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China and EM: growth and policy Q&A

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Q1. China recorded a surge in Covid-19 cases in January, the worst flare-up in 10 months. How will this winter outbreak affect the growth outlook?

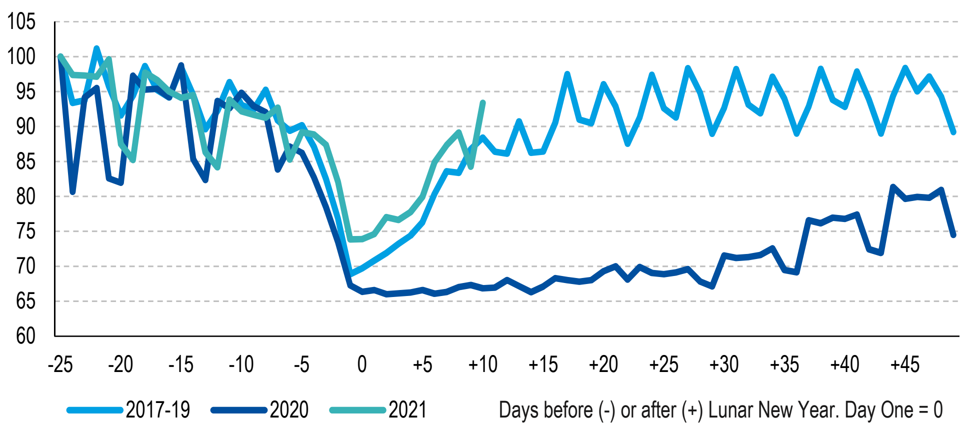
The resurgence of Covid-19 cases in three northern Chinese cities prompted the government to escalate pandemic containment measures aggressively, just ahead of the Lunar New Year (LNY), leading to a plummet in travel during the holiday season.

Despite the steep decline in inter-provincial mobility, local mobility and consumption was little affected. Retail sales and catering revenues during the LNY Golden Week (11-17 February) were up 28.7% from a year ago, and 4.9% higher than the same period in 2019. Box offices hit record highs, while auto and property sales held up. Nonetheless, transportation and tourism services were hit hard, pulling the related CPI into deeper contraction.

From the production side, as the majority of migrant workers stay put, the working hour during this holiday season would have been prolonged. The return-to-work is smoother and earlier than in previous years (Chart 1). High-frequency industrial data, including the refinery operation rate, cargo traffic at ports and air pollution severity, show that production activities were stronger than usual during the LNY holidays.

Since the winter outbreak was contained quickly, we only expect a small set-back in the services sector recovery. As for the industrial sector and exporters, this special staycation would serve as a moderate boost, given the smaller disruption from holiday travel and longer working hours. So far, the evidence to hand suggests that China's economy could avoid falling into contraction again in sequential terms, better than our previous expectation. The low base last year means the Q1 GDP figure could easily show growth in the high teens.

1/ **China's city traffic congestion during the Spring Festival**



Source: Wind, Gaode, Amundi Research as of 25 February 2021

The message is clear, the PBoC is normalising its policy with a tightening bias

Q2. What happened in China's interbank market? Has the PBoC monetary policy stance changed?

Usually before the Lunar New Year, the PBoC maintains an accommodative stance in the interbank market, to meet the seasonal surge of liquidity demand. As well as its daily go-to tool, the 7D reverse repo, it will also use longer-tenor tools, including 14D/28D reverse repos, 1yr MLF/TMLF (similar to LTRO/TLTRO), or targeted RRR cuts.

Nevertheless, the PBoC had only injected the bare minimum this year (Chart 2). Despite already tight liquidity, it started to net withdraw liquidity two weeks before the LNY break, driving the overnight borrowing rate to a record high since Jul 2013. The term spread (10y – O/N) turned negative for several days, which has only been seen in April 2018 and June 2013, when spikes in short rates were mainly policy-driven.

Hence, we believe this round of unexpected liquidity tightening is not accidental. It is debatable what the PBoC is actually tightening for, be it the equity market, the housing market or financial arbitrages/ leveraged trades in the interbank market. But the message is clear, the central bank is normalising its policy with a tightening bias.

We continue to believe that the PBoC will anchor interbank market rates around its OMO rates for most of 2021, i.e. 7D repo rate at 2.2%, and 1-year MLF rate at 2.95%. But

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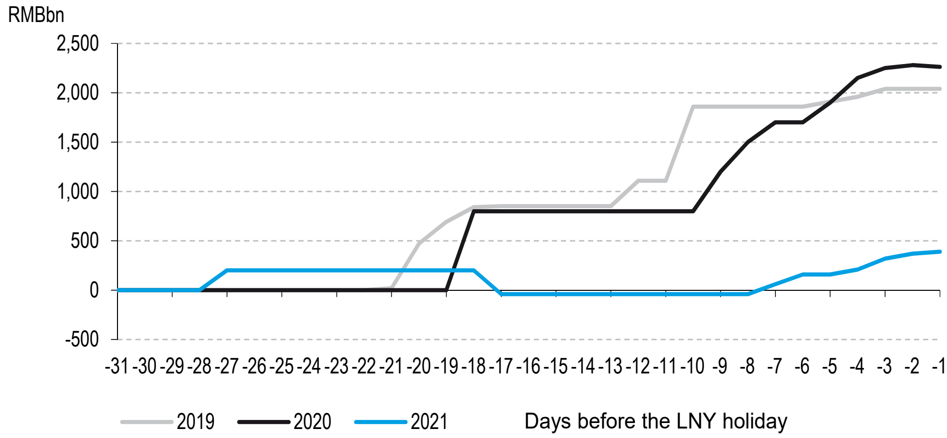
we should not be surprised if there is a brief deviation from these anchors. We expect the PBoC to leave the headline policy rates and RRR unchanged. The risks of a rate hike this year remain low as policy easing has started to withdraw on all fronts.

2/ The PBoC's cumulative liquidity injection before LNY



Source: PBoC, Wind, Nomura, Amundi Research as of 18 February

Q3. What is your expectation for China's fiscal policy in 2021?

With the overarching goal to control the debt-to-GDP ratio, we expect public debt to grow at a slower pace in 2021, and fiscal policy to be less expansionary. Specifically, we expect the headline budget deficit to narrow from 3.6% to 3.2%, which will be announced at the National People's Congress that convenes on 5 March.

The augmented fiscal measure, comprising sales of land use rights in the Government Fund, will be under the spotlight. In 2020, the quota of Special Local Government Bond (LGB) to finance the Government Fund was raised significantly to RMB3.75tn from RMB2.15tn in 2019, contributing to c.1.5ppt of the budgeted deficit expansion. The consensus is forecasting a reduction to RMB3-3.5tn in 2021. In our view, a figure in the upper range is more likely, amid mounting refinancing pressures of contingent local government debt and increasing cases of local SOE defaults.

The more comprehensive measure to watch is Total Social Financing (TSF) growth, which consists not only of government bonds but also quasi-fiscal lending to the SOEs and LGFVs. Following a decisive acceleration just after the pandemic outbreak, TSF growth started to drift downwards in November 2020. We expect it to remain on a gradual downtrend, slowing by around 2ppt to 11.5% by the end of 2021, which is still higher than the pre-Covid level of 10.7%. At this rate, China's debt-to-GDP ratio will stabilise in 2021 at around 270%, after picking up 23.6ppt from 246.5% at end-2019.

We expect credit growth to remain on a gradual downtrend

Q4. Base on the latest macro-financial developments, are EM assets still attractive?

One of the most important drivers for investing in Emerging Markets is growth: not only domestic growth at country level but also global growth reflected in continuous robust external demand either for commodities or for manufacturing products.

Among the leading global growth drivers, we list the US and China. Looking now at the US, we expect a strong economic performance in 2021, thanks to the sizable fiscal package to be unveiled and approved shortly (between \$1tr and \$1.9tr). Moreover, as a further upside risk to growth, discussions are ongoing about a large infrastructure plan of about \$2tr, to start by early 2022.

The current recovery is benefiting oil and commodity exporters, with terms of trade decisively improving in some Latam countries (such as Chile and Peru), as well as manufacturing exporters across the universe with a preference for countries more exposed to the IT sector and PPE (personal protective equipment), such as Asia and mainly North Asia.

Concerning the services, tourism and hospitality sectors in particular, the recovery is much slower and we will see a more robust rebound once the vaccination roll-out is more global. Countries like Thailand, for which around 11% of its GDP is dependent on tourism, are still struggling to recover. Overall, in the EM, the mobility path is stable or mildly heading upward given that the restrictions are less severe than in certain more advanced economies.

Together with the more positive reassessment of economic growth, another important factor under review is the ability of the main central banks to navigate an environment with extremely accommodative monetary policy and rising inflation expectations, driven by a perceived economic overheating. It is

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EM asset classes still offer exposure to high yields, and some exposure to growth at a reasonable price

worth remembering that a supportive global financial backdrop is essential for continued investment in EM.

Although we are seeing some pressure on prices from costs (commodities, food, shipping rates), the demand side remains subdued; indeed, the great majority of countries have not reached their 2019 growth levels and will take time to do so. Therefore, our inflation outlook is not a source of concern; it should allow the central banks to withdraw their liquidity support very gradually and even more gradually change their monetary policy stance.

With all the necessary diversification (mindful that the EM universe is very heterogeneous in its strengths and fragilities), EM asset classes still offer exposure to high yields in a world of ultra-low or negative interest rates, and some exposure to growth at a reasonable price.

Finalised on 18 February 2021

Top Asian suppliers of medical goods & materials

Ranking within Asia (2019 data)	Plastic (HS 39)	Rubber (HS 40)	Glass and glassware (HS 70)	Organic chemicals (HS 29)	Pharmaceutical products (HS 30)	Tubular needles (HS 901832)	Syringes (HS 901831)	Refrigeration equipment (HS 8418)
1	China (1st)	China (1st)	China (1st)	China (1st)	India (11th)	China (4th)	China (2nd)	China (1st)
2	South Korea (4th)	Thailand (3rd)	Japan (5th)	South Korea (7th)	China (15th)	Japan (6th)	Singapore (8th)	South Korea (6th)
3	Japan (6th)	Japan (5th)	Hong Kong (6th)	India (8th)	Singapore (17th)	Thailand (8th)	Philippines (15th)	Thailand (7th)
4	Taiwan (10th)	South Korea (6th)	South Korea (12th)	Japan (9th)	Japan (18th)	Singapore (10th)	Hong Kong (16th)	Singapore (14th)
5	Singapore (12th)	Malaysia (7th)	Taiwan (13th)	Singapore (11th)	South Korea (21st)	South Korea (11th)	Japan (17th)	Japan (15th)

Ranking in parentheses equals global ranking in terms of exported US dollar value in 2019. Sources: ITC, The EIU. Amundi Research as of 25 February 2021

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March 2021 #03

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