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Exit of Stimulus Policies in China

In early April, we forecasted that the negative CPI could persist for the coming few months but prolonged deflation is unlikely because of the aggressive monetary and fiscal stimulus policies introduced by the Chinese authorities. The deflationary pressure has eased few months later as we expected. In middle of October, the National Bureau announced that CPI in September dipped 0.8% from a year earlier, the eighth consecutive months of decline since it dropped 1.6% in February. Although China has no inflation problem, the government is highly concerned about inflation expectations. According to the forecast released by Peking University's China Center for Economic Research (CCER), a major government think tank, China's economy is expected to grow by 10.6% year-on-year in the fourth quarter of this year, while it's CPI is expected to rise by 0.5%. Some economists even expect China's CPI will grow about 4% annually in 2010. We believe that the State Council gave its first clear signal on Oct22 that it was considering the exit of stimulus policies. This article discusses the different stage of the exit strategy in China, the reason behind and the impact to the market.

"A key point of China's macro-regulation for the rest of the year would be to balance the tasks of ensuring a stable and relatively fast economic growth, adjusting economic structure and managing inflation expectations", according to the statement released after the State Council executive meeting. In our view, this statement implies that there would be no significant change in the monetary policy by the end of this year, but slight change is required. Actually, the People's Bank of China (PBOC) has started to withdraw liquidity through open market operations in the last week of October, with a net drain of 133 billion yuan from the market, sending the net withdrawal in October to 156 billion yuan, the biggest monthly drain since February. We can consider it as the first stage of the exit strategy. Open market operations are the means of implementing monetary policy by which the central bank controls its national money supply by buying and selling government securities, i.e. Central Bank Notes. Last month might be the first turning point of the central bank's open market operations since the fourth quarter of 2008. PBOC will probably allow some moderate upward moves in Central Bank Notes' yields to help absorb liquidity when necessary.

China has overseen a massive increase in lending this year. New loans in the first nine months totaled 8.67 trillion yuan, far exceeding the government's initial minimum target of 5 trillion yuan for 2009. It is anticipated that the current ultra-loose monetary policy will allow full-year lending in this year to reach 10 trillion yuan. The Chinese government may set a loan target for 2010 by the end of this year. There is no doubt that aggressive lending will spill into stocks and property, creating a bubble and making a hard landing for the economy more likely, however, we don't expect the target amount will be reduced significantly because the infrastructure projects that banks loaned to this year would continue to need financing. New government-funded projects, more confidence in the economic recovery and active auto and housing markets will contribute to a huge demand for new loans. So we expect that China's new bank loans target likely to amount to 7 trillion and 8 trillion yuan.

We also expect China will raise the reserve-requirement ratio for commercial banks in the first quarter next year. The ratio is expected to be raised from 15.5% to 16.5%. Such policy can help to reduce the expected inflation rate and, therefore, the impact of the negative interest rate (i.e. assets bubble) and it will be adopted before PBOC start raising interest rate. Negative interest rate arises when the nominal interest rate is lower than the expected inflation rate. (Currently, the one year time deposit rate is 2.25% and the expected inflation rate is about 3% - 4%) Increase in reserve-requirement ratio can be considered as the second stage of the exit strategy.

Finally, Chinese government will rise both the lending and deposit rates. We expect the interest rate hike will begin in Q2 next year and PBOC may hike the interest rates by 18 – 27 basis points at the first time. We believe that the policymakers will refrain from hiking the interest rate unless annual growth rate in CPI and export turns positive. Growth in CPI and export are expected to turn positive in Q2 next year due to the base effect and global economic recovery. However, we think that the interest rates should be raised only moderately because 1) some sectors still have excess capacity and redundant construction and 2) unemployment is worse than its look (the official unemployment rate is 4%). These two factors can help ease the inflationary pressure.

Some people think that yuan will appreciate 5% next year, but we believe that it is still a rather distant story. In our view, policymakers are unlikely to choose to appreciate the currency at a time when export growth remains weak and the external imbalance is not swelling. Appreciation of yuan will likely invite more hot money inflows to bet on further appreciation, making the PBOC's control over domestic liquidity even more challenging. Between the choices of tightening domestic investment versus exports, the Chinese government usually find the former easier to control and preserves export strength to support employment in labor-intensive sectors.

In conclusion, the policymaker's top priority has shifted from preventing a further sharp fall in economic growth and employment towards preventing medium-term risks of non-performing loans and overinvestment. We believe that the first stage of exit strategy has been started and the second and third stage will come in Q1 and Q2 next year respectively. Uncertainty exists before PBOC rise the interest rates and the market correction seems likely or upside potential is limited. However, once the interest rate hike starts, the market rally may come again.

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