MARCH 2021

ASIA MACRO

China's Five-Year Plan: A transformative shift towards self-sufficiency

For Professional Investors only in Hong Kong and Accredited Investors (in respect of accounts opted-in to be treated as Accredited Investors) and Institutional Investors in Singapore only

KEY TAKEAWAYS

- GDP growth expected to reach 8.6% in 2021, exceeding the official target floor of 6.0%. The targets during the 14th Five-Year Plan will be set on an annual basis, as more emphasis will be placed on employment and innovation.
- Five themes will shape the next five years: 1) China will achieve high-income status by 2025; 2) Domestic consumption will take over as the next driver of growth; 3) Innovation will reduce external vulnerabilities; 4) Climate goals will require sizeable investments; and 5) Structural reforms will benefit the development of domestic bond and equity markets.
- Investors that can successfully embrace these themes will be better positioned to benefit the most from China's brightening cyclical outlook and favourable long-cycle backdrop.

2021 targets: Premier's Government Work Report places more emphasis on employment and innovation

The National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPCC) closed in Beijing on March 11th. This is the most important event on China's political calendar, as the NPC approves the main policy objectives that will set the tone for the remainder of the year. This year was especially important, as it also coincided with the start of the 14th Five-Year Plan (14-FYP, 2021-2025) and the 100th founding anniversary of the Communist Party of China.

The economy will expand at a pace of "at least 6.0%" in 2021. We believe that this is something which is easily attainable. We have therefore maintained our growth forecast for 2021 at 8.6% and 4.5-5.0% thereafter. However, it is noteworthy to mention that 6.0% is in line with both the pace of growth before COVID-19 as well as GDP growth in 2021 excluding favourable base effects in Q1-21. By reducing the focus on the growth target, the authorities will be able to focus on other policy priorities, including stabilising the labour market and reducing inequalities that have built up as a result of the global pandemic. To highlight this point, Premier Li Keqiang's Government Work Report mentioned the word "GDP" 19 times, far fewer than "employment" (62 times) and "innovation" (57 times).

The market reaction to the targets was generally favourable, as it points to continued gradual tightening but without removing support to the most vulnerable sectors of the economy. For instance, the fiscal deficit target was lowered to -3.2% of GDP in 2021, down from -3.6% in 2020 but above expectations of -3.0%. To balance this slightly lower fiscal target, the local government special bond quota was set at CNY 3.65 trillion (USD 560 billion or 4% of GDP), down from CNY 3.75 trillion in 2020, but higher than expected – most economists had predicted that this would be scrapped.

On the monetary policy front, M2 growth will trail nominal GDP, down from an average rate of 10.3% y/y in 2020. To offset slightly tighter monetary conditions, the PBOC extended financial forbearance, meaning that Micro, Small and Medium Enterprises (MSMEs) will be allowed to defer principal and interest repayments by another 12 months, while banks will be asked to increase loans to MSMEs by 30% in 2021. The latter is understandable in the context of

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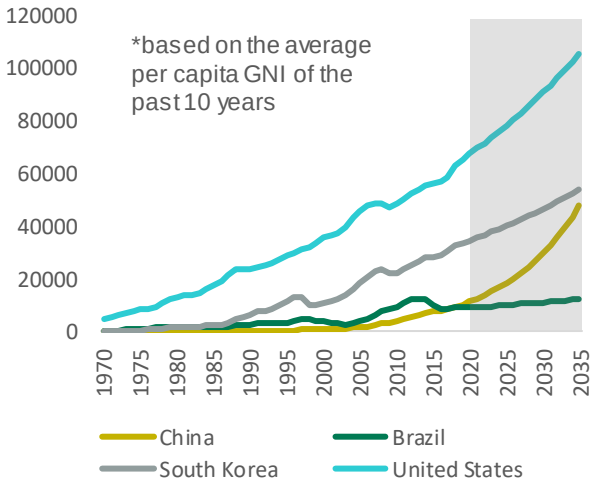
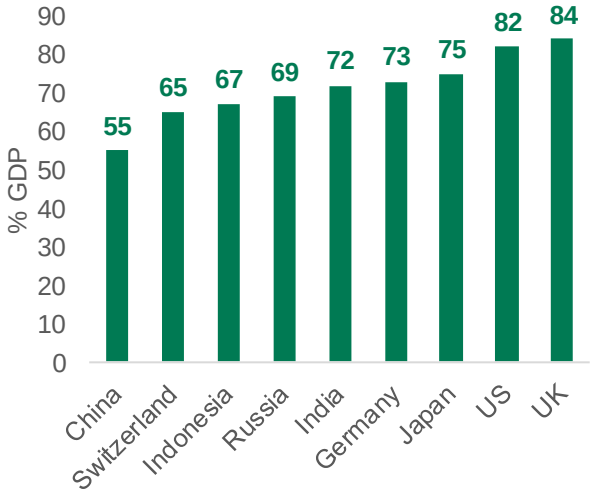
sustaining employment. The central government set an unemployment target of 5.5% for 2021 and aims to create over 11 million new jobs during the same period. MSMEs account for more than 80% of urban employment in China.

Chart 1: GNI per capita projections* (USD, Atlas Method)



Source: World Bank, UBP

Chart 2: Final consumption expenditure (% GDP)



Source: World Bank, UBP

14-FYP: Five themes that will shape the next five years

Against this backdrop, Chinese officials unveiled what we believe will be one of the most transformational reform agendas announced to date. The main aim of the new five-year plan will be to unlock latent growth potential, boost total factor productivity and reduce external vulnerabilities. In order to achieve this, China will deploy a strategy of "Dual Circulation", comprised of "Internal Circulation" and "External Circulation" pillars. On the internal front, China is expected to pivot towards a more sustainable, consumption-oriented growth model by 2025. Simultaneously, China will also seek to reduce its dependency on imports of high value-added components.

To achieve this, the document covered a comprehensive range of targets and objectives. However, these can be summarised into five key themes:

1) Growth targets: As expected, the GDP growth target was de-emphasised, but not abandoned entirely. The 14-FYP did not set a specific growth target for the period, departing from the modus operandi of previous years. Instead, the government will set yearly growth targets, that will be adjusted as needed to achieve a wider policy agenda. For this reason, we expect that GDP targets will be complemented by per capita gross national income (GNI) growth targets, as well as targets aimed at stabilising the labour market and maintaining price stability. That said, China's goal to become a "high-income" country by the end of the five-year plan suggests relatively high GDP growth in the remainder of the period. The World Bank defines high-income nations as those enjoying per capita GNI levels exceeding USD 12,536 in 2019. In contrast, China's per capita GNI was only USD 8,130 during the same period (Chart 1). GDP growth will have to remain around 4.5-5.0% during the 14-FYP for China to reach this. High growth rates will be sustained beyond the 14-FYP to play catch-up with South Korea before 2035.

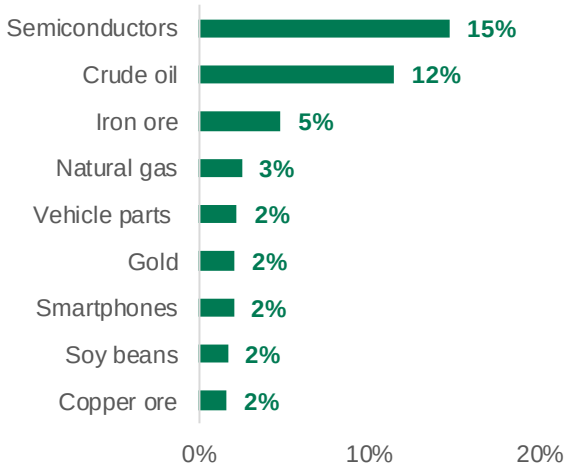
2) Domestic consumption: As expected, the new five-year plan will promote China's "Internal Circulation" strategy. To this avail, the 14-FYP will boost China's final consumption expenditure as a share of GDP. Final consumption expenditure accounts for just 55% of GDP in China, a share which is much smaller relative to other "high income" nations and even other Emerging Markets (EMs) in the region (Chart 2). Per capita disposable income growth will trail nominal GDP, which will be higher than the 5.6% per annum that was registered during the 13-FYP. Moreover, to underpin consumption propensity, the 14-FYP will seek to improve the basic pension coverage to 95% by 2025. China's gross domestic savings rate remains high at 44.3% of GDP according to figures by the World Bank (vs global average: 25.3%). China's high propensity to save has its origins in inadequate social security, especially in the context of an ageing population. Furthermore, the 14-FYP will also remove restrictions to China's "hukou" (or household registration) system. More specifically, it aims to increase the proportion of permanent urban "hukou" holders to 65% of the total population by 2025, up from 60% in 2020. Middle-classes in urban clusters have access to better social security systems vis-à-vis rural "hukou" holders. They have also been associated with a higher propensity to consume. The plan specifically mentioned e-commerce, electric vehicles and big-ticket items such as home appliances and electronics. Despite the 14-FYP not mentioning a specific target for the share of services on GDP, it reiterated support for culture, education, travel and leisure. Moreover, improving China's propensity to consume will require changes to the social security system. In the context of China's ageing population, this will benefit

service providers in the insurance and healthcare sectors.

3) Innovation: The 14-FYP will also aim to facilitate China's move up global value chains and become a global leader in key 21st century technologies. This serves two important functions. Firstly, China has a very real dependency on imports of semiconductors, which overtook crude oil as its largest import by value in 2014 (Chart 3). Moreover, it serves the dual purpose of hedging against the risk of a more hostile external environment. According to estimates by Standard and Poor's, total factor productivity – or the ability to generate more output out of an equal amount of capital and labour, has been the most important contributor to China's rapid growth, boosting GDP by more than 5 percentage points between the 1980s and the 2000s. This is due to a shift in the labour force towards industry and services, away from agriculture. This shift was facilitated by China's rapid accumulation of gross fixed capital investments. However, productivity growth has slowed gradually over the past decades, as many of the industries where China has specialised remain in the lower value-added segments of global supply chains. The 14-FYP aims to address this issue by increasing Research and Development (R&D) spending by 7.0% per annum between now and 2025. While this is lower than the 11% per annum registered during the 13-FYP, it is parting from a much larger base. As a result, R&D spending as a share of GDP may rise from 2.4% in 2020 to around 2.7% in 2025, slightly lower than levels seen in the US (2.9%), Japan (3.26%) and South Korea (4.81%). Beyond the 14-FYP, we expect that R&D spending as a share of GDP will exceed 4% under China's upcoming Sci-Tech 2030 Agenda. To facilitate this colossal shift, tax rebates on corporate R&D activities of up to 75% will be introduced (up to 100% for manufacturing). On the innovation front, the 14-FYP will encourage the following areas: 5G networks, semiconductors, smart infrastructure pharmaceuticals and biotech.

4) Environment goals: During the 14-FYP period, China will also establish the foundations to achieve peak emissions by 2030 and carbon neutrality by 2060. A few key targets will underpin this strategy, including reducing energy consumption per unit of GDP by 13.5% (3% in 2021); reducing carbon dioxide emissions per unit of GDP by 18% (3% in 2021); and increasing forest coverage to 24.1% of the total land area. This shift is significant and will entail sizeable investments into renewable energy and low carbon technologies. This is easier said than done. China's total energy supply remains very coal-oriented (62% of total). The increase in energy efficiency over the past two decades can be traced back to an increase in natural gas from 1% to 7%. On the flip side, the share of renewables increased from 0% to 6%, with hydro accounting for the bulk of this. Huge investments into renewables should provide impetus behind key low carbon technologies, but it might take a stronger regulatory push for China to deliver on its climate change and environmental agenda.

Chart 3: China's top-10 imports (% total)



Source: UN Comtrade, UBP

5) Structural reforms: Finally, the plan will not overlook ongoing structural reforms. It identifies five priority tasks: deleveraging, cutting overcapacity, reducing excess housing inventory, lowering costs (i.e. market-based resource allocation) and strengthening weaknesses. Chinese policymakers will have to wean corporates off their historic dependency on bank loans as their main source of financing (83% of total), steering them towards market-based instruments instead. In other words, China will seek to deepen financial reforms and promote the development and internationalisation of its bond and equity markets.

Implications for investors

The new five-year plan will shed more clarity as to where the strategic priorities will lay. Sectors that are linked to domestic consumption and innovation (corresponding to the two pillars of China's "Dual Circulation" strategy) will clearly benefit from policy support in the next five years. While we continue to observe some short-term pressure on the equities front, investors that are able successfully position themselves around these themes will benefit the most from China's brightening cyclical outlook and favourable long-cycle backdrop. Compounded by financial reforms and gradual currency appreciation, this will continue to support a more favourable secular narrative. As a result, our long-term view on China remains constructive and we expect to see continued inflows into Chinese asset classes.

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