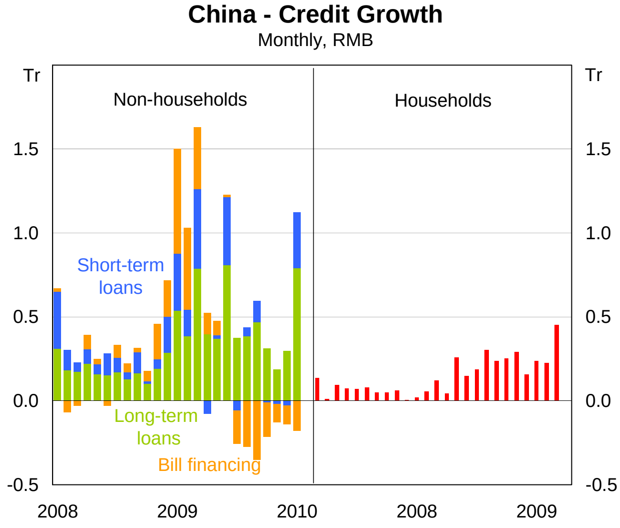
February 2010

Chinese Update – January in Review

Given the difficulty in reading activity data around Chinese New Year, this month we focus on the stance of policy within China.[1] *Overall, macroeconomic policy has been tightened in China, which seems appropriate given the rapid pace of activity, emerging inflation and fears of unsustainable growth in the housing market. However, in our view, the reaction to recent policy tightening by markets has been overly negative. Monetary policy remains highly accommodative, and there is scope for continued expansionary fiscal policy. Further, the many ad-hoc administrative adjustments have been largely aimed at the housing market, which in itself, is unlikely to result in a broader economic slowdown. The obvious risk is that authorities tighten too soon, or too aggressively. Overall, we expect policy to be tightened further through 2010 and economic growth to be 9¼ per cent.*

Monetary Policy remains clearly expansionary despite some tightening in the reserve requirement ratio. Benchmark lending and mortgage rates are historically low and credit availability remains high. Financial institutions lent RMB1.4 trillion in January, with very strong growth to both households and enterprises (Graph 1). While credit growth is typically more rapid at the beginning of the year, it reportedly was enough for the People's Bank of China (PBOC) to force some banks to halt lending temporarily. Lending in January amounts to nearly one-fifth of the Chinese Banking Regulatory Commission's credit growth target of RMB7½ trillion in 2010. If achieved it would represent very accommodative monetary conditions by historical standards.

Graph 1



The PBOC has raised the reserve requirement ratio by 100 basis points in the past month, to 16.5 per cent (the second increase is effective from 25 February). This requires financial institutions to hold more funds with the central bank, thus limiting the supply of funds available to be lent to the non-financial sector. While the direct effect is fairly modest – we estimate it reduces the money supply by around RMB600 billion – it, more importantly, indicates the PBOC has shifted toward a tightening bias.

Mitigating the impact of higher reserve requirement ratios, the PBOC's open market operations have injected RMB660 billion into money markets in February so far (Graph 2). This is somewhat unusual as the bank typically withdraws funds from the system as a means of sterilising capital account inflows.

[1] Based on lunar cycle, the Chinese New Year festival affects activity in either January or February or both. Subsequently, standard seasonal adjustment is unable to adjust for the distortion and renders most activity measures unreliable until February data is available.

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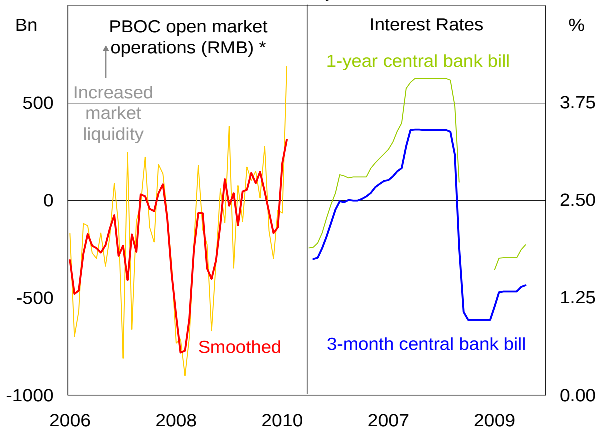
Graph 2

China - Money Markets

Monthly



* Includes bank bills and repurchase contracts

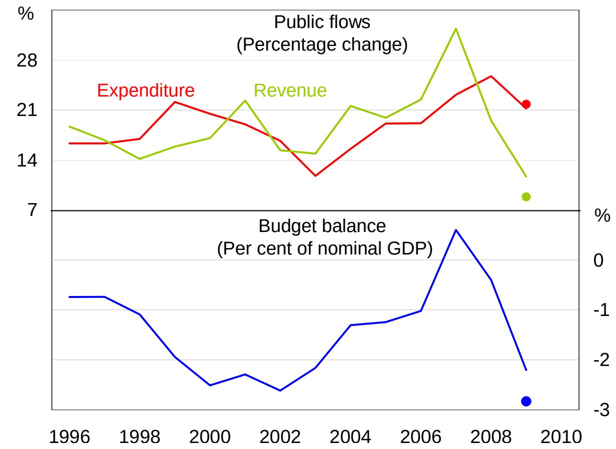
In aggregate, however, money supply growth has slowed slightly in recent months. Moreover, money market interest rates have risen slightly, with the 3-month central bank bill up by nearly 10 basis points in the past two months. This would indicate some overall tightening in money markets, although it is very modest and, given relatively ineffective transmission channels, its impact on the broader economy is likely to be small at this stage.

Fiscal policy appears to have been less expansionary than expected in 2009. The general government deficit was around 2¼ per cent of nominal GDP, compared with the official projection at March 2009 for a deficit of around 3 per cent (Graph 3). Expenditure growth was broadly in line with expectations, while revenue growth was stronger than projected. This probably reflects the impact of a more rapid economic recovery over 2009 than anticipated, resulting in higher tax revenue. More importantly, it suggests a healthier fiscal position and thus enables further stimulus to be delivered this year if required.

Graph 3

China - Fiscal Postion*

Annual



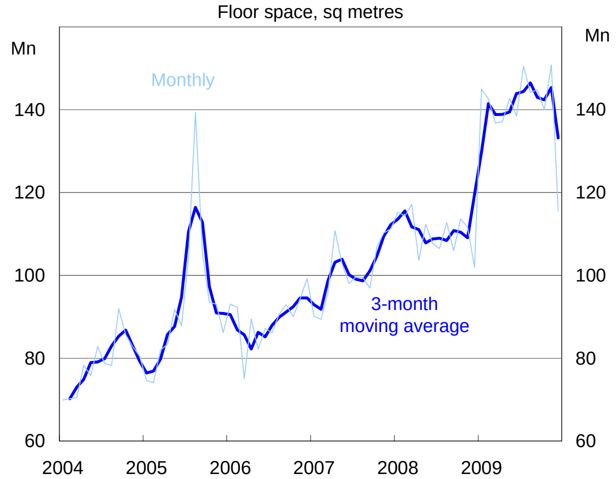
● Budgetary forecast at March 2009

Administrative controls have been used to dampen housing market activity, but there seems little risk of this spilling over to the broader economy. Controls have included greater scrutiny of lending for housing-related activity, higher down-payment requirements for land purchases, and less favourable taxation arrangements for second dwellings. The impact of these policies remains reasonably opaque; construction activity fell sharply in December but house prices rose rapidly in January (Graph 4).

Graph 4

China - New Building Construction

Floor space, sq metres



However, a policy-induced slowdown in the housing market is unlikely to presage an economy-wide downturn for two reasons:

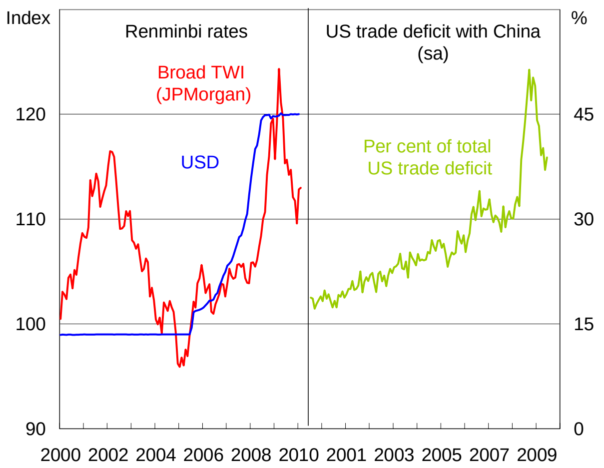
- Any downturn in private dwelling construction could be partly mitigated by public-funded construction. For example, authorities have committed to building more than 3 million homes in 2010.
- The indirect effect of a housing market downturn is likely to be relatively small. House prices do not seem yet to be excessively overvalued and households have significant equity in housing. Further, housing loans account for less than one-tenth of financial institution loans, and thus a high default rate would have only small implications for the health of the financial sector.

Exchange rate policy has been unchanged despite another period of increased international pressure. Chinese authorities have held the RMB/US exchange rate constant since late 2008, following a 17 per cent appreciation over the preceding three years (Graph 5). International pressure on China to further appreciate its currency has escalated recently, with President Obama vowing to 'get much tougher' on trade and currency issues with China. Chinese authorities insist that their exchange rate policy will not be adjusted because of international pressure. However, in the current economic climate the issue is likely to remain important, and the threat of protectionism may force the Chinese authorities to seek a compromise. Indeed, there is growing concern over the size of the US deficit with China, which now stands at around one-third of the total US merchandise trade deficit. Further, Chinese exports are more competitive in many other economies whose currencies have appreciated against the US dollar over the past year.

Graph 5

China - Exchange Rate Policy

Monthly



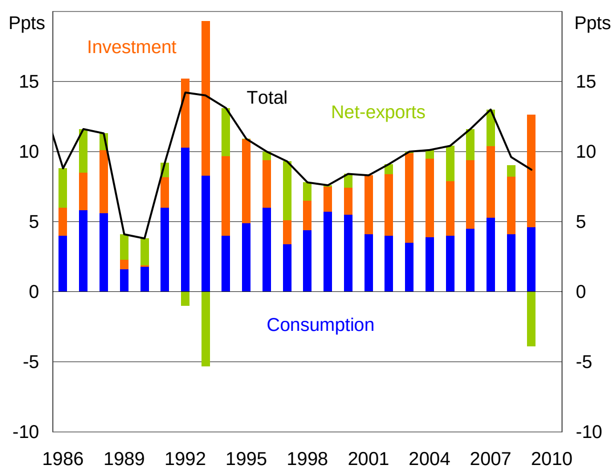
GDP by expenditure components

The National Bureau of Statistics (NBS) recently published the annual GDP by expenditure contributions. For 2009, investment contributed 8 percentage points; this is the largest contribution since 1993 which was also a year of public-led infrastructure spending (Graph 6). Consumption proved to be resilient, contributing 4.6 percentage points to GDP growth in 2009, while net exports subtracted nearly 4 percentage points.

Graph 6

China - Contribution to Real GDP Growth

Annual



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