Economics

China: No U-turn in monetary policy

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China's recent snowstorms have caused a direct loss of CNY111bn (USD15bn) by mid-February according to a spokesman for the Civil Affairs Ministry. Although the odds have risen that monetary tightening could be less aggressive in the first quarter of this year as the government encouraged commercial banks to ease lending to assist hard-hit regions rebuild (mostly eastern, central and southern regions), it is too early to say there has been a fundamental shift in monetary policy stance.

With limited success in slowing down the economy after five years of double-digit growth, China announced it would ratchet up its monetary policy in 2008 to "tight" at the annual Central Economic Work Conference in Dec07. The snowstorm disaster alone should not be enough to bring a U-turn in monetary policy. Rather, the event has exposed the country's need to simultaneously step up investments in infrastructures and the energy sector, while tightening the belt on overheated sectors.

The big picture has not changed

China's underlying economic problems – high liquidity/credit growth and inflationary pressure – remain. Recent money supply and lending growth figures have stayed above the central bank's target levels (***Chart 1***). M2 rose 18.9% YoY in Jan08, up from 16.7% YoY in Dec07, while yuan loans edged up slightly by 16.7% YoY in Jan08 from 16.1% YoY in Dec07.

In recent years, the trade surplus has become the major determinant of liquidity growth (***Chart 2***). The slowdown in the US over the past three years has indeed dragged US' contribution to China's overall export growth from 7.4ppts in 2004 down to 3ppts in 2007. Yet, China's exports figures managed to sustain a strong momentum, maintaining above 25% YoY growth, thanks to both Europe and Asia (***Chart 3***). In fact, the importance of the EU has risen as the share of China's trade surplus with the US narrowed. China's trade surplus with the EU accounted for around 50% of China's total surplus in 2007, while that of the US

Chart 1: Liquidity & credit growth remain high

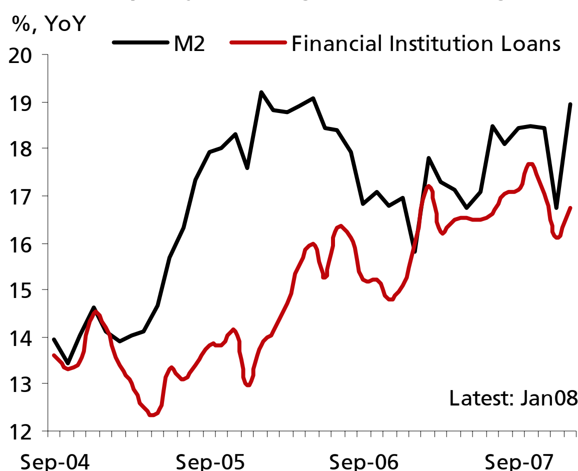
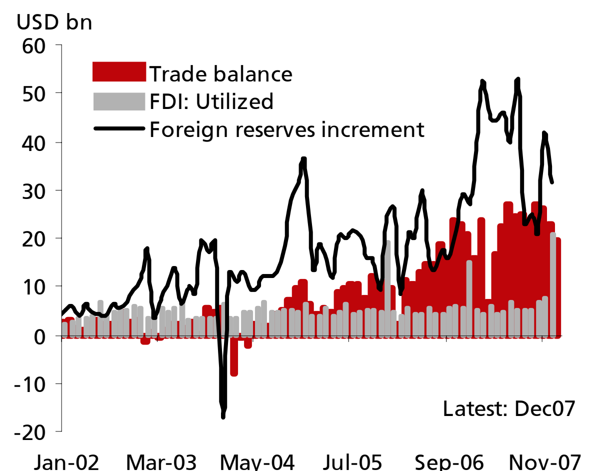


Chart 2: Trade surplus/FDI/FX reserves



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accounted for around 60% of the total. In 2008, Eurozone growth should slow to about a 2% rate mainly due to slowing consumption, hence imports. We doubt that China's trade surplus will grow by 50% this year, as it nearly did in 2007, but the USD262bn surplus registered in 2007 is already a lot to wipe up. The central bank will have to continue with open market operations and probably higher reserve requirements too.

Rising inflation does not support monetary easing

Current inflation does not support monetary easing (***Chart 4***). PPI inflation for January accelerated for the sixth consecutive month, rising to 6.1% YoY up from 5.4% YoY in Dec07, the highest since Dec04. Overall cost pressure intensified following rapid gains in food prices (10% YoY), oil and natural gas extraction costs (35% YoY) and ferrous metal-related costs. CPI inflation registered an 11-yr high of 7.1% YoY in January, and is likely to stay above the central bank's comfort zone in the coming months, possibly reflecting further rises in food and raw material costs. Even after the short-term effects of the weather shock and the Lunar New Year taper-off in 1Q07, headline CPI is not expected to ease substantially. The government announced earlier this year that they will maintain a freeze on energy prices and hold down prices of essential consumer goods. However, the artificial price caps will not be an effective long-term solution to tackle inflation, especially if current demand and supply side factors remain in play.

The Fed's 225bps of rate cuts have made it 'harder' for the PBoC to raise local rates. The widening interest rate spread between CNY and USD rates could bring more speculative capital into China (especially when the market is looking for at least 7%-10% CNY appreciation this year). However, this does not mean that the central bank need not bring inflation-adjusted deposit rates back to the positive territory at a time when inflationary pressure remains, if not intensifying. In fact, negative real deposit rate was one of the key causes of asset inflation last year as residents rushed to reallocate their savings to higher yielding vehicles. The least the central bank should do is to gradually bring the real deposit rate to zero.

At the upcoming National People's Congress in March, the authorities will likely grasp the opportunity to reassess both domestic and external risks the Chinese economy is facing before adjusting macroeconomic policy directions, if any. At this point in time, with real GDP growth having accelerated for 6 consecutive years to a cyclical high of 11.4% in 2007, rising inflation seems to be a bigger threat than growth deceleration.

Chart 3: Trade

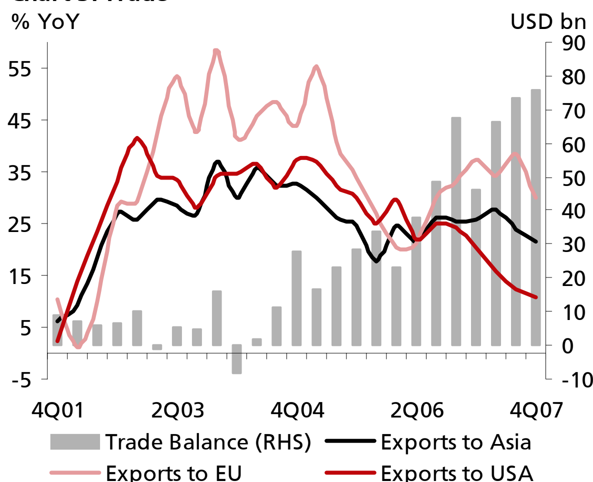
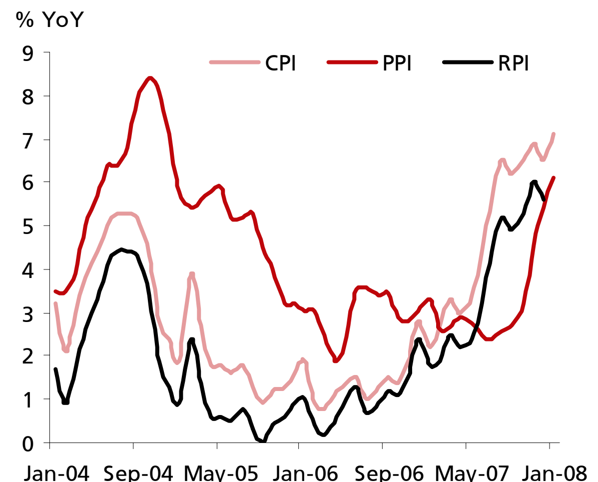


Chart 4: inflation



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