**Economic Watch**

# China | What will be the monetary policy stance in 2021?

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The recent SOE bond default wave and the overheating property markets in some tier-1 cities have triggered the authorities concern of rising financial risks. In addition, the hawkish stance on curbing financial risks and debt evasion in the Third Quarter Monetary Policy Conduct Report by the PBoC further further ignited the market concern. Thus, a hot debate recently among policy makers and economists has been focusing on the next year's monetary policy stance. Intrinsically, the key divergence is whether the policy will remain neutral while accommodative or it will begin the tightening cycle to restart the deleveraging campaign to curb ongoing financial risks and asset bubbles.

For China's monetary policy, better settle in for a long-haul. Regardless of all the impressive bounce-back in economic activity in many perspectives, quite a bit of stamina is still needed for the economy to completely go back to the pre-pandemic level, to regain all the lost ground. Considering domestic and global circumstances from multi perspectives, we prefer to support the former argument, that means, a neutral, prudent but accommodative monetary policy will be the main monetary policy stance in 2021, while the authorities will postpone the beginning of a real tightening cycle and "proactive deleveraging" to a later stage after the economy truly stabilizes.

First, the domestic economy is not completely recovered to the pre-pandemic level while the global economy is far from stabilization, thus, accommodative policy support will be required for a while. It is true that, China, first in and out of lockdown, has swiftly bounced back, apparently. But the recovery remains uneven, heavily supported by local government bond driven infrastructure investment and credit-driven real estate investment with the private and manufacturing investment still lagging behind, remaining in the negative territory. Consumption, on the other hand, although has started to join in the supply side to bolster growth, is still far from the pre-pandemic level, with October retail sales picking up to 4.3% y/y with ytd y/y growth still -5.9%, much lower than pre-Covid growth at 8%. In addition, the second round of Covid-19 outbreak significantly dragged the US and Europe recovery until the vaccine is mass produced and distributed. Thus, the restart of "proactive deleveraging" like what the authorities did in 2018-2019 is much less to be accepted amid global recession and an incomplete domestic recovery.

Second, China's easing monetary measures in the pandemic time has been already much more prudent and restrained compared with what the authorities did in 2008-2009 Global Financial Crisis, let alone the flooding liquidities injected by the central banks of the advanced economies this year, thus the room for normalization is not that large.

Third, approaching zero CPI inflation and negative PPI inflation environment leaves room for accommodative monetary policy. After the African Swine Flu dissipated and the supply of pork goes back to normal recently, CPI decelerated significantly to 0.5% y/y in October, the lowest in the past years and we predict it to be approaching zero at the year end, which is on the other hand in line with the global deflationary environment. Under the low inflation circumstance, again, the interest hike seems not to be urgent at all.

Fourth, amid the ongoing strong RMB appreciation trend, hiking interest rate will lead to RMB further appreciation, giving pressure on exports in 2021. During the pandemic time, the good news, economically, is that the exports have held much better than feared. Yet, there is a long call among the market participants that momentum may fade in the coming months as the world normalizes and needs fewer of those goods from China it demanded when lockdown measures imposed elsewhere. On the other hand, due to the weak USD DXY cycle, Chinese CNY to

USD exchange rate has already appreciated by 8% from May to now. Considering all of these, if the central bank hikes interest rate, it will lead to currency further appreciation, undermining exports thus recovery in 2021.

Last but not least, we have to also consider the monetary policy synchronization globally. The interest rate differentials between China and other advanced economies have already been at the historical high, hiking interest at this moment will expand this gap thus trigger hot money inflows and financial instabilities. Thus, a vicious cycle of "tightening monetary policy-higher interest rate attracting capital inflows-asset bubbles and credit expansion-further tightening monetary measures" might not be avoided.

Based on the above arguments, we predict a policy mix of neutral while accommodative monetary policy together with a more stringent financial regulation is more likely to be implemented in 2021. Notwithstanding, our argument does never mean the partial and passive deleveraging such as curbing evasion debt and housing bubbles is not important. Instead, the authorities, without a doubt, could maintain the aggregately accommodative monetary policy and targeted financial regulation at the same time.

Looking ahead, under this logic, a combination of a gradual shrinking of total credit expansion while a stable interest rate is anticipated. For 2021, in particular, the total social financing expansion and M2 will be lower than that of this year, among which total social financing is anticipated to slow to 11% from 13% and M2 decelerate from 10% to 9%. Regarding the interest rate, we do not expect the PBoC will hike the LPR next year, maintaining the one-year LPR at 3.85% throughout 2021. We believe the neutral while accommodative monetary policy stance will be conserving Chinese economy to gain all of the lost ground by the pandemic persistently and eventually, and at the same time preventing the financial risks.

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