



November 2010

### China's Interest Rate Hike, Positive or Negative?

The People's Bank of China increased the benchmark one-year interest rate on loans and deposits by a quarter of a percentage point on Oct 19. The move is the first adjustment to interest rates since December 2008, when the central bank cut them by 0.27 percentage point as part of a stimulus package. The last increase in interest rates was in December 2007, when inflation was over 6%. PBOC's action surprised investors and sparked a world-wide sell-off in stocks, commodities and emerging-markets currencies at that day. However, the negative impact didn't last long. Shanghai Composite Index even closed higher on Oct 20 compared with a trading day before. As we mentioned, this is a clear signal that the bull market has entered the final stage (Bull 3) and the market momentum remains strong.

First of all, let see the economists' view on China's interest rate hike:

We expect this rate hike to be the first of a series to come. Since the rate hike caught the market by surprise, we think the initial reaction is likely to be negative, especially for the property and related sectors. However, in general, we think the market should see the rate hike as a speed bump on the road, as it also reflects the government's confidence in the strength of economic activity. – Tao Wang & Gao Xu, UBS

The decision suggests the acceleration in growth and official worries about property and inflation are more serious than anticipated. Moreover, while tightening is expected to contain growth and inflation over the next 2 to 4 quarters, more serious economic and financial reform is needed to resolve medium-term risks. – Ben Simpfendorfer, Royal Bank of Scotland

It conveys at least two important messages: 1) top policy makers in China are watchful of the increasing risks on inflation, especially at a time when energy price deregulation is undergoing more quickly and 2) Chinese leaders probably see less of a risk of a double dip in global growth and a severely negative impact on the Chinese economy. Meanwhile, we still expect the divide in the policy mix to continue, with easing in investment and fiscal policies to help support growth stability, and a tightening bias in monetary and property policies to manage inflation and asset inflation risks – Helen Qiao & Yu Song, Goldman Sachs

Chinese policy makers have become more confident on the real economy, especially regarding the strengthening momentum on domestic demand. On the inflation front, we expect headline CPI inflation rate to peak out in coming months, with the inflation rate to gradually stabilize at around 3% by early next year. – Qiang Wang, Grace Ng & Lu Jiang, JP Morgan Chase

Our views are shown below:

- 1) From table 1, we find that the deposit rate increase at a greater extend for longer term deposit. It shows that PBOC would like to attract longer term deposit.
- 2) The unexpected interest rate hike has changed the market expectation successfully. People expect interest rate will be on uptrend in the foreseeable future. Meanwhile, interest rate hike can reduce the effect of negative interest rate, which can help to suppress the bubbles in property market.
- 3) A share is still attractive, there may be some capital switching from mainland property market to equity markets.
- 4) Interest rate hike may attract foreign capital inflow. We believe that PBOC would rise the required reserve ratio or purchase more U.S. Treasury so as to reduce RMB's appreciation pressure.
- 5) Annualized PPI, the leading indicator of CPI, stopped rising in September compared with August. Therefore, we believe that annualized CPI in 2010 would be 3%, and PBOC might not raise interest again by the end of 2010.

Bull markets usually end before the end of interest rate cycle, but not the beginning of it.

**Table 1. RMB Benchmark Deposit & Loan Rates**

	Rate (before adjustment)	Rate (after adjustment)	Change
Household & Corporate Deposit			
1. Demand Deposit	0.36	0.36	0
2. Time Deposit			
3-month	1.71	1.91	+0.20
6-month	1.98	2.20	+0.22
1-year	2.25	2.50	+0.25
2-year	2.79	3.25	+0.46
3-year	3.33	3.85	+0.52
5-year	3.60	4.20	+0.60
Loans			
6-month	4.86	5.10	+0.24
1-year	5.31	5.56	+0.25
1 to 3-year	5.40	5.69	+0.20
3 to 5-year	5.76	5.96	+0.20
Over 5-year	5.94	6.14	+0.20

Sources: PBOC

**Important Notice:**

The information contained within this document is for the information of prospective clients and existing clients of Arcadia Financial Services (Asia) Ltd (here after AFS) and/or Arcadia Asset Management (Asia) Ltd (here after AAM). The information is not intended to be a recommendation, offer or solicitation to buy products, securities or services. Products and securities described within this document are not applicable to all persons of all nationality, residence or domicile. Persons interested in making any investment or purchasing any products or securities described within this document should inform themselves as to the legal requirements in their country of nationality, residence or domicile.

Investment in securities carries risks. Past performance is not necessarily a guide to future investment performance. If there is any doubt, you should seek advice from your financial consultant before contemplating any investment.

The information contained within this document is believed to be correct and was obtained from sources believed to be reliable, but accuracy, timeliness or completeness cannot be guaranteed. AFS and AAM cannot be held responsible for any errors or omissions contained within this document or for any consequences arising from the use of this document or the information contained within it.

*If you want to receive Arcadia Market Commentary or you have any comments to us, please send to us by email: [servicing@arcadia-asia.com](mailto:servicing@arcadia-asia.com) or contact us at below at no obligation. Information sent to us will be treated strictly confidential.*

**Arcadia Financial Services (Asia) Ltd  
Arcadia Asset Management (Asia) Ltd  
Room 1404 & 06, Leighton Centre, 77 Leighton Road, Causeway Bay, Hong Kong  
Tel: (852) 2114 8488 Fax: (852) 2111 0777**