping China cement and expand its exports to other countries in the region. As for imports, China’s sustained economic recovery will fuel a strong bounce-back in domestic demand. High-level opening-up and RCEP implementation will diversify imports to import more advanced technologies, equipment and

components. Overall, exports are expected to grow by about 2% and imports to expand by about 3% in 2021.

I.4 Demand improvements and low comparison base will further accelerate supply growth, and the service sector will contribute a bigger share in economic growth

The service sector took the biggest hit from COVID-19 in 2020. In the first three quarters, the service sector's contribution to cumulative YoY GDP growth fell to 30.5%, down 30.5 percentage points from one year ago. The primary sector and the secondary sector recorded a rise in contribution to cumulative YoY GDP growth, which was 20.3% and 49.2% in the first three quarters, up 17.2 percentage points and 13.3 percentage points YoY respectively. The supply side showed the following overall characteristics:

First, the midstream industrial enterprises recovered faster than downstream ones. In 2020, industrial activity staged an accelerating recovery in Q2 from the steep recession seen in Q1, and showed YoY improvements in Q3. The cumulative growth rate of industrial value added turned positive in August, reaching 1.8% for the first ten months. Midstream industrial activity grew faster on the recovery of demand in infrastructure and real estate, with monthly average growth rate rising from 6.8% in April to 9% in October, much faster than upstream mining and downstream consumer goods manufacturing activities.

Second, industrial activity took the lead in recovery, while the service sector started to improve faster than industry in H2. Compared with industrial enterprises, the service sector was hit harder by the coronavirus outbreak. The services value added gained 1.9% in Q2, down 5.1 percentage points YoY. With the pandemic effectively contained in China, the value added in wholesale and retail, transportation, warehousing and postal services turned positive and grew in a faster pace from quarter to quarter. The service sector started to recover faster than industry, with services value added growing at 4.3% in Q3, up 2.4 percentage points from Q2.

Looking into 2021, the supply side will further gain pace. **First**, the policy environment for the real economy development will continue to improve. The government will further cut taxes and charges to relieve the burden on the real economy and continue to improve the business environment through deepened reforms to streamline administration, delegate powers, improve regulation and upgrade services. **Second**, the comparison base in 2020 is low. All sectors recorded exceptionally low growth in 2020Q1, with industrial value added down 8.4%. The service sector (except financial services and information transmission, software and information technology services) registered negative growth. The annual value added in 2021 is projected to grow by around 7.4% and 7.7% for the industrial and service sectors respectively. The service sector will contribute a bigger share of economic growth.

I.5 CPI growth will retreat and PPI growth will return into positive territory

The CPI showed a “high-to-low” pattern in 2020, indicating gradual slowdown of growth. The CPI rose by 3% in the first ten months, 0.4 percentage point faster than one year ago. **First, pork price was the key influencer on CPI movements.** Pork price grew by 122.5% on average in Q1 due to the African swine fever, environmental policy and “pig cycle”. Then the pork price hike gradually ebbed from the high comparison base in the same period of last year as the hog production recovered continuously. After a hike run for 19 consecutive months, pork price fell (-2.8%) for the first time in October. Food price inflation dropped to 2.2% in October from the February peak of 21.9%. **Second, the carryover effect of price changes in the previous year was a major influence on the CPI.** As the demand slowed down and inflationary factors showed mild hikes in 2020, the overall acceleration in CPI was principally driven by the carryover effect, which remained above 3% in each month during H1. The carryover effect has dropped faster and faster

since Q3, standing at only 0.4% in October.

Looking into 2021, the CPI hike will slow down. **First, the pork price hike will be subdued notably.** The domestic hog supply gradually strengthens. Currently the inventory of hogs and reproductive sows has recovered above 80% of normal level. The hog-grain price ratio¹ dropped to about 12 in November 2020, yet still above the break-even point for hog farming. Thus hog farmers are highly motivated to expand the inventory. Pork price hike is likely to be in negative territory in 2021, which will be a significant contributor to the CPI moderation. **Second, the carryover effect is significantly weaker.** As prices showed an overall downtrend in 2020, the carryover effect in 2021 will average -0.5% to 0%, far below the 2020 level (2.2%). Overall, the pork price and carryover effect will weaken the CPI inflation, which is estimated to be about 1.8% in 2021.

Due to the COVID-19 shock on demand and supply at home and abroad, the monthly PPI hike fell from 0.1% from the beginning of 2020 to -3.7% in May, followed by a moderation in PPI deflation as the economic activity was resumed faster to warrant a mild recovery in demand. The PPI fell by 2% accumulatively in the first ten months, 1.8 percentage points faster than one year ago. **First, as the production side recovered first, the price deflation of producer goods started to soften in Q2.** Producer goods underwent significantly wider fluctuations than consumer goods, with monthly price inflation falling from -0.4% at the beginning of 2020 to -5.1% in May. Then the price deflation of producer goods started to recede on gradually demand recovery, reaching -2.7% in October. **Second, the PPI inflationary factors were negative in 2020, worsening the PPI deflation when compared with the prior year.** Inflationary factors averaged -1.9% in the first ten months of 2020, down 1.5 percentage points YoY.

Looking into 2021, the PPI inflation will turn from negative to positive. **First,** domestic consumer and investment demands will further improve, driving the prices of producer goods to turn positive and the prices of consumer goods to hike in a faster pace. **Second,** the carryover effect from the prior year will be higher than in 2020, while the inflationary factors in 2021 will gain momentum. **Third,** global economic growth will be better than in 2020 in general, fueling a bounce-back in prices of crude oil and other commodities and inflating the PPI to some degree. The PPI is projected to rise by about 1.2% in 2021.

II. 2020 Financial Review and 2021 Outlook

Battered by the coronavirus outbreak when 2020 began, the world economy suffered the worst decline since the Great Depression of the 1930s. High leverage ratio, big bubble, high volatility and low interest rates have become a normal in international financial markets. Unlike other financial markets, China's financial markets outperformed most economies, thanks to the government's strong COVID-19 containment efforts. China's financial markets showed stable movements with a relatively high return, despite a correction in the Chinese stock market early this year. Overall, the Chinese financial markets were characterized by "countercyclicality, high growth, strong supervision and more capital inflows" in 2020.

Looking into 2021, the outlook on the external conditions for China's financial markets will remain downbeat. On the one hand, the global economic recovery is fragile and has a long way to go. Major economies will adhere to an easy monetary policy. The economy will still show a pattern of "weaker real sector than the financial sector". On the other hand, as some countries' government leverage ratios ratchet up and emerging economies pose a higher risk of sovereign debts, the global

¹The ratio of live hog price to the price of corn, the primary feed for live hogs. The hog price/corn price ratio of 6:1 basically stands for the breakeven point for hog production. A higher hog-grain price ratio means stronger profitability of hog production, vice versa.

economy will remain in a climate of high debt, high leverage ratio and big bubble.

In China, the year 2021 will mark the first year of implementing the country's 14th Five-year Plan. China's financial sector will serve the real economy more efficiently with better quality. On the one hand, to ensure long-term stable growth of the national economy, China's monetary policy will attach greater importance to balancing stable growth and risk prevention. Thus it will be neither too loose nor too tight. In 2021, the growth rate of outstanding aggregate financing to the real economy (AFRE) and the broad money supply (M2) are expected to retreat from 13.5% and 10.4% in 2020 to about 12% and 9% respectively. On the other hand, the macro-economy is expected to grow fast from a low comparison base, a favorable environment for banks' balance sheet expansion. Meanwhile, due attention should be paid to some major risks in 2021, including a possible surge in non-performance assets, frequent bond market defaults, overshooting rise in RMB value and more challenges to internationalization of banks.

II.1 Growth in RMB loans showed a “high-to-low” transition, while the growth in M2 and AFRE remained stable with a downward tendency

Major financial supply indicators manifested the following characteristics in 2020: **First, M2 growth rose and then fell, with the growth of AFRE on a fast track.** M2 growth rose to 11.1% at the end of June 2020 from 8.7% at the end of 2019, a combined result from the faster credit supply and rising government spending since the coronavirus pandemic began. Government spending slowed down in H2, with the YoY M2 growth ebbing to 10.5% at the end of October. The outstanding AFRE grew steadily, in a pace rising from 10.69% at the end of 2019 to 13.7% at the end of October 2020, a three-year high.

Second, total RMB loans hit an all-time high, with a steadily rising share of medium- and long-term loans. Financial institutions provided increasingly stronger support for the real economy. New RMB lending was RMB17.36 trillion in the first ten months of 2020, expected to reach an annual total of about RMB19 trillion for the year. In addition, medium- and long-term loans took up a markedly higher proportion. In the first ten months of 2020, accumulated new medium- and long-term loans accounted for 74.9% of total new loans, up 17.9 percentage points from one year ago.

Credit and money supply will continue to grow steadily in 2021. The financial sector will serve the real economy more efficiently with improved quality. **First, the growth of M2 and AFRE will ebb to a stable medium-to-high level.** The overshooting growth in M2 and AFRE in 2020 was principally driven by COVID-19 responses. As the economy keeps improving, credit demand and supply will gradually stabilize. Growth in main financial data will recede from high as the monetary policy return to a prudent stance. **Second, growth in loans will restore the “high-to-low” pattern, and medium- and long-term loans will be stable with a tendency of upturn.** The pace of credit supply will return to normal in lockstep with economic recovery. Following the principle of “earlier lending, earlier return”, financial institutions' credit growth will return to the “high-to-low” pattern in 2021. Total RMB lending is expected to increase by RMB20.5 trillion or so in the year. **Third, SME loans and loans to major industries will keep growing fast.** With policy support in place, SMEs will continue to have easier access to financing. Growth in SME loans will remain high.

II.2 With credit risk premium on the rise, the money market rates are unlikely to fall significantly

Interest rates manifested the following characteristics in 2020: **First, policy rates showed an inclined L-shaped curve.** The PBOC took quick actions after the coronavirus outbreak came to light, lowering the 7-day, 14-day and one-year MLF rates. The policy rate curve moved downwards

steadily, showing remarkable monetary easing. However, the monetary policy returned to its prudent stance as the economy rebounded and more importance was attached to forestalling risks. **Second, money market rates slumped and then picked up, with market expectations gradually stabilized.** Money market rates including DR007 and R007 fell sharply at the beginning of 2020 in an expansionary policy environment, before staging a gradual pickup in April. Money market rates have remained close to policy rates since June, and market expectations gradually stabilized. **Third, credit interest rates plunged, followed by a gradual deceleration, to reduce enterprises' financing costs materially.** With joint support from authorities, the credit market experienced a sharp decline in interest rates before a gradual deceleration started in Q2. The weighted average interest rate of RMB loans from financial institutions fell rapidly from 5.44% at the end of 2019 to 5.08% at the end of 2020Q1, followed by a softer decline of 2 bps to 5.06% at the end of Q2.

Looking into 2021, in spite of the likelihood of further policy rate cuts, money market rates are unlikely to fall significantly due to rising credit risk premiums. Interest rate movements are estimated to show the following characteristics in the year ahead: **First, there will be limited space for policy rate cuts.** Given the adherence to a prudent monetary policy, the policy rates are unlikely to show continuous one-way movements. Policy rates are estimated not to fall continuously in 2021. Repurchase, MLF and LPR rates are expected to undergo one or two cuts as maximum or even remain unchanged. **Second, money market rates are likely to remain stable with a modest rise.** Money market rates will fluctuate around policy rates in H1. If the economic foundation keeps firming up in H2, the market rates are projected to move higher slightly. **Second, credit market rates still have space for going down.** The world economy still faces major uncertainties amid the pandemic, with businesses remaining in a complicated situation. Relieving enterprises' burdens will continue to be a major policy orientation. Corporate lending rates are still likely to move lower in 2021, yet in a slower pace and with smaller decrements.

II.3 The bond market will still feel the fallout from the “default storm”, likely to remain highly volatile

Against the backdrop of economic downturn, changing pace of monetary easing and elevated default risk, the 10-year treasury yield fell and then picked up in 2020, showing a V-shaped annual curve with wide fluctuations in the year. The 10-year Treasury yield closed at 3.29% on November 24, 2020, up 24 bps from the end of last year.

Below are the five major characteristics of China's bond market in 2020: **First**, the bond market supplied more bonds and provided stronger support for the real economy. RMB51.3 trillion of bonds were issued accumulatively during the first eleven months of 2020, up 21.2% YoY. **Second**, the bond market was significantly more volatile than before. The 10-year Treasury yield moved between 2.48% and 3.35% in 2020, representing a standard deviation of 0.22, much broader than the band of 3.0% to 3.43% and a standard deviation of 0.09 recorded in 2019. **Third**, the term spread rose and then fell, with the credit spread polarized. As at November 24, 2020, the “10Y-1Y” treasury yield spread fell to 41 bps from 56 bps recorded one year ago, but the credit spread of lower-rating bonds (between three-year AA- enterprise bonds and treasury bonds with the same term) widened, showing pressure from rising credit risk. **Fourth**, the China-US interest rate spread continued to widen. In the global tides of interest rate cuts, China's treasury yields are relatively high. The China-US 10-year Treasury yield spread widened to 241 bps on November 24, 2020, from the bottom of 11 bps in November 2018, even going beyond 324 bps at the peak. **Fifth**, a “default storm” hit the bond market. Unlike before, there were many more local SOEs and high-rating issuers among the bond issuers in default in 2020. On November 12 alone, 20 high-rating bonds (including Founder, Unisplendour and even some high-rating large SOEs, such

as CYMG and Brilliance Auto) went into default. A default storm swept the bond market. However, its impact remains under control at present. As at November 24, 2020, a total of 120 bonds worth RMB137 billion had been defaulted, accounting for less than 0.5% of the total balance of credit bonds.

Looking into 2021, economic fundamentals, liquidity and confidence will remain the biggest three factors determining the bond market's future. As for economic fundamentals, GDP growth is expected to rebound substantially to push overall interest rates higher. As for liquidity, given the rising importance of preventing risks, the monetary policy will return from expansionary to normal, keeping interest rates at a stable level. As for confidence, because of the eruption of high-rating bond defaults in late 2020, the market confidence is extremely fragile now, and investors will be more cautious about credit bonds in the future. Overall, the bond market will fluctuate in a wide band in 2021, with the credit spread further widening. The 10-year Treasury yield is estimated to fluctuate in the band of 3.1%-3.6%.

II.4 The A-share market moved up with fluctuations, likely to become more resilient.

The A-share market remained on the rise with fluctuations through 2020 amid a mix of bullish and bearish factors, including domestic economic recovery, ongoing capital market reforms, global spread of COVID-19, trade conflicts and US presidential election. The Shanghai Stock Exchange (SSE) Composite Index closed at 3402.82 on November 24, up 11.6% from the end of 2019. The A-share market showed the following characteristics: **First**, the market moved in a W-shaped curve, finishing the year with a big gain. A-shares started to plunge in late January on the coronavirus outbreak, hitting its first trough (2746) in early February. As the virus started to spread overseas, the world's major stock markets triggered a chain of "circuit breakers", plunging the A-share market into the second trough (2660). Since July, as China got the coronavirus situation controlled effectively, A-shares kept going strong and moved around a high level of 3300. **Second**, the market performance was obviously mixed. In the wake of the pandemic, tech, consumption and pharmaceutical stocks led the market, while financial, real estate and traditional energy stocks remained low. Semiconductors, food and beverage and automobile indices recorded the biggest gains (55.41%, 55.15% and 53.50%, respectively) from the beginning of 2020 to November 24. Real estate, energy and telecoms service indices fell by 3.31%, 3.07% and 2.62%, respectively. **Third**, foreign capital had bigger impact on the stock market. A-shares have become the safe haven for international capital as Chinese economy recovers continuously. Since the beginning of March, the net Northbound buying has shown substantially the same trends as the SSE Composite Index, indicating an important influence on the A-share market.

Looking into 2021, the continuous improvements in economic fundamentals will be strong support for the A-share market, which will further go strong with fluctuations. But due attention should be paid to the spillover effect of foreign financial market turmoil. **First**, the capital market will further unleash its hub role. The phase-in of the registration-based IPO system, implementation of the new Securities Law and the relaxing of restrictions on foreign institutions and funds will be bullish factors for the A-share market over the long term. **Second**, sustained foreign capital inflows create a capital increment effect. On November 11, 2020, the world's largest index company MSCI announced to rebalance the MSCI China Index by including 58 new stocks and removing 23 existing constituents.

II.5 RMB exchange rate fluctuated at highs, under a mild depreciation pressure and even likely to remain strong

The RMB exchange rate against USD fell and then picked up in 2020 as a combined result of the COVID-19 pandemic and Sino-US trade frictions. The RMB exchange rate once fell through 7.15

at the worst time of the pandemic, followed by a major surge as China led the world in reining in the coronavirus. As at November 24, 2020, the spot exchange rate of RMB against USD was quoted at 6.5761, an appreciation of 5.88% from the beginning of the year. The exchange rate market showed the following characteristics: **First, the exchange rate was more flexible.** RMB exchange rate showed prominent two-way fluctuations in 2020. As at November 24, 2020, the RMB exchange rate against USD moved in a wide range of 6.5425 to 7.1547, suggesting a further rise in RMB flexibility. **Second, the market expectations of the RMB exchange rate remained neutral to upbeat.** In the first ten months of 2020, banks' foreign exchange settlements and sales on behalf of customers remained positive, standing at USD11.056 billion in October, suggesting a steady pickup. The market entities were more tolerant of exchange rate fluctuations, as no one-way trading occurred. RMB exchange rate expectations remained stable. **Third, the countercyclical policy toolkit was adjusted.** China's economy has sustained a strong recovery since Q3, with the eased pressure of massive capital outflows and strong appreciation in RMB. To curb rapid one-way appreciation expectations, the PBOC decided to cut the reserve requirement for forward forex sales from 20% to zero as from October 12. Meanwhile, the "countercyclical factor" was removed from the quotation model for RMB/USD central parity rate.

Looking into 2021, in spite of a still-complicated external environment, the RMB exchange rate will fluctuate at highs under a mild depreciation pressure as the Chinese economy recovers continuously. The following factors support a strong RMB: **First, China's economic fundamentals keep improving.** The global economic recovery may slow down due to coronavirus resurgences across the globe. China will become one of the best-performing economies in the future. **Second, domestic assets were attractive.** Given the low probability that the US will contain the pandemic in the short term, the Fed will keep its monetary policy easy in the future. The China-US interest rate spread will remain wide, making domestic assets attractive in the foreseeable future. However, the RMB exchange rate movements will also face uncertainties: **First, RMB value has already shown a big gain.** RMB exchange rate has moved significantly higher since 2020H2. The foreign exchange market has fully priced in the earlier bullish factors. Moreover, as the countercyclical policy is prepared for a possible one-way appreciation in RMB, the RMB exchange rate will show mild volatility in the future. **First, Sino-US trade frictions remain uncertain.** The Sino-US trade conflicts have manifested a long-lasting and complicated nature. Any eruption of extremities is very likely to send the RMB exchange rate into unexpected fluctuations.

Table 1: China's Main Economic & Financial Indicators and Forecasts in 2021 (%)

Indicator	2016 (R)	2017 (R)	2018 (R)	2019 (R)	2020					2021 (F)
					Q1 (R)	Q2 (R)	Q3 (R)	Q4 (E)	Full year (E)	
GDP	6.7	6.8	6.6	6.1	-6.8	3.2	4.9	5.5	2.1	7.5
Industrial value added of enterprises above designated size	6	6.6	6.2	5.7	-8.4	4.4	5.8	6.4	2.3	7.4
Value added of the service sector	7.8	8	7.6	6.9	-5.2	1.9	4.3	5.2	1.7	7.7
Fixed asset investments (cumulative)	8.1	7.2	5.9	5.4	-16.1	-3.1	0.8	3.5	3.5	6.5

Total retail sales of consumer goods	10.4	10.2	9	8	-19	-4	0.9	4.5	-4.4	10.0
Exports	-7.7	7.9	9.9	0.5	-13.4	0.2	8.9	10.1	1.8	2.0
Imports	-5.5	16.1	15.8	-2.7	-3.0	-9.4	3.2	5.3	-0.8	3.0
Consumer Price index (CPI)	2	1.6	2.1	2.9	4.9	2.7	2.3	0.5	2.6	1.8
Producer price index (PPI)	-1.4	6.3	3.5	-0.3	-0.6	-3.3	-2.2	-1.8	-2.0	1.2
Broad money supply (M2, ending balance)	11.3	8.1	8.1	8.7	10.1	11.1	10.9	10.4	10.4	9.0
Aggregate financing to the real economy (Stock)	12.8	14.1	10.3	10.7	11.5	12.8	13.5	13.5	13.5	12.0

Source: BOC Research Institute

III. Macroeconomic Policy Orientations

Firstly, the proactive fiscal policy will continue to be employed in an effort to directly fund the real economy and improve the bond issuance system. **First**, as the fallout from COVID-19 ebbs, China's economic growth will get back on track and the fiscal policy will return to normal step by step. **Second**, policies will be refined to promote direct funding of the real economy and improve the bond issuance system. **Third**, China will continue to cut taxes and fees for private businesses and micro, small and medium-sized enterprises (SMEs) to bring down their operating costs.

Secondly, structural monetary policy instruments will remain the priority, seeking to be more targeted and flexible. **First, the monetary policy will be more targeted.** Taking into account the insufficient internal drivers of economic growth and particularly the difficulties facing SMEs, the monetary policy will be more targeted to channel funds into the real economy. **Second, structural monetary policy instruments will remain the preferred choice.** The monetary policy will continue to address structural issues, giving priority to illiquidity of smaller financial institutions and SMEs' limited access to funds.

Thirdly, consumption stimulus will remain strong, while the infrastructure investment policy will place equal emphasis on conventional and new types of infrastructure. As for consumption, automobile consumption will be stabilized and expanded by adjusting the auto purchase restriction measures and increasing the licence plate quotas. Consumption regarding home appliances, furniture and improvements will be encouraged with subsidies. As for investment, the infrastructure investment policy will continue to focus on key projects regarding strengthening weaker areas of infrastructure and fields of new infrastructure. The real estate investment policy will, while upholding the principle that "houses are for living in, not for speculation", further highlight the importance of having a long-acting mechanism in place, and speed up the reforms in the *hukou* (household registration) system and land supply management.

Fourthly, the coordinated development of innovation and industry will be strengthened to promote industrial transformation and upgrading. Enterprises will be encouraged to spend more on research and development, especially basic researches, by granting tax breaks and launching industry guidance funds. China will promote integrated development of key industries and modern services, step up the effort to foster service-oriented manufacturing and establish a number of enterprises, platforms and demonstration areas for deeply integrated development and

service-oriented manufacturing, which will play a leading role.

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