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What Are the Implications of China's Policy Tightening?—Our Answers to the Main FAQs

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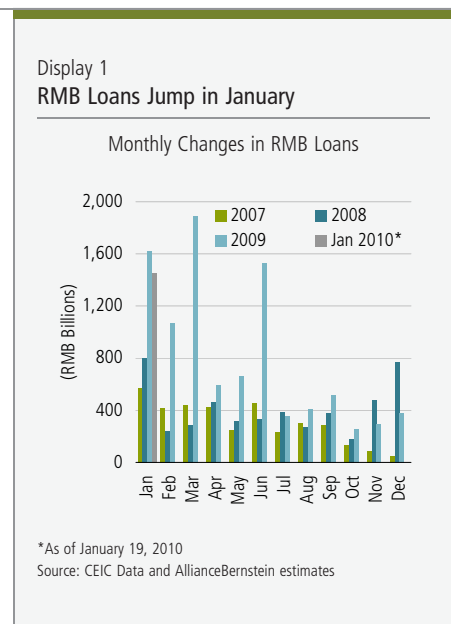
Confusion over China's monetary policy has increased as investors have tried to judge the extent and consequences of Beijing's latest tightening. Here, we provide our answers to the most frequently asked questions about the turn in the country's policy cycle and add some color to the outlook for 2010.

Will China's monetary tightening kill economic growth in 2010?

This is the market's main fear, in our view—in stark contrast to the worry only a quarter ago about asset bubbles. The problem is that, previously, the consensus had seriously underestimated the pace and extent of China's monetary exit, believing that a real tightening would not occur until the second half or even the fourth quarter of 2010. The 50 basis point hike in the reserve requirement ratio (RRR) two weeks ago and the increasingly heavy-handed controls on banks' lending by the People's Bank of China (PBOC) were wake-up calls to the market, forcing it to recognize that China's monetary tightening could be much more preemptive. The market now fears a highly concentrated tightening in the first half of the year that might choke the recovery, sabotage the country's demand for world commodities and turn much of China's large volume of bank loans into nonperforming assets.

Display 1 underlines our belief that it makes absolute sense for China to exit proactively from its ultra-loose liquidity position, imposed by the global crisis a year ago. We have written extensively recently on China's monetary policy outlook, but there are three important points worth highlighting again.

First, China's monetary-policy instrument of first resort is to target the quantity of money by applying heavy regulatory pressure on the banks. Beijing can ramp the credit cycle up and down, but the trajectory tends to be volatile, particularly when policy changes direction. Administrative measures are not sustainable and, for longer-term effectiveness, policymakers need to draw upon market forces (through changes in interest rates, for example, and open-market operations, etc.) On this occasion, we think the hike in the benchmark one-year lending rate will come sooner than generally expected—probably before the end of the first quarter.



Second, we think the PBOC aims to smooth the path of credit growth to achieve its RMB7.5 trillion new-loan target for 2010. This will be the second-largest credit growth in China's monetary history after last year's RMB9.6 trillion and will ensure more than enough liquidity to support nominal GDP growth of 13%–15%. Moreover, the PBOC will aim to keep to the usual annual pattern of roughly 65% of new loans being front-loaded into the first half of the year. We think the PBOC has a good chance of achieving this target—the important implication being that, by mid-year, the growth of total loans outstanding will be on target at around 18% year on year

compared with 32% in December 2009. This will be consistent with 13%–15% nominal GDP growth (**Display 2**).

Third, fixed asset investment (FAI) growth has already slowed from its frenetic expansion in early 2009, to around 20% in real terms in December. We expect full-year 2010 FAI growth to be about 25% compared with 36% in 2009. The return of more sustainable investment and credit growth will put China in the sweet spot of its policy-exit cycle. At that point, we expect the financial markets' mood towards China will improve. So far, the markets have acted true to form in responding negatively to the initial headwinds of a policy tightening. Once the benefits of preemptive tightening start to emerge, however—that is, the reduced risk of harsher measures at a later point in the cycle, and the increased chance of sustainable economic growth—the markets should begin to reprice the fundamentals.

Will hot money inflows complicate matters?

We have analyzed this issue in detail in the past two *Asian Perspectives* and believe that the current volume of speculative inflows is not too threatening either to the economy or to policy settings. As long as market expectations for RMB appreciation stay reasonable, short-term capital flows should remain subdued, leaving the PBOC free to mop up domestic liquidity without the need to confront a monetary overhang similar to that of 2007–2008. During those years, about US\$220 billion (RMB1.7 trillion) of speculative funds flowed into China, forcing the central bank to raise the RRR by 800 basis points cumulatively and expand bond issuance sharply, merely to prevent a blowout in liquidity. Today's monetary problem is arguably less complicated than that of two years ago. The growth in China's purchase of foreign assets and the country's evolution into a provider of capital for the world economy are new channels which did not then exist as a way to offset foreign inflows.

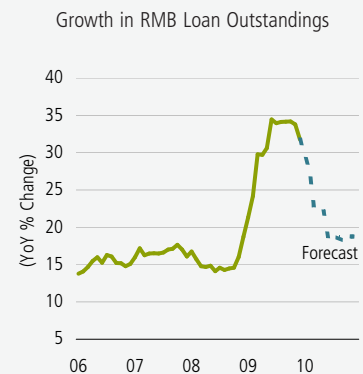
An RMB-USD de-peg is fully priced in, but how much upside is there for RMB?

The rationale behind this question is that China needs a firmer exchange rate to offset growing imported inflation this year, while the export recovery should make Beijing less concerned about exchange-rate competitiveness. In our view, the upside risk would have to be very significant for Beijing to allow an appreciation of more than, say, 6%–8% against the US dollar in the coming year. We expect neither a significant revaluation nor a considerable widening of the RMB daily trading band (say 3% or more, which would add volatility to the economy during a monetary tightening cycle). We expect nothing more exciting than a crawling appreciation trend, beginning in the second quarter.

Will consumer loans remain a priority area as China enters the tightening cycle?

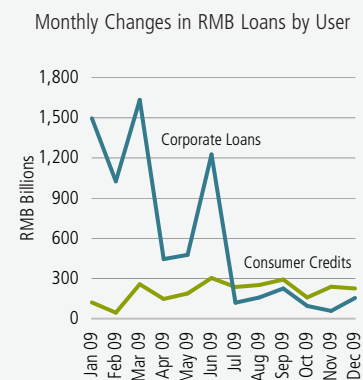
This week, the head of China's Banking Regulatory Commission confirmed that consumer credit and loans to support low-cost housing are still being encouraged, even though the monetary policy cycle has turned. **Display 3** shows that while growth in corporate loans slowed during the second half of 2009, new loans earmarked for the household sector (including mortgages) remained solid at RMB225 billion in December and basically maintained the firm trend since mid-2009. A softer property market this year may dampen consumer credit growth; however, overall consumption should stay strong, helped by the extension of the government's program of subsidies for home appliance and motor vehicle purchases. China's fiscal strength will support the policy of promoting consumer spending and reducing households' precautionary savings (for pension and healthcare reforms, etc.)

Display 2
Credit Growth Returns to Sustainable Levels



Source: CEIC Data and AllianceBernstein forecasts

Display 3
Consumer Credits Stay Firm



Source: CEIC Data and AllianceBernstein estimates

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