BROWN BROTHERS HARRIMAN

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Where Is China In Its Tightening Cycle?

PBOC hiked lending and deposit rates by 25 bp this week to 6.56% and 3.50%, respectively. This comes weeks after it hiked reserve requirements by 50 bp to 21.50%. We don't want to get too caught up trying to guess the timing of the PBOC's next moves, but we do think it is time to look at what the PBOC has done this past year and how far it still may go in this tightening cycle. Suffice to say that over the rest of this year, PBOC will continue to use a combination of policy rate hikes, reserve requirement hikes, and currency strength to help limit inflation pressures. How much more can we expect, and where do we stand in the process? We think there may be a subtle shift in the mix away from reserve requirement hikes, and feel that PBOC is nearing the end of its tightening cycle.

We go back to the most recent tightening cycle for some clues on future PBOC monetary policy. PBOC started hiking in April 06 with a 27 bp hike in the 1-year lending rate from 5.58%, while the final 18 bp hike in December 2007 took the 1-year lending rate to 7.47% for a total of 189 bp of tightening in that cycle. We note that the commercial bank reserve requirement was also hiked steadily in 50 bp increments starting in July 06 that took it from 7.5% up to 14.5% in December 2007. After that, even though the lending rate was kept steady, the PBOC continue to hike the reserve requirement in H1 08 to a peak of 17.5% in June 08 for a total of 10 percentage points. During this more aggressive period of tightening in 2007, China's GDP growth was still accelerating to peak at 12.6% y/y in Q2 07, while inflation was rising sharply from 3.4% y/y in May 07 to a peak of 8.7% y/y in February 08. Retail sales accelerated to around 20% y/y then, loan growth was close to 20% y/y, and Fixed Asset Investment (FAI) was growing almost 30% y/y.

Current economic conditions (both domestically and globally) are somewhat softer than the last tightening episode, and support the view that PBOC is justified in taking a gradualist and more cautious approach to tightening. Q1 11 GDP growth slowed slightly to 9.7% y/y from 9.8% y/y in Q4 10 and 9.6% y/y Q3 10, and is expected to ease to 9.3% y/y in Q2 11. CPI inflation accelerated to 5.5% y/y in May vs. 5.3% in April, and is expected to accelerate to 6.2% y/y in June and would be another new peak for the cycle. While there may be some distortions from food prices, the headline figure is still uncomfortably high. FAI growth moved back above 30% in Q1 11, while money and loan growth have slowed. The real economy is showing signs of slowing in response to previous measures, and suggests that total tightening in this current cycle will not match in scale the tightening that was seen in 2006-2008. So far, PBOC has hiked the 1-year lending rate 125 bp since starting in October 2010 and hiked reserve requirements by 600 bp since starting in January 2010. While this may suggest that PBOC still has much room to tighten when compared to the 189 bp and 1000 bp of hikes, respectively, during the previous cycle, we note that current inflation and growth fall short of the elevated levels seen in 2006-2008 and so is likely to require a less aggressive policy response by PBOC.

PBOC Policy Is Near Neutral, More Tightening Ahead

Given that the mainland economy as slowing but still fairly strong, we would characterize current PBOC policy as neutral to slightly restrictive. With a real 1-year lending rate that's barely positive (and potentially could go negative again) and a 1-year deposit rate that is still deeply negative, we think some more tightening is needed before policy becomes moderately restrictive, which we think is the aim of the PBOC. We believe that the recent spike in 3-month SHIBOR will lead PBOC to rely less on reserve requirement hikes and more on orthodox policy rate hikes. Tightness in the interbank market stems in part from the reserve requirement hikes seen so far, and is reportedly hurting small- and medium-size businesses' ability to fund themselves. That requirement stands at a record high 21.5%, and so recent developments suggest that this tool will be relied on to a lesser extent going forward.

We believe that the 1-year lending rate could be hiked another 50 bp in H2 11. Note that the real 1-year lending rate remains positive but at a very low 0.8% in May (vs. 2000-2007 intra-crisis average of 4.1%), too low for this stage of the business cycle. Going forward, the PBOC needs to continue its tightening, but is unlikely to get more aggressive given the rising external risks. The global growth backdrop is much weaker now than it was back in 2006-2008, and until the outlook becomes clearer, we think PBOC (and most other EM central banks) will favor a more dovish, wait-and-see approach in H2 11. Fears of a hard landing in China will surely remain in play as tightening continues, but we think policy-makers still have the ability to reverse course quickly, as we saw back in 2008.

With the real 1-year deposit rate still deeply negative, we think there is a chance that this rate is hiked by more than the 50 bp predicted in H2 11 for the 1-year lending rate. This would narrow the gap between the two from 306 bp currently, and this gap was as narrow as 216 bp back in 1998. With negative deposit rates potentially leading investors to move into property and other real assets, PBOC may hike the deposit rate to a greater extent than the lending rate in order to encourage deposits in the banking system instead of speculation in riskier asset markets.

Lastly, greater CNY strength should continue in H2 11 as part of the adjustment process. 12-month CNY NDFs are pricing in 1.2% appreciation, but we think it will be more than that. Actual y/y appreciation as of July 6 is 4.8%, down slightly from the 5.6% y/y peak in mid-June. If China is serious about limiting inflation, a stronger yuan is a part of its policy tool kit. During the previous tightening cycle, CNY y/y gains were as much as 11% y/y in 2008 before the global financial crisis led the PBOC to repeg the yuan temporarily. We are looking for at least 5% CNY gains over the next year.

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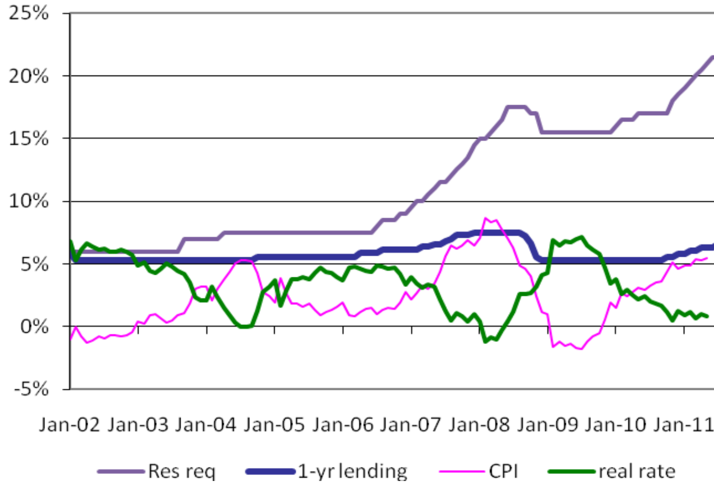

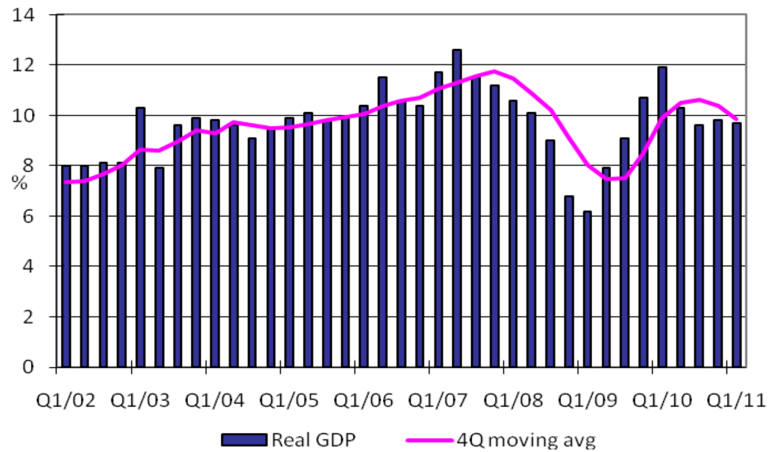

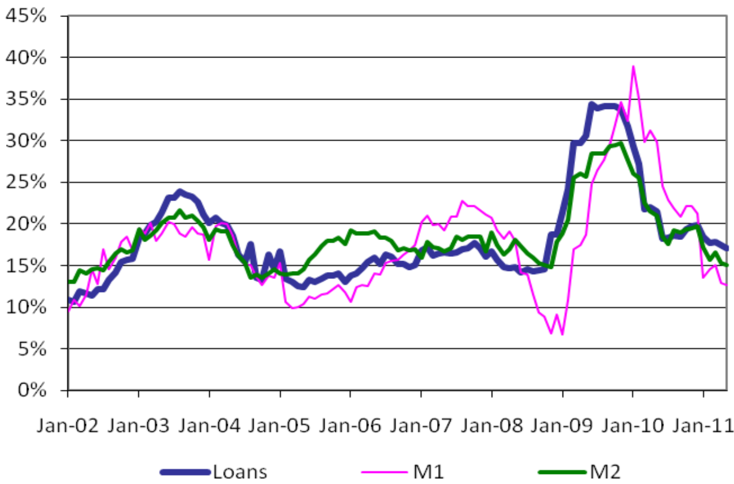

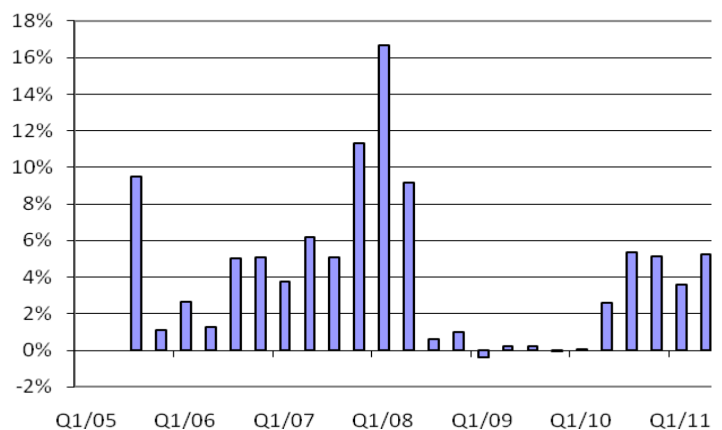

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