

People's Bank signals major shift

- *Policy turnaround more emphatic than anticipated*
- *We now expect a further two RRR cuts by the end of Q1, and a big jump in lending*
- *Coming data releases provide context: Both export growth and inflation are tumbling*

With a statement comprising a single sentence on its website, the People's Bank of China today signalled a major policy shift. Incoming economic data have been weak and the global outlook is worsening. Accordingly, policymakers may have to act more aggressively over the coming year than previously seemed likely.

The immediate impact of today's cut to the required reserve ratio (RRR) is to ease constraints on bank lending. We estimate that the cut has an impact on banks' ability to lend equivalent to the injection of RMB400bn (\$63bn) of base money.

More important is the signal the move gives to markets and to investors. The People's Bank (PBC) could have achieved the same end of loosening constraints on credit growth quietly through its open market operations. The fact that it chose to act in this more public way is a signal not only that policymakers are loosening but also that they want to be seen to be doing so. Accordingly, we see the reserve requirement cut as a decisive shift in policy stance. Maintaining growth, rather than tackling inflation, is now the primary focus.

The change of direction was expected. (See our previous *China Watch*, "China on cusp of policy shift", 3rd November.) But it may have been hastened by weakness in the incoming economic data in the last few weeks as well as the growing uncertainty about the euro-zone. **Property project starts have stalled and heavy industry is also struggling**, if the recent weakness in electricity output is any guide. **We suspect November's**

trade figures will make grim reading too. (See the data preview below.)

None of these developments was altogether unexpected. But the speed at which the euro-zone crisis is escalating suggests external conditions will be more challenging over the next year than previously seemed likely. In turn, policymakers are likely to respond more forcefully.

We now expect two more 50bp reserve requirement cuts by the end of Q1, taking the RRR for major banks to 20.0%, and a further three cuts after that in 2012. (We had previously expected three 50bp moves in total.) Banks typically need little encouragement to ramp up lending, which a guaranteed interest rate spread makes highly profitable. The extra space afforded by RRR cuts and the apparent change in policymakers' stance gives them the green light. **We expect net new lending of RMB8.5-9trn in 2012, compared with RMB7.5trn this year.**

The statements that follow the annual Economic Work Conference, due to be held anytime now, will give a clue as to whether benchmark rate cuts are likely. For now, we still think they are not imminent. **Benchmark rate cuts have little direct economic impact, but they are a strong signal and so more effective if used sparingly.** If the euro-zone starts to break apart next year, as we expect, we would expect multiple rate cuts in an effort to shore up confidence.

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Data Preview – CPI, PPI (Nov.)

Fri. 9th Dec.

	Time (China)	Previous	Median	Capital Economics
CPI (% y/y)	10.00	(+5.5%)	(+4.5%)	(+4.3%)
PPI (% y/y)	10.00	(+5.0%)	(+3.5%)	(+3.0%)

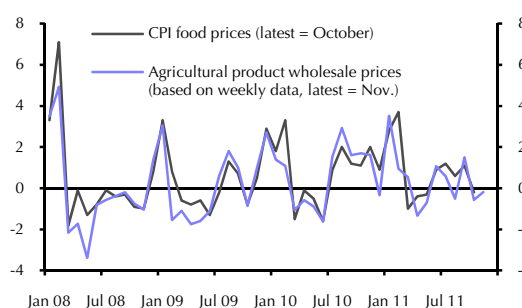
Inflation falling towards policymakers' comfort zone

Consumer price inflation fell sharply in October. We expect an even larger fall in November. Admittedly, this largely reflects a favourable base effect – prices rose unusually fast at this time last year. But price pressures have also eased.

Wholesale food prices fell further in November (see Chart 1), with pork prices at the end of the month almost 11% beneath their September peak. Meanwhile, non-food price pressures have been steadily easing as indicated by 3m/3m seasonally-adjusted inflation figures and the latest HSBC/Markit PMI data.

Looking ahead, we expect headline inflation to fall further in the next few months, although at a slower pace, dropping below 4% in Q1.

CHART 1: FOOD PRICES (% M/M)



Sources – CEIC, Capital Economics

Data Preview – Retail Sales, Industrial Prod'n & FAI (Nov.)

Fri. 9th Dec.

	Time (China)	Previous	Median	Capital Economics
Retail Sales (% y/y)	-	(+17.2%)	(+16.8%)	(+16.5%)
Industrial Production (% y/y)	-	(+13.2%)	(+12.9%)	(+12.6%)
Fixed Asset Invest. (% y/y, ytd)	-	(+24.9%)	(+24.8%)	(+24.8%)

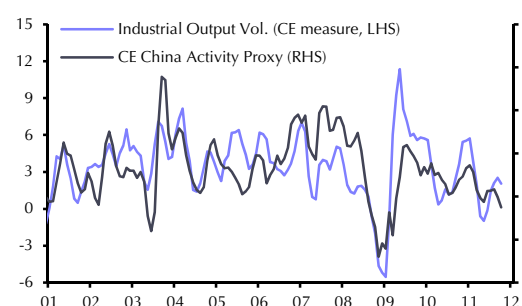
Broadly weakening expected in activity data

Industrial output growth fell in October. With the PMIs and our China Activity Proxy (CAP) downbeat (see Chart 2), it seems reasonable to expect the slowdown to continue.

Similarly, we expect a continued slowdown in nominal retail sale growth. In this case though, this fall should largely reflect much lower y/y retail price inflation rather than fast deteriorating in consumption demand. In real terms, consumer spending growth seems stable. Consumer confidence about the outlook appears healthy although confidence in current conditions remains low.

Meanwhile, investment growth was unchanged in October, but may have declined a little last month, as activity in real estate sector has started to slow.

CHART 2: CAP & INDUSTRIAL OUTPUT (SEAS. ADJ., % 3M/3M)



Sources – Thomson Datastream, CEIC, Capital Economics

Data Preview – External Trade (Nov.)

Sat. 10th Dec.

	Time (China)	Previous	Median	Capital Economics
Exports (% y/y)	10.00	(+15.9%)	(+11.0%)	(+9.5%)
Imports (% y/y)	10.00	(+28.7%)	(+18.4%)	(+19.0%)
Trade balance	10.00	+\$17.0bn	+\$15.0bn	+\$13.0bn

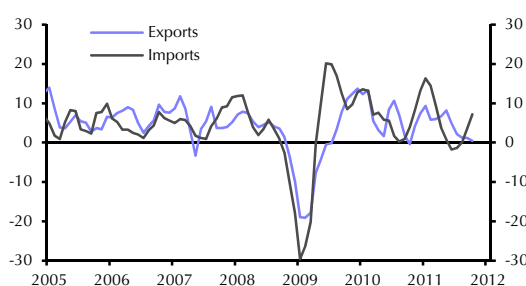
Slump in export growth

We think that y/y growth for both exports and imports fell significantly last month. This partially reflects the fact that there is an unusually strong base for comparison – both exports and imports rose by nearly 10% m/m in November last year once the seasonal pattern is taken into account.

The bigger picture though is that the strength of end-2010 soon faded and the level of exports has barely risen at all over the last few months. (See Chart 3.) Meanwhile, the outlook for global demand has further darkened, with risks rising in the euro-zone. Import growth should hold up relatively well. But with domestic demand also

apparently slowing, we weaker growth probably lies ahead.

CHART 3: EXPORTS & IMPORTS (SEAS. ADJ., % 3M/3M)



Sources – CEIC, Capital Economics

Data Preview – Net New Lending, M2 (Nov.)

11th – 15th Dec.

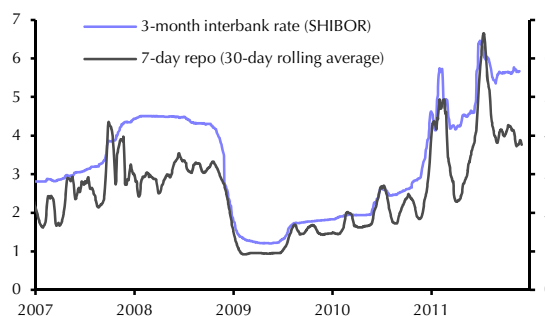
	Time (China)	Previous	Median	Capital Economics
Net New Lending (RMB)	-	+587bn	+580bn	+600bn
M2 (% y/y)	-	(+12.9%)	(+12.9%)	(+12.8%)

Lending little changed last month but strong rebound to come

We expect net new lending to have been slightly higher in November than in the month before. There were already signs in late October that controls on credit had been eased. Meanwhile, the PBC has stopped actively draining liquidity in interbank markets through its sterilisation debt operations in recent weeks. Reserve requirements for a number of small rural banks were also cut in late November. These moves fit with the idea of policy “fine-tuning”. Interbank rates – a direct gauge of monetary conditions – were stable or dropped back only a little in November. (See Chart 4.) But we think the tide has now turned. Wednesday’s reserve requirement cut comes into

effect in early December and should support a lending pickup in the coming months.

CHART 4: INTERBANK RATES (%)



Sources – Thomson Datastream, Capital Economics

Latest Data & Main Forecasts

CHINA ECONOMIC INDICATORS

Monthly Indicators	m/m(y/y) unless stated	Jun	Jul	Aug	Sep	Oct
CE China Activity Proxy (CAP)		(+9.4%)	(+9.5%)	(+9.0%)	(+9.0%)	(+8.6%)
CAP, seas. adj., annualised	3m/3m	+8.8%	+8.8%	+8.8%	+8.2%	+7.2%
Consumer Prices	Headline	+0.8%(+6.4%)	+0.5%(+6.5%)	+0.2%(+6.2%)	+0.3%(+6.1%)	+0.2%(+5.5%)
	Food	(+14.4%)	(+14.8%)	(+13.4%)	(+13.4%)	(+11.9%)
	Core (excl. food & energy)	(+2.5%)	(+2.4%)	(+2.5%)	(+2.4%)	(+2.3%)
Producer Prices		(+7.1%)	(+7.5%)	(+7.3%)	(+6.5%)	(+5.0%)
M2 Money Supply		(+15.9%)	(+14.7%)	(+13.5%)	(+13.0%)	(+12.9%)
Net New Lending	RMBbn	+634	+493	+549	+470	+587
Exports		(+17.9%)	(+20.4%)	(+24.5%)	(+17.1%)	(+15.9%)
Imports		(+19.3%)	(+22.9%)	(+30.2%)	(+20.9%)	(+28.7%)
Trade balance	\$bn	+22.3	+31.5	+17.8	+14.5	+17.0
Retail Sales		(+17.7%)	(+17.2%)	(+17.0%)	(+17.7%)	(+17.2%)
Industrial Production		(+15.1%)	(+14.0%)	(+13.5%)	(+13.8%)	(+13.2%)
Fixed Asset Urban Investment	ytd	(+25.6%)	(+25.4%)	(+25.0%)	(+24.9%)	(+24.9%)
Foreign Exchange Reserves	\$trn	3.20	3.25	3.26	3.20	-

Quarterly Indicators	%q/q ann.* (%y/y)	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011
GDP		+9.2%(+9.6%)	+11.0%(+9.8%)	+8.9%(+9.7%)	+8.9%(+9.5%)	+8.4%(+9.1%)

*CE estimates

LATEST MARKET DATA

Instrument/rate	1 mth ago*	Latest	Instrument/rate	1 mth ago*	Latest
Official rates			Global yields		
1-year lending	6.56	6.56	US 10-year	2.11	1.98
1-year deposit	3.50	3.50	German 10-year	2.03	2.24
RRR (major banks)	21.5	21.0	Equity indices		
Interbank rates			Shanghai Composite	2,468	2,333
7-day repo	4.88	3.98	US S&P 500	1,253	1,195
Govt. Bond			Exchange rates		
1-year	3.13	2.60	RMB/\$	6.35	6.38
10-year	3.76	3.65	RMB/Euro	8.91	8.47

*End of Oct.




















MAIN ECONOMIC & MARKET FORECASTS

%q/q annualised (%y/y), unless stated	Latest	Q4 2011	Q12012	2011	2012	2013
GDP	+8.4*	+7.5	+7.2	(+9.1)	(+8.5)	(+7.5)
Consumer Prices	(+6.3)*	(+5.0)	(+4.2)	(+5.5)	(+3.0)	(+3.0)
M2 Money Supply	(+12.9)**	(14.0)	(14.5)	(+14.0)	(+14.0)	(+13.5)
Net New Lending	RMBtrn	+1.5*	+1.6	+2.6	+7.5	+8.5
Trade Balance	\$bn	+64*	+80	+30	+190	+220
Foreign Exchange Reserves [†]	\$trn	3.20*	3.35	3.55	3.35	4.10
7-day repo [†]	%	3.98	3.25	3.00	3.25	2.50
RMB/\$ [†]		6.38	6.32	6.29	6.32	6.20
China 1-year lending [†]	%	6.56	6.56	6.56	6.56	6.06
China 1-year deposit [†]	%	3.50	3.50	3.50	3.50	3.00
China RRR (major banks) [†]	%	21.0	21.0	20.0	21.0	18.5

*Q3; **Oct.; [†]End of period

Monthly Diary – December 2011

CHINA AND HONG KONG

Date	Country	Release/indicator/event	Time (China)	Previous*	Median*	CE Forecast*	
1 st Dec	 Chn	"Official" Manufacturing PMI (Nov)	09.00	50.4	49.8	49.0	
	 Chn	HSBC/Markit Manufacturing PMI (Nov)	10.30	51.0	-	48.0	
9 th Dec	 Chn	CPI (Nov)	10.00	(+5.5%)	(+4.5%)	(+4.3%)	
	 Chn	PPI (Nov)	10.00	(+5.0%)	(+3.5%)	(+3.0%)	
	 Chn	Retail Sales (Nov)	-	(+17.2%)	(+16.8%)	(+16.5%)	
	 Chn	Industrial Production (Nov)	-	(+13.2%)	(+12.9%)	(+12.6%)	
	 Chn	Fixed Asset Investment (Nov)	ytd.	(+24.9%)	(+24.8%)	(+24.8%)	
10 th Dec	 Chn	Exports (Nov)	-	(+15.9%)	(+11.0%)	(+9.5%)	
	 Chn	Imports (Nov)	-	(+28.7%)	(+18.4%)	(+19.0%)	
	 Chn	Trade Balance (Nov)	-	+\$17.0bn	+\$15.0bn	+\$13.0bn	
15 th Dec	 Chn	Flash HSBC/Markit Manufacturing PMI (Dec)	10.30	48.0	-	-	
19 th Dec	 HK	Unemployment Rate (Nov)	s.a.	16.30	3.3%	-	3.3%
20 th Dec	 HK	CPI (Nov)	16.30	(+5.8%)	-	-	
29 th Dec	 HK	Trade Balance (Nov)	HK\$	16.30	-	-	-
	 HK	Exports (Nov)	16.30	-	-	-	
	 HK	Imports (Nov)	16.30	-	-	-	
Expected during the period:							
-	 Chn	Economic Work Conference (dates unknown, usually late Nov./early Dec.)			-	-	
11 th - 15 th	 Chn	New Net Lending (Nov)	RMB	-	+587bn	+580bn	+600bn
11 th - 15 th	 Chn	M2 Money Supply (Nov)		-	(+12.9%)	(+12.9%)	(+12.8%)

China is eight hours ahead of GMT. *m/m(y/y) unless otherwise stated; p = provisional estimate