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ASIAN WEEKLY ECONOMIC INSIGHTS

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China: Monetary Conditions Improving

The June balance of payments statistics reveal one major change in trend that has important implication for the conduct of monetary policy – hot money inflows have slowed drastically which will provide the PBOC some breathing spaces after a series of intensified domestic sterilization. Our estimation suggests that the implied speculative inflows have fallen to just USD3bn in June from a peak of USD13bn in February (**see Display 1**).

China's FX reserves reached USD471bn in June, up from USD440 in March. This means the average monthly build-up of FX reserves slowed to USD10bn in 2Q/04, from USD12bn in 1Q/04 and USD21bn in 4Q/03. In 2Q, China's trade surplus has expanded and FDI inflows have also surged. This point to the fact that speculative inflows have declined as market speculations on a RMB revaluation receded over the past few months. This is good news to PBOC because the sharp reduction of speculative inflows will significantly reduce the needs for domestic sterilization in an effort to put interbank liquidity under control.

However, inspection of PBOC's balance sheet shows that, while the growth of net foreign assets has peaked out in late 2003, reserve money growth has rebounded somewhat to 18.7% yoy in June after reaching a recent trough of 14.4% yoy in March. This was mainly due to a more relaxed stance on domestic liquidity withdrawals (i.e. net domestic assets), especially with regards to the issuance of short-term bills to mop up liquidity (**see Display 2**).

Is the monetary authority being too complacent? Not exactly at this point. Over the past quarter, the increase in banks' reserve requirement, the heightening of political pressures, moral suasions and administration controls on curtailing excessive capex lending have been effective in slowing broad liquidity growth and, in particular, the velocity of money creation. For the latter, our estimation suggests that the money multiplier (ratio of M2 to high-power money) has been falling persistently over the past ten months. This was the main cause for the deceleration of M2 and loan growth even though there was a slight revival in monetary base (**see Display 3**).

Moreover, inspection of the sector-breakdown of loan growth shows that the Chinese government's administrative tightening measures have been surprisingly effective in targeting lending to the 'overheating' sectors without choking off credits to the 'productive' sectors of the economy. Since the middle of 2003, the slowdown in short-term loans has been much more severe than that of medium- and long-term loans. This has induced fears of a sudden cutoff of working capital for the normal functioning of companies' operation. In fact, our analysis of the breakdown of short-term loans indicates that the slowdown has largely been in the construction and related sectors, while banks' credit lines to the industrial, commercial and agricultural sectors have remained stable (**see Display 4 and 5**).

The bottomline is that China's monetary condition has improved, and there is strong evident of an initial successful of curbing bank lending for property/construction activities without choking off credits to the rest of the economy. But as the administrative controls soften overtime, the PBOC will need to rely more on market-based measures (such as interest rate and exchange rate adjustments) to control the overall monetary condition. A further rebound of base money growth will not be in the favor of PBOC's policy.

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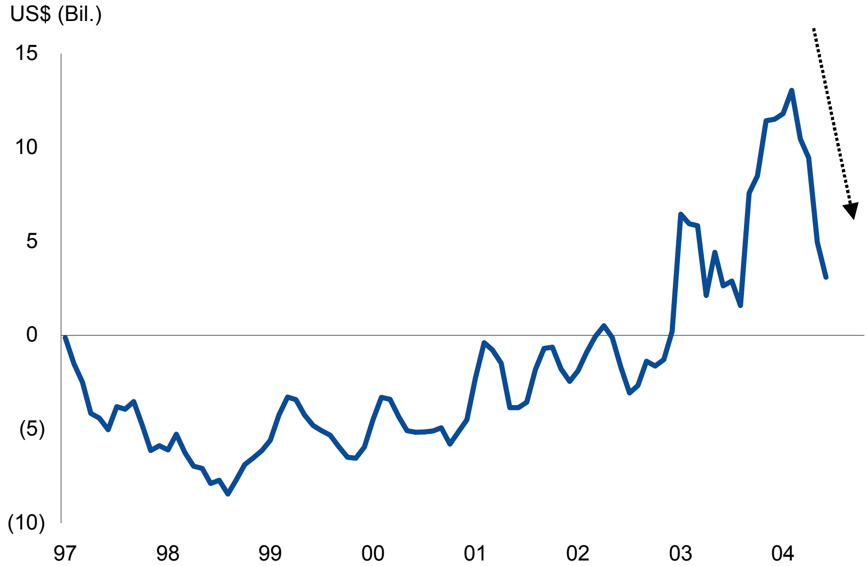
Display 1: A Marked Slowdown in Hot Money Inflows

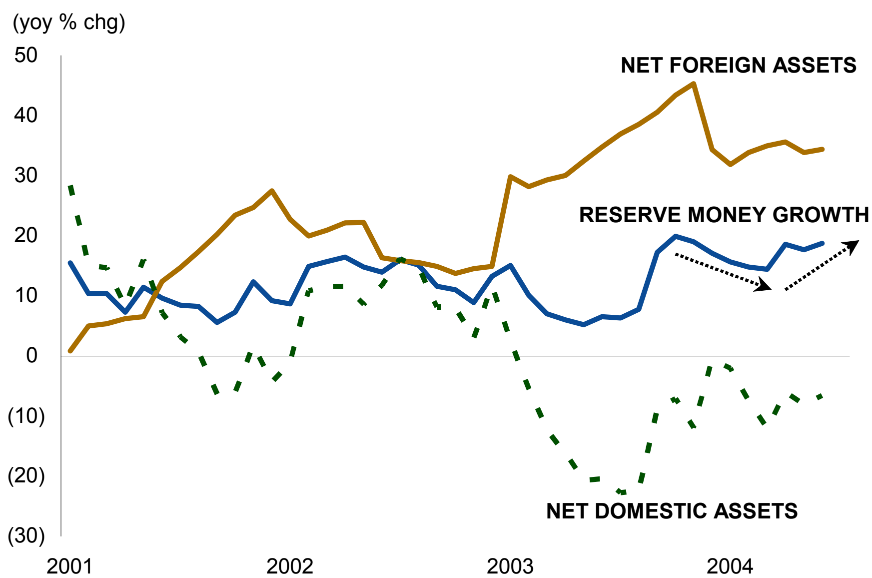
Implied Short Term Flows = Change in FX Reserves Minus Trade and FDI Flows



Source: CEIC and Alliance Fixed Income estimates

Display 2: Too Early To Relax Policy?

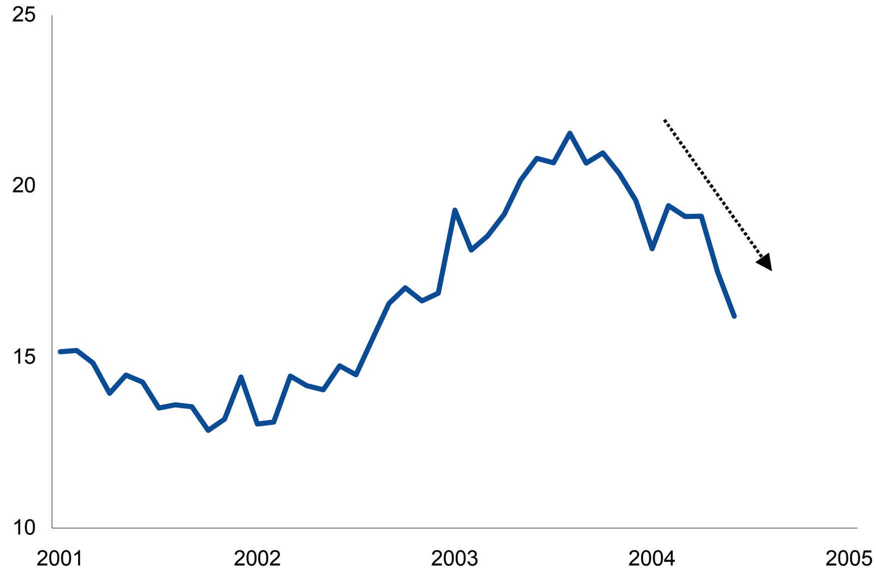
Breakdown of Monetary Base



Source: CEIC and Alliance Fixed Income estimates

Display 3: A Falling Money Multipler

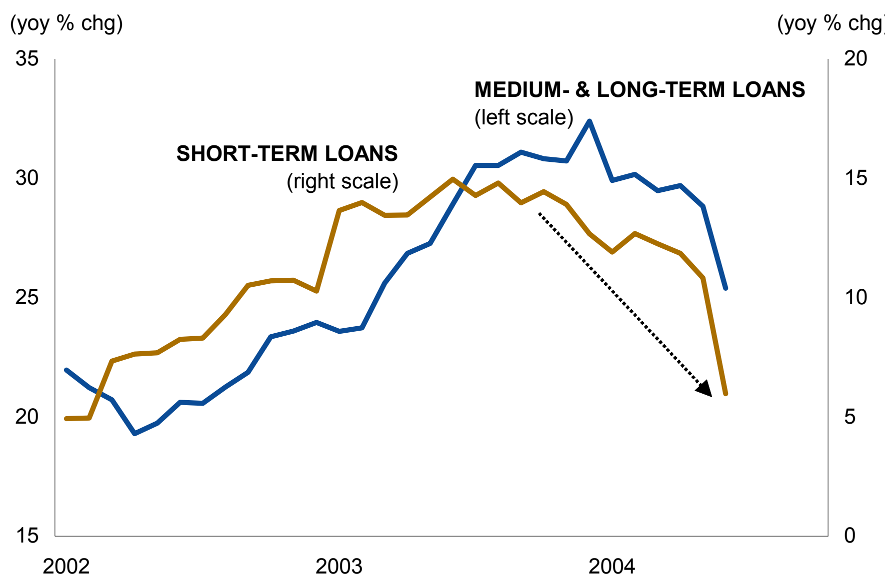
Ratio of M2 to High-Power Money



Sources: CEIC and Alliance Fixed Income estimates

Display 4: Short-Term Loans Have Slowed Faster Than Medium- & Long-Term Loans

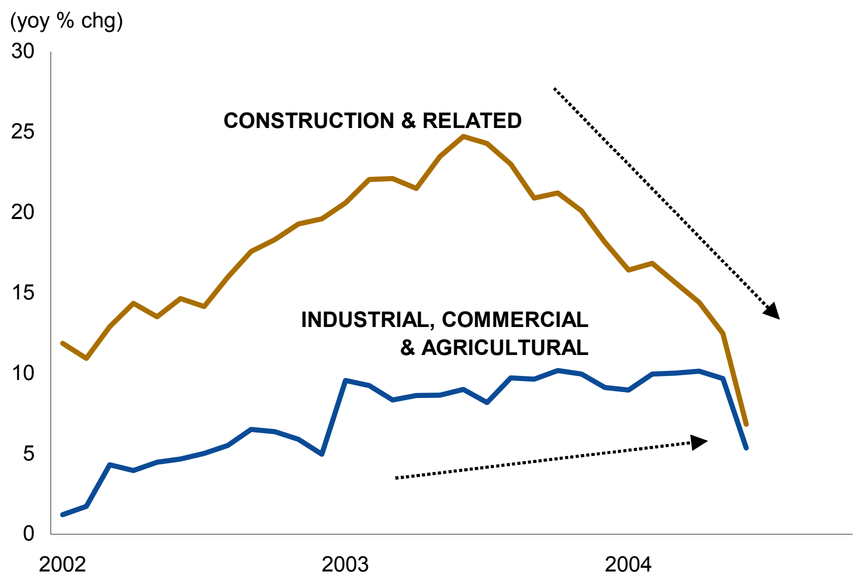
Financial Institutions' Loans



Source: CEIC and Alliance Fixed Income estimates

Display 5: Credit Tightening Has Not Severely Affected the 'Productive' Sectors

Sector Breakdown of Short Term Loans



Source: CEIC and Alliance Fixed Income estimates