BEA 東亞銀行

Economic Research

March 2021

Market Monitor – Mainland China

Monetary Policy to Tighten Amidst Stabilising Economy

COVID-19 weighing on economy in early 2021

The lockdown measures imposed in January to curb the resurgence in new infections dampened consumer sentiment before the Chinese New Year. Inflation decreased 0.3% year on year in January, starting from a high base last year and a 0.2% growth in December. While food prices edged up amid the cold weather, non-food prices recorded their first drop since November 2009 due to weak domestic demand.

Meanwhile, the producer price index (PPI) reversed its previous drop with a 0.3% year-on-year increase in January. The swift recovery of the manufacturing sector compared to that of peer economies and the rebound in commodity prices, including refined oil and copper, supported China's PPI. The divergence between inflation and PPI reflects a faster recovery in manufacturing than in the services sector.

Behavioral change in the Chinese New Year

As individuals were encouraged to stay put during the CNY holiday, appetite switched from international and inter-provincial travel to local tourism. The number of passengers during the first eve to the fourth day of Chinese New Year plunged 49.7% compared to last year, but people did spend on movies and staycations. Sales revenue for major retail and catering firms rose 28.7% yearly in the golden week of Chinese New Year, which is 4.9% more than that in 2019. Box-office revenues also rose to a record high of CNY7.5 billion during the holiday.

- **Despite the continued recovery of the Chinese economy, the pace is uneven. The recovery in manufacturing is faster than in the services sector.**
- **The PBOC is expected to cautiously balance the monetary tightening and economic growth amid the imbalanced economic recovery.**
- **Home purchase restrictions remained as regulators eye on the causes of the high household debt problem.**

That said, the services sector continues to face pressure from the anti-pandemic measures. The buoyant consumption is also mainly in urban areas. With workers kept from returning to their home towns and villages, retail sales in rural areas will be under pressure, as will the tourism and consumer-facing industries in those areas.

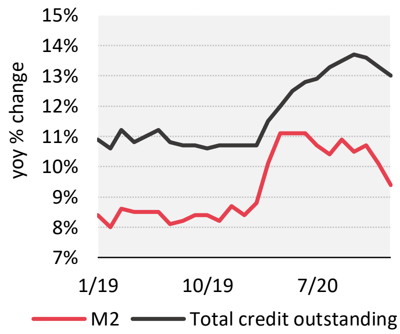
High leverage problem draws attention

On top of the pressure on rural areas, the Chinese economy faces a high leverage issue amid the monetary support to the economy. As the economy stabilized after the pandemic shock, the People's Bank of China (PBOC) has been tapering its effort in liquidity injection. The M2 growth has slowed significantly to 9.4% in January from 10.1% in December.

Meanwhile, new yuan loans reached a historical high of CNY3.58 trillion in January. Firms' demand for credit remains robust amid the continuous economic recovery.

However, the jump in new loans to households to CNY1.27 trillion in January, up from CNY563.5 billion previously, has triggered concern in the PBOC over the rapid increase in household leverage. In its monetary policy implementation report of the fourth quarter of 2020, the PBOC warned of related risks and point out that an economy should not rely on developing consumer finance to expand consumption. This reflects the PBOC's intention to slow the rise in leverage and constrain credit growth. To avoid an abrupt withdrawal in funding to firms, the PBOC is expected to cautiously balance monetary tightening and economic growth amid an imbalanced economic recovery.

Credit growth



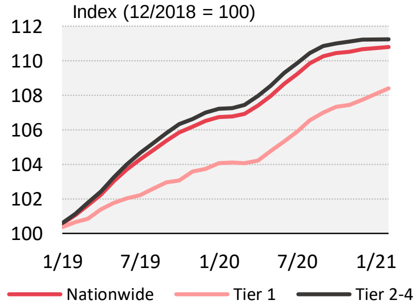
Source: The People's Bank of China, data as of 19/2/2021

Continued controls in the housing market

Home prices rose 0.3% monthly in January, after a 0.1% growth in December. Regulators have been eyeing the housing market and implementing a range of restrictions in major hotspots. Shenzhen, one of the cities that has seen a rapid rise in house prices, has in February established a mechanism for buyers to reference transaction prices of second-hand homes.

Besides these restrictions, the government is also developing the long-term residential rental market to address the demand for accommodation. Shenzhen requires a proportion of new land for constructions to be set aside for rental flats. Looking ahead, the growth of home prices is expected to remain subdued amid the housing market restrictions and monetary tightening.

New commercial home prices index by tiers



Sources: National Bureau of Statistics of China, BEA Economic Research Department, data as of 19/2/2021

Pandemic subsidence supports stock market

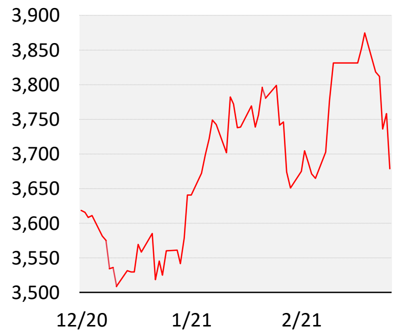
In the stock market, the A share index has increased by 0.7% in February. An infection rate of zero new domestic cases and record high credit data have served to support market confidence, while stock market reforms also raised market sentiment. The main board of the Shenzhen Stock Exchange will merge with its small and medium-sized enterprise board. The rules and supervision will be unified, while IPO requirements and investor thresholds will remain unchanged. However, concern over the tightening of monetary policies and the volatility in the global bond market have dampened the market sentiment, weighing on the stock market performance.

In the bond market, international investors have been chasing Chinese bonds since last year. The gap between US and Chinese government bond yields, which has been hovering at around 200 basis points for most of February, is making Chinese bonds more attractive for foreign investors. Demand has also been fuelled by the inclusion of Chinese bonds into international bond indices. Following their inclusion in the JP Morgan Government Bond Index – Emerging Markets and Bloomberg Barclays indices, Chinese government bonds will also be included the FTSE World Government Bond Index from October. As of end-January, foreign investors held CNY3.06 trillion of Chinese bonds, which represents a year-on-year growth of 62%.

In the foreign exchange market, the Chinese government is increasingly concerned about the strong renminbi. It is considering the cancellation of the yearly quota on foreign currencies purchases and allowing individuals to invest in offshore equities and insurance with a cap of USD50,000. In addition, the US dollar turned stronger amid the volatility in the global bond market. The US dollar index rose 0.3% in February. These factors caused the CNY to depreciate by 0.8% against the US dollar over the same horizon, while the CNH by 0.4%.

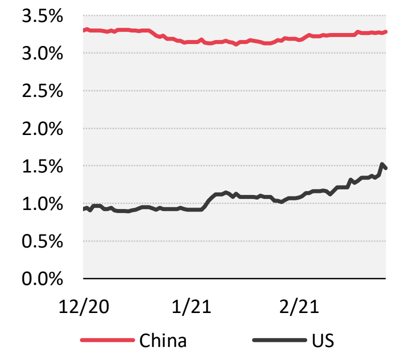
In the coming weeks, China's financial markets will be supported by continuous economic growth and the effective pandemic control measures. However, monetary tightening will continue to weigh on the financial markets. Following a global recovery, China's advantage of a rapid economic recovery will fade, putting pressure on market performance. Meanwhile, the renminbi's outlook hinges on the trend of the US dollar. But the currency will continue to be supported by foreign demand for Chinese bonds in light of the persistent yield gap between the US and China.

A Share Index



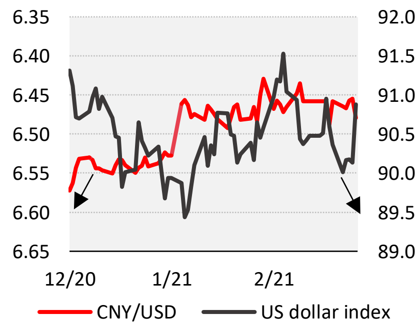
Source: Bloomberg, data as of 26/2/2021

10-year Government Bond Yield



Source: Bloomberg, data as of 26/2/2021

RMB/USD vs USD Index



Source: People's Bank of China, Bloomberg, data as of 26/2/2021

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