

## China: Politburo's Policy Direction for Second Half

China's Communist Party Politburo concluded its meeting last Fri (25 July). The Politburo is the party's top decision making body, consisting of members of the Cabinet, including President Hu Jintao and Premier Wen Jiabao. The statement released after the meeting indicated that China's top leadership was concerned about both international and domestic factors impacting on growth and inflation outlook. However, the Politburo did not lean one way or another on the growth-inflation balance in the second half of the year, stating mainly to "maintain steady growth" and "emphasize the control of inflation". As there is no clear direction from the Politburo meeting, it remains an open question the direction of monetary policy in the months ahead. The risk however, remains that tight monetary policy is still the order of the day given record high inflation environment, although the pace may ease off in terms of the reserve requirement hike as well as for the USD/RMB.

### Unprecedented Visits by Top Officials

What is significant about the latest event is that prior to the meeting, six of the top Politburo members had fanned out through six coastal provinces/cities in 20 days' time in June/July, visiting various private sector companies and discussing current conditions with management and employees. In addition, members of the tax department, bank regulatory agency, and others also accompanied these officials' visits. The visits were described as "unprecedented in modern Chinese history" in terms of areas of coverage, ranks of officials involved, and duration. Note also that subsequent to the visits and just days before the Politburo meeting, the State Council had also held three consecutive sessions of forums to discuss economic and business issues with experts from outside the party.

The reason why the Chinese government took such serious view of the economy was the combination of both external and domestic factors that coincide at the most difficult time. Externally, the subprime-related impact continues to reverberate through the system ever since the event unfolded middle of last year. Domestically, weaker demand for exports, appreciation of the RMB and tight monetary policy, high commodities prices, and natural disasters have added further pressures on companies. In addition, the expected slowdown post-Olympic is another cause of concerns for the decision makers.

### Monetary Policy Implications

As the Politburo did not lean one way or another in terms of the growth-inflation balance and there were no explicit remarks on the key policy tools, we believe PBoC's main policy framework should remain unchanged, i.e. tight policy is likely to be maintained. However, the pace of the policy tightening may begin to ease off somewhat as the political leaders heard concerns and grievances from the businesses and employees from the export-driven coastal provinces. Overall, we still see some softening of China's headline growth number as well as slower inflation as food prices begin to stabilize, in the second half. **The more important question is how 2009 is going to shape up given the uncertain external conditions and the effect of tight policy over the past 2 years begin to take hold. For now, we are maintaining our call for the USD/RMB to ease to 6.60 by end-2009, and there are at least two rounds of hikes in the reserve requirement ratio to 18.5% by end of this year. We still expect two rounds of interest rate hikes for China this year, though the probability is much lower now after last Friday's meeting.**