10 Macro Economic Trends in 2021

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Executive summary

COVID-19 is undoubtedly a ‘black swan’ and has significantly affected the global economy in 2020. As 2020 draws to a close, there are many ways to review China’s economic performance. We believe that there are two ‘upside surprises’ that provide an interesting angle to look at China’s economic development in 2020: exports and foreign direct investment. Despite very strong global headwinds, both areas have shown positive growth this year, beating market expectations.

The rationale behind the two upside surprises is similar. Thanks to its fast and effective measures to control the spread of the pandemic, China has led the world in restarting its economy. However, many other countries are still trying to fully contain the pandemic, which is holding their economic recovery back. At the same time, many advanced economies have introduced massive fiscal and monetary stimulus to stabilize economic growth, and consumption demand has remained resilient. The gap between demand and supply in those markets has made China’s role as a production base and investment destination increasingly important.

Against this background, we expect China’s economic growth to continue to recover and to grow 8.8% in 2021. In particular, we anticipate 10 macro trends for China's economy next year:

1. Consumption and service sectors continue to improve and become the main driver for China’s economic recovery in 2021
2. Growth of manufacturing investment further accelerates
3. Exports remain robust, with growth rate staying high in 1H and moderating in 2H
4. Fiscal and monetary stimulus will be gradually dialled back, but the pace of policy adjustment should be watched closely
5. China remains attractive to foreign investment; supply chain resilience becomes an important consideration
6. Foreign holdings of RMB financial assets rise further and RMB exchange rate is expected to stay relatively strong
7. The global economy continues to recover, but is still influenced by pandemic control and vaccine roll-outs
8. US-China trade frictions may ease temporarily with the new US administration
9. Asia Pacific economic integration will be further strengthened
10. Innovation, security and green development are expected to be the key policy focus

Two upside surprises of 2020

COVID-19 is undoubtedly a 'black swan' event and has significantly affected the global economy in 2020. There are many ways to review China's economic performance in the past year, but two 'upside surprises' provide an interesting angle: exports and foreign direct investment (FDI).

Exports

China's exports increased 2.4% year-over-year (YoY) in the first 10 months. By contrast, global trade decreased by 14% YoY in the first half of 2020 and the WTO expects it to decline by 9.2% for the full year. As a result, we calculate that China's share of global exports increased by 2.7 percentage points from the end of 2019 and reached 16.7%.

FDI

A common concern at the beginning of the year when the pandemic just started to spread was that foreign investment might leave China. Policies by some countries to support such reshoring further accentuated the concern. In reality however, FDI into China has remained resilient and grew 6.4% in Jan-Oct from a year ago, with even seeing double-digit growth rates in recent months. By contrast, global FDI decreased by 49% in 1H2020 and UNCTAD expects global FDI to fall 30%-40% this year.

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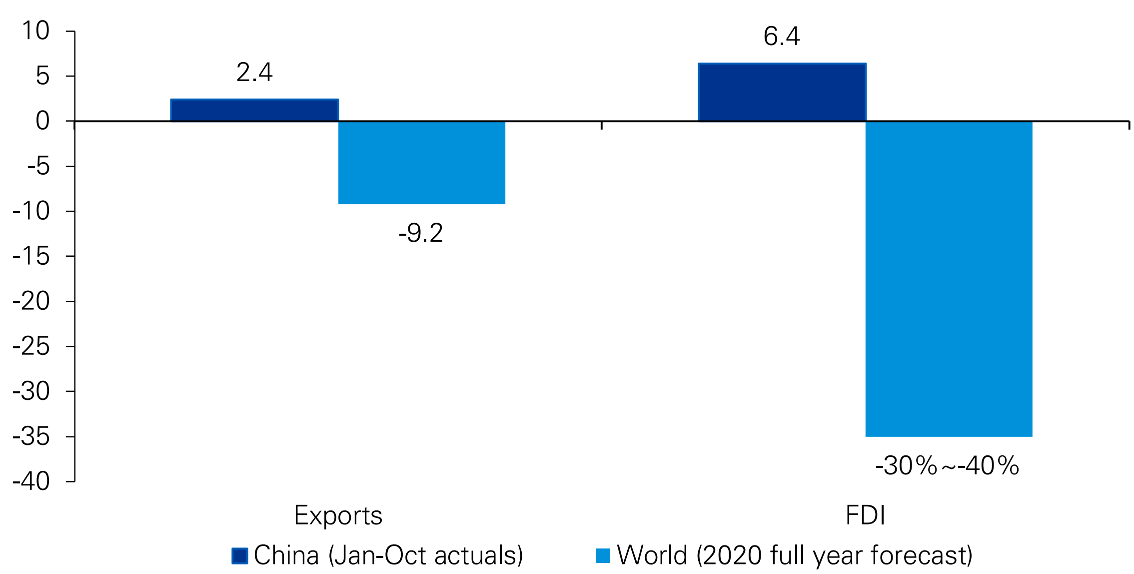
Against this background, we expect China's economic growth to continue to recover and to grow 8.8% in 2021. In particular, we believe there are 10 macro trends that companies should pay attention to for next year's economic environment.

Figure 1 China's exports and FDI growth, YoY, %



Data source: Wind, KPMG analysis

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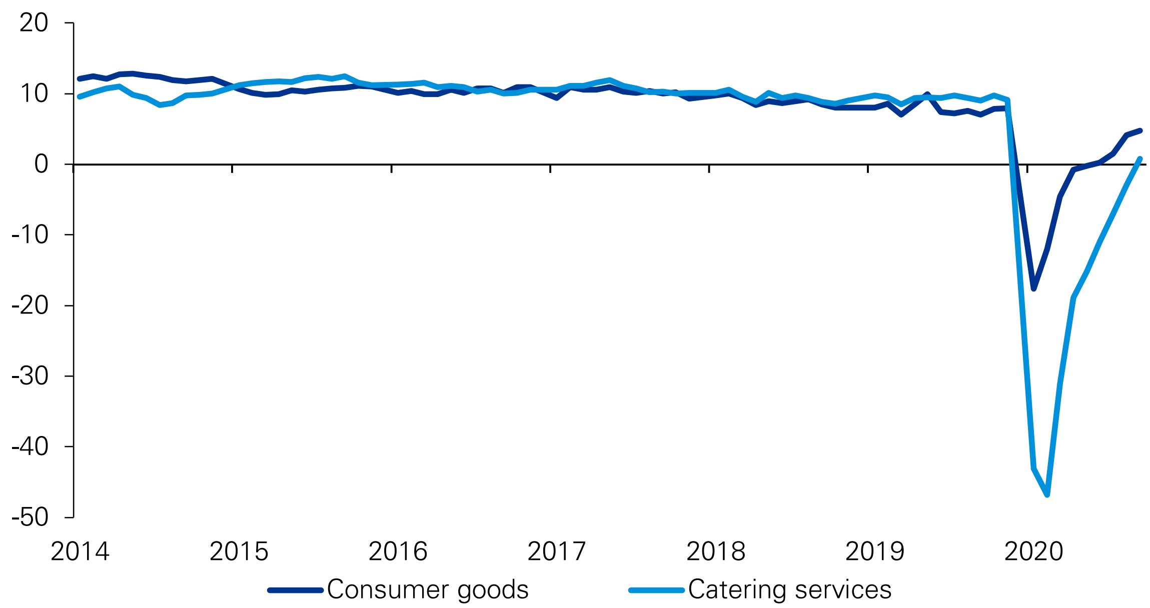
1 Consumption and service sectors continue to improve and become the main driver for China's economic recovery in 2021

Manufacturing, investments and exports have been the main drivers of China's economic recovery in 2020. However, the rebound in consumption, especially service-related consumption, was slow and lagged the manufacturing recovery. Looking forward, we expect consumption and the service sector will improve and become the main drivers for China's economic recovery in 2021. The labour market has continued to improve since Q3 and household disposable income has rebounded to the same level as last year. Growth in catering services also turned positive for the first time this year in October. China's economic recovery is gradually shifting from corporate-driven to household-driven. The improving labour market, stronger consumer confidence, and normalization of pandemic containment measures should continue to boost consumption next year.

Figure 2: Retail sales of consumer goods and catering services, YoY, %



Data source: Wind, KPMG analysis

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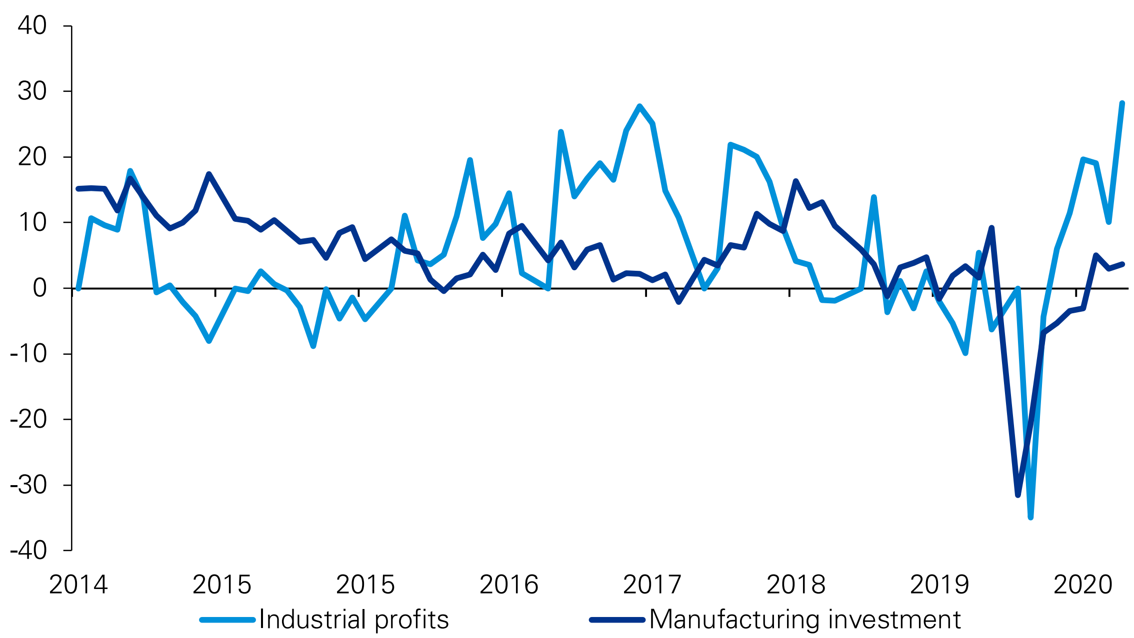
2 Growth of manufacturing investment further accelerates

The manufacturing sector has seen a healthy rebound. Supported by tax and fee cuts, industrial profits have also experienced strong growth, and corporates have started to build up inventory. The manufacturing purchasing managers' index (PMI), a leading indicator, has remained in the expansionary range since March and has continued to improve. The Caixin manufacturing PMI even hit a 10-year high in November, indicating sustainable growth in the manufacturing sector. The guidelines of the upcoming 14th Five Year Plan (FYP), covering the 2021-2025 period, emphasized manufacturing as an essential driver for China's economy. The government will accelerate growth of the advanced manufacturing sector to build a strong industrial base. We believe that manufacturing investment, especially in high-tech manufacturing supported by industrial upgrading, will continue to grow rapidly and become the major driver of investment next year. It is worth noting that the private sector is the main driver of manufacturing investment and contributes about 90% of total manufacturing investment. Growth in manufacturing investment reflects the improvement of the private sector.

Figure 3 Industrial profits and manufacturing investment, YoY, %



Data source: Wind, KPMG analysis

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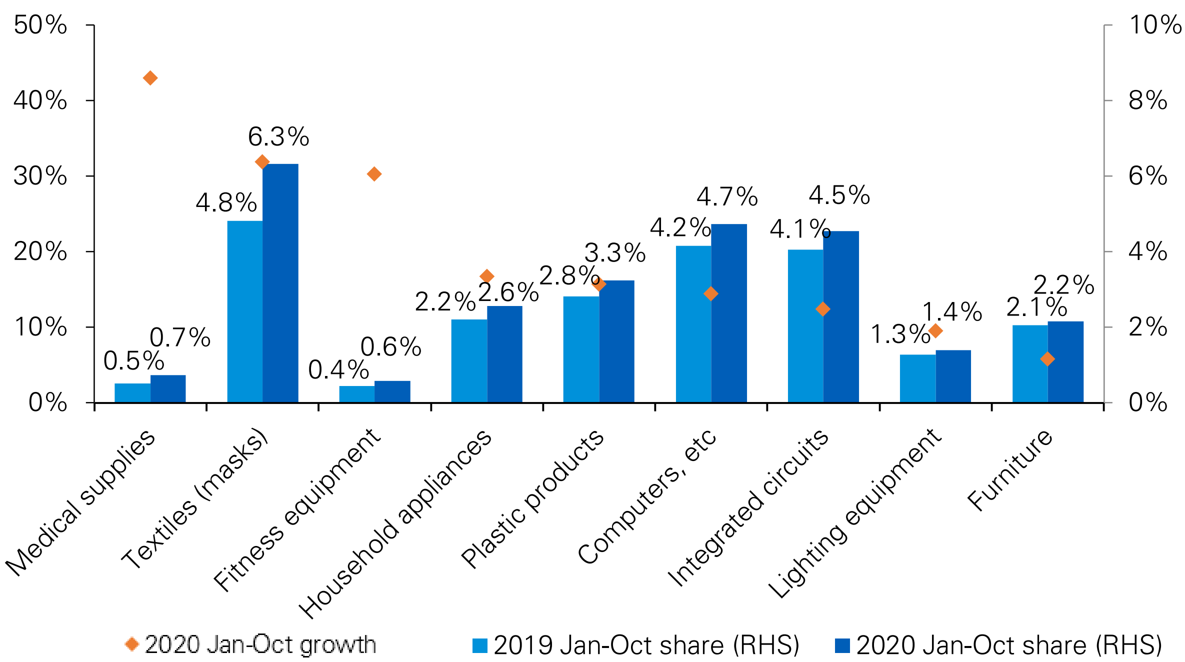
3 Exports remain robust, with growth rate staying high in 1H and moderating in 2H

Medical supplies and the "at-home economy", such as computers, home appliances and fitness equipment, are the two main drivers of China's exports this year. In addition, as production capacity in many emerging markets has yet to recover, some orders have shifted to China and have also supported export growth. As the pandemic is still spreading around the world, the gap between production and demand in many markets is expected to remain in the near future, which should continue to benefit China's export sector. Growth of China's exports is expected to remain high in the first half of 2021 but will moderate in the second half. As the global economy gradually normalizes with the roll-outs of vaccines, medical supplies and substitution export orders will abate. A high base also makes the year-over-year comparison less favourable, causing export growth to retreat in the second half of 2021.

Figure 4 Growth and shares of China's merchandise exports, %



Data source: General Administration of Customs, KPMG analysis

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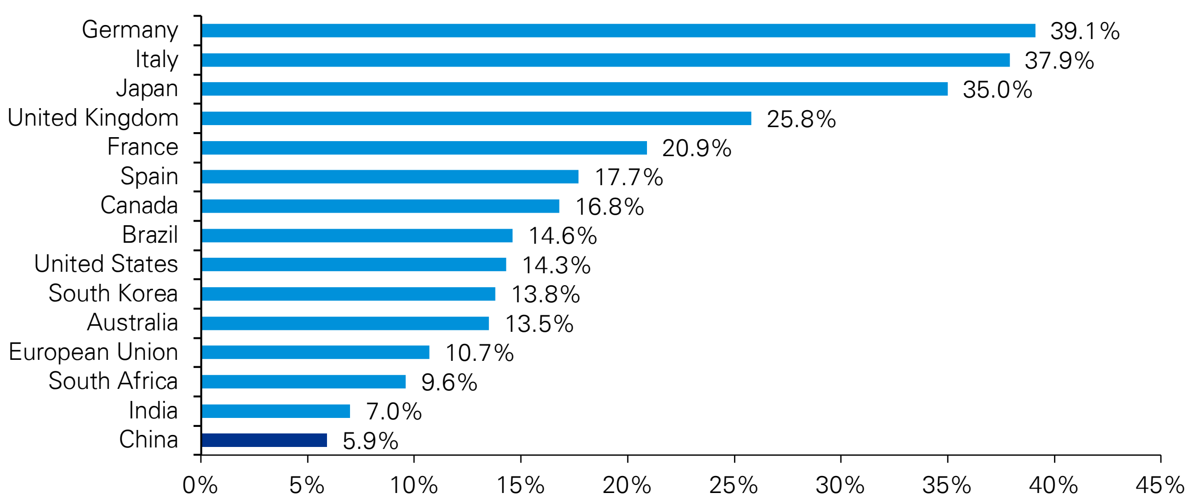
4 Fiscal and monetary stimulus will be gradually dialled back, but the pace of policy adjustment should be watched closely

Compared to the massive fiscal and monetary stimulus launched by many economies, the Chinese government's response has been very restrained. For example, fiscal stimulus in the US has already totalled nearly USD3 trillion, accounting for more than 14% of its GDP. By contrast, China's fiscal stimulus is less than 6% of its GDP. We expect with continued economic recovery, China's fiscal and monetary policies will be gradually normalized. For example, China's fiscal deficit ratio has never exceeded 3% since the 1980s, but in order to fight the epidemic the ratio was set at "above 3.6% " this year for the first time. We expect the deficit ratio to be dialled back to around 3% in 2021. In addition, in the Q3 Monetary Policy Report released by the People's Bank of China recently, the central bank indicated growth of money supply and total social financing in 2021 will be "basically in line with nominal GDP growth", compared to its goal of "significantly higher than last year" for 2020. However, the current recovery is still fragile and subject to many uncertainties. Policy support measures should remain flexible and not be withdrawn too early or too quickly. Companies should pay close attention to the speed and pace of policy normalization and make business plans accordingly.

Figure 5 Fiscal stimulus measures in response to the COVID-19 pandemic, percent of GDP



Data source: Wind, KPMG analysis

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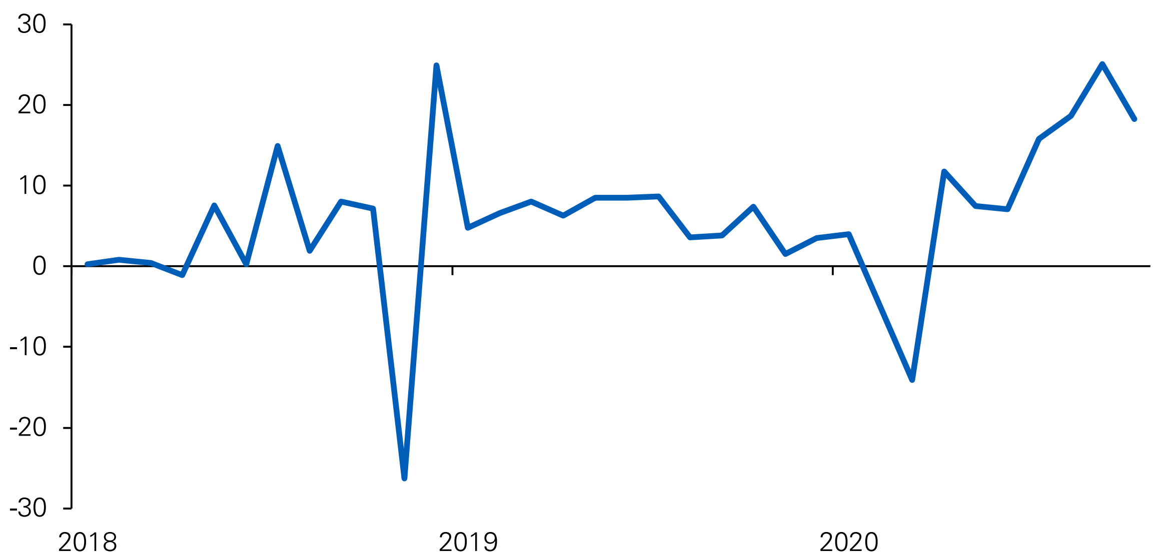
5 China remains attractive to foreign investment; supply chain resilience becomes an important consideration

A huge and rapidly growing domestic market, broad industrial base, high-quality infrastructure, and continuous opening-up policies all make China an attractive destination for foreign investment and a high priority for multinational corporations. Traditionally, cost and response speed have been top factors in companies' supply chain decisions. However, the COVID-19 outbreak has hit supply chains in many markets, particularly for those industries with long and complex supply chain networks. Enterprises have had to rethink the importance of security and stability throughout the supply chain. As a result, supply chain resilience has become an important dimension when companies evaluate their global production strategies and make necessary adjustments.

Figure 6 Growth rate of FDI to China, YoY, %



Data source: Wind, KPMG analysis

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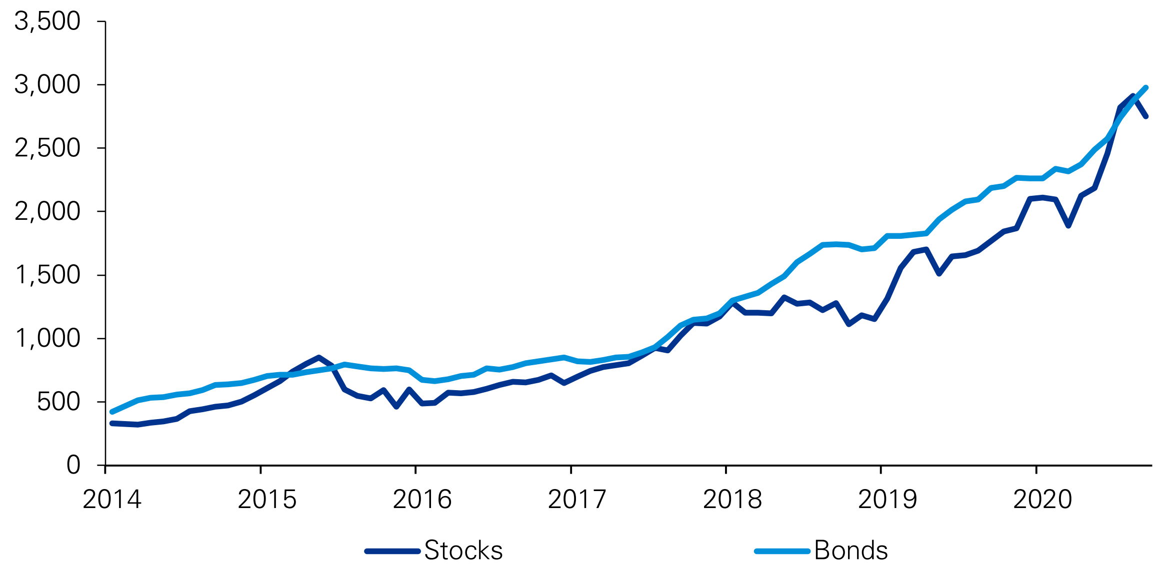
6 Foreign holdings of RMB financial assets rise further and RMB exchange rate is expected to stay relatively strong

The global financial market has seen unprecedented volatility this year, but it has not stopped China from continuing to open up its financial markets. For example, China scrapped the quotas on Qualified Foreign Institutional Investor (QFII) after 18 years of implementation; allowed international rating companies to enter the market; removed ownership restrictions for foreign financial firms; and had government bonds added to the global major indices. Meanwhile, China's economic recovery has also make its financial assets more attractive. For example, the 10-Year government bond spread between China and the US has widened to 240 basis points. All these factors have attracted global investors to increase their holdings of China's financial assets. We expect foreign holdings of China's domestic equities and bonds to reach RMB6 trillion. China will continue to promote the opening-up of the financial sector and facilitate foreign investment in RMB financial assets in 2021. We expect the CNY exchange rate to remain stable with some modest appreciation pressure.

Figure 7 Foreign holdings of China's domestic RMB stocks and bonds, RMB billion



Data source: Wind, KPMG analysis

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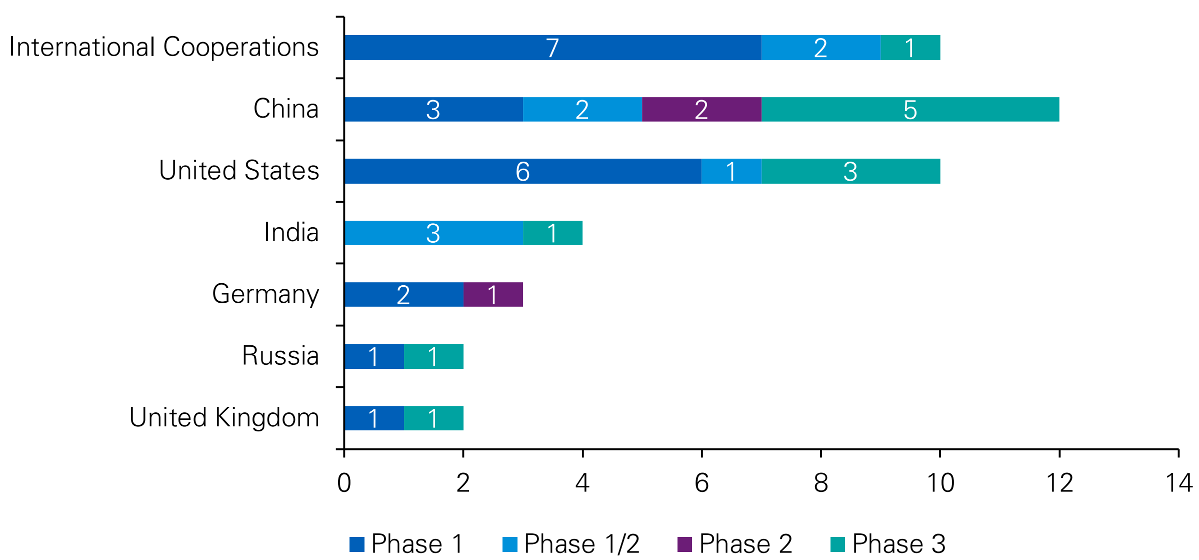
7 The global economy continues to recover, but is still influenced by pandemic control and vaccine roll-outs

We analysed the relationship between a country's economic recovery and its success in containing the pandemic for major economies around the world. Not surprisingly, we found a strong positive correlation: countries that have a better control over the pandemic usually see stronger economic recovery. We expect the global economy to continuously recover from the trough but the pace of the recovery is still subject to pandemic containment and vaccine roll-outs. COVID-19 vaccine development has made significant progress recently. According to the WHO, there are 51 vaccines in clinical trials worldwide as of 2nd Dec. 13 vaccines, including 5 from China, have already been in the Phase 3 of clinical evaluation. On 2 December, the UK became the first country in the world to give emergency-use-authorization (EUA) to the Pfizer/BioNTech COVID-19 vaccine[1]. With new progress on vaccine development, financial markets have responded favourably and the global economy is expected to continue to improve. It is worth noting that the production, distribution and administration of vaccines will still take time and globally coordinated efforts are needed to fight the common threat to mankind.

Figure 8 Stages of clinical testing for global vaccine development, number of vaccines (as of 2 December)



Data source: WHO, KPMG analysis

[1] Regulatory approval of Pfizer/BioNTech vaccine for COVID-19, the UK government, December 2020, https://www.gov.uk/government/publications/regulatory-approval-of-pfizer-biontech-vaccine-for-covid-19

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8 US-China trade frictions may ease temporarily with the new US administration

The dust should settle from the 2020 US presidential election, and President-elect Joe Biden should be inaugurated on 20 January 2021. There are still some areas of uncertainty before the new administration formally takes the reins. For example, the US Congress recently passed the Holding Foreign Companies Accountable Act, which may have an impact on Chinese companies listed on the US stock markets. Key priorities for the new administration are expected to include containing the pandemic and restarting the US economy, and the US-China trade frictions may ease temporarily. The Biden administration may likely revert to a more traditional foreign policy structure and rely on multilateral approaches and existing international organizations. We expect dialogue between the US and China may increase somewhat in 2021, which would help reduce uncertainty. However, it is still challenging for the US-China relationship to see substantial improvement soon and our baseline scenario is that the status quo will be maintained in the near term. Tariffs and other restrictive measures that have been imposed earlier may be difficult to remove quickly.

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9 Asia Pacific economic integration will be further strengthened

A major change in China's foreign trade this year is that ASEAN surpassed the US and the EU to become China's largest trading partner. Recently, after 31 rounds of negotiations spanning 8 years, 15 economies in the Asia Pacific region signed the Regional Comprehensive Economic Partnership (RCEP). It is regarded by some as "the most important breakthrough for East Asia's economic integration in nearly 20 years"[2]. The RCEP established for the first time a free trade agreement between China-Japan and South Korea-Japan. The agreement should further strengthen economic collaboration in the region through measures such as reduced tariffs, cumulative rules of origin, negative list on foreign investment, and e-commerce development. It should also allow more flexibility and collaboration for supply chain deployment in the region. It is true that economic levels, government structures, and cultures across the 15 member countries vary substantially and there is still a long road before the RCEP's benefits are fully realised. However, stronger regional economic collaboration has been on the rise as progress on globalisation has stalled in recent years. The global economy may instead form three hubs comprising the Asia Pacific, North America, and the European Union.

Table 1 Comparison of the regions in the three free trade agreements

	RCEP		EU		USMCA	
Number of economies covered	15		27		3	
Population (million)	2,262	(29%)	448	(6%)	493	(6%)
GDP (USD billion)	25,816	(29%)	15,593	(18%)	24,369	(28%)
Exports (USD billion)	5,481	(29%)	5,815	(31%)	2,551	(13%)
Imports (USD billion)	4,956	(26%)	5,532	(29%)	3,498	(18%)
FDI (USD billion)	364	(24%)	388	(25%)	329	(21%)
ODI (USD billion)	441	(34%)	424	(32%)	212	(16%)
Avg. GDP growth rate, 2015-2019 (%)	5.2%		2.3%		2.4%	
Avg. GDP growth rate, 2020-2025 (forecast, %)	4.2%		1.1%		1.2%	

Note: The shares of each region to the world total is in parentheses.
Data Source: IMF, UNCTAD, World Bank, WTO, and KPMG analysis. Growth rate and forecast are from Oct 2020 issue of IMF WEO, weighted by GDP of purchasing power parity.

[2] Landmark achievement for East Asia regional economic collaborations, People's Daily (Chinese), November 2020, http://opinion.people.com.cn/n1/2020/1116/c1003-31931587.html

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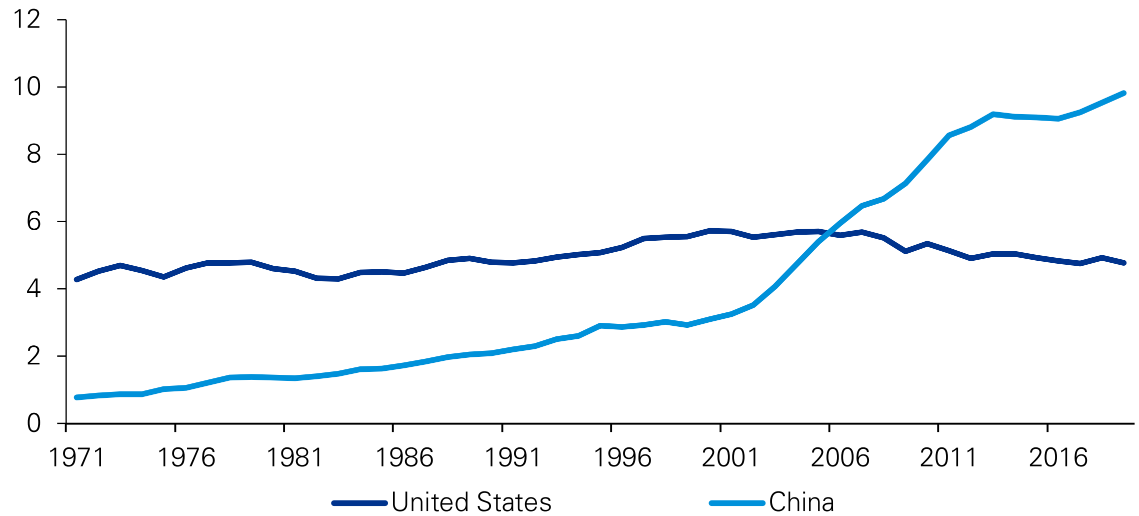
10 Innovation, security and green development are expected to be the key policy focus

China recently released the guidelines for the 14th Five-Year Plan (FYP) and the 2035 long term vision. The 14th FYP carries particular importance, as it will be the first five-year plan after China has completed its first centennial goal of building a "moderately prosperous society in all aspects" and started driving towards its second centennial goal. It not only set targets for the next five years but also lays out a path for medium to long term development. It emphasizes three new features in China's future development: new era, new concept and new pattern. We believe there are three keywords that deserve close attention: innovation, security, and green development. Indigenous innovation, especially on core technology areas, is considered fundamental to China's future growth. China is set to invest heavily in key technology areas such as artificial intelligence, quantum computing, integrated circuits, life/brain science, crop breeding, space, deep earth and deep sea explorations. In addition, in light of increasing external uncertainty, national security has also received special attention under the 14th FYP and it calls for implementing a holistic national security strategy. The 14th FYP should have an impact on many areas of the economy, such as industry structure, infrastructure, natural resources, technology, finance, and ecosystems. On green development, China has set a goal to see CO_2 emission peak by 2030 and realize carbon neutrality by 2060. China has replaced the US to become the largest CO_2 emitter in the world: it is not an easy job for the country to achieve these goals and promoting greener development is imperative. This presents expanding opportunities in areas such as new energy vehicles, environmental conservation and restoration, smart grid development, and resource recycling.

Figure 9 CO2 emissions, billion tons



Data source: IEA, KPMG analysis

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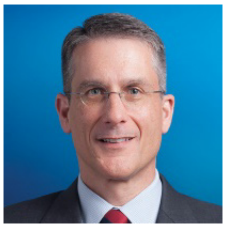

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