Chi Time

FOR PROFESSIONAL INVESTORS – 19 December 2017

HOW WORRIED SHOULD WE BE ABOUT CHINA'S RISING CORE INFLATION?

He who learns but does not think is lost! He who thinks but does not learn is in great danger.

Confucius

China's core CPI has risen to 2.3% YoY recently, which is above the headline CPI of 1.9% and is the highest rate since September 2011. The driver is a broad-based increase in service prices, notably household services and healthcare (see Chart 8 below). Some are worried that the rise in core CPI might prompt the PBoC to tighten up soon, pulling the rug out from under the economy's feet and hurting Chinese asset prices. How worried should we be?

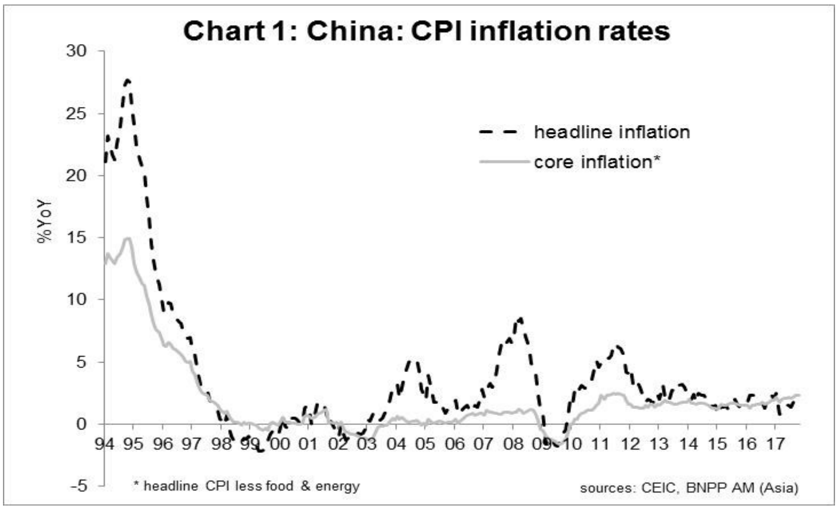
Inflation in perspective

The concern is not so much about core CPI rising to a multi-year high because core CPI inflation is still low. But it is disturbing to see core CPI inflation rise above the headline CPI (Chart 1). Together with the PPI strength sustained at 5% YoY, investors are right to worry about an inflation scare leading to monetary tightening. Chinese bond yields have indeed been rising since October in response to this concern.

However, the current macroeconomic dynamics do not point to monetary tightening in the coming year[1]. The fact that PPI inflation has not trickled down to CPI inflation suggests that there is an inherent deflationary drag in the economy due to a stock of excess capacity and a flow of structural reforms to cure this stock problem.

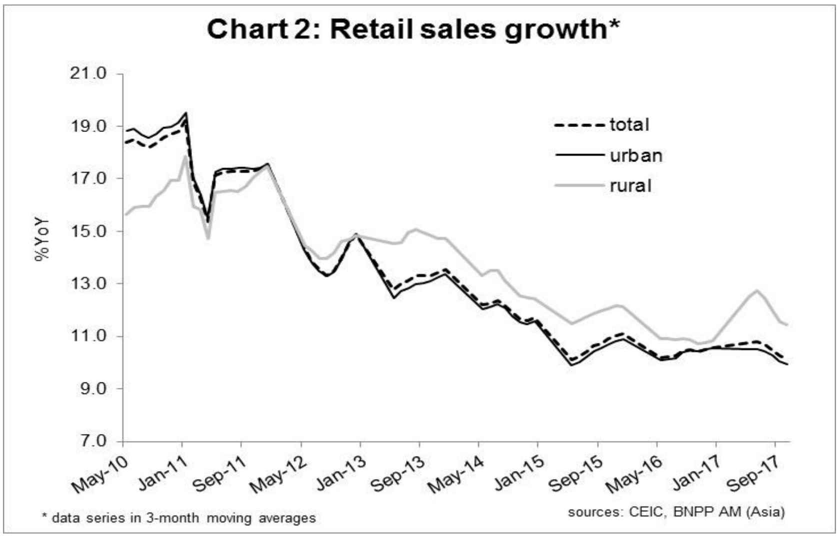
Unless CPI inflation surprises on the upside and pushes above the 3.0% official target persistently and the US Fed raises rates by more than market expectation, the PBoC will likely keep a neutral policy stance in the coming year to ensure sufficient liquidity for supporting Beijing's moderate growth target.

[1] See *"Chi Time: China's 2018 Outlook and Implications*", 1 December 2017.



Forces restraining inflation

There are headwinds to growth that will constrain demand (including for services) from pushing up inflation higher-than-expected. They include a slowing housing market, scaling back of fiscal stimulus, intensifying deleveraging and structural reform efforts (including tightening up of environment controls), a lack of "animal spirits" and easing export growth. Consumption indicators (Charts 2-5) are showing moderating demand already. Meanwhile, the recovery of PPI inflation has boosted nominal GDP and industrial profit growth (Charts 6-7), creating a benign backdrop for Chinese equities, *ceteris paribus.*



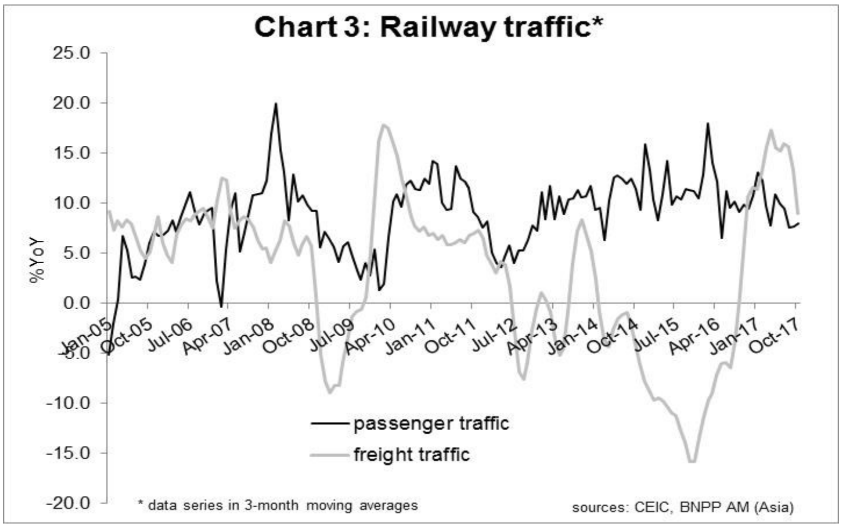


Chart 3: Railway traffic*
%YoY
passenger traffic
freight traffic
* data series in 3-month moving averages
sources: CEIC, BNPP AM (Asia)

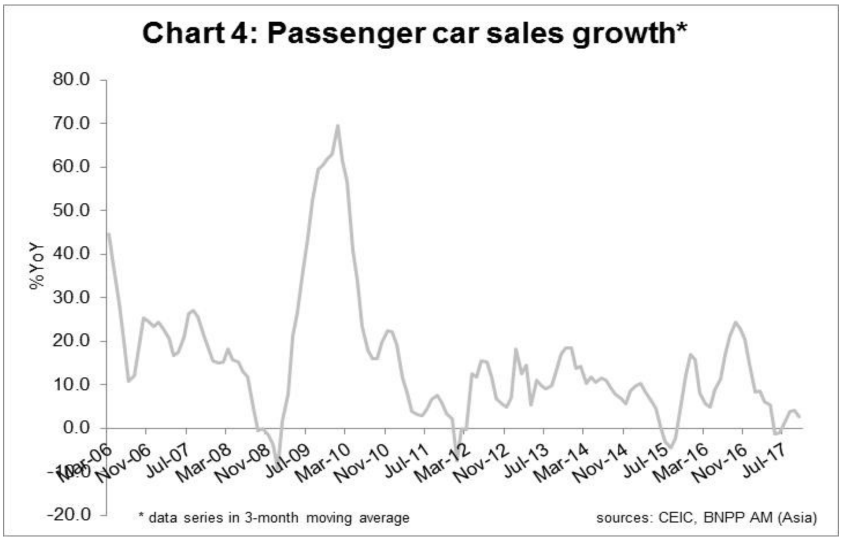


Chart 4: Passenger car sales growth*
%YoY
* data series in 3-month moving average
sources: CEIC, BNPP AM (Asia)

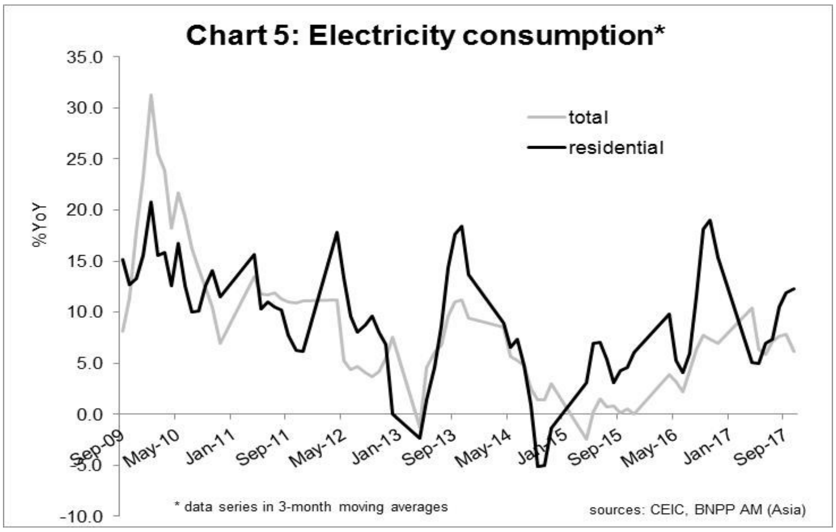
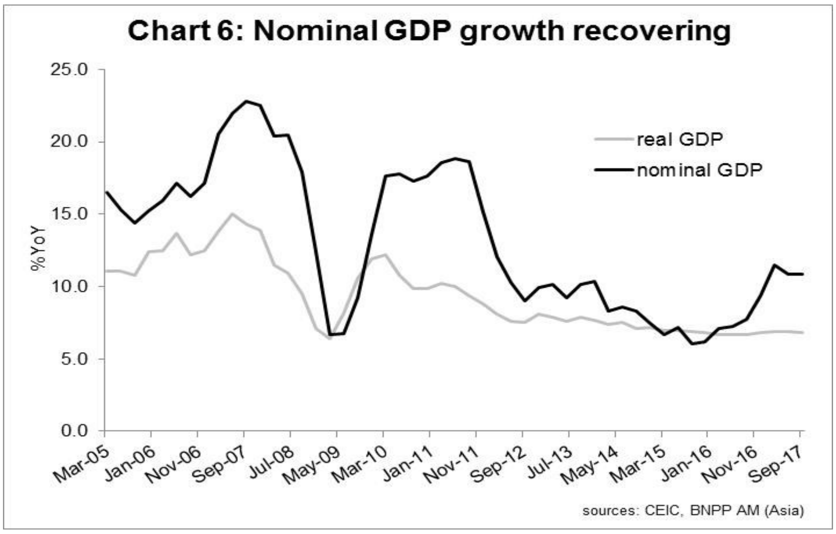
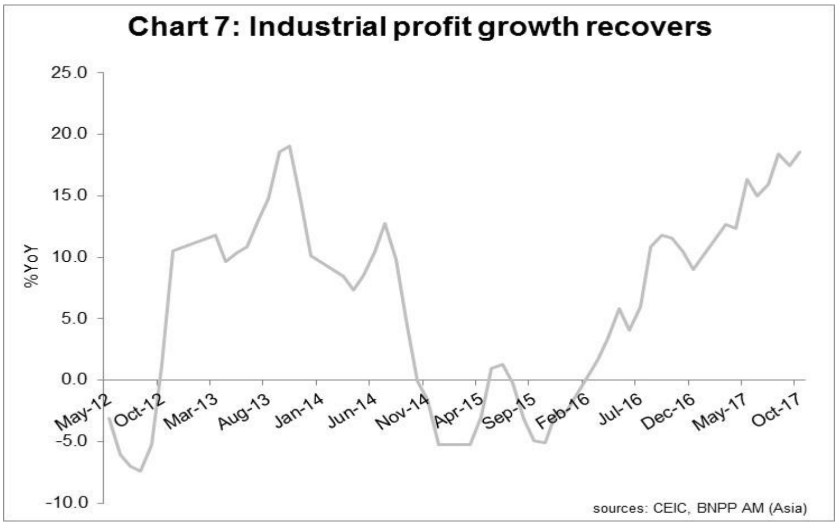


Chart 5: Electricity consumption*
%YoY
total
residential
* data series in 3-month moving averages
sources: CEIC, BNPP AM (Asia)





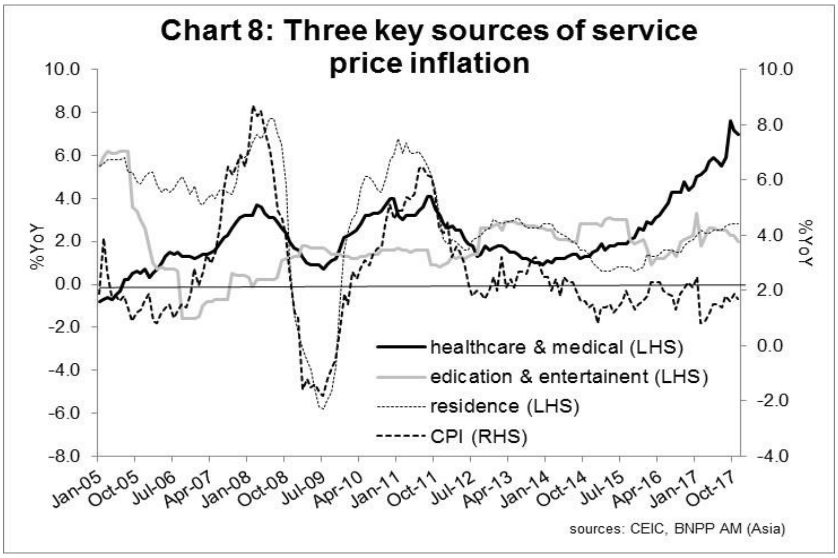
The policy perspective

There is also a policy angle to consider. In many developed economies, core CPI inflation is more important than the headline CPI because their central banks tend to follow/target core CPI. However, the PBoC's policy reaction function is different from the developed market central banks' practice.

The PBoC does not pursue an inflation-targeting monetary policy model based on core inflation behaviour. It follows multiple targets, including inflation, economic growth, financial stability, structural reforms and employment. Crucially, these targets and their weights in the PBoC's policy reaction function change from time to time. The PBoC has never had a rule-based policy of tracking/targeting core CPI. It always refers to overall CPI and sets a target on overall CPI inflation (which is 3%); and 30% of CPI is food.

What's driving service price inflation?

It is true that core inflation has been rising due to rising service prices, which are driven mainly by healthcare, education & entertainment and residential costs including rents, renovation, utilities etc. (Chart 8). Soaring healthcare & medical service prices are mainly due to the reform of China's medial system since mid-2016 when Beijing started abolishing the price caps on most medicine and drugs and allowing private hospitals to charge their services at market-determined prices (but public hospital services are still subject to government price controls). The pace of medicare price inflation should moderate once the reform is implemented across the country (so that the low-based effect will fall out of comparison).



Residential costs inflation will also likely come down due to the cooling of the property sector. Education and entertainment costs inflation has already rolled over as slowing growth momentum, deleveraging and structural reforms drag on entertainment and discretionary expenses. Therefore, core CPI inflation may not rise much further.

What matters?

In China, rising core CPI matters only when it pushes up overall CPI persistently. The core CPI concept itself does not determine Chinese monetary policy at this stage. Evidence shows that the PBoC only hikes benchmark interest rates when overall CPI is high; and in many occasions when overall CPI was high, food price was high too.

So we should be monitoring food-price behaviour. If it picks up and couples with non-food and PPI inflation to boost overall CPI, this may prompt monetary tightening. But the growth headwinds will likely provide an offset to these forces and overall CPI is expected to rise by 2.2% (my forecast) next year. This will still be lower than the official 3% target. It is too early to conclude that rising core CPI inflation would prompt monetary tightening soon.

Chi Lo, Senior Economist, BNPP AM

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