BEA 東亞銀行

The Rising Risk of Inflation

Inflation has been accelerating lately, fuelled by a pickup in global demand and supply shortages. Biden's massive stimulus programme will only exacerbate this process.

Economic Research Department

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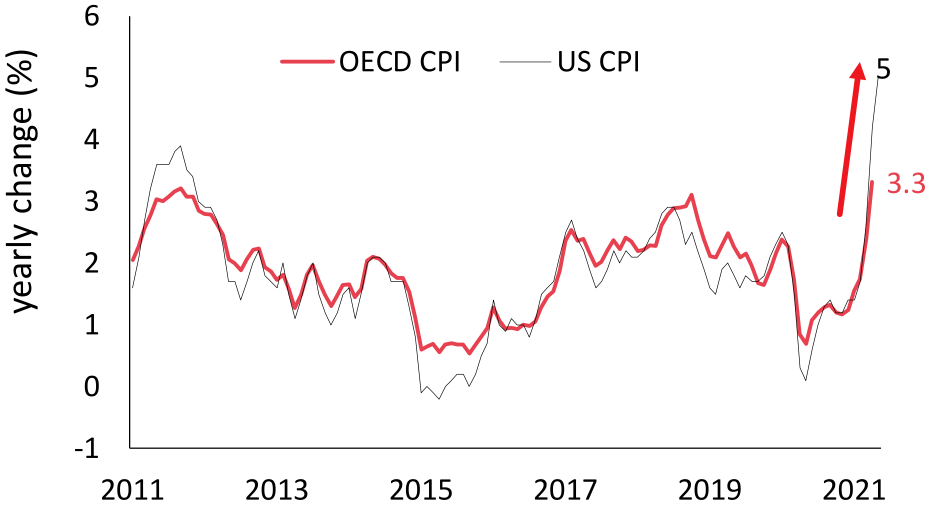
Prepared by The Bank of East Asia, Limited
由東亞銀行有限公司編寫

Global inflation is rising faster than expected

Recent uptick in inflation

Global inflation rate

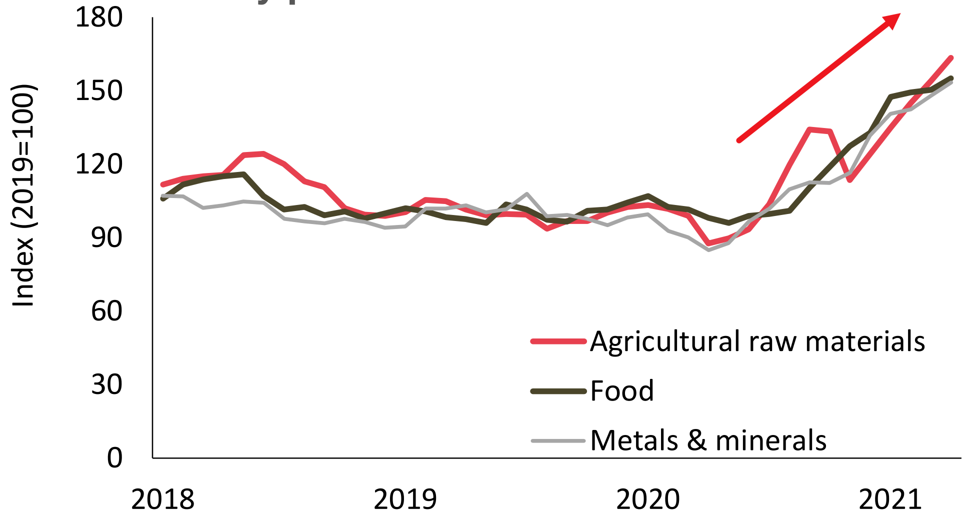


Source: Bloomberg, data as of 11/6/2021

- Inflation hits highest level since 2008.
- Rise fuelled by a pickup in global demand as economy reopens, as well as by stimulus cheques.

Driven in part by surging commodity prices

Global commodity prices



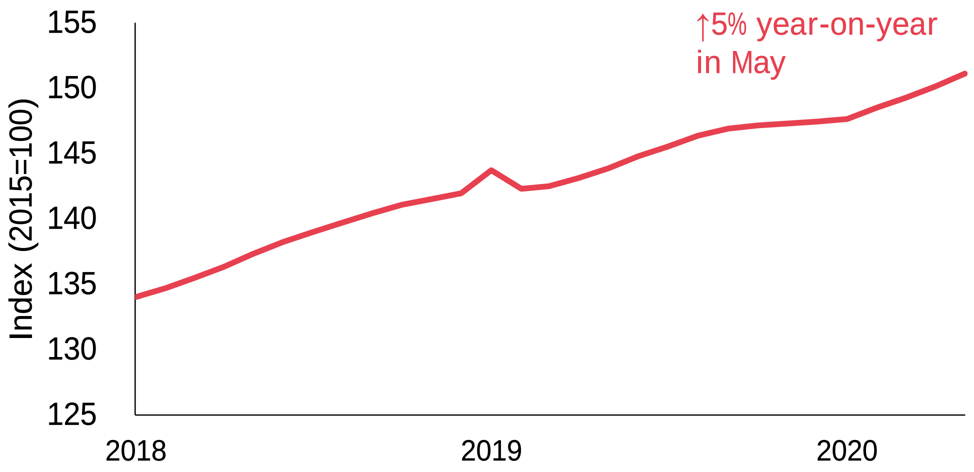
Source: OECD Economic Outlook, vol. 2021, issue 1

- Curbs and shutdowns in 2020 have reduced production capacity but are mostly temporary.
- This is seen across all industries, including commodities, manufacturing, logistics, and services.

Becoming a concern for China

Inflation expectations driving rising property prices

China property prices

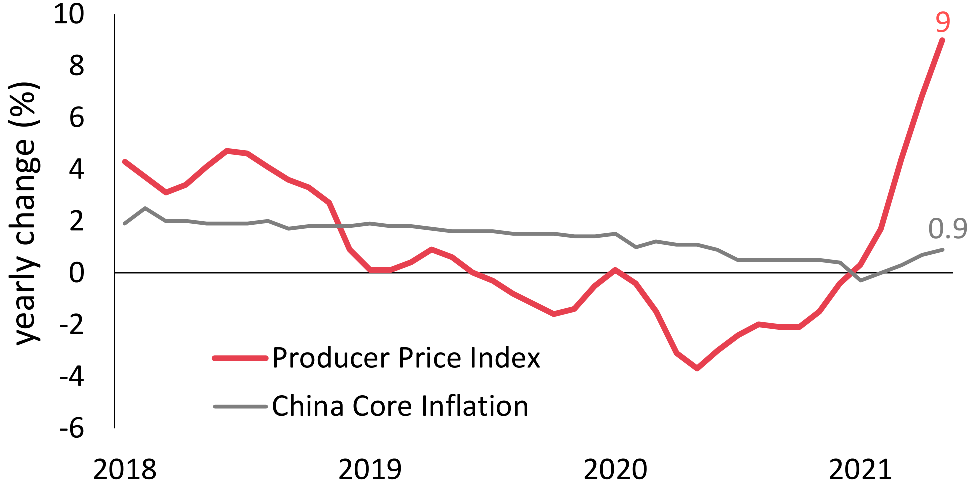


Sources: National Bureau of Statistics; BEA Economic Research Department, data as of 20/6/2021

- Property investment as a hedge against inflation is another driver of Chinese optimism about the real estate market.
- Despite various government curbs during the year, home prices have continued to rise 0.6% monthly, especially in lower tier cities.

Commodity prices will eventually translate into higher consumer prices

China's price indices



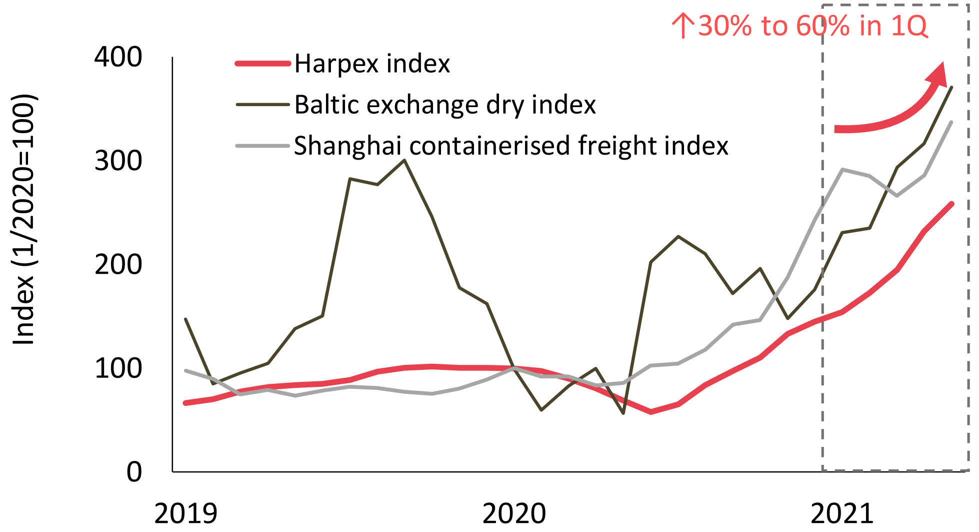
Source: Bloomberg, data as of 9/6/2021

- Shortage in raw materials and higher commodity prices raise production costs.
- Persistently large gap between producer prices and consumer prices will reduce manufacturers' profitability.

Inflation expected to stay elevated this year

Supply bottlenecks & increased economic activity translate into spiraling freight rates

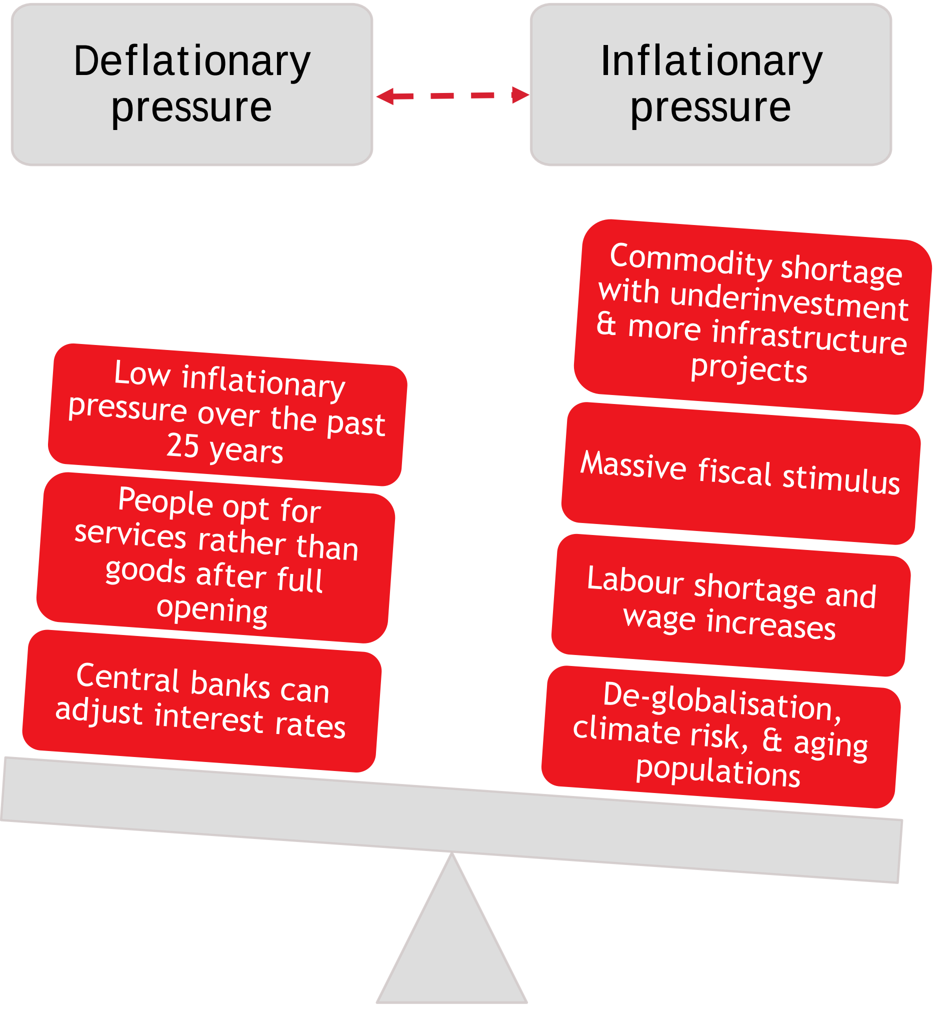
Freight cost indices



Source: OECD Economic Outlook, vol. 2021, issue 1

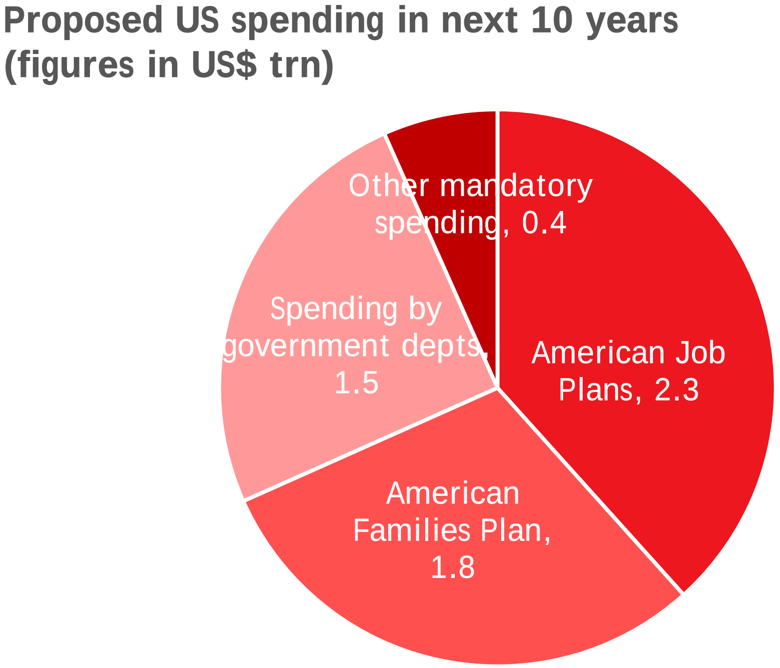
- Empirical study shows it will continue to affect import prices and CPI for more than 1 year.

*Harper index tracks container shipping rate changes for 8 classes of all-container ships; Baltic exchange dry index is created by the London-based Baltic Exchange for dry bulk carriers or merchant ships; Shanghai containerised freight index measures sea freight rates for container transport from the Chinese main ports.



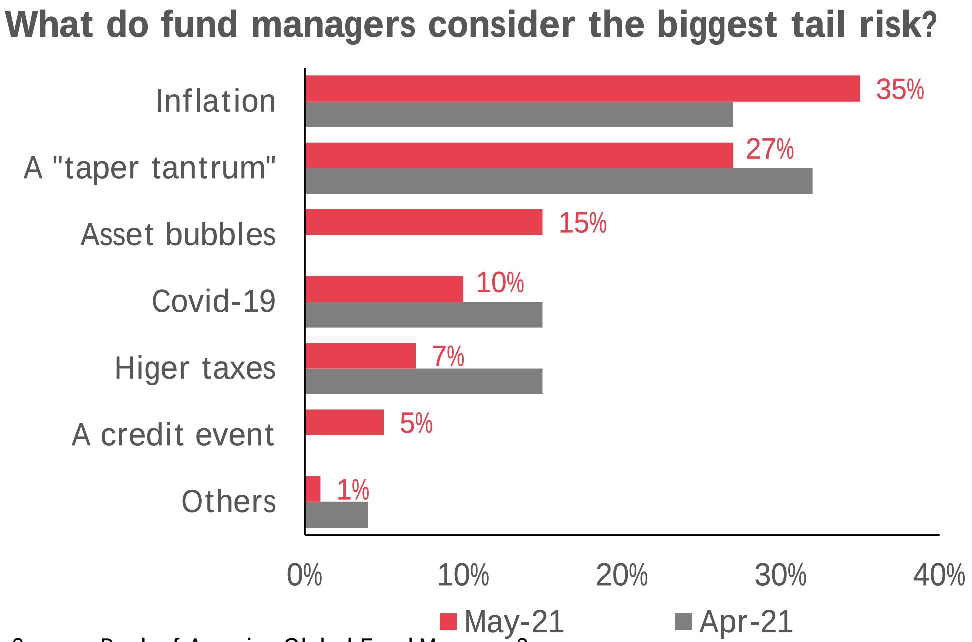
Biden's stimulus package risks prolonging inflationary pressures

Biden's bold budget includes outsized spending for the next decade…



- Federal government annual deficits: US$1.8 trillion in 2022; at least US$1.3 trillion until 2030.

The Fed insists the price surge is transitory, but the market thinks otherwise



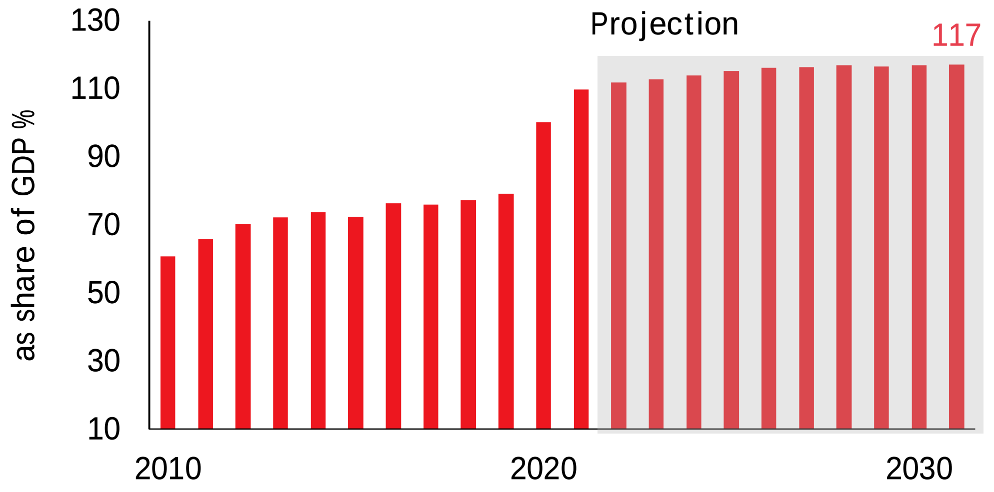
Source: Bank of America Global Fund Manager Survey

- Inflation overtakes Covid-19 as global fund managers' biggest perceived threat to their portfolios.

The Fed has been timid about when to tighten its loose policies

High public debt makes it difficult for the Fed to raise interest rates

Federal debt held by public

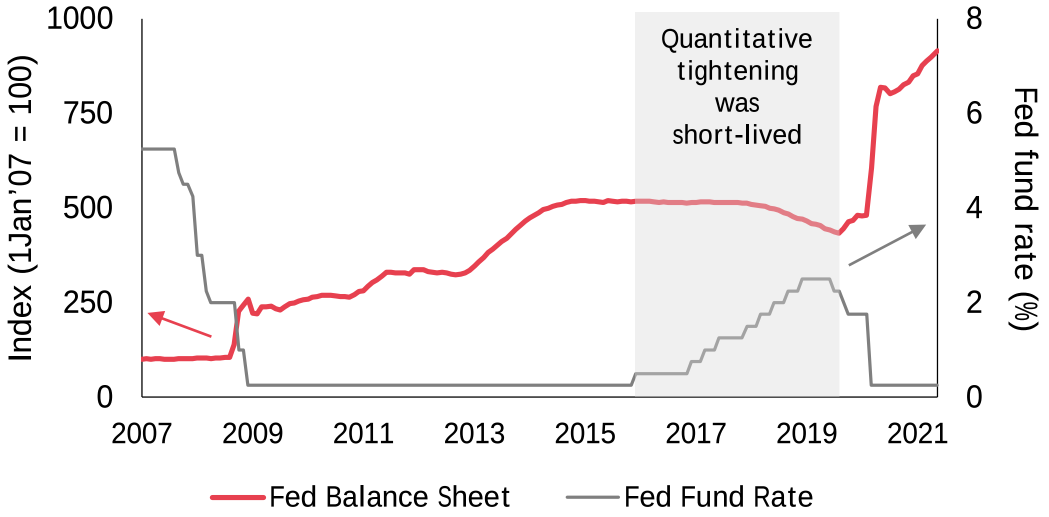


Source: Congressional Budget Office & Office of Management and Budget, data as of May 2021

- This assumes no normalisation of the fed funds rate, and that 10-year Treasury yields never rise above 2.8%.
- If borrowing costs rise any further, the debt burden will be much higher.

The Fed is not determined to reduce its balance sheet

US Fed's policy and capital market movements



Source: Bloomberg, data as of 7/6/2021

- After the 2013 Taper Tantrum, the Fed raised interest rates very gradually from end-2015.
- While it started quantitative tightening in Oct 2017, it reversed course in Sep 2019.

On balance, risk tilted towards bear market scenario in the medium term

Optimistic Scenario:

1. Biden significantly downscales his stimulus plan; and
2. Fed tapers off asset purchasing at an early stage

Inflation risk cools

Productivity and GDP is boosted, unemployment rate is lowered

More sustainable global economy

Baseline Scenario:

1. Fed raises rates very gradually

Rising yields prevent the government issuing full-scale stimulus

Inflation stays high, leading to wage increases and lower profit margins

Asset prices are hit, but the fall is contained as the rate hike is very gradual

Softening momentum for the global economy

Bear Market Scenario:

1. Biden retains his stimulus plan; and
2. Fed delays taking action

Government sells more bonds, economy overheats, & purchasing power is lowered

Fed abruptly tightens monetary policy

Companies face difficulties in servicing debt; asset bubbles burst

Capital flows out of emerging economies

Global economic downturn

In event of a bear market, even HK & China may be vulnerable

Possible impact on Hong Kong

Economy
- Vulnerable to **property market correction**.
- Private consumption and exports could weaken.

Companies
- Weak outlook could reduce investment appetite.
- Increased borrowing costs, and more limited ability to invest and increase debt burden.

Households
- Weaker property market could reduce household wealth.
- Private consumption could thus be reduced.

Possible impact on Mainland China

Economy
- With increased debt servicing costs, **the highly leveraged property and financial sectors** are especially vulnerable.

Companies
- Reduced profits could lead to downsizing and a high unemployment rate.

People & Government
- People become cautious and consume less.
- Aging population adds to medical bills and lower tax revenue, straining local government finances.

But China has more tools & headroom to act decisively

China has plenty of room to address the threats of high global inflation

- As a closed economy, China is less directly affected by the US monetary policies than many of its counterparts.
- It has ample forex reserves (US$3,221.8 billion as of end-May 2021) to stimulate targeted sectors.
- More headroom to loosen fiscal & monetary policies to stimulate the economy in the face of a global recession.

Possible policy tools for China

Monetary Policies

- Various monetary tools, including open market operations (OMOs), standing lending facilities (SLFs), medium-term lending facilities (MLFs), etc.
- Room to lower 1-year loan prime rate and/or cut banks' reserve requirement ratio (RRR).

Fiscal Policies

- Cut taxes for companies and individuals.
- Increase infrastructure spending.

Others

- Use administrative measures to contain price rises.
- Crack down on hoarding & and speculation in commodities.

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