Global Economic Research

ASIAN WEEKLY ECONOMIC INSIGHTS

July 20, 2007

Anthony Chan

Asian Sovereign Strategist
Global Economic Research

+ 852 2918 7846

This document reflects the views of AllianceBernstein as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

China Braces for More Tightening as Excess Liquidity Persists

China is once again on the point of tightening monetary policy in an attempt to manage one of the key risks to its economy—persistent excess liquidity in the financial system. Second-quarter foreign exchange (FX) reserves figures and money supply and loan growth data for June show the size of the challenge for policymakers. Base money growth has surged remarkably over the past few months, highlighting the need for the People's Bank of China (PBOC) to intensify its sterilization efforts. The central bank's recent resumption of special mandatory bond issuance to local banks highlighted the urgency of the situation: The volume of bonds placed was a massive RMB101 billion.

Soon, China will acquire new tools for the task of managing liquidity. A bond issuance program to finance the start-up of the government's new investment corporation—expected to be RMB1.55 trillion—and a gradually expanding Qualified Domestic Institutional Investors (QDII) program should help reduce liquidity in the banking system. We expect neither project to be sufficiently developed in time to make an impression on domestic liquidity this year, however. Monetary tightening, in other words, will continue to take the form of further hikes in interest rates and increases in the reserves that commercial banks are required to deposit with the PBOC.

Speculative Inflows Slow but Remain Large

China's FX reserves stood at US$1.33 trillion at the end of the June, having increased US$131 billion over the second-quarter—close to the US$136 billion first-quarter increase. Monthly reserves accumulation averaged about US$44 billion in the first half, more than double the US$20 billion monthly average for the whole of last year.

After taking out the trade surplus and net foreign direct investment inflows, US$32 billion of the second-quarter increase can be attributed to "speculative inflows". Though substantial, the figure was down from about US$58 billion in the first quarter (**Display 1**). We now know that some of these short-term inflows are related to the unwinding of FX swap positions between the PBOC and Chinese commercial banks, as well as the repatriation of IPO funds by Chinese firms from offshore markets (see 'China's FX Spike is a One-Off but Short-Term Inflows Remain a Risk,' *Asian Weekly Economic Insights,* April 20, 2007). Although we lack detailed information about the unwinding of the swaps and the repatriation of IPO funds, we can at least see clearly the trend of "hot money" inflows during the first two quarters. The good news is that the spike in short-term inflows appears to have peaked in the first quarter and that there are early signs of a marked slowdown, with inflows down from US$14 billion–US$18 billion a month in April and May to just US$600 million in June. Further consolidation of the China A-Share market, (shares in companies incorporated in mainland China and traded on the mainland), will be the key to sustaining the slowdown in hot-money inflow in the third quarter, as long as the speculative funds do not migrate back to the property market.

Base Money Growth Accelerates

The impact of surging FX reserves on base money[1] growth over the past two quarters was significant but has not been widely reported. Base money growth jumped to 27% year on year in May as the central bank's sterilization measures failed to offset fully the effect of the acceleration in reserves accumulation (**Display 2**). This is likely to be the main reason for the continued robust expansion in

[1] The sum of currency in circulation and reserves held by depository institutions at the PBOC.

M2 or broad money supply growth, up 17% year on year in June, above the PBOC's target of 16%. More importantly, the abundant liquidity together with continued robustness in nearly all sectors of the economy—exports, fixed investment and household consumption—have encouraged banks to expand their loan books. New RMB loans bounced back to RMB450 billion in June from RMB250 billion in May, maintaining the high rate of expansion seen in the first four months (**Display 3**).

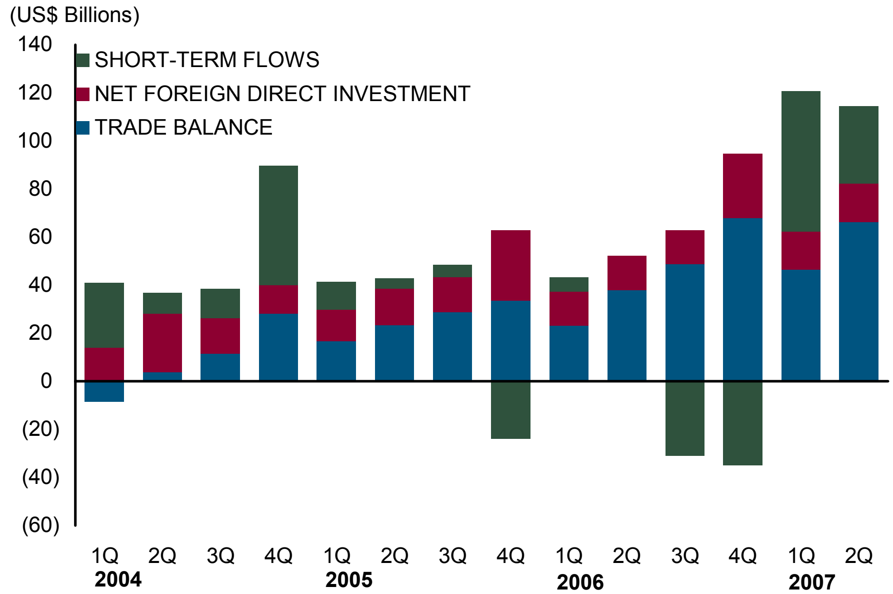
More Tightening in Third Quarter

Pressure from rising FX reserves plus continued robust money and credit growth will prompt the PBOC to tighten monetary policy further. We expect imminent hikes in both lending and deposit rates as well as a further 50 basis point rise in banks' reserves requirement ratio (currently 10.5%). Recent acceleration in RMB appreciation indicates upside potential on the exchange rate, but currency appreciation is still under a controlled path and, in our view, will only attract more speculative inflows. The chances of a sizeable one-off RMB revaluation may increase, but we believe that the political will to make a bold currency move is still lacking.

Anthony Chan
Global Economic Research
July 20, 2007

Display 1: Hot Money Accounted for a Third of 1H07's FX Surge

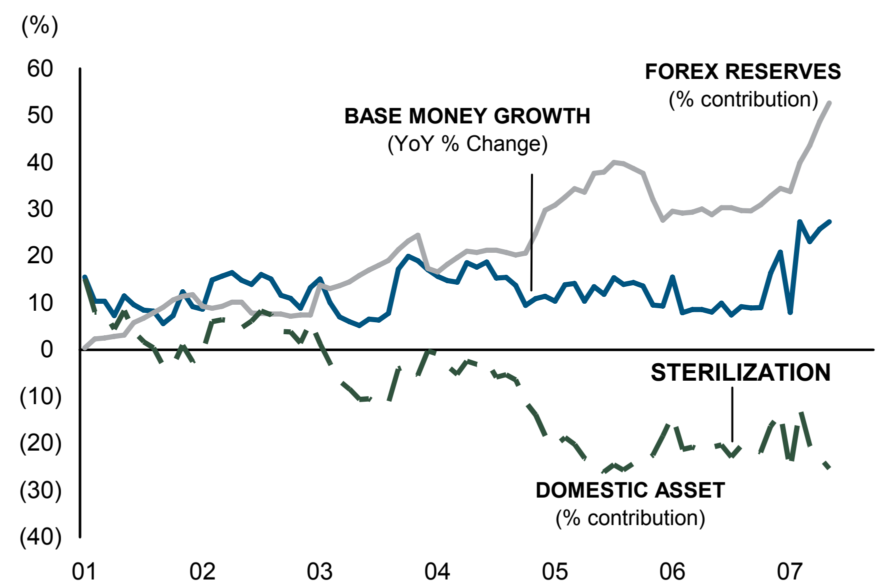
Sources of Quarterly Foreign Exchange Accumulation



Source: CEIC Data and AllianceBernstein estimates

Display 2: Base Money Growth Surges in 2007

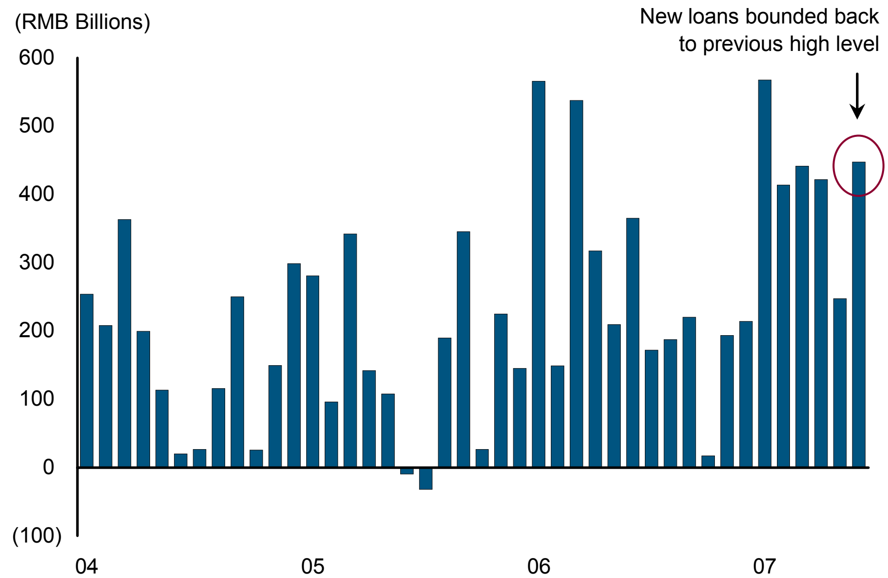
Sources of Base Money Growth



Source: CEIC Data and AllianceBernstein estimates

Display 3: Banks Rebuild Their Loan Books

Monthly Changes in RMB Loans



Source: CEIC Data