

ASIAN WEEKLY ECONOMIC INSIGHTS



May 2, 2008

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.

UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ. It is registered in England no. 577714012

Asian Economic Perspectives

Beijing's Reluctance to Raise Rates Builds Pressure for Tighter Policy

We have just returned from a research trip to Beijing. Our focus was on monetary policy but we also discussed the potential domestic risks to growth in 2008 with government economists. These include the potential shutdown of production during the Beijing Olympics to reduce pollution, and the impact on manufacturing activities of a recent tightening of the labour law. In summary, we believe the factory shutdown will be targeted rather than widespread, with only a minor impact on national GDP. Higher running costs introduced by the more stringent labour contracts will affect many manufacturers in the Pearl River Delta of Guangdong, the Yangtze River Delta near Shanghai and other major coastal provinces such as Shandong. We view this as a transitional issue, however: the end result should be higher value-added production.

No Bold Monetary Tightening on the Horizon

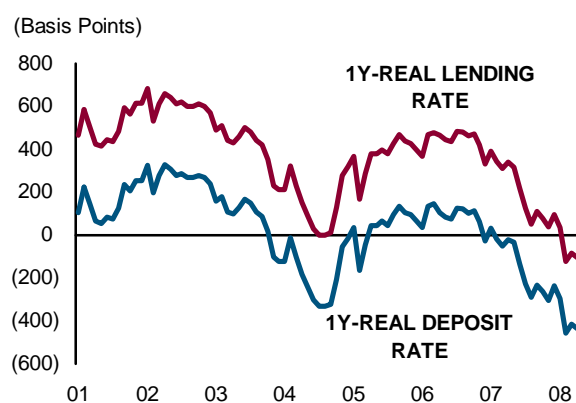
We are less sanguine about policymakers' ability to resolve China's monetary dilemma. A swift policy change might only exacerbate problems in other economic areas—a familiar challenge for Beijing which has to manage an economy that is not yet fully market-based. Indeed, policymakers' need to balance different vested interests suggests that the piecemeal approach to monetary management is likely to persist for some time yet. Although China has been able to muddle through its excess liquidity problem during the last few years, we now believe that the risks associated with an extended monetary overhang are higher, particular if global liquidity improves as risk appetite returns to the global financial markets.

Below we present a few of our observations on China's economic policy thinking.

PBOC's Policy Dilemma

The People's Bank of China (PBOC) appears unwilling to increase lending rates this year, despite rising inflation having pushed real interest rates further into negative territory. This is because the PBOC fears that further widening of the interest-rate differential with the United States will intensify the pressures that are causing the renminbi (RMB) to appreciate. Officials expect that a moderation of food inflation, combined with the favourable effect of coming from a high base, will cause headline inflation to fall from more than 8% year on year to around 5% year on year in the second half of this year. This inflation forecast is in line with our own. The important point, however, is that the benchmark one-year real lending rate and one-year real deposit rate are running at around -100 basis points and -440 basis points respectively (**Display 1**). Even if headline inflation were to fall by 200 to 300 basis points, China's real interest rate environment would remain highly stimulating and far removed from the central bank's rhetoric about maintaining a tight monetary stance.

Display 1: Monetary Policy Is Not Tight Real Interest Rates



Source: CEIC Data and AllianceBernstein estimates

In our view, pushing up real interest rates as growth remains robust and inflation rises has to be the top monetary policy priority for any country, China

included. In China's case, failure to take such action will mean commercial banks remaining eager to expand their loan books, so that the credit quotas imposed on the banks by the PBOC will have little lasting effect. This view is supported by the fact that commercial banks frontloaded about 80% of their first-quarter 2008 lending quota in January alone. Also, the recent surge in foreign-currency loans, which fall outside the central bank's loan restrictions, are an indication of China's loose monetary conditions. They are currently growing by 40% to 50% year on year.

The Misconception of Hot Money Inflows

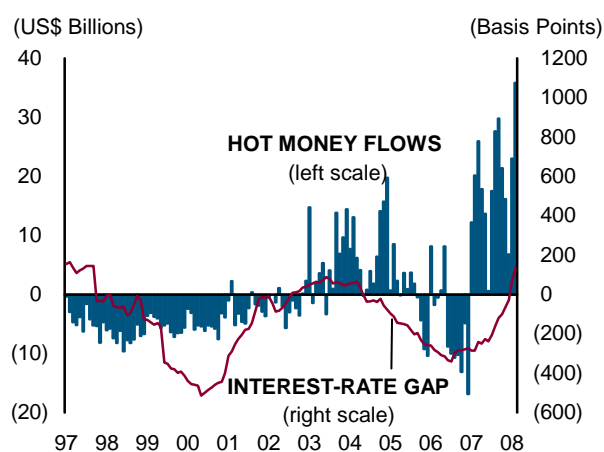
In contrast to government officials' fears that a wider interest-rate gap will fuel the RMB's appreciation, we believe that there is no obvious cause-and-effect relationship between "hot money" speculative inflows into China and changes in interest rates. Rather, we believe speculative inflows are more the result of a highly predictable currency appreciation regime and the low two-way risk associated with such a trade. Against the US dollar, the RMB has largely been a negative carry currency (in terms of the one-year interest rate differential) during much of the past 10 years (**Display 2**). Since Beijing began allowing the RMB to appreciate gradually in 2005, the movements of the interest-rate gap within negative territory have had little to do with the sporadic influx of hot money into the country. In light of this—and in the absence of a more prudent real interest-rate policy amid rising inflation and firm economic growth—the fear that the interest-rate gap will induce further RMB appreciation appears somewhat out of proportion.

A Balanced Policy Choice

Unfortunately, Chinese policymakers are in our view unlikely to take decisive action with regard to exchange-rate policy in the foreseeable future, although they appreciate the importance of introducing two-way risk as a way of deterring currency speculation. One reason we hold this view is that the central bank is not the only voice pushing policy recommendations to the State Council which, in turn, has to balance overall policy with different economic interests.

The difficulty of managing economic policy under these circumstances can be seen from the fact that the high operating costs that many companies (particularly small- and medium-sized enterprises) now face are partly the cumulative results of a series of highly concentrated policy changes implemented over the past year. They include the cuts in export-tax rebates, increases in export taxes, the rise in wage costs triggered by the abrupt tightening of labour laws, and the acceleration in currency appreciation since the start of this year. This is on top of the continued surge in local commodity prices such as coal and many ferrous and non-ferrous metal products. Against this backdrop of growing cost burdens on domestic firms, we think it will be extremely difficult for the State Council to approve higher loan and currency-hedge rates, even though they make absolute sense in terms of monetary policy.

Display 2: No Obvious Causality
Speculative Flows and 1 Yr Interest-Rate Differential vs. US\$



Source: CEIC Data and AllianceBernstein estimates

Rate Hike Pressure Will Continue

In first-quarter 2008, China's foreign-exchange reserves surged by some US\$154 billion to US\$1.68 trillion. The quarterly increase in reserves alone matched the foreign-exchange reserve of many major developing economies. This highlighted the fact that the scale of the monetary sterilization challenge faced by the PBOC has not only grown, the problem has also increasingly handicapped the PBOC's largely reactive approach

to monetary tightening. We expect more or less the same policy responses from the central bank during the next six to nine months: namely, further hikes in banks' reserves requirement ratio (possibly to 18% from 16% currently) and an expansion in the volume and duration of sterilization bonds on issue. In the absence of real interest-rate increases, the use of credit rationing as a quick fix to curb credit growth will have only a limited effect, as there will be no price adjustments (that is, interest-rate rises) in resolving the monetary overhang problem. In short, China's rate hike pressure will be protracted and will extend well into 2009.

In addition to these factors, there is a view in China that policymakers should capitalize on the anticipated moderation of inflation in the second half of 2008 to continue the country's final round of price reforms and liberalizations. The argument is that since so much pressure on input costs—

specifically on coal and crude oil prices—has built up during the past year, it is now a matter of urgency to release those pressures in the form of higher electricity, water and retail fuel prices. Beijing, however, has halted energy/utility price hikes for more than a year for fear of jeopardizing social stability. While the proposed price increases make sound economic sense, we think the leadership may have a stronger political will to implement energy price increases once the Olympic Games are over. The consequence of such a policy, however, is plain to see: energy price hikes would rekindle inflationary pressure, reinforcing the upward pressure on China's interest-rate tightening cycle.

Anthony Chan
Global Economic Research
May 2, 2008