

MACRO OUTLOOK

Return of De-Risking Focus Will Hurt Near-Term Growth

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1Q2021 KEY TAKEAWAYS

- Growth will slow down in the first quarter as a result of policy tightening and the end of relief spending.
- Recovery will eventually pick up steam in the second half as the labor market improves and consumption strengthens.
- As such, the Chinese economy will likely see a shallow V-shaped growth in 2021 even in the absence of stimulus.

In the first quarter, Beijing will continue to pursue a prudent fiscal policy, prioritize de-risking vulnerabilities in the economy, and begin implementing structural reforms as part of the 14th Five-Year Plan (FYP). Combined, these priorities will put downward pressure on near-term growth. But so long as growth holds around 5%, Beijing is willing to ride it out without stepping on the gas.

The Chinese government has shown considerable reluctance in continuing to support stimulus-driven recovery, as the industrial and the property sectors have already roared back. The lag in consumption recovery remains worrisome but will likely become the new growth driver by the second half of 2021.

The potential for consumption to drive growth remains large and will accelerate because of the resilience of the labor market, which will likely improve even in the absence of substantial policy support. But such a transition in growth drivers will take time, so a bumpier first half will likely yield to V-shaped growth later in the year.

This outlook focuses on the risks to near-term growth but also looks ahead to anticipate how the nature of growth will improve in 2021.



OLD GROWTH DRIVERS GONE, NEW GROWTH DRIVERS LAG

Over the coming months, downward pressures on growth will outweigh the residual relief measures, such as subsidized lending to small businesses, that will soon dry up. For instance, Beijing has already ended the cut in social security contributions—[totaling more than](#) 1.6 trillion yuan (~\$240 billion)—that made up the largest component of relief measures in 2020.

Curtailing short-term growth drivers and renewing emphasis on de-risking will dominate the first quarter. Beijing has telegraphed that it intends [to concentrate](#) on long-term issues to ensure a good start to the 14th FYP, which will mean less attention to near-term growth. Consequently, Beijing will likely aim for around 8% growth during the annual “State of the Republic” report at the National People’s Congress in March.

That growth may seem very high, but it’s misleading to take it at face value given the dramatic contraction seen in 2020. With 2020 growth of 2.3, an 8% growth rate implies just 5% growth year-on-year for 2Q-4Q 2021. This is actually lower than the 6.5% growth achieved in 4Q2020 when the economic rebound picked up steam. In other words, Beijing is not looking to accelerate growth beyond where it ended 2020.

This comports with the expectation floated by Han Wenxiu, a minister-level technocrat and a close associate of Vice Premier Liu He, after the Central Economic Work Conference in December 2020. Han publicly stated that Beijing will aim for an average growth of around 5% for the 2020-2021 period.

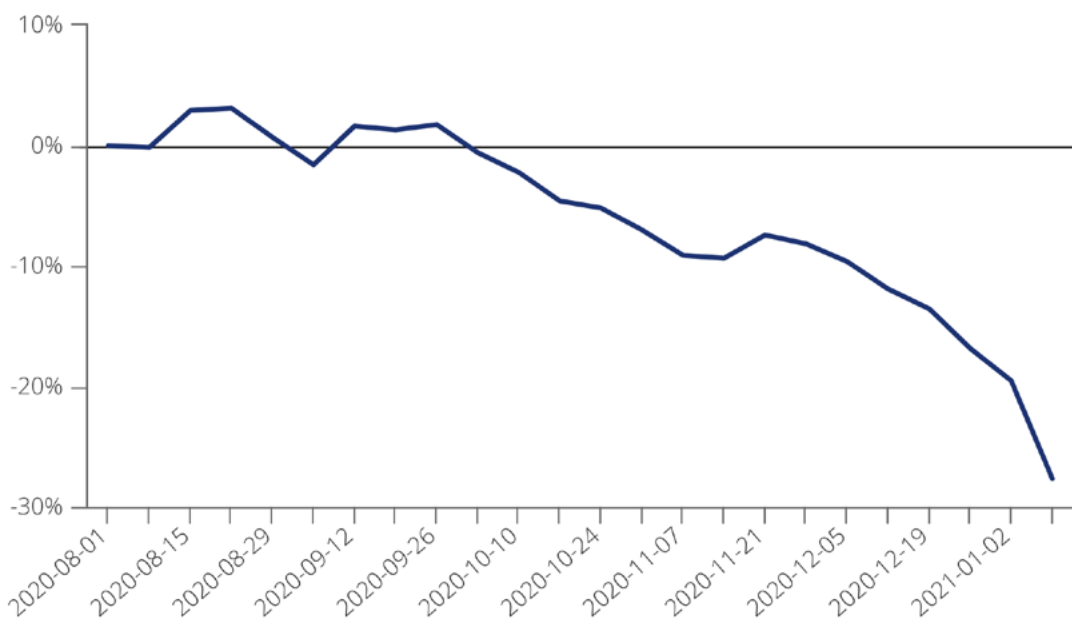
Meanwhile, addressing vulnerabilities such as local government debt and property overheating are back on the agenda, which means existing growth drivers such as investment and property will be stifled.

Local government debt has been on the back burner for the last couple of years as Beijing tried to cope with uncertainty associated with the trade war and a growth slowdown in 2018-2019. But now, Beijing’s posture on controlling debt is expected to shift from preventative to proactive. As a result, the first quarter will likely see a series of policies on local government deleveraging that will put a drag on growth and infrastructure investment.

Property was a key growth driver in the second half of 2020, but it will no longer be so. The Chinese government [now believes](#) the property sector is one of the biggest risks in China's financial system. Since August 2020, Beijing has been tightening the screws on property firms' debt growth, while more recently banks have been forced to curb mortgage lending.

Each on its own has a limited impact, but taken together, the effect of these restrictive policies on the property sector has been substantial. Since last September, property stocks have underperformed the top 300 stocks in China by 28%, underscoring investors' bearish outlook on the property sector (see Figure 1).

Figure 1. Property Stocks Have Significantly Underperformed the CSI 300 Index (%)



Source: Wind.

De-risking and tightening will likely be concentrated in the first quarter, but because of the lag between policy and impact, the effect on growth will reverberate through 1H2021. In short, despite Beijing's promise of no sudden turn in policy, the first quarter will nonetheless be quite disruptive for growth.



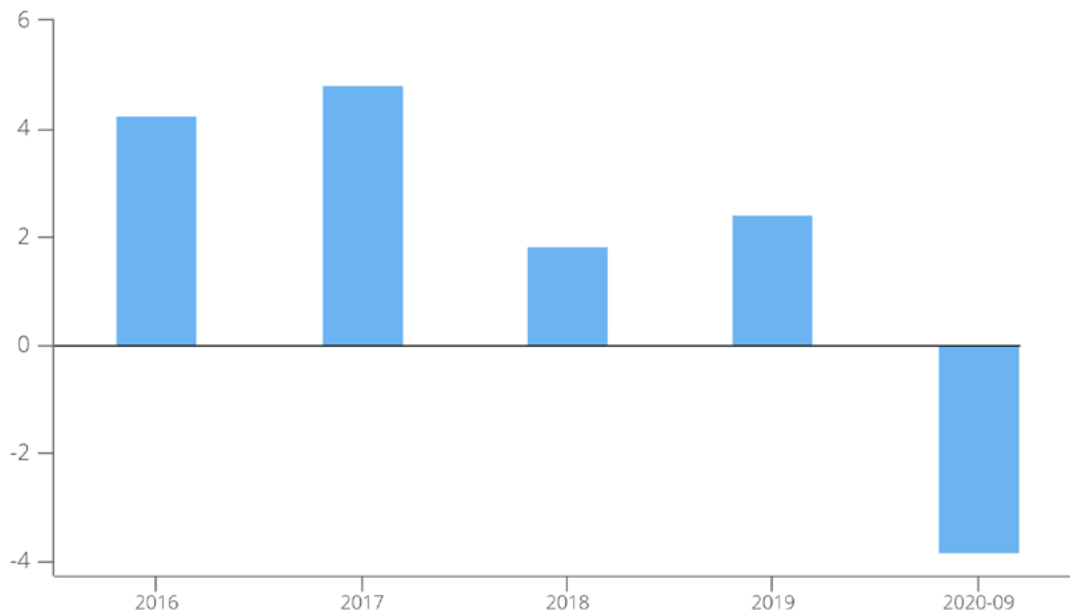
Potential for Recovery Grows

Yet not all is lost on growth for 2021. A bumpy first quarter will likely yield to solid growth in the second half because the potential for consumption recovery remains significant. It has been clear for some time that China's rebound from the Covid-19 shock has been highly unbalanced, with consumption lagging behind production. But the slow pace of consumption recovery also means there is a lot of upside yet to be seen.

The upside will come from a labor market that has yet to return to pre-Covid levels. Although urban employment conditions have been improving overall since 2Q2020, both jobs and wage growth are still below pre-pandemic levels. This is especially notable in the migrant jobs market, which was already weak even before the pandemic hit.

For instance, the 2016-2017 period created an average of 4 million more migrant jobs than the 2018-2019 period, a dip that is likely partly the result of the US-China trade war (see Figure 2). Migrant employment growth of course collapsed in 2020, while wage growth in the same year was also 5 percentage points below the norm.

Figure 2. Migrant Employment Still Far below the Norm (in millions)

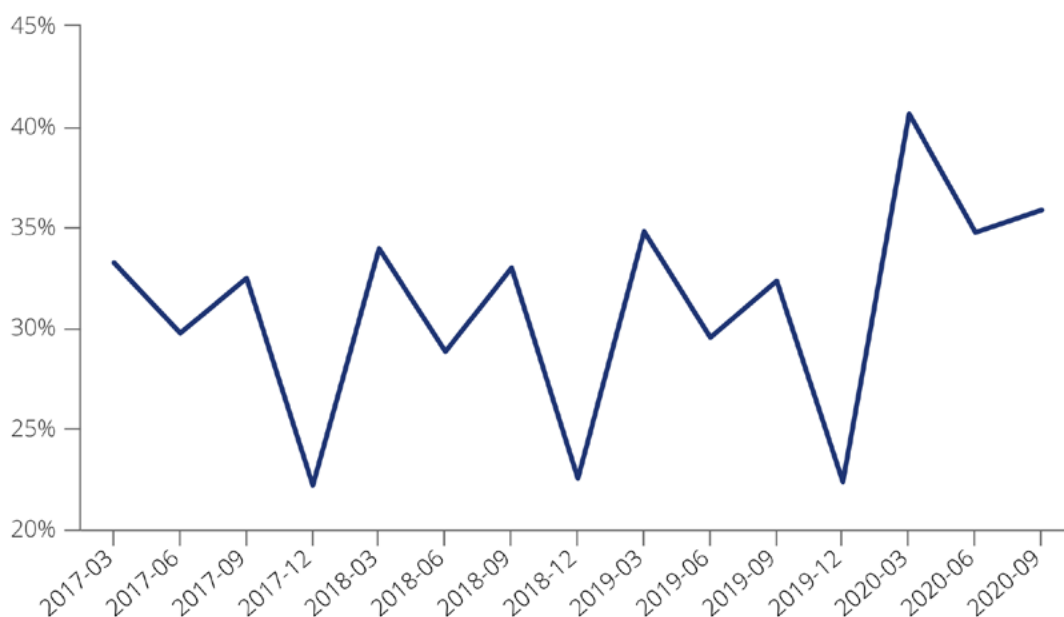


Note: Shows y-o-y change in migrant employment.

Source: Wind.

The slack in the labor market directly affects consumer confidence, which has a considerable impact on Chinese households already wary of spending. In fact, the Chinese household savings rate has climbed four percentage points to 36% during the pandemic (see Figure 3). In other words, if the savings rate drops to its pre-Covid level, that alone would translate into ~7% more consumption.

Figure 3. Chinese Household Savings Rate Remains Elevated



Source: Wind and MacroPolo.

So a sustained consumption recovery hinges on labor market conditions, which are likely to improve in spite of inadequate policy support. This is because, over time, China's labor market has demonstrated an ability to self-correct above expectations, both during the previous slowdown cycle and over the pandemic year.

Even as GDP growth in the 2018-2019 period dropped by nearly one percentage point, the unemployment rate increased by just 0.2 percentage points. In contrast, a one percentage point drop in US GDP growth has historically [led to](#) 0.5 percentage points increase in the unemployment rate. Moreover, despite no growth rebound in 2019, migrant employment growth actually accelerated. Similarly, although 2020 GDP growth was 4 percentage points below that of 2019, migrant employment growth was only 3 percentage points below trend.



If the labor market continues to exhibit signs of resilience, then the consumption picture will look rosier in the second half. As a result, the negative impact of policy tightening will eventually be offset by a stronger labor market.

V-Shaped Growth Coming

As policy tightening hits existing growth drivers such as fiscal spending and property investment in the first quarter, growth will necessarily depend more on consumption. But this transition in drivers will take time to manifest itself and to have a tangible impact. This means sectors such as infrastructure and housing will weaken in the near-term, dragging growth down with them.

Moreover, the expiration of relief spending, particularly the social security contribution cuts, will have a sizeable negative impact on job creation because hiring is now more expensive. This will retard labor market recovery and continue to hurt household consumption in 1Q2021.

As growth momentum weakens in the near term, some turbulence should be priced in. Yet at the same time, the transition of growth drivers will continue apace on the back of a labor market that is poised to recover by the second half. This will inject more optimism for V-shaped growth, and we will continue to track this transition in the outlooks for the rest of the year.