10 December 2020

The China Letter

Strong growth, self-reliance and a new US-China path

- **Strong economic finish to 2020. CNY strength continues**
- **US-China tensions to continue in a new setting under Biden presidency**
- **Moderate stress in Chinese credit markets maybe not a bad thing**
- **Five-Year Plan to focus on self-reliance, innovation and stronger domestic market**

Strong finish to 2020

China is ending 2020 on a strong note economically. PMI indicators for both manufacturing and services are at high levels, profit momentum is robust and export growth reached a 10-year high in November (if disregarding the occasional spikes you see around the Chinese New Year). For an overview of Chinese indicators, see our *China Macro Monitor – A strong finish to 2020*, 8 December 2020.

The CNY has continued to strengthen against the USD, but it is as much a story about USD weakness as CNY strength. Lately CNY weakened a bit against the EUR and the trade weighted CNY is less than two percent above the average of the past five years (chart 3).

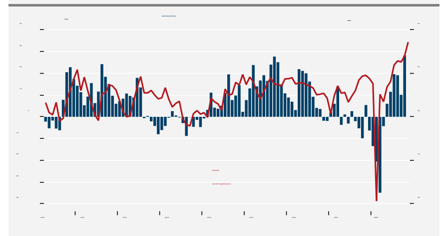
Comment: The strength in Q4 has been even stronger than we had expected. One explanation seems to be that the global manufacturing recovery has strengthened further in Q4, despite new COVID-19 related restrictions in US and Europe. However, we still look for growth and PMIs to peak in Q1 2021, as the catch-up effect following the plunge in Q1 starts to fade and stimulus is likely to start to dwindle during 2021. The latter is already indicated by slower credit growth (chart 2). For more on the outlook see *China Outlook – From rebound to cruising speed*, 9 December 2020. We look for CNY to strengthen further against the USD due to monetary policy divergence and we have a 12-month target of 6.40.

US-China relations to remain tense under Biden

Although President-elect Joe Biden will bring a big change in style to the White House and will be less erratic than President Donald Trump, the Democrats generally share the grievances over China and a continued tough stance is set to continue. In an interview with *New York Times*, Biden highlighted two points:

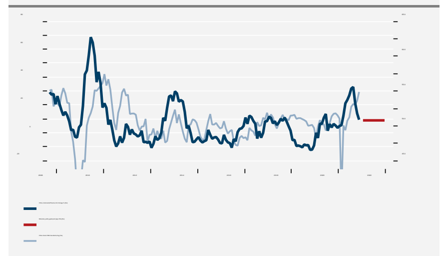
- **Build an alliance to confront China.** "The best China strategy, I think, is one which gets every one of our — or at least what used to be our — allies on the same page. It's going to be a major priority for me in the opening weeks of my presidency to try to get us back on the same page with our allies."
- **Industrial policy investing in US tech.** It is all about leverage "and in my view we don't have it yet". According to the article, part of getting leverage is developing a consensus of government-led investments in American research and development,

Chart 1: Very strong PMI and profit growth in Q4



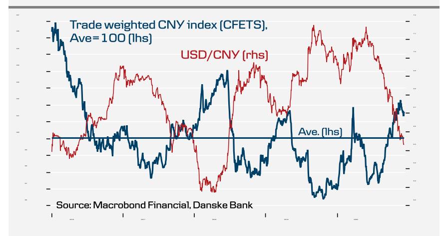
Source: Macrobond Financial

Chart 2: Slower credit growth points to a peak in PMIs soon



Source: Macrobond Financial, Danske Bank

Chart 3: CNY strengthened vs USD but not much in trade weighted terms



Source: Macrobond Financial, Danske Bank

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infrastructure and education to better compete with China – and not just complain about it. Both Democratic and Republican senators have draft bills for such a strategy. Biden mentioned energy, biotech, advanced materials and AI as areas ripe for government investments.

On Monday Chinese foreign minister Wang Yi called for Beijing and Washington to reset ties after months of rising hostility. In a speech at the board of the US-China Business Council he talked about rebuilding trust, strengthening communication and expanding areas of cooperation and said that "we expect and believe that the US' China policy will return to objectivity and rationality sooner or later."

Comment: It seems clear that Biden will work to build an economic coalition of like-minded countries, which together can confront China on economic issues and possibly on other areas as well, such as human rights. **China is not going to like this approach and will see it as a containment strategy.** China may look for individual countries to work more closely with, possibly in Eastern Europe, while punishing other countries within the 'alliance' as is seen with Australia currently. At the same time, China will continue to work to bring Asian countries closer economically – as they did it the RCEP trade deal – and work even more with partners in other Emerging and developing countries.

Biden was clear that he will not remove the Trump-imposed tariffs immediately but it may come down the road. His choice for Treasury Secretary, Janet Yellen, has spoken against tariffs as it mostly leads to a stronger currency and American consumers and companies mostly pay the bill. **On the tech war front, the new administration may grant more licences to Chinese companies**, but for a company like Huawei, export bans aimed at its 5G technologies can be expected to remain. Huawei has become the symbol of China's security threat towards the US and it will be hard for Biden to be too soft, even though the US semiconductor industry has lobbied against the export bans. For good reason; China is now clearly on a journey to develop its own semiconductors and Chinese companies are starting to look for alternatives to US suppliers out of fear they may be next to be hit by US export bans.

Stress in credit markets is not a bad thing

Following the default of several state owned enterprises, Chinese credit markets turned sour lately with some state owned enterprises (SOEs) seeing a sudden increase in their bond yields. Three state companies, a coal-miner, a chip-maker and an auto company, all missed bond payments, surprising investors as they were expected to enjoy an implicit state guarantee as reflected in their AAA rating. While credit markets have been under moderate stress, it has so far been contained and conditions have been eased by some larger than expected injections of liquidity by the People's Bank of China.

Comment: While causing stress in the short term the defaults will, in our view, turn out to be positive in the long term. First, it is a **sign that China is gradually removing the implicit state guarantee on SOEs**, which will force them to become more efficient. It highlights the government's aim of improving the profitability of SOEs and is a necessary component of further SOE reform. Second, it **should make credit markets function better,** as companies will be priced more in line with their financial strength and profitability than on an expected implicit guarantee. It should improve the allocation of capital.

While we are likely to see more defaults, the **government is unlikely to allow a big wave of defaults**. This could put financial stability at risk and lead to a sharp rise in financing costs for all existing SOEs. However, a signal has been sent to markets and SOEs and this should gradually push things in the right direction.

Five-Year Plan: Self-reliance and "dual circulation"

China's top leaders met in late October at what is called the 5th plenum of the 19th CPC Central Committee to outline priorities for China's new Five-Year Plan (FYP), which will be presented March 2021. **A key focus in the new FYP is "self-reliance" and strengthening of the domestic market** as the mainstay of the economy. At the same time, China's new expression of "dual circulation" highlights a strengthening of foreign markets with the domestic and foreign market boosting each other.

The communique from the meeting stated that China faces a "complicated international situation", a clear reference to the much tougher stance from the US in recent years. There was no GDP target mentioned, but one can be expected when the final plan is revealed. Some think tanks have suggested 5% for the period 2021-2025, which would entail a further decline in growth. It underlines China's increased focus on quality over quantity in growth and that broader goals take a higher priority. These include a greener development path, fighting financial risks and strengthening the social system.

Comment: China's focus on self-reliance has been clear for a while. The US export restrictions on China have dealt a huge blow to a company like Huawei and it is obvious to China that it **has no choice but to aim to become independent of US technology**, in order to be master of its own economic fate and development. The result is even more investment in core technologies. While the US will likely to succeed in holding back parts of Chinese tech businesses in the short term, it could turn out to be a Pyrrhic victory if China gains technological independence. US tech companies would end up losing significant market share in their biggest market. Even if Joe Biden softens on the export bans, China cannot be sure that new restrictions would not come back later with another US president. Hence, the self-reliance strategy is here to stay.

The downplay of a GDP target is positive as it has been contributing to much wasteful investment over the years. There is still need for reform in China, to level the playing field for private vs state companies and foreign vs domestic companies, to and make state companies more efficient. The rules are increasingly in place, for example in the new Foreign Investment law, but as with many other things in China, it is ultimately the enforcement of the rules that counts.

Key features in the coming Five-Year Plan

- **Self-reliance in technology**
- **Focus on innovation as key development driver**
- **Domestic market mainstay of the economy**
- **"Dual circulation" with domestic and foreign markets boosting each other**
- **Strengthening high-quality manufacturing**
- **Further opening-up**
- **CNY internationalisation in a steady and prudent manner**
- **Deepening of reform**
- **Advancing green development**

Source: Caixin, Xinhua

Other news lately

Asian leaders sign *RCEP*, the world's largest trade deal. It was a clear geopolitical victory for China at a point where the US has been pulling out of deals, not least the TPP which was a big disappointment for many Asian nations. Here's a good *analysis* of RCEP by Robert Ward of International Institute for Strategic Studies.

Monetary *policy exit* is a matter of timing. Liu Guoqiang, vice governor of the People's Bank of China on 6 November: "Exit is a matter of timing, and it is also necessary…But the timing and method of exit need to be carefully evaluated, mainly based on the status of economic recovery."

China urges US to *stop increasing* ties with Taiwan. Comment: The development in US-Taiwan relations will be another important component of how the US-China relationship develops over the next four years.

The China-Australia relationship keeps hitting a new low. The most recent confrontation was over a tweet by Foreign Ministry spokesman Zhao Lijian, one of Beijing's so-called Wolf Warriors. This *article* in The Diplomat gives a good overview of the latest development.

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Report completed: 9 December 2020, 17:35 CET

Report first disseminated: 210 December 2020, 09:00 CET