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PBOC Regains Upper Hand

As China's economy continued to grow dangerously fast, we feared growing complacency among top policymakers. But yesterday the People's Bank of China (PBOC) announced a 27 basis-point increase in its 1-year benchmark lending rate to 5.58% and 1-year bank deposit rate to 2.25%. In our view, this lowers the risk of another boom-bust cycle in 2005 and helps China avoid the possibility of a marked investment rebound in the next two quarters, which would have inevitably led to tightening in the second half of next year.

Moreover, the central bank appears to have finally kick-started the normalization of its interest rate structure, lifting the 9.03% lending rate ceiling while maintaining the lower bound at 4.78%. The policy is twofold: First, it is a return to positive real interest rates for both lending and bank deposits (**Display 1**); and second, it provides banks with a flexible interest rate structure so that loan interest rates can reflect credit quality.

The earlier-than-expected policy action was a pleasant surprise, and came just in time. Indeed, it would appear that Beijing wanted to hike interest rates before the end of October, when the six-month ban on land sales expires.

We expect another increase of 25 to 50 basis points **on lending rates** over the next two quarters. Year-over-year growth in the consumer price index is at 5.2% in September and expected to ease to around 4.0% by mid-2005. And, deposit rates remain grossly in negative territory even after yesterday's hikes, suggesting a further 150 to 200 basis-point increase is required in the coming year. Higher interest on bank deposits would discourage companies from withdrawing funds to finance uncompleted projects (**Display 2**). It could also be a key to stopping the outflow of bank liquidity to the reemerging 'curb market.'

Many argue that rate hikes will not make a dent in China's economic activity as long as the curb market offers credit at interest rates of 15% to 20%. We disagree. For one, we suspect the size of this 'underground lending' remains relatively small and has been conducted largely by private small- and medium-size enterprises. The fact is that large state enterprises simply do not have a return on equity high enough to bear the 20% funding costs. Moreover, the Chinese economy is the second most leveraged in non-Japan Asia outside of Korea, with a credit/GDP ratio of around 170%. The economy is much more market-driven than it was in the 1980s and early 1990s. While it is true that the inherent credit culture and structural non-performing loan problems may dilute the effectiveness of interest rate hikes, previous instances of economic overheating suggest that higher rates do have an impact on investment and growth.

Implications for the Coming Months

As the higher funding costs start to kick in, credit controls are likely to ease further. We expect bank lending to further revive, over and above the resumption in September. The main objective will be to ease some of the working capital shortages of firms in non-overheating sectors.

Speculative inflows for a RMB revaluation may intensify as Beijing moves toward market-based measures following its first rate hikes. Accordingly, we have factored in an exchange-rate policy shift at mid-year 2005. It looks to us as though it may occur following one or more interest rate hikes in the next two quarters, in a bid to further fine-tune the economy.

If a RMB revaluation occurs, China's initial step will be small. But although the adjustment could be just 3% to 5% (along with a regime shift to a basket of currencies) the Malaysian Ringgit surely would follow suit, leading to a region-wide currency appreciation. It could prove to be the beginning of the global rebalancing the US hopes for.

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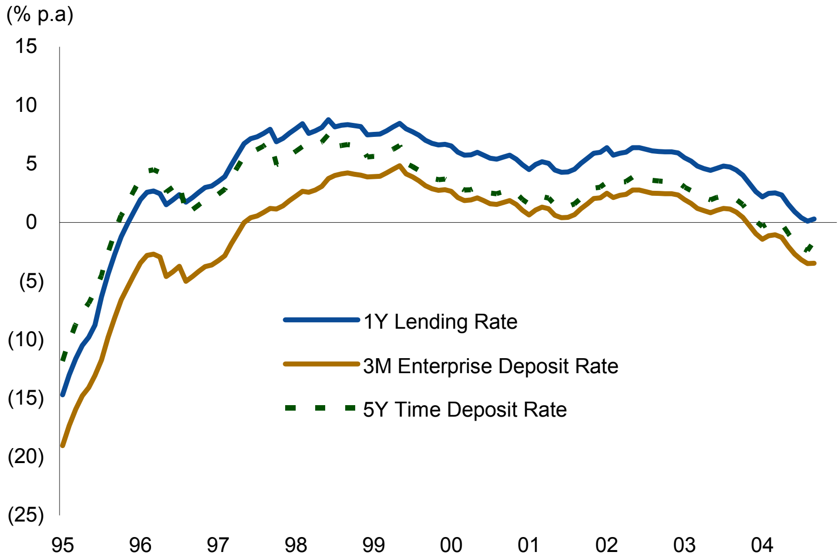
Display 1: Interest Rates Have Been Too Low

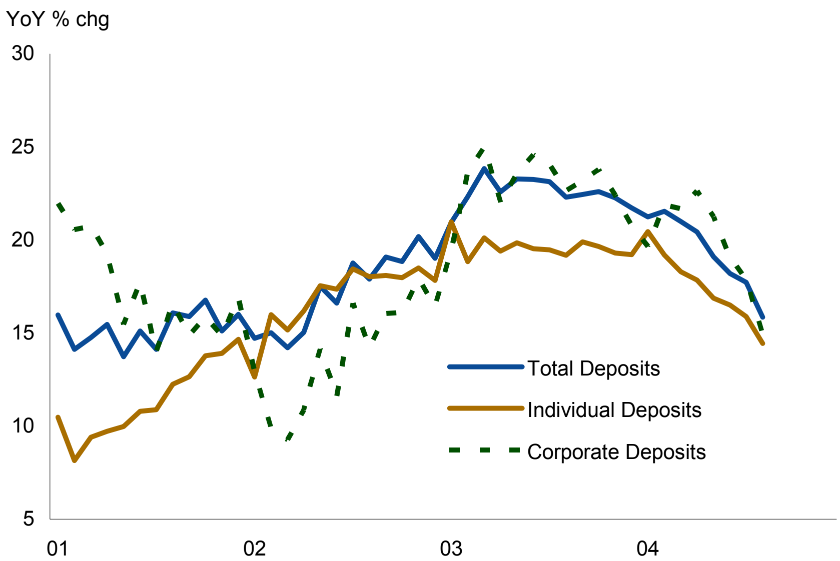
Real Lending and Deposit Rates



Source: CEIC data and Alliance Fixed Income estimates, November 1, 2004

Display 2: Higher Interest Rates Could Help Raise Bank Deposits

Bank Deposits



Source: CEIC data and Alliance Fixed Income estimates, November 1, 2004