Taking Stock Of Recent Policy Moves

What Does It Mean To RMB?

Summary:

- ***Taking stock of recent austerity measures***
  We first outline some of the measures taken over the last 12 months.

- ***Is interest rate becoming the main tool of economic management?***
  Monetary policy transmission mechanism remains weak, and administrative measures are still the most effective.

- ***How high will interest rates go this time?***
  With the consumer prices expected to fall below 3.5% in 2005, a 100bps rate hike will move real return back to positive territory. In all, we think this cycle of rate hike should be brief and short.

- ***Is interest rate liberalization a prelude to RMB move?***
  The recent rate hike should be seen more as a structural change to the financial system. This is a logical move ahead of the listing of two state-owned banks before the domestic banking sector is opened to foreign competitions by end-06.

- ***Milestones to watch for a RMB move***
  (1) Reform of domestic financial institutions; (2) Building up of infrastructure for domestic forex market; and (3) Rationalizing capital account control measures.

- ***What does it mean to RMB?***
  That officials have explicitly indicated a move sooner than later, the question now is if the change will be tying the RMB to a basket of currencies (a la Singapore), or merely a band widening. We expect the former is the ultimate objective, but PBOC will probably start with a band widening of 3-5%. Consensus is that the move could come around 3-6 months. Some of the windows of opportunity include the Lunar New Year holidays in early Feb 2005 or the May Day holidays.

The 18-month long austerity exercise culminated to the PBOC's surprised move to raise the key 1-year working capital loan rate by 27bps on 28-Oct, the first hike in 9 years. In the same stroke, the CB has also removed the cap on lending rates to allow commercial banks to set their own loan rates. As the market begins to speculate whether such rate liberalisation is

Key Austerity Measures Since April 2003

Date	Measures Taken	Authority
May 2003	Tighten approvals on new investment in alumina plants	NDRC
Jun 2003	Tighten bank lending to property development projects	PBOC
July 2003	Suspend new approvals on industrial land development projects	NDRC
Aug 2003	- Tighten regulation on investments in auto, cement, steel plants	NDRC
	- Raise required reserve ratio (RRR) to 7% from 1% starting from 21 Sep 2003	PBOC
Jan 2004	Beginning 1 Jan 2004,	PBOC
	- widen upper band of lending rate to 9.03% (from 6.903%) or 1.7x of base lending rate (from 1.3x);	
	- reduce interest paid on excess reserve to 1.62% from 1.85%	
	State Council to nullify illegally approved industrial land development projects	NDRC
Apr 2004	- Tighten new lending to and approvals of projects in various segments of heavy and light industries (include. steel,	
NDRC		
	non-ferrous metal, oil and petrochemical, building materials, printing, textile machinery & etc.)	
	- Raise RRR by 0.5% to 7.5%;	PBOC
	- Differentiated RRR ratio to penalize banks that fail to meet the minimum capital requirement ratio	
May 2004	- A blanket 6-month ban on land sales to facilitate audits on previous/pending land transactions	State Council
Oct 2004	- Raise base lending rates by 18-36bps;	PBOC
	- Replace blanket ban on land sales with tighter control over land use right by the central government	State Council

Source: PBOC, SDRC, Ministry of Land and Resource

a prelude to RMB band-widening, senior government officials have also commented more openly and more frequently regarding the possibility of a more flexible RMB regime, fuelling even more intense speculation of an imminent RMB move.

In the absence of obvious cyclical economic pressure, the Chinese government has the luxury to modify the forex regime at anytime that serves their best interest. We can't really tell when the move will happen, but we can easily argue for a more flexible exchange system on structural reasons which can support a move before 1H 2005. Based on that, we propose a few important milestones to watch out for before a RMB move takes effect.

Taking stock of recent austerity measures

The PBOC and the National Development and Reform Commission (NDRC) are the two key institutions devising and co-coordinating the current round of policy tightening. Table 1 outlines the key monetary measures and policy directives issued by these two agencies since May 2003. In addition, PBOC has also conducted several sessions of 'window guidance' – a 'moral suasion' exercise with commercial banks to convey concerns over banks lending practices.

It is interesting to note the following:

- Being the first in the series of tightening exercises, property development projects are seen as important sources of economic overheating. However, tackling structural over-investment in selective sectors (i.e. auto, steel, cement and aluminium) is equally important to reining in property and related investment.
- Casual observation also reveals that monetary actions by the PBOC are always accompanied by corresponding administrative measures with a very short time lag from the NDRC, or vice-versa. This is not surprising given that PBOC is not an independent central bank and still requires complementary actions from the State Council to back its policy changes.

Chart 1: Effects Of Austerity Measures As Reflected In Loans Growth

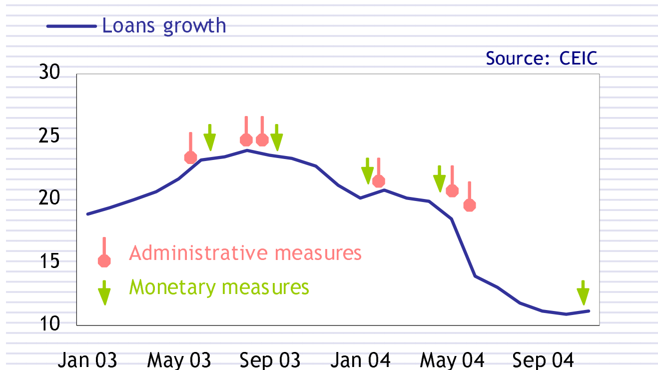
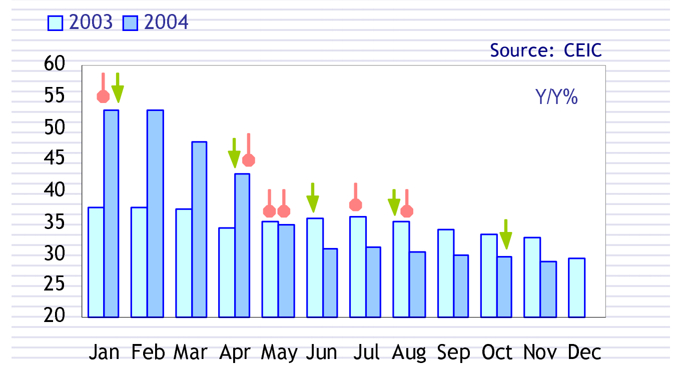


Chart 2: Effects Of Austerity Measures On Investment



- Superimposed these measures with loans growth, it is obvious that the most effective measure has been the 6-month blanket ban on land transactions introduced in May 2004 by the State Council (charts 1 & 2).

Is interest rate becoming the main tool of economic management?

The removal of the blanket ban on land sales in late Oct coincides with PBOC's rate hike. This has stoked speculation that interest rate hike is going to be the main tool to economic management going forward. But that probably oversimplifies the situation in China. One important message from the above observations is that monetary transmission mechanism is not effective without administrative measures. The key reason is that local government has strong incentives to compromise central government's goal to slow down economic growth. After the fiscal reform in 1994, local governments' autonomous revenue has been passed over to the central government. At the same time, the central government has gradually passed down land use right to local government as greater flexibility in land-use is warranted by an increasing market-based economy. To make up for diminished revenue at the local coffers, local government sells land use rights to property developers, often times lacking in proper town planning, which probably contributed to the current investment frenzy in local property market.

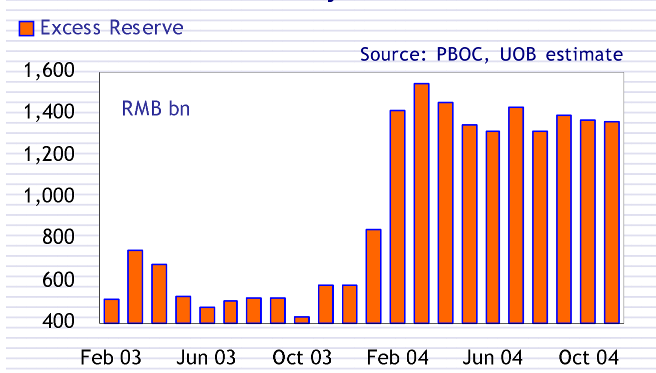
Realizing this structural weakness, the central government has adopted a middle-ground solution. In the latest directives on land sales, the State Council now holds provincial government accountable for all land transactions. While reducing the risk of improper land-use management, it is has not eliminated the need to apply administrative measures to check on local authority.

Domestic lending is not interest rate sensitive

Another reason why interest rate is not going to play a greater role is because domestic lending is not interest rate sensitive. This is because the state-owned banks, which account for 60%

of outstanding credits, have yet to learn to price risks accordingly. This is easily seen in the changes in bank balance sheets after the widening of lending rate band (to 9.03% from 6.903%) and the reduction in interest paid on excess reserves in January 2004. Logically, a commercial bank should withdraw its excess reserves and translate them into new lending to borrowers who were previously priced out of the banking system due to the interest rate cap. It turned out that loan growth barely budged while excess reserves rose 67% to RMB 1,415bn (Chart 3).

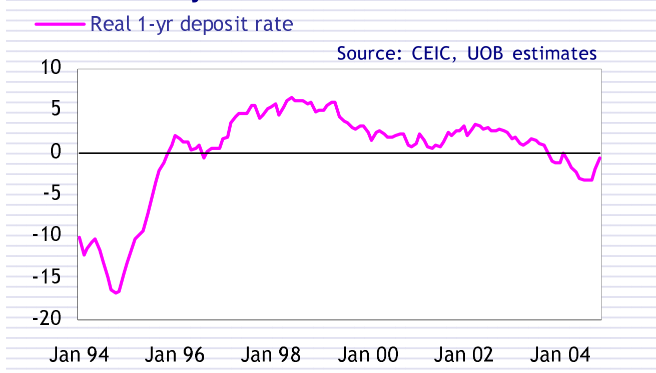
Chart 3: Excess Reserves Rose Sharply Post Widening Of Interest Rate Band In January 2004



After the liberalization of lending rates in October 2004, PBOC has stepped effort to coerce domestic banks to increase lending to SMEs. A futile effort we think, because banks lending practices are not going to transform over a period of 10 months. Even if banks were succeed to entice borrowers from the black market that charges 15-20% p.a. rates, the working of adverse selection problem can almost guarantee further impairment of bank's already serious NPL problem going forward.

Neither is the impact on consumption obvious in China. A recent survey by PBOC in second half of Nov finds that 9.4% of households are still preparing to make big-item purchase after the rate hike, barely changed from 9.5% three months ago.

Chart 4: Real Deposit Rates Have To Move Back To Positive Territory



The same survey also finds that the percentage of households planning to buy property has actually increased by 1.1 percentage point to 21.2% post rate hike.

How high will interest rates go this time?

A key cyclical reason for the October rate hike is to bring real deposit rates back to positive level. As a result of recent spikes in inflation, real returns on retail deposits have fallen to negative territory since November 2003 (Chart 4). This has led to an outflow of domestic saving from the formal banking sector to the underground money market in search of higher yield. Although the situation is not yet critical, PBOC has chosen to take a early, prudent step as the NPL-plagued banking system is too fragile to withstand a persistent liquidity outflow.

We think this cycle of interest rate hike should be brief and short. Keeping in mind the need to withhold black market activities, the average increase in deposit rates should be larger than the rise in lending rates. Yet at the same time, the central bank has to avoid the narrowing of interest spread from significantly hurting domestic banks profitability, and to contain the impact higher interest payment on SOE's profitability. The first round of rate hike in October has narrowed the interest rate spread of banks lending by about 11bps. Going by the same margin, a total of 100bps hike will cut interest spread by 50bps. Such changes are probably bearable by both state-owned lenders and borrowers. This amount of rate hike is in line with the inflation trend. Although Nov CPI has fallen considerably to 2.8% from 4.3% in Oct, with administrated prices of coal, energy and water expected to be adjusted upwards in 2005, coupled with continued pressure from producer prices, which has stayed high at 8.1% in Nov, consumer prices may still range between 2-3% in 2005. A total of 100bps rate hike (including the Oct hike) will be more than suffice to push real return back to positive territory. **Taking 1-year deposit rate as a benchmark, we think PBOC will stop at 3% by mid-2005, implying further 75bps rate hikes to come.** In reality, the hike can be smaller because the government can remove the 20% tax on interest income that has been imposed since 2001.

Is interest rate liberalization a prelude to RMB move?

The recent rate hike should be seen more as a structural change to the financial system. This is a logical move ahead of the listing of two state-owned banks before the domestic banking sector is opened to foreign competitions by end-06. The introduction of a market-based interest rates structure at this stage should help to accelerate the structural reform as well as future profitability of domestic banks,

More importantly, given the relatively closed capital account, interest rate flexibility is not a prerequisite for greater RMB flex-

ibility. Yet with the increased frequency of official remarks on exchange rate reform, it is likely that China will move the RMB sooner than later. In fact, we see little rationale for RMB to be used as an austerity measure. The current round of overheating is driven mainly by domestic factors i.e. infrastructure bottlenecks in terms of rail transportation, power generation, food production, excessive political-motivated investment projects, and a structural rise in housing demand and etc. Tackling these issues require measures to rationalize the country's governing processes, but not exchange rate adjustment.

The case for a near term move towards a more flexible RMB regime is however supported by a confluence of favourable external factors.

i) Supportive external environment. A stronger RMB is in the interest of Asian economies. Amidst the threat of oil shock, stronger regional currencies will provide more flexibility in the conduct of domestic monetary policy to support domestic demand. But regional central banks have been reluctant to allow local currency appreciations for fear of losing competitiveness, especially towards the ultra competitive China. A more flexible forex regime will almost guarantee an instant RMB appreciation to ease the worries of regional central banks. Just as in the case of Asian financial crisis, China will gain significant political mileage from this move.

ii) External balance. China's current account has recorded persistent surplus of around 2% of GDP since the reunification of RMB exchange rates in 1994. More significantly, the dismantling of various import barriers post-WTO has not destabilized the current account situation. This suggests the depth of export competitiveness is capable of absorbing significant import shocks. Taking this argument further, a more slight RMB appreciation around the current level is not likely to affect much both the export and import sectors.

iii) Politically correct timing. Tactically, the China government has successfully regained the driver seat to determine RMB's revaluation timetable after its surprise interest rate hike. With a quieter US post-presidential election, a move by the Chinese government any time now will not be perceived as bowing to the pressure of the developed world.

Milestones to watch for a RMB move

Without any obvious external impediments to hinder a near term RMB move, it looks like domestic condition will be the key to determine when the RMB is allowed to move. We will be looking closely at the news flow on three areas that have been mentioned by Zhou Xiaochuan, the PBOC governor, as the key building blocks for a more flexible RMB regime.

1. Reform of domestic financial institutions. The listing of Bank of China and Construction Bank of China will epitomize an era when domestic banks are ready to take on foreign institutions. According to the listing rule, both banks can only get listed 1-year after incorporation, which means mid-Aug 2005 the earliest. Prior exceptions however have been given by the state council to accelerate the listing of state-owned companies. Persistent expectation of RMB appreciation will help to facilitate the fund raising exercise. And tactically, this does not preclude a minor move before the IPOs to lend more credibility to the RMB appreciation story.

2. Building up of infrastructure for domestic forex market. Many actions are taking place at the PBOC-backed China Forex Trade Center. They include,

a. setting up trading and settlement systems for USD-majors and cross currency trading;
b. enlarging the forex futures settlement businesses beyond the big-four banks;
c. technology and technical transfers from the Chicago Mercantile Exchange Board after the signing of memorandum of cooperation in June 2004.

3. Rationalizing capital account control measures. Works to be done mainly involves relaxing controls on capital outflow as the PBOC has ample instruments to sterilize capital inflow.

a. Since Nov 2003, enterprises in 22 provincial cities only have to report outward remittance for FDI but need not seek prior approval. We are looking for further liberalization on this rule in the next 6 months as more channels are opened to ease accumulation of foreign capital within the domestic economy.
b. Currently, foreign investors are only allowed to remit profits but not initial equity investment out of the country. We think there could be a move towards a relaxation in this area, possibly via a system of capital gain tax.
c. The recent move by the Chinese Security Regulation Commission (CSRC) to compensate investors in case of failures of domestic security houses has removed a major negative from the local equity market. This has also revived the possibility of introducing the qualified domestic institutional investor (QDII) scheme which has been shelved earlier for fears of depressing equity prices. Indeed, social security funds and insurance companies have been permitted to invest overseas from August 2004.

Since Nov, PBOC and State Administration of Foreign Exchange (SAFE) have taken numerous actions to liberalise capital control measures. They include i) permitting Chinese emigrants and foreign national to remit out proceeds from asset/

inheritance sales, ii) allowing individuals to bring in or out the country RMB notes up to RMB20,000 from RMB6,000 previously, iii) permitting business travellers to purchase foreign currency notes for personal spending overseas, iv) raising the limit of and simplifying application process on purchases of foreign currency for students going overseas. In fact, such concrete actions further validate China's readiness to widen RMB fluctuation band, despite recent official remarks to cool speculation on an imminent FX regime change.

What does it mean to RMB?

In the event of a change of forex regime, the value of RMB will be determined by two key factors:

- Is the USD peg to be replaced by a currency basket?
- Will RMB repeg to a new USD level?
- How wide is the new fluctuation band?

We do not think a switch to currency basket is likely in the near term. Ideally, tying the RMB to a basket of currency will free the local unit from the policy direction of the Fed. This freedom is especially precious as the dismantling of capital control measures adds restrictions on the central bank to manoeuvre according to domestic economic cycle. However, we suspect operational difficulties in managing a basket of currencies within a narrow fluctuation band are likely to put off the idea of currency basket for the time being. Specifically, USD weighting in a proforma RMB currency basket is likely to be significant at about 60%. In the event of volatile USD movements, it will be very difficult for the central bank to reposition in other smaller, less liquid regional currencies to keep the level of weighted RMB exchange rate within its targeted range.

Neither do we think USD/RMB will be repeg to a new level for the very reason that RMB is not a peg-currency in the first place. China has been practising a managed-float regime since 1994. The only reason why it is perceived to be pegged at 8.28/USD is because of the very tight fluctuation band since 1995. By announcing a new peg level will only introduce an explicit target for currency speculators, which will complicate PBOC's FX management.

Our calculations of real effective exchange rate – one commonly used measurement for export competitiveness, show that RMB is 10-15% lower than most regional currencies, except for KRW, HKD and SGD (Chart 5). Under the assumption

Chart 5: Trade-Weighted RMB Is 10-15% Below Regional Currencies After Inflation Adjustment

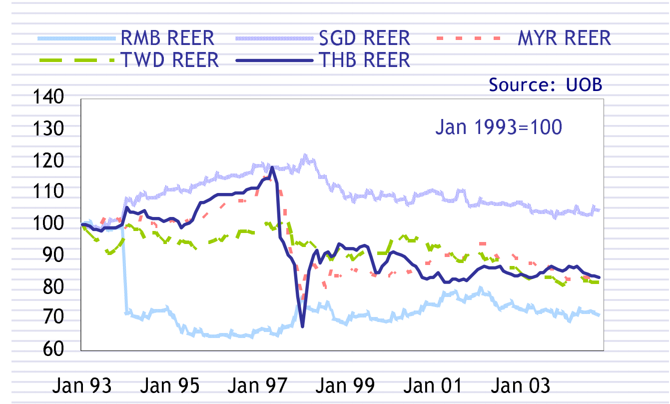
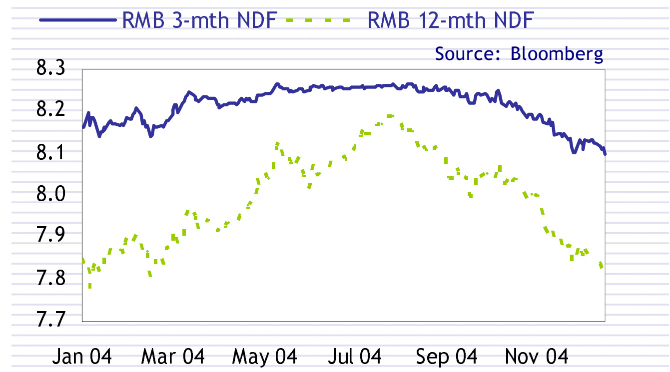


Chart 6: NDF Has Priced In 4% RMB Appreciation In 12 Months



that the Chinese government will only take a minor step in the initial phase of exchange rate reform, **a reasonable range of new fluctuation band for USD/RMB should be less than 5%.** This is happens to be in line with the 12-mth NDF discount priced by the market at the moment.

Interestingly, there was a closed door meeting hosted by a local bank, along with CB officials and FX regulators. Besides highlighting the extended capital inflows over the last 6 months (estimated $70bn), the minute of the meeting revealed that Chinese companies can afford to undertake a small and gradual RMB appreciation. According to a survey of 200 companies in Yangzhou, 79% of the companies said a RMB appreciation of 5% can be accepted. Such explicit statements indicate a RMB move could be sooner than later. Against more than 12 months at the start of the year, players are now putting down a move within the next 3-6 months.