

ASIAN WEEKLY ECONOMIC INSIGHTS



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Asian Economic Perspectives

China's Surging External Surplus Puts Pressure on Sterilization Policy

China's foreign-exchange reserves have further increased in 2006 and are set to exceed US\$1 trillion by the end of the year. However, the composition of the reserves accumulation has changed, with most of the buildup coming from the trade surplus while speculative inflows have waned. This will make it harder for Beijing to argue against the assessment that the renminbi (RMB) remains grossly undervalued against the US dollar and other major currencies. Moreover, we are concerned that the speculative inflows are likely to return once the US dollar resumes its depreciation path. Growing trade and capital inflows will further boost China's external surplus, and the People's Bank of China (PBOC) will need to double its efforts to rein in excess liquidity and slow the financial intermediation in the banking system to curb credit expansion.

Sources of Forex Reserves Accumulation

In the first five months of 2006, China's forex reserves increased by a massive US\$106 billion, reaching US\$925 billion in May. The trade surplus accounted for some 44% of the reserves accumulation; net foreign direct investment (FDI) for 19% and speculative inflows for another 35%. This represents a complete change in composition compared to 2004, when the trade surplus accounted for only 16% of the reserves buildup and net FDI and speculative inflows contributed 26% and 56%, respectively (**Display 1**).

Ironically, China's trade surplus has started to surge since the second half of 2005 despite the modest RMB appreciation since last July. While net FDI inflows remained steady at around US\$4 billion to US\$5 billion a month during the past year, speculative inflows actually fell to just US\$1.8 billion cumulatively in the second half of 2005

before rebounding to US\$37 billion between January and May 2006. We believe that the size of speculative inflows is closely associated with the market perception of the US dollar. Our take is that once the US Federal Reserve's tightening cycle comes to an end in the second half of 2006, the US dollar will return to its depreciation path as the forex market refocuses on the growing US external imbalance. This should spur a rebuilding of the long RMB position in the market, and China's growing trade surplus will fuel expectations of further RMB appreciation.

Sterilization Effort Must Intensify

The impact on PBOC's "sterilization" policy will be significant. Inspection of the central bank's balance sheet shows that reserve money growth has actually slowed from a high of 14% to 15% in mid-2005 to around 8% to 9% during the last few months. This was the result of a domestic sterilization exercise, in which the liquidity created by forex reserves accumulation was effectively offset by the issuance of treasury bills and withdrawal of government deposits from the central bank (**Display 2**). As far as it went, this first level of defence was a fairly effective way of curbing the growth of high-power money in the system. The problem, however, lies in the continued recovery in broad liquidity growth (M2) and credit expansion, as a result of the re-acceleration of financial intermediation (or a revival of the money multiplier) in the banking system (**Displays 3–4**).

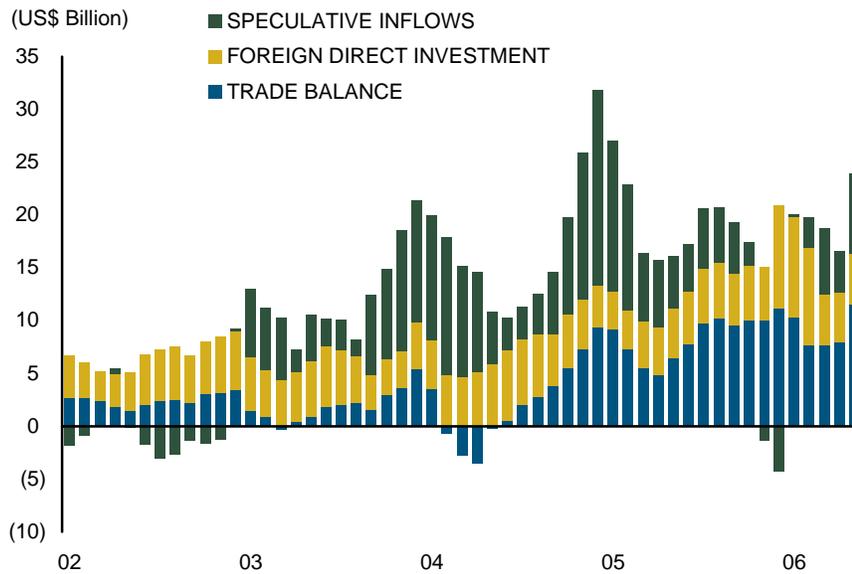
In our view, the PBOC has the following policy choices to curb money creation: first, to increase the RMB's trading volatility so as to make the currency less of a one-way bet; second, to further raise commercial banks' reserves requirement ratio (currently at 8%) to reduce the ability of banks to expand their loan books; third, further raise the prime lending rate to increase the cost of funds for corporate and individual borrowers; fourth, to

implement administrative measures to curb lending to overheated or overcapacity sectors.

We believe the PBOC will use a combination of the above measures. But the important point is that more vigorous action will be needed to prevent liquidity from causing an explosive rate of expansion.

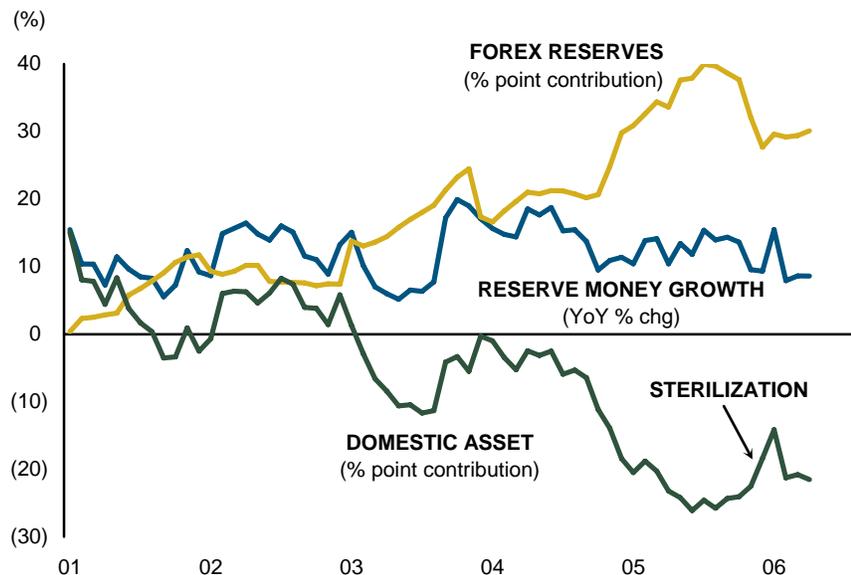
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Display 1: Trade Surplus Accounts For Most of Reserves Buildup Sources of Forex Reserves Accumulation



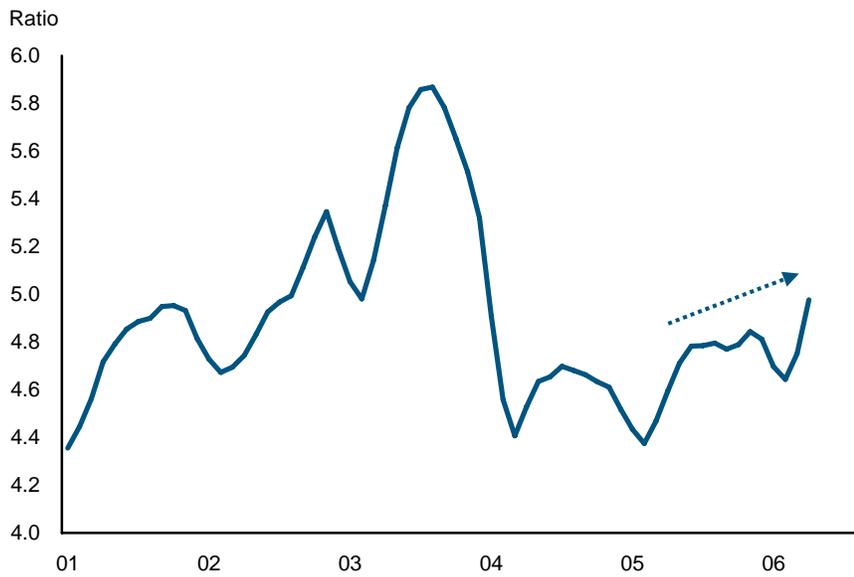
Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 2: Reserve Money Growth Has Eased... Sources of Reserve Money Growth



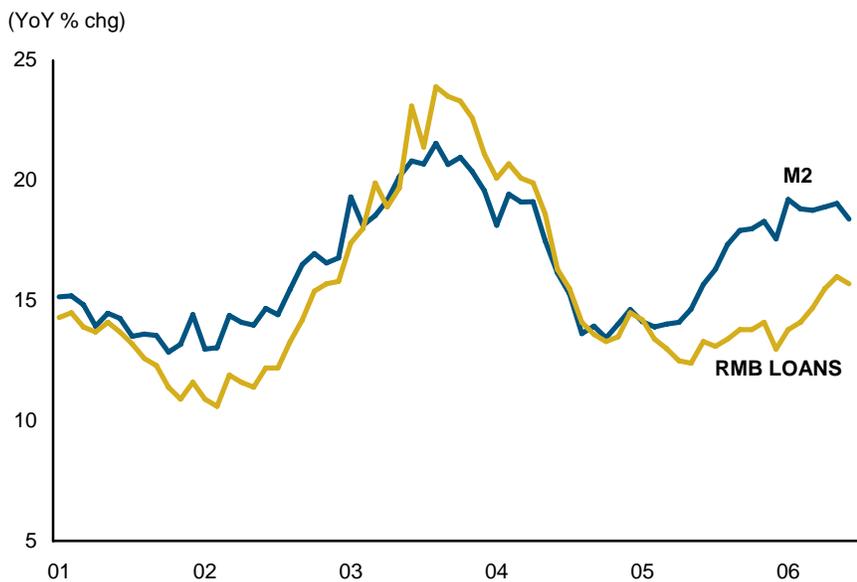
Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 3: ...But the Money Multiplier Has Expanded ...
 Ratio of M2 to Reserve Money



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 4: ...Leading to a Continued Surge in Broad Liquidity Growth
 Growth of M2 And RMB Loans



Source: CEIC Data and AllianceBernstein Fixed Income estimates