A reversal in the monetary policy of China

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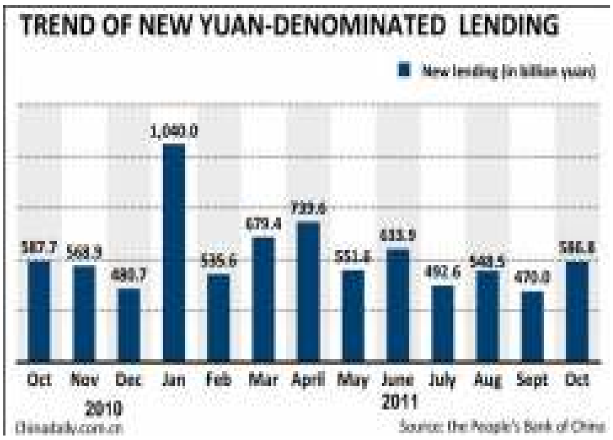
Is there a reversal in the current monetary policy?

Currently some hints are given about the possible policy changes in the current monetary and fiscal policies by Beijing.

China's central bank said on Wednesday, Nov 30th, that it will **lower banks' reserve requirement ratio (RRR) by 50 basis points** starting on December 5th. The cut, the first of its kind since December 2008, will drop the RRR for large commercial banks to 21 percent.

The move comes amid easing inflationary pressure and slower economic growth. The economy's growth rate slowed to 9.1 percent in the third quarter of this year, down from 9.5 percent in the second quarter and 9.7 percent in the first quarter. The National Bureau of Statistics reported a 5.5 percent increase in the Consumer Price Index (CPI) in October, which eased from a 37-month high of 6.5 percent in July. October inflation is announced as 5.5%. In Figure 2, we can see that inflation seems to be in a downward trend. China's inflation is predicted to fall for a fourth consecutive month in November with the consumer price index (CPI) likely to drop to 4.3 percent, according to a Bank of Communications' report. Food prices have dropped as warm weather has allowed for an abundant winter supply of vegetables, eggs and pork, according to the report. Food prices have a one-third weighting in the calculation of China's CPI, which eased to 5.5 percent last month, down from 6.1 percent in September. In addition to lower food prices, declines in global commodity prices and weakening tail-raising factors will also contribute to the CPI's decline in November.

In Figure 1, we can also see a hike in the new Yuan denominated lending by the banking sector during October. This signals that a loosening of the monetary policy has started earlier than expected due to the easing inflationary pressure and worsening export demand globally. Similarly, PMI values for November also refers to a similar situation in the manufacturing industry in China.



According to a report by the Bank of Communications, as government tightening measures gradually take effect and international commodity prices decline, the CPI will fall under 4 percent in December and stand around 5.4 percent for the whole year. To rein in runaway inflation, the People's Bank of China hiked banks' RRR six times and the benchmark interest rate three times this year.

During November we have seen the global economic outlook further deteriorate. The biggest risk in the global financial markets still is the European debt crisis and the disagreements within European countries about the possible solution to the financial crisis. Furthermore, political stalemate in the USA for agreement over the budget deficit reduction created further negative sentiment in the financial markets around the world. The deteriorating conditions and outlook for the world economy continue to reduce the demand for exports from China increasing the pressure on Chinese manufacturing and export industries. However, even though China is not the origin of the global economic problems it is being affected significantly by the reduction in demand abroad. From an international perspective global markets are expecting China to do more in terms of doing the heavy lifting by stimulating its economy by increasing consumer spending and its imports. Currently, central government is trying to ease the credit crunch on the small and medium sized enterprises, which often face difficulty to access credit. *The recent move to lower the RRR ratio can be seen as the first step of relaxing the current monetary and fiscal policies in China.*

Overall, we should note that the economic outlook for 2012 further deteriorated in China due to the weakness in global demand and start of the price drops in housing market throughout in China, particularly in the second tier cities. As mentioned in our earlier reports, the growth expectations for 2012 is already significantly lower than 2011 and Central government is ready to accept single digit growth rates in the coming years. ***The five year plan for the years 2011-2015 already forecasts growth rates between 7.5%-8.5%.***

The growth expectations we mentioned in our last report has been reaffirmed recently by the China central government stating that growth rate of 8.5% is expected in 2012. Last quarter growth rate has slowed to 9.2% and there is a risk of acceleration of the cooling down in the Chinese economy in the coming months. However, we should mention that China is considering the cooling down of its economy as an opportunity to transform into a more efficient one. With the reduction in global demand inefficient and low-tech industries that were already operating on very low profits margins are being closed down. On the other hand with its cash rich large state owned enterprises, China is pushing for increased overseas investment and acquisitions in Europe and US markets. This way China is expecting to increase it's know-how in the long run and establishes a market share in high tech products around the globe.

Consistent with Chinese growth strategy China is increasingly subsidizing its own high-tech companies and considering unifying the tax scheme for both domestic and foreign companies except the high-tech and service industries. Meaning that; the *tax advantages that are currently provided for FDI will be* *reduced to only high tech and service industries in the near future.*

Furthermore, with the recent start of trade disputes between China and the USA. In the coming months we are likely to see businesses in China will have a tougher time and similarly the effects of trade protection will show its effects with lower trade volumes between China and the US.

Does the Chinese Yuan appreciation coming to an end?
Statement by the PBOC in the news media claimed that Chinese Yuan is getting close to its equilibrium level. The Yuan's previous downward moves and the slowing growth of China's foreign exchange reserve signaled the currency "may" already have entered a new stage. A report issued by the PBOC's financial research center last month said the **RMB has risen against the dollar by 30.2 percent since July 2005**, when China started to reform its currency mechanism. With the recent statements we expect that the current levels of USD/RMB exchange rate will keep roughly at its current level in the coming months.

According to latest statistics, the country's forex reserve increment in the third quarter was $50.9 billion less than that of the second quarter, dragged down mainly by the narrowing trade surplus.

Recent PMI
The preliminary HSBC China manufacturing Purchasing Managers Index (PMI), a gauge of nationwide manufacturing activity, fell sharply to **48.0 in November** compared with a final reading of 51.0 in October, HSBC Holdings PLC said.

Conclusion
In summary global economic outlook continued to worsen during November, with China signaling a change in its monetary stand. With a cooling down economy and falling housing prices local governments and the construction industry overall will have difficulty for paying back their loans. Defaults will be increasing in the coming months; however banking industry is expected to remain safe. Since Chinese banks are backed by a fiscally very strong government, an increase in the default rates is very unlikely to turn into a similar financial crisis as happened in the USA.

Under the most likely scenario; we will observe increasing defaults and non-performing loans in the banking industry in China during 2012 and 2013. However, at the same time domestic demand and consumption growth will remain strong combined with loosening monetary and fiscal policies. Chinese economy will be on a relatively stable path of growth around 8-8.5% in 2012.

Major macro statistics with percentage changes during the last one month

Growth indexes
Industrial output: +13.2%
Retail sales: +17.2%
Urban fixed-asset investment: +25%
Power consumption: +8.75%
Financial indexes
New yuan loans: 586.8b yuan
M2: 81.68t yuan
Fiscal revenue: +16.9%

Price indexes
CPI: +5.5%
PPI: +5.0%
PMI of manufacturing: 50.4%

Foreign trade indexes
Import: $140.46b
Export: $157.49b
Trade surplus: $17.3b