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China's Economy in 2020: Navigating Headwinds

China emerged in June 2020 as the first major country to announce a return to economic growth since the outbreak of the COVID-19 pandemic. The government reported 3.2% gross domestic product (GDP) growth in the second quarter and 4.9% GDP growth in the third quarter of 2020. The International Monetary Fund (IMF) projects China's economy to grow by 1.9% in 2020. China is still grappling with the economic effects of the COVID-19 pandemic, however, including sluggish domestic consumption, slow recovery in its top export markets, and reliance on government spending and exports to boost initial growth. China also is facing growing restrictions on its overseas commercial activities and access to foreign technology and pressures for firms to diversify China-based supply chains. Against this backdrop, China's leadership is deliberating the country's economic direction and national industrial plans for the next 5 to 15 years.

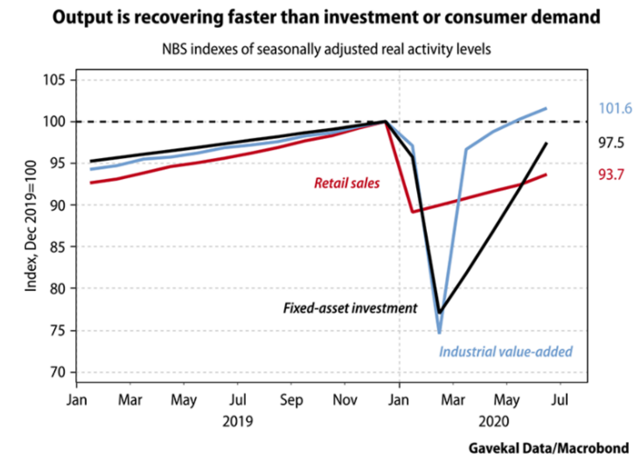
COVID-19 Support Measures to Boost Growth

To boost economic growth, China since February 2020 has provided an estimated $506 billion in stimulus and increased the government's budget deficit target to a record high of 3.6% of GDP, up from 2.8% in 2019. China reduced the value-added tax (VAT) rate and introduced VAT exemptions for certain goods and services. China's central bank extended monetary support with interest rate cuts, eased loan terms, and injected liquidity into banks. Shifting from efforts to reduce debt, the government announced the issuance of $142.9 billion of special treasury bonds for the first time since 2007; increased the quota for local government special bonds (a source of infrastructure funding); and fast-tracked issuance of corporate bonds to cover pandemic costs but with potential broader uses. The IMF estimates that the fiscal measures and financing plans announced amounted to 4.1% of the China's GDP, as of July 2020. The government says it seeks to control credit risk but the need for additional fiscal and monetary support to boost growth may undermine this goal.

Systemic Economic Challenges

China also is grappling with economic challenges that predate the pandemic, including slowing domestic growth, rising labor costs, trade pressures including U.S. tariffs, rising consumer inflation, and rising corporate and government debt levels. In September 2020, China's Purchasing Manager's Index was 51.5%—a sign of modest expansion—but industrial activity remains below 2019 levels. August 2020 retail sales were reliant on government stimulus to increase 0.5% over August 2019. The ongoing outbreak of African Swine Flu since 2018 has decimated over half of China's pork herd and led to acute shortages. The Chinese government has tapped strategic pork reserves and increased imports from Europe and Brazil, but this has not compensated for the decline in imports from the United States since China imposed tariffs on U.S. pork in 2018. China has now increased U.S. pork imports to meet demand and implement purchase targets set in the January 2020 U.S.-China trade agreement. In August 2020, President Xi launched a campaign against food waste, signaling a potential focus on strengthening domestic food supply and the possibility that shortages are more serious than official reporting indicates. Food and energy security was one of six economic priorities at the Communist Party of China (CPC)'s Politburo meeting in April 2020.

Figure 1. China's Industrial Production and Retail Sales (January 2019 to July 2020)



Source: Gavekal with data from China's National Bureau of Statistics

Since 2016, the Chinese government has pursued a deleveraging campaign to reign in bad debt accrued by local governments, commercial banks, and unauthorized "shadow" lending. China's total debt across sectors—household, corporate, government, and financial sector—could reach 335% of GDP in 2020, according to the International Institute of Finance. China also has an estimated $90 billion and another $100 billion in U.S. dollar-denominated debt due in 2020 and 2021, respectively. Onshore, Chinese companies owe an estimated $694.6 billion in 2020 and $706 billion in 2021. The deleveraging campaign led to several regional bank bailouts in 2019. The number of defaults dropped in 2020—likely due to stimulus measures and laxer rules—but debt and non-performing loan challenges persist and could grow if policy measures push loan forbearance and growth.

Trade Outlook

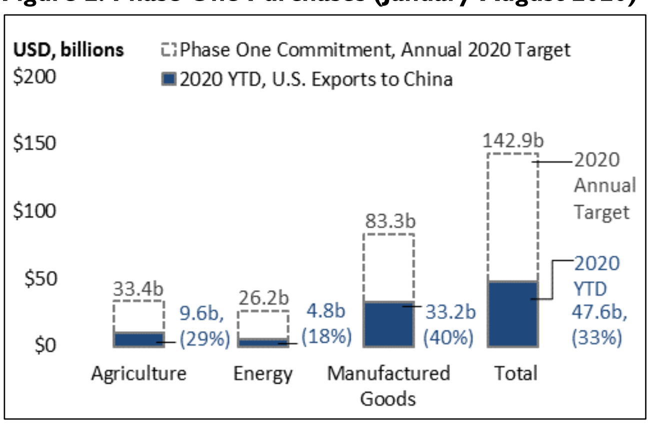
China's trade recovered in the third quarter of 2020, but future export drivers are uncertain. Initial export growth was mainly driven by a short-term surge in medical personal protective equipment and consumer electronics. China lost share in machinery and some consumer goods during the first 8 months of 2020, areas it may seek to boost. In March 2020, China increased VAT export rebates for 1,500 products, including steel, building materials, insecticides, chemicals, and agricultural goods. In August 2020, China increased its Export-Import Bank's loan exposure cap by $85.1 billion. China supplies over half of global steel and may encourage exports to address domestic overcapacity. China's 2019 production was at an all-time high (almost 1 billion tons), and Chinese crude steel production between January and July 2020 is up 2.8% over the same period in 2019. In contrast, crude steel production over the same period is down by 19.2% in the EU; 18.7% in North America; 24% in India; 18.8% in Japan; and 9.6% in South Korea.

China has been taking steps to stem appreciation of its currency, likely in part to keep exports competitive. China's central bank chairman said that China aims to keep domestic prices and foreign exchange values stable. This goal could require further market intervention, however. The Treasury Department's semi-annual report on foreign exchange policies for major trading partners is due on October 15, 2020. The January 2020 U.S.-China trade deal has a currency commitment—similar to Chapter 33 of the U.S.-Mexico-Canada Agreement—for market-determined exchange rates, transparency and reporting requirements.

Rising costs, U.S. tariffs and technology restrictions, and business uncertainty have driven firms over the past five years to migrate elements of China-based supply chains to other countries, such as Vietnam and Mexico. The COVID-19 pandemic exposed the risks of concentrating China production, likely accelerating this trend. Some governments—such as those of Australia, India, Japan, the UK, and the United States—are calling for secure supply chains and technology alliances among like-minded countries in high-value areas. China is attracting foreign investment in sectors, such as electric vehicles, where it requires a local presence to sell in China, creating a counter pressure to offshoring.

China appears reticent to market opening, except in financial services where it seeks to offset risk. China has imposed import restrictions on agriculture and other commodities from Australia and Canada in an apparent effort to create commercial pressures to advance China's political goals In September 2020, Canada abandoned trade talks with China, and in June 2020 European officials chastised China for failing to address longstanding trade concerns.

Figure 2. Phase One Purchases (January-August 2020)



Source: CRS with U.S. export data from the U.S. Census Bureau.

Notes: This data does not include China's $67.8 billion commitment in services imports for 2020.

Phase One Trade Deal

The U.S.-China trade deal included a commitment for China to buy $468 billion over 2 years of U.S. agriculture, energy, goods, and services. To date, China has purchased 33% of its 2020 commitment and some purchases fall below 2017 levels (e.g., coal), although agricultural trade is expected to get a boost as U.S. fall harvests ship. China's efforts to diversify sources of agricultural imports—resulting in record imports from countries, such as Argentina and Brazil—may hinder its ability to meet its commitments. When global oil prices collapsed in March 2020, China imported 53.18 million tons of crude oil from non-U.S. sources to replenish its strategic reserves.

Economic Policy Direction

The CPC's 19th Central Committee—a body of China's 204 senior Party leaders—is scheduled to hold its 5th Plenum on October 26 to 29, 2020 to deliberate on China's 14th Five-Year Plan (2021-2025) and economic goals out to 2035. (The Central Economic Work Conference is to review the plans in December 2020 ahead of the annual session of the National People's Congress in March 2021.) Of potential interest to Congress, ahead of these meetings, Chinese leaders are signaling policies to counter what they describe as new global constraints on China. Early details suggest that China is seeking to leverage the global economy to advance its goals in some ways that could challenge or reshape global rules and counter certain U.S. interests and policies.

President Xi is reviving a "dual circulation" policy that his predecessor used in the 2009 financial crisis. The term refers to leveraging the dual forces of domestic and global demand, or in other words, developing domestic capacity while pursuing openings in global markets. In 2009, the government used this approach to subsidize increased production in 13 industries while global industry contracted. This generated excess capacity that China then exported. China under President Xi is advancing a strong state role in the economy and advocating for Chinese leadership in global standards-setting. A digital campaign calls for $1.4 trillion over five years in 5G, smart cities, and other technology infrastructure, and a push to adopt this approach globally. In September 2020, the CPC Central Committee called for strengthening Party control of the private sector to "build a backbone of private economic actors that are reliable and useful at critical moments." Chinese leaders are emphasizing self-reliance and indigenous innovation—longstanding themes in China's policies—and sustained access to foreign technology and markets. An emphasis on basic research calls for foreign collaboration. A new semiconductor plan calls for overseas research and production centers. The Chinese government is advancing a cryptocurrency to try to influence global finance and ecommerce, and diversify from U.S. dollar financing. In October 2020, China issued an export control law to counter U.S. export controls and sanctions.

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