China’s Economic Outlook

- The Chinese economy is on a road to gradual recovery after a deep contraction in activity in the first quarter of 2020.
- Significant downside risks persist, such as a second wave of COVID-19 infections and flaring up of trade tensions with the US.
- Chinese policymakers will likely announce further significant fiscal stimulus measures following the National People’s Congress, expected to take place in May.
- A monetary easing bias will remain in place for the foreseeable future to complement fiscal stimulus and support the economy’s recovery.

ECONOMIC GROWTH OUTLOOK

China’s economic outlook continues to be challenging due to the COVID-19 outbreak, yet early signs of recovery are emerging. The virus outbreak has stabilized in recent weeks (chart 1), allowing Chinese authorities to start gradually relaxing restrictions on the movement of people and reopening the economy. The first quarter of 2020 marked the peak of the COVID-19 crisis in China, triggering a significant contraction in activity (chart 2). Real GDP declined by 6.8% y/y in the January–March period compared with a 6.0% gain in the final three months of 2019. In non-annualized quarter-over-quarter terms, activity dropped by 9.8% in the first quarter.

The Chinese economy has embarked on a recovery path as production is gradually resumed and life is returning to normalcy (chart 3). China’s coal consumption has been rising in recent weeks from the February slump and road congestion in large cities has returned to pre-Lunar New Year levels. We expect real GDP growth to rebound through the rest of 2020 and into next year, assisted by significant stimulus by fiscal and monetary authorities. The supply side of the economy, particularly the industrial sector, will likely record the fastest recovery, reflecting the fact that it is much easier to resume factory production than consumer spending, for example. The demand side will recuperate only after business and consumer confidence has started to strengthen sufficiently, which will be a slower process. Indeed, high frequency data for the month of March show that the recovery in industrial production is leading that of retail sales (chart 2 again). We forecast China’s real GDP growth to average 1.6% in 2020, followed by a rebound to 8.5% next year.

The economic outlook continues to be highly uncertain with risks tilted to the downside. A potential second wave of infections is a significant risk. Moreover, given that a large part of the world economy will be in recession over the coming months with contracting demand, China’s recovery dynamics will be tempered accordingly. Meanwhile, trade tensions with the US continue to linger in the background. Given the challenging economic backdrop, we assess that it will be very difficult for China to meet its purchase commitment of US goods as agreed in the “phase one” trade deal in mid-January. Accordingly, the risk of the trade conflict flaring up again over the coming months is high.
Public outlays will play a key role in supporting the economy’s recovery; the government has announced various measures, such as tax and fee cuts as well as a larger quota for local government bond issuance. We expect further substantial fiscal stimulus to be unveiled in the near future, given the severity of the economic contraction in the first quarter. Details will likely be shared following the annual parliamentary gathering, the National People’s Congress, which is expected to take place in May after being postponed in March due to the virus outbreak. We foresee additional tax and fee cuts that will underpin the Chinese consumer—an important policy measure for maintaining social stability. Additional support measures for private sector enterprises are also likely, along with higher infrastructure outlays focusing on urban transportation, utilities facilities, and rural development. Due to the lack of transparency of the Chinese administration and its finances, exact monetary figures capturing the size of fiscal stimulus are unlikely to become available.

**MONETARY POLICY, INFLATION AND YUAN OUTLOOK**

The People’s Bank of China’s (PBoC) monetary easing steps will complement the government’s fiscal stimulus. On April 20, the 1-year Loan Prime Rate was lowered by 20 basis points to 3.85%; the rate has been cut by 40 bps since August 2019. The latest move was in line with the central bank’s other actions; on March 30, the 7-day reverse repo rate was also lowered by 20 bps to 2.20% while on April 15 the 1-year medium-term facility rate was reduced by the same magnitude to 2.95%. In addition, the central bank has been easing monetary conditions by lowering banks’ reserve requirement ratios (RRR). In January, the RRR for large banks was lowered by 50 bps to 12.5%, which followed 150 bps of cuts over the course of 2019 (chart 4). The latest announcement took place on April 3; the central bank cut the RRR by 100 bps for small and medium-sized banks, taking effect in two steps on April 15 and May 15 (50 bps each). We expect further monetary stimulus over the coming months. Chinese authorities have also communicated that ample liquidity in the banking system will be maintained and credit availability will be increased. The PBoC is also guiding banks to increase credit support to small private sector companies, the manufacturing industry, and industries that are directly either affected by the virus outbreak or involved in the control of the pandemic. Accordingly, credit growth has picked up in recent months (chart 5).

China’s headline inflation is easing from elevated levels, which reflected higher food—particularly pork—prices. Annual inflation was 4.3% y/y in March compared with the January peak of 5.4%. We expect further weakening over the coming months on the back of low commodity prices and muted demand-driven price pressures; the headline rate will likely drop below 3% y/y before the end of 2020. Moreover, inflation further up the distribution chain remains non-existent, with annual producer price gains currently residing in negative territory.

The Chinese yuan (CNY) has faced a depreciating bias against the US dollar (USD) since 2018 when trade tensions with the US flared up; the currency crossed the USDCNY7.0 mark in August 2019 and has since hovered around that level. We expect the PBoC to prioritize yuan stability over the coming months given elevated uncertainties globally. Indeed, using significant devaluation of the CNY to support the country’s exporters would be risky as it might trigger capital flight pressures. Furthermore, the yuan’s value remains a sensitive issue in the trade discussions with the US, further incentivizing the PBoC to promote currency stability. We expect USDCNY to remain in the 7.05–7.15 range over the coming weeks.