China Macro Weekly (13-19 Sep)

Economic Analysis

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Notes on CPC, RMB, PBoC report, banks, UST...

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Quiet on the macro front around the 60th anniversary

Last week onshore Shanghai composite almost unchanged around the psychology level of 3000 while offshore H-shares were up 2.8%. The CPC hold its annual meeting, but the focus was anti-graft instead of the economy. As expected, current economic policy stance will be continued. National focus in the next couple of weeks will be cerebrating 60th anniversary of the PRC. Even after that (and before end-2009), we think China will be relatively quiet on the macro front but will be busier on the micro front as China's NASDAQ-style Growth Enterprise Market (GCM) board will be launched soon.

Markets in the past week

In the past week, metal prices fell across the board. Copper spot price in China fell 1.0% after a gain of 0.5% in the prior week, driven by rising global inventories and less copper imports from China in August from July. Sport steel price fell 0.4%, but 3-month future price rose 0.6% after falling for 5 weeks. Baltic Dry Index fell 4.5%, due perhaps to concerns on weaker iron ore demand from China.

In the money market, short-term rates moved up on the week as some banks were required to pay the RMB100bn in special central bank bills. Overnight and 7day repo rates were up 16bp and 10bp to 1.266% and 1.544% respectively, while 1-month repo rates stood at 1.691%. There were no changes to rates on PBoC’s 3-month, 6-month, and 1-year bills.

For FX, the USD-RMB spot rate stayed below 6.83 since it broke the psychological level of 6.83 on 4 September. While the spot rate was down 2bp to 6.8278 on the week, the USD-RMB 12m NDF was up 16bp to 6.7375, implying an1.3% RMB appreciation in one year expected by the market. We believe that, in the near term (before end-2009, or even before spring 2010), the USD-RMB rate won’t significantly deviate from the current level of 6.83.

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CPC meeting concluded: no change to policy stance

The CPC Central Committee vowed to build and manage the Party more efficiently in today's fast-changing times. A statement issued at the end of the four-day Fourth Plenary Session of the 17th CPC Central Committee also promised to expand and deepen intra-Party democracy, fight corruption more vigorously, intensify economic development and crack down on ethnic separatist activities. China will continue with its proactive fiscal policy and moderately loose monetary policy. (Xinhua News, 18 Sep)

PBoC: to keep monetary policy unchanged into 2010

China will maintain its "appropriately loose" monetary policy into next year to stimulate growth, Mr. Su Ning, vice governor of the PBoC, said on Thursday. Su cited uncertainties over the global economic recovery, negative inflation as reasons to stick with the current loose monetary policy. In addition, he warned about credit risks rising from concentrated lending particularly to local government projects. (Reuters, 17 Sep)

Comment: As what we wrote in the previous China Macro Weekly (6-12 Sep), the focus of this CPC meeting was on politics rather than economics, and there should be little change in overall policy stance. The official announcement of the CPC meeting confirmed our expectation.

Together with other sources such as the speech by PBoC's vice governor Su Ning, we reiterate our view that major policy stance (proactive fiscal and relatively loose money policy) won't be changed in the near future (or before spring 2010, see our two-phase exit strategy framework in "Raise 2009E GDP to 8.7%; and a roadmap for exit strategy" (27 July 2009)). We don't expect rate hikes, RRR hikes or major changes to the RMB-USD before spring 2010.

NDRC economist projects GDP growth of 9% in 3Q

China's economy is likely to grow 9% y-o-y in 3Q09, and to accelerate further to double-digit growth in 4Q09, bringing full year growth to be 8-9% in 2009, according to Mr. Chen Dongqi, vice director of the macroeconomic research institute with the NDRC. More specifically, he laid out a set of conditions that he thought could prompt authorities to shift to a tighter monetary policy stance from the current "appropriately loose" policy. Beijing may have to consider tightening monetary policy if annual GDP growth exceeds 9%, consumer inflation exceeds 3% or export growth is above 15%. On the government's proactive fiscal policy, Chen said there was no need to change direction. (Reuters, 17 Sep)

Comment: This piece of news flashed in major business media for a couple of days. It delivers an important message that advisors to top policymakers are already quite confident about an above 8% GDP growth this year, and also pre-conditions for changing current policy stance. Surprisingly and interestingly, those quarterly GDP forecast numbers and even those three pre-conditions are extremely similar to (and the three conditions are the same with) our views first presented in "Raise 2009E GDP to 8.7%; and a roadmap for exit strategy" (27 July 2009). Mr. Chen's views might have impact particularly on two aspects:

- 3Q09 GDP forecast will likely converge to around 9.0% (ours is 9.2%) and annual GDP growth forecast may converge to around 8.5% (ours is 8.7%).
- Some of our competitors will likely have to tone down their hawkish views on monetary tightening in China. We reiterate our views that before spring 2010 there will be no rate hike, no RRR hike and no major changes to RMB-USD.

RMB-USD rose to three-month high: Our views on yuan

The dollar's fall to a fresh nine-month low against the euro (EUR/USD at 1.4713) on Wednesday triggered strong demand for the Chinese yuan. On the over-the-counter market, the dollar ended at CNY6.8258, its lowest closing level since May 25, and down from Tuesday's CNY6.8289. Offshore 1-year dollar-yuan non-deliverable forwards were at 6.7330/6.7370 late Wednesday afternoon, down from 6.7395/6.7455 late Tuesday. The central bank set the dollar-yuan central parity rate at 6.8281, down marginally from 6.8284 Tuesday, despite the dollar's significant fall against the euro overnight. (Dow Jones, 16 Sep)

Comment: The RMB started to move, but not as much as what many might perceive. There is a psychological part of the perception. As the market has gradually perceived 6.83 as the new peg for USD-RMB, any move towards below the 6.83 mark (for example, from 6.830 to 8.829) will attract much more attention than moves towards above 6.83 (for example, from 6.830 to 6.839). But we know the move from 6.830 to 6.839 is much bigger than the move from 6.830 to 8.829.

It's our view that the RMB won't be pegged to USD forever. We think USD-RMB will move eventually, and when USD-RMB moves, we will most likely see an appreciation of RMB versus the dollar. But that's likely a case for 2010, or even later. In the near term (before end-2009, or even before spring 2010), we believe USD-RMB won't significantly deviate from the current level of 6.83 (if you round the number, recent fixings were still at 6.83). Why? Let us make three points here:

- Not to forget that China has its trade politics (somewhat like the case of tire in the US). The headline export growth will likely return to positive territory only in November or December, with those custom statistics reported with a one-month delay. We think China's trade politics simply won't allow a RMB appreciation against the dollar when export growth is still negative.

- Asset bubbles and hot money inflow could reinforce each other. What China tries to avoid is an asset bubble which could weaken China's recovery. Since China's interest rates are already above rates in most developed economies, a gradual appreciation of the RMB will only attract more hot money inflow. Learning the lessons from 1H08, China might take more time (that is, not in such a haste) to figure out a better way to appreciate its currency.

- A significant appreciation of RMB-USD might trigger a flight out of dollar, which is not in the interest of China as 70% of China's US$2.1tn FX reserves might be denominated in the USD.

Our scenario for RMB appreciation

There are basically two options for the Chinese to appreciate RMB-USD. One is a gradual, step by step appreciation, just something like what we had in the first half of 2008. The problem with that approach is a potential massive hot money inflow. The advantage of this approach is that it could be started earlier and staves off criticism abroad. A second approach is a one-off RMB appreciation. The advantage of that is to avoid strong appreciation expectations and hot money, but the problem is the timing and scale.

It's also likely for the Chinese government to widen the band first to test the market. The current band is 50bp per day on either side of a daily fixing rate. The government might raise this 75bp or even 100bp per day, and check the reaction of the market.

The best scenario is a two-stage reform program, in our view. In the first stage, China can copy the Singapore model by benchmarking the RMB against a basket of currencies and allowing a wider band. This stage can be started from the middle of 2010 when China has no worries on growth at all and exports return to growth. This stage can last 3 to 5 years. After that, China should have enough confidence and skills to allow a free float of the RMB. Of course, the PBoC can still explicitly set some rules for intervention when necessary.

PBoC 2Q09 payment system survey

The PBoC published its survey of payment system in 2Q09: (1) The RMB amount of no-cash transaction rose 6.6% y-o-y in 2Q09, up from a decline of 1.6% y-o-y in 1Q09; (2) Overdue loans on bill financing rose 3.9% q-o-q (or 84.3% y-o-y), compared to 15.2%, 22.6%, and 25.6% q-o-q (or 51.1%, 21.8%, and -5.1% y-o-y) respectively in 1Q09, 4Q08 and 3Q08; (3) As of end-June, the number of credit cards issued was up 32.9% y-o-y, card balance was up 77.0% y-o-y and overdue amount rose 131.3% y-o-y. (The PBoC, 16 Sep)

Comment: We make some observations from this quarterly survey. First, the positive growth of no-cash payment in 2Q09, which was the first y-o-y increase since 3Q08, is another evidence of strengthening economic recovery in China.

Second, the continued moderation in q-o-q growth of overdue loans from bill financing supports our view (please see page 3 of here) that bill financing is not so risky as people might think from reading the headline data in previous quarters. The recent surge in bill financing started in November 08, and outstanding bill financing soared 76.9% and 33.7% q-o-q (or 51.1% and 21.8% y-o-y) respectively in 1Q09 and 4Q08. Note that those new bills could only become overdue from 1Q09 onwards. However, the q-o-q growth of overdue bills moderated further to 3.9% in 2Q09 from 15.2% in 1Q09, compared to 22.6% in 4Q08 when China's export sector was hit hard by slumping external demand.

Third, as banks are competing fiercely for personal credit card business, and the government vows to boost private consumption, banks have loosened card issuance standard and adverse selection could become more problematic. As a result, delinquency ratio is set to rise. It was at 3.1% as of end-June, up from 3.0% as of end-March.

PBoC data suggest foreign capital outflows

PBoC data of "Positions for forex purchases" show that the central bank and other financial institutions spent RMB119bn to absorb new foreign exchange flowing into the system in August. It was down from RMB220bn in July and the least since a multi-year low of RMB112bn in November 2008. This could be an indication that speculative funds fled China's asset markets in the month, in particular stocks. (Reuters, 17 Sep)

Comment: There are a variety of factors which could contribute to swings in monthly data of "positions for forex purchases", such as the PBoC's intervention in FX market. However, we think the withdrawal of foreign capital from speculating in the domestic stock market could be the main driver of the sharp fall of "positions for forex purchases" in August, given that A-shares dropped 22% in the month, the third worst monthly performance in history.

More importantly, it may reflect the market perception on China's asset prices has started to change course as the government carried out fine-tuning measures from July (for example, the CBRC had required banks to strictly abide by regulatory rules on 2nd home mortgage). To some extent, some investors started to question the foundation of China's asset prices, and some foreign capital might choose to leave.

However, it is likely September will see foreign capital inflows again, but the increase may not be as high as in May 2009. After the market correction in August, we expect relatively stable foreign capital inflows in coming months, on the back of rising stock prices and increasing expectation of RMB appreciation.

"Aggressive lenders" to pay for special PBoC bills

Some Chinese banks, which are deemed as aggressive lenders in 2Q09, will make payments in mid-Sep for special bills the PBoC issued with the aim to curb surging bank loans. According to media reports in July, these 1-year notes would bear a punitive yield of 1.5%, and the total size of issuance could be RMB100bn. BoC spokesman confirmed the BoC was required to buy RMB42bn of these bills, but the yield would be same as market yield.

Comment: China's financial regulators started to intervene in bank loan growth, but the targeted issuance of "special PBoC bills" is more like a symbolic move to send some signals. The actual impact on loanable funds and those commercial banks is quite small. It's "punishing" in that the rate paid on those bills is only 1.5%, which is below 1.62% paid on required reserves. However, we should know that the 1.5% rate is higher than the 0.72% paid on excess reserves, which is still about 1.6% of total deposits. The 1.5% rate is also above the current 1.3% overnight repo rate (the return banks can make in the overnight money market), and only a bit below the 1.6% in the one month repo loans.

Last but not the least, loan to deposit ratio is only 67% for China's commercial banks which have a total RMB57.4tn in RMB deposits as of end-August, so the RMB100bn in special bills will have negligible impact on rates and loanable funds. That being said, big banks might use this as an excuse to demand higher rates on interbank loans in the short-term.

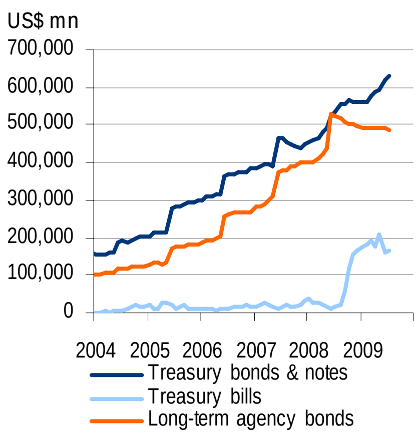
State banks raised foreign currency deposit rates

The Bank of China announced to raise interest rates for deposits in major foreign currencies on 17 Sep, following the rate hikes of other state banks in the prior week. These were the first upward rate adjustments for foreign currency deposits from the major Chinese banks in 2009. The one-year rates at the BoC were raised to 0.95% and 1.0% for USD and Euro deposits respectively from 0.75% and 0.9% previously. (Bank of China & First Financial Daily, 17 Sep)

Comment: Shall we be surprised by such a "rate hike" on foreign currencies in China? Are foreign currencies in shortage "again"? Not really. In March last year we wrote a report titled "Solve the paradox: Why dollar rates so high in China?" (28 March 2008), we explained why dollar rates in China were so high (implied dollar rates were above 10%) at that time. In contrast to the view that green bucks were in shortage in China at that time, we explained high rates on dollar by employing "uncovered interest rate parity," which states that onshore USD rates = CNY rates + expected appreciation of CNY against USD.

Now if you take into account the recent rise in the expectation of RMB-USD appreciation, you can easily figure out why onshore USD rates need to be raised. In the past month, USD-RMB broke the 6.83 psychology threshold, and the USD-RMB 12-m NDF rose by about 1pp. If China started to let RMB appreciate again, you should expect higher dollar rates inside China.

Chart 1: China's holdings of US debt



Source: US TIC, Banc of America Securities – Merrill Lynch.

China increased its holding of US Treasuries in July

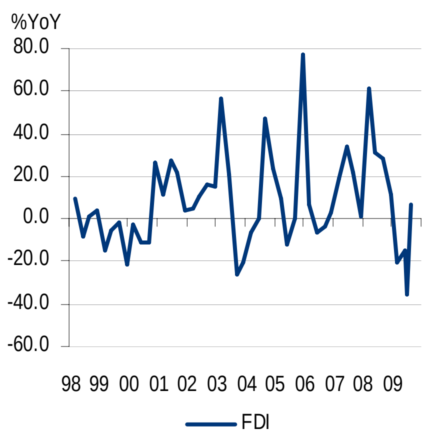
China purchased $24.1bn worth of US Treasuries in July, pushing up its total holdings to $800.5bn. The net purchase came after a big cut of $25.1bn in June. China remains the biggest holder of US Treasuries. (US TIC, 16 Sep)

Comment: China will likely continue to increase its overall holdings of US Treasuries. This is because we expect more capital inflows to China and a majority of those will end up with the PBoC, but the central bank is lack of alternative low risk and liquid assets as US Treasuries to invest. In our weekly (24 Aug), we suggested not to over-interpret the decrease of China's US Treasury holdings in June from May.

For its US Treasury portfolio, we think China will continue to favor long-term bonds over short-term bills. Among China's $24.1bn net purchase in July, $15.3bn was for bonds and the rest $8.8bn was for bills. China has greatly boosted its holdings of short-term bills from almost nothing in mid-2008 to $210bn in May 2009. But such a sizable holding of low-yielding bills may not be sustainable going forward as the global economy recovers. In fact, China cut $51.8bn bills in June.

We expect China will continue unwinding its position in US agency bonds. It cut $2.2bn agencies in July.

Chart 2: FDI growth is bouncing back



Source: CEIC, Wind and BAS-ML calculations.

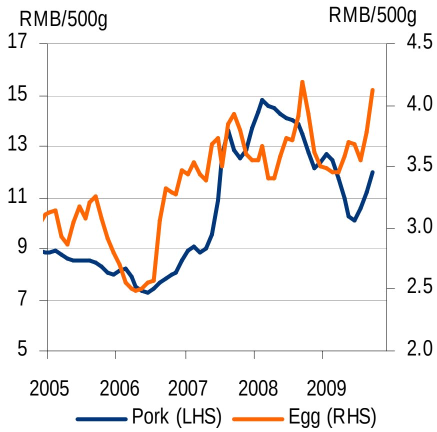
FDI in August picked up

Foreign direct investment in China rose 7% y-o-y to $7.5bn in August, the first increase in 11 months. Foreign investment in the January-August period was still down nearly 18% y-o-y, for a total of $55.9 bn. Ministry spokesman, Mr. Yao Jian, pointed out August's rise was mainly the result of investment in the manufacturing sector increasing nearly 12% y-o-y to $4.3bn. (WSJ, 15 Sep)

Comment: Monthly FDI data are extremely volatile, as they are often dominated by a number of large deals. However, we think FDI growth will trend upward in coming months because:

- There are rich investment opportunities in china due to its fast recovery, high growth and resilient domestic demand. A good example is the auto sector, where foreign brands and joint ventures make up a large share. Chinese market is playing a key role in supporting some of world's top automakers amid this global crisis. In August, passenger car sales surged 90.2% y-o-y;
- Foreign companies are getting funding again as the worst of the global financial crisis has passed;
- Rising asset prices, increasing expectation of RMB appreciation, and higher interest rates will likely attract hot money inflows and some of them will likely come in under the guise of FDI.

Chart 3: Pork and egg prices continued to rise



Source: CEIC, Wind and BAS-ML calculations.

Pork price rose for the fourteenth week

The average wholesale pork prices in major 36 Chinese cities rose 1% in the past week to RMB16.51/kg in wholesale market, according to Ministry of Commerce. This was the fourteenth weekly rise in pork prices in a row, and the price was now back to the same level in Mar 09. Egg prices rose 0.8% in the week. Overall, the agricultural product price index which tracks price of 57 agricultural products rose 0.5% from the prior week. (Ministry of Commerce, 15 Sep)

Comment: Our views on recent rises in pork prices could be summarized into points below. (1) Despite the 16% gain since early June, pork prices are still down 20% y-o-y in Aug and about 25% below the peak in Feb 2008. (2) Pork price might drop in 4Q09 as supply responds to price increase. The pork supply actually increased in the past week and there was small decline in pork prices in some areas, according to the Ministry of Agriculture. (3) The recent memory of porkflation does result in an unproportional attention to pork prices when people form inflation expectations, so policymakers need to be cautious in this regard.

Sovereign fund eyes on foreign resources

China Investment Corp., the country's sovereign-wealth fund, is considering investment in foreign commodity producers. One is a Mongolian iron-ore miner owned by Hong Kong's Lung Ming Investment Holdings. Another is Indonesia's biggest coal miner, PT Bumi Resources. The fund is also in talks to acquire a stake in U.S. power-plant developer AES. (China Daily, 16 Sep)

An update on China's RMB bond sales in HK

China's Ministry of Finance said Thursday that it will sell RMB6bn worth of two-year, three-year and five-year yuan-denominated bonds in Hong Kong on 28 Sep. It will issue the two-year bonds mainly to retail investors, the five-year bonds mainly to institutional investors, and the three-year bonds to both sets of investors. RMB2bn or more of the bonds will be sold to retail investors. This is its first yuan sovereign bond sale outside mainland China (Dow Jones, 17 Sep)

China encourages lending to SMEs

China's outstanding RMB loans to SMEs were up 21.4% to RMB15.2tn in 1H09, exceeding the rise of 21.1% in corporate loans and 19.9% in total loans for the first time, Mr. Yang Jiacai, a senior official from the CBRC said. As of end-June, outstanding loans to SMEs accounted for 53.7% of corporate loans or 36.7% of total loans. Yang said China will continue encouraging lendings to SMEs. Measures will include tax benefits to banks lending to SMEs, and establishment of compensation fund for credit risks rising from SME loans. (Caijing, 15 Sep)

Data tables:

Table 1: Selected financial market movements

	Price	YTD	1week	1mth	3mth	6mth	12mth
		Period change (%)					
Stock market							
Shanghai A shares	3,109	62.6	-0.9	1.8	2.8	27.4	56.2
H shares	12,615	59.8	2.8	10.2	20.0	58.5	46.1
S&P 500	1,068	18.3	2.5	7.2	16.0	29.8	-11.5
Commodities (RMB/tonne[1])							
Shanghai copper spot	49,325	94.6	-1.0	2.5	25.4	49.0	-13.1
Shanghai copper 3m future	49,120	109.8	-1.1	3.9	25.2	47.4	-6.7
China rebar spot avg.	3,584	-3.0	-0.4	-12.2	-2.2	6.9	-26.8
Shanghai rebar 3m future	3,967		0.6	-7.8	1.0		
Zhengzhou cotton 3m future	13,910	18.0	3.5	3.3	6.7	9.7	7.1
Dalian Soybean 3m future	3,757	11.6	2.7	2.2	2.0	3.4	-2.5
Dalian Corn 3m future	1,730	12.2	3.2	5.6	5.4	0.9	0.3
China container freight index	945	-0.1	0.4	9.0	21.9	13.2	-16.6
Baltic Dry Index	2,356	204.4	-4.5	-9.9	-42.1	32.9	-52.5
Interest and Exchange Rate							
SHIBOR overnight (%)[2]	1.258	31.1	16.5	16.0	35.6	45.4	-144.0
PBoC repo 28d (%)[2]	1.180	28.0	0.0	0.0	28.0	28.0	-198.0
US$/RMB spot	6.828	0.00	-0.02	-0.09	-0.11	-0.08	-0.17
US$/RMB 12m NDF	6.738	-3.58	0.16	-1.12	-0.28	-1.56	-3.47

Note: Data as of 18 Sep; 1except for China container freight index and BDI ; 2changes in bps calculated instead.

Source: Bloomberg, CEIC, Banc of America Securities - Merrill Lynch.

Table 2: Key economic data and forecast

(% YoY*)	Aug 09	Jul 09	2Q09	1Q09	4Q08	3Q08	2008	2009F	2010F
								BAS-ML Forecast	
GDP, real			7.9	6.1	6.8	9.0	9.0	8.7	10.1
Urban fixed asset investment	33.6	29.9	35.9	28.6	23.1	28.7	26.1	36.0	25.0
Retail sales	15.4	15.2	15.3	15.0	20.6	23.2	21.6	15.2	15.5
Exports	-23.4	-23.0	-23.5	-19.7	4.3	23.1	17.2	-16.7	7.1
Imports	-17.0	-14.9	-20.2	-30.8	-8.9	26.0	18.5	-17.0	12.4
Trade balance (USD bn)	15.7	10.6	34.8	62.5	114.6	83.3	295.5	239.5	206.3
Industrial production, real	12.3	10.8	9.0	5.1	6.4	13.0	12.9	11.0	14.6
Consumer price index	-1.2	-1.8	-1.5	-0.6	2.5	5.3	5.9	-1.0	2.5
Producer price index	-7.9	-8.2	-7.2	-4.6	2.5	9.7	6.9	-5.0	3.0

*Unless otherwise stated

Source: NBS, CEIC and Banc of America Securities - Merrill Lynch.

Important Disclosures

Other Important Disclosures

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