

Stephen Green  
Senior Economist, +86 21 5887 1230 ext. 5223  
Stephen.Green@cn.standardchartered.com

0345 GMT 26 October 2007

## Six reasons to expect more rate hikes

- PBoC still needs to hike rates and continue other tightening policies
- Real rates are too low, money growth too rapid, loan growth too fast
- Discount market rates are up, mortgage lending constrained

## China

**What are we to make of the Q3 numbers? Some seem to be taking the 11.5% y/y growth rate as evidence of the economy slowing – it was less fast than the 11.9% y/y recorded in Q2 after all. Consumer price inflation might have peaked too in year-on-year terms in August, at 6.5% y/y, falling to 6.2% y/y in September. Does that mean growth is slowing, China's inflationary worries are over and interest rates can remain at this level for a while? We do not think so.** We have six reasons for arguing for more hikes now, and for forecasting three more 27bps hikes before this cycle is over. But before we get into these though, here is something that we are *not* arguing; that China is currently facing serious inflation on a whole series of fronts. Au contraire; core CPI inflation (taking out the food component) remains stable at below 1% y/y. We all know that pork and chicken prices have skied in recent months (OTG in Asia, 11<sup>th</sup> November 2006, *'Pigs...in...space!! We raise our 2007 CPI and rate forecasts'*). But still grain prices are not inflating strongly, as Chart 1 shows. If that were to happen, it would be something to be concerned about, since in the absence of imports, limited spare land and low farm productivity growth, there will unlikely be a quick supply response. But until now, food is showing no evidence of widespread inflationary pressures. As we have argued recently too, we do not believe recent wage growth is evidence of over-heating (see OTG in Asia, 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup> August 2007, 'The Icarus Economy', Parts I, II, II). However, having said all that, this is not to say that we are not concerned about inflation tomorrow. And importantly, we do not believe that the apparent peak in CPI is enough to put such concerns to bed. So today we lay out six reasons for why we think the People's Bank should and will continue to raise rates.

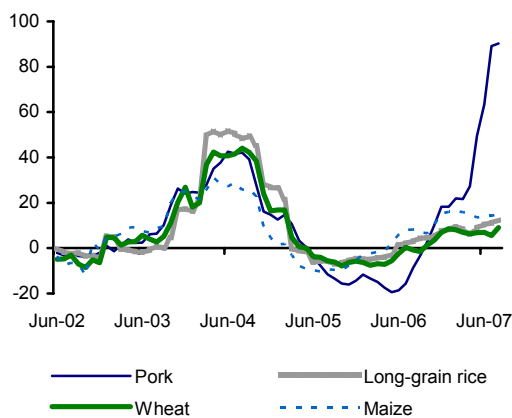
**First, one should never put much faith in one month's numbers, especially given the state of numbers on CPI there is a wide margin of error.** The short-term trends are still strong. Moreover, there is a wider problem here to note – that the People's Bank of China (PBoC) seems to have an easier time of persuading others in the State Council of the need to raise rates when CPI is rising (see 12<sup>th</sup> April 2005, *'China Money Monitor, April 2005'*). This is clearly not ideal, given that inflation might already be out of the bottle at such a point, or that a rising CPI might just be expressing pork trends and nothing fundamental about the economy, or that a CPI falling in y/y terms provides limited information about what is happening on a month-on-month



basis or what will happen in 6-12 months' time. This is not an ideal situation – the PBoC has to be allowed to act even when the CPI is falling on a year-on-year basis, as it should be concentrating on forward-looking data, not today's.

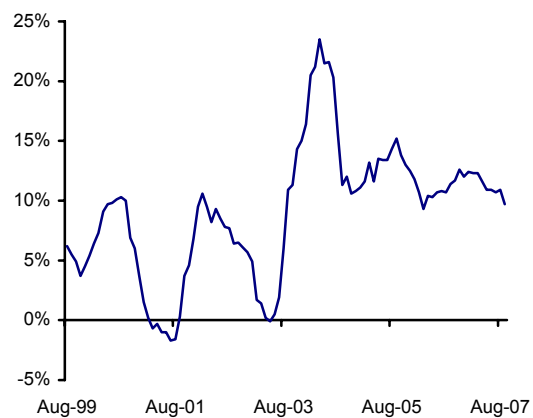
**Second, growth still looks strong to us.** We do not put much faith in the monthly fixed asset investment numbers, which some claim are now suggesting a moderate slowdown. These numbers get influenced by land prices, acquisitions, changes in which month data is counted in, and all manner of reporting incentives. GDP growth looks stable and strong, as our freight index indicates. This, we reckon, tells a pretty good story about the industrial economy and we show it, with data up to September, in Chart 2.

**Chart 1: Its still just pork, y/y %**



Sources: SCB Global Research, CEIC

**Chart 2: The SCB China Freight Index, y/y %**

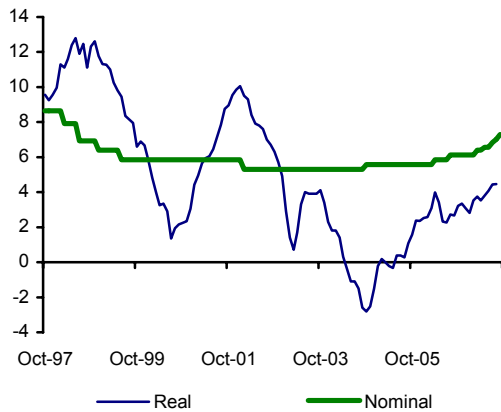


Sources: SCB Global Research, CEIC

**Third, the most important real interest rate for corporates is still very near negative territory.** Chart 3 shows the nominal and (our estimate of the) real one-year loan rate, as far as a firm is concerned (so we use the producer price index to deflate the nominal rate, rather than CPI, on the basis that firms do not care that much about pork dumping prices). Real rates for firms have now moved firmly into positive territory, above 4% in real terms. Credit is thus not expensive compared to the overall real growth rate (which one can use as a rough proxy for average return), but at least rates are not in negative territory and continue to push up. Chart 4 shows the same on the deposit side. And this is more of a worry. Since the majority of investment comes from firms committing their retained earnings, real deposit rates are probably more important to influencing corporate investment decisions than loan rates. And real deposit rates are still very near zero, just emerging from negative territory. Moreover, since most firms are looking at global commodity prices rising today, they will probably be expecting more inflation tomorrow (expectations are key when working out real rates). Today, we will not deal with households, and the incentives they currently have for borrowing at even lower real rates, and investing in stocks, another issue. In sum, the PBoC still has more to do to push the cost of funds towards where they should be.

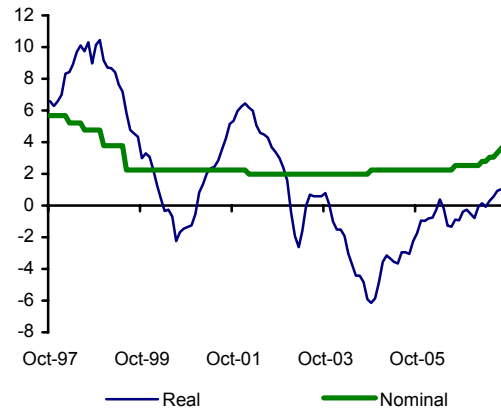


**Chart 3: One year loan rates, %**



Sources: SCB Global Research, CEIC

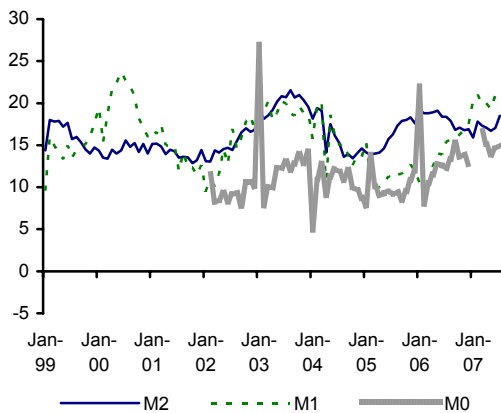
**Chart 4: One year deposit rates, %**



Sources: SCB Global Research, CEIC

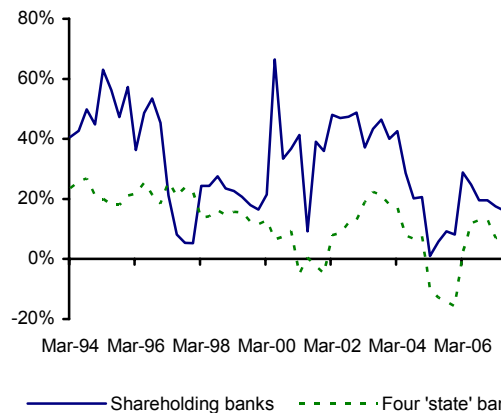
**Fourth, money is still getting more liquid – and as we have explained before this could also be a precursor of more upward price pressures** (see OTG in Asia on 11<sup>th</sup> November 2006 again). We show in Chart 5 the acceleration of M0 and M1, even while M2 remains relatively stable (though even M2 looks to be accelerating).

**Chart 5: Money supply growth, y/y %**



Sources: SCB Global Research, CEIC

**Chart 6: Growth in bank lending, y/y %**



Sources: SCB Global Research, CEIC

**Fifth, a rebound of bank lending.** Credit growth rebounded at the beginning of 2007, with loan growth at shareholding banks hitting 30% y/y, as Chart 6 shows. Shareholding banks' loan growth has kept pace with their deposit growth, in contrast to the bigger banks, which have seen a clear relative decline in lending.

**Sixth, we see accumulating evidence of increasingly tough PBoC action beneath the headlines.** In addition to interest rate (the loan rate is now up 117bps this year) and reserve requirement hikes (now at 13% on CNY deposits, 14% we expect by year end, and probably another 300bps or so to come in 2008), the central bank has been quietly doing other things which are constraining liquidity. Some of these policies are not that transparent, and here we piece together the evidence we have. Among the “tightening-by-stealth” policies are:-



- During the previous two months, we have heard a number of anecdotal reports about the central bank instructing smaller shareholding banks to stop or severely constrain lending in H2 2007.
- A clamp down on mortgage loans. In August, one of the major banks reportedly stopped all mortgage lending in Shenzhen, and in September, the China Banking Regulatory Commission (CBRC) increased the down-payment required on second homes from 30% to 40%. There are other reports that banks in Wenzhou and Hangzhou have severely cut down on mortgage lending too.
- The discount rate (*tiexianlu*) for discounting bills (and then re-discounting them) has shot up, suggesting that short-term financing has become constrained (see *OTG in Asia*, 13<sup>th</sup> March 2006, '*PBoC backs re-introduction of the draft*'). Our colleagues tell us that in many cities now, all banks are refusing to discount bills presented to them – when they went out to ask for market quotes, only one local bank was willing to offer a quote, and that for only AAA corporates. Rates have risen to well above the PBoC's official minimum rate of 3.14% (a dramatic change to last year, when local banks in many areas seemed to be flagrantly pricing below the official minimum), to more or less equal the PBoC loan rate (6.48% for six-month term). This is a dramatic change which can only probably be explained by tough PBoC 'window guidance'. Interbank rates have also risen, but are being driven up by the vast stocks of money being frozen in bank accounts during IPO periods.
- Liquidity tightening has been particularly forceful for onshore USD, where rates have continued to climb. As we have highlighted before, the PBoC seems particularly concerned about FX loan growth, which has accelerated in recent months, most obviously closing down the import of dollars via reduction of banks' foreign debt quotas (FDQ) (see *OTG in Asia*, 21<sup>st</sup> August 2007, '*China's man-made dollar drought*'). However, there is much talk of the authorities using other methods, including encouraging local banks with USD on their balance sheets not to lend them out, and asking domestic banks to deposit USD instead of CNY for meeting the recent increase in the CNY reserve requirement. Why might the PBoC be doing this? We suspect it is probably being driven by a concern that USD borrowing for CNY speculation has picked up, including via the onshore forward market. This tighter USD liquidity is already being felt as some international banks, which have used up their FDQ, are being forced to pass on the extra cost to customers. But more on this another day.

## Global Research

### Bangkok

+6221 724 8878

### Islamabad

+92 21 2442008

### Mumbai

+91 22 2268 2325

### Seoul

+822 3702 5045

### Dubai

+9714 508 3655

### Jakarta

+6221 5799 9117

### New York

+1 212 667 0564

### Singapore

+65 6530 3464

### Hong Kong

+852 2821 1013

### London

+44 207 280 6071

### Shanghai

+86 21 5887 1230 ext 5223

### Taipei

+866 2 6603 6338

This document is issued by Standard Chartered Bank (SCB). While all reasonable care has been taken in preparing this document, no responsibility or liability is accepted for errors of fact or for any opinion expressed herein. Opinions, projections and estimates are subject to change without notice. This document is for information purposes only. It does not constitute any offer, recommendation or solicitation to any person to enter into any transaction or adopt any hedging, trading or investment strategy, nor does it constitute any prediction of likely future movements in rates or prices or any representation that any such future movements will not exceed those shown in any illustration. The contents of this document are not made with regard to the specific investment objectives, financial situation or the particular needs of any particular person. Any investments discussed may not be suitable for all investors. Past performance is not necessarily indicative of future performance; the value, price or income from investments may fall as well as rise. SCB, and/or a connected company, may have a position in any of the instruments or currencies mentioned in this document. You are advised to make your own independent judgment with respect to any matter contained herein. In the U.K., SCB conducts designated investment business only with Market Counterparties and Intermediate Customers and this document is directed only at such persons. Other persons should not rely on this document. In Singapore, securities research documents are only issued and intended for persons whose business involves the acquisition and the disposal of, or the holding of, capital markets products and accredited investors. Copyright: Standard Chartered Bank 2007. Copyright in all materials, text, articles and information contained herein is the property of, and may only be reproduced with permission of an authorised signatory of, Standard Chartered Bank. Copyright in materials created by third parties and the rights under copyright of such parties is hereby acknowledged. Copyright in all other materials not belonging to third parties and copyright in these materials as a compilation vests and shall remain at all times copyright of Standard Chartered Bank and should not be reproduced or used except for business purposes on behalf of Standard Chartered Bank or save with the express prior written consent of an authorised signatory of Standard Chartered Bank. All rights reserved. © Standard Chartered Bank 2007