36. CHINA

China's economic recovery continued in early 2021 despite localised virus outbreaks and the reimposition of social distancing measures in parts of the country. While the recovery in investment and exports has so far spearheaded growth, the latest data confirm a gradual rebalancing towards consumption led growth. As the overall outlook remains positive, monetary policy is expected to be gradually withdrawn while policymakers focus on reducing existing macroeconomic imbalances. Downside risks stemming largely from high indebtedness by both the corporate and the public sector appear more pronounced in the short term and are only partially offset by potentially stronger than expected pent up demand.

The recovery continues with some signs of weakening momentum

With the main impact of the pandemic and its containment measures concentrated in the first quarter of 2020, China's economy recovered strongly over the rest of the year, driven initially by dynamic investment and strong exports. Stronger consumption helped further strengthen GDP growth in 2020-Q4, to 6.5% (y-o-y), bringing annual GDP growth in 2020 to 2.3%, making China the only major economy to grow last year.

Despite the record growth rate in 2021-Q1 of 18.3% y-o-y, which largely reflects the unprecedented decline of economic activity a year ago, the 0.6% q-o-q rate reveals a noticeable slowdown. GDP was again driven by a strong consumption recovery, 11.6% y-o-y, aided by positive contributions from other demand components. The momentum of economic activity was undermined in January and February by new localised outbreaks of COVID-19 and the subsequent reintroduction of lockdown measures in the north of the country. While still below their levels at the end of 2020, PMI indicators point to a partial recovery of economic activity in March.

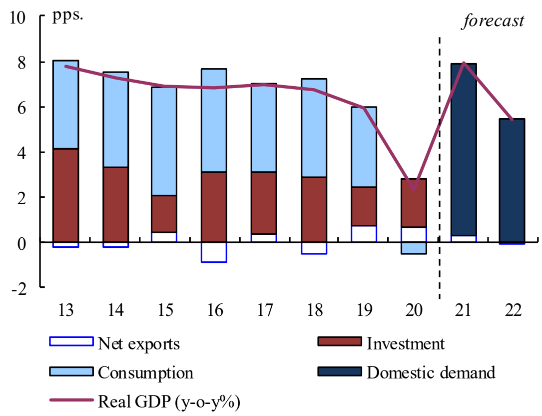
Consumption to drive growth in 2021

Annual GDP growth is expected to reach 7.9% in 2021, largely due to a strong carry-over effect and strong pent up demand. Growth is expected to recede to 5.4% in 2022, as the pandemic shock dissipates and the economy gets back to its decelerating trend, weighed down by weakening productivity growth, high stock of corporate and public debt and geopolitical uncertainties.

Consumption is expected to be the main driver of growth in both 2021 and 2022, supported by rising personal incomes, relatively low inflation, and improvements in the labour market. Investment activity growth is expected to moderate, as the government focuses on tightening credit conditions, especially for real estate purchases, and local government bond issuance normalises. Investment may also slow as a high debt overhang will increasingly limit the investment capacity of corporates and local government units.

In 2020, Chinese goods exporters benefited from the relatively early recovery of production in China, stable epidemiological developments, weaker competition due to disruptions in competitor economies, and a shift in consumer preferences towards consumer goods and away from services. They were thus able to markedly increase their market share but as these effects dissipate over the forecast period, the growth of goods exports is expected to moderate. Furthermore, the recovery of domestic demand should push imports higher and thus further undermine the growth contribution of net exports. Accordingly, China's current account surplus is projected to decline gradually in both 2021 and 2022.

Graph II.36.1: **China - Real GDP growth and contributions**



Gradual withdrawal of policy support

China's overall approach towards paring back its stimulus measures has been cautious. Monetary stimulus focused on supporting liquidity and lending to the corporate sector; while fiscal measures included increased healthcare expenditure, employment subsidies, corporate tax deferrals and reductions, and additional investment. While both monetary and fiscal stimuli were relatively contained and targeted, they exacerbated some of the economy's structural challenges, notably high corporate indebtedness and a surging property sector. Maintaining stability by avoiding sharp policy reversals will thus remain a priority for some time.

Monetary policy is expected to gradually adopt a more neutral stance, balancing support for growth with prudential measures to curb excessive lending. With the benchmark lending rate (loan prime rate) unchanged since April 2020, the People's Bank of China is focusing on withdrawing excess liquidity and tightening credit conditions.

On the fiscal side, policy support is expected to be gradually withdrawn over the forecast horizon. The budget for 2021 aims for mild reductions of the official headline fiscal deficit and local government special bond issuance, while halting entirely the issuance of special treasury bonds dedicated to help fund the recovery from the pandemic last year.

Downside risks remain elevated

The financial sector, especially the bond market, has recently come under stress, with several high profile defaults, including by state-owned enterprises. Given the risk of contagion to the wider financial sector, target policy action will be needed to ensure orderly debt restructurings. The recent tightening of financial conditions to curb excessive lending for real estate purchases should help, but risks related to the property sector remain elevated. Supply disruptions of key components for the automotive industry could exacerbate production delays and negatively impact manufacturing output in the second half of 2021. On the positive side, stronger-than-expected pent up demand, especially for services, could further boost economic output.

Finally, the accelerated economic decoupling between China and the USA could weigh on already weakening productivity growth in China over the medium term.

Table II.36.1:

Main features of country forecast - CHINA

	2019			Annual percentage change						
	bn CNY	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP		98651.5	100.0	9.5	7.0	6.7	6.0	**2.3**	**7.9**	**5.4**
Consumption		55263.2	56.0	-	-	-	-	**-**	**-**	**-**
Gross fixed capital formation		42245.1	42.8	-	-	-	-	**-**	**-**	**-**
of which: equipment				-	-	-	-	**-**	**-**	**-**
Change in stocks as % of GDP				-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		22565.7	22.9	14.0	7.9	3.7	0.8	**-0.2**	**9.1**	**4.0**
Final demand				-	-	-	-	**-**	**-**	**-**
Imports (goods and services)		21425.9	21.7	13.3	7.6	6.7	-3.2	**-1.9**	**7.8**	**4.8**
GNI (GDP deflator)		-	-	-	-	-	-	**-**	**-**	**-**
Contribution to GDP growth :	Domestic demand			-	-	-	-	**-**	**-**	**-**
	Inventories			-	-	-	-	**-**	**-**	**-**
	Net exports			-	-	-	-	**-**	**-**	**-**
Employment				-	-	-	-	**-**	**-**	**-**
Unemployment (a)				4.1	3.9	3.8	3.6	**4.2**	**-**	**-**
Compensation of employees/head				-	-	-	-	**-**	**-**	**-**
Unit labour costs				-	-	-	-	**-**	**-**	**-**
Real unit labour costs				-	-	-	-	**-**	**-**	**-**
Saving rate of households				-	-	-	-	**-**	**-**	**-**
GDP deflator				3.6	4.2	3.5	1.3	**0.6**	**3.1**	**2.2**
Private consumption deflator				-	-	-	-	**-**	**-**	**-**
Index of consumer prices (c)				2.4	1.6	2.1	2.9	**2.5**	**-**	**-**
Merchandise trade balance (b)				4.5	3.9	2.7	2.8	**3.5**	**3.1**	**2.9**
Current-account balance (b)				4.0	1.5	0.2	0.7	**1.9**	**1.5**	**1.3**
Net lending(+) or borrowing(-) vis-à-vis ROW (b)				-	-	-	-	**-**	**-**	**-**
General government balance (b)				-	-	-	-	**-**	**-**	**-**
General government gross debt (b)				-	-	-	-	**-**	**-**	**-**

(a) urban unemployment, as % of labour force. (b) as a percentage of GDP. (c) national indicator.