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China: Monetary Policy Update

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The People's Bank of China (PBC) recently released its quarterly report for the first quarter of 2011, providing a review of developments in the Chinese economy, financial markets, and monetary policy. The report also updates the domestic macroeconomic outlook and monetary policy focus in reference to the 12th Five Year Plan and the Government's stated goal of rebalancing growth. The PBC reiterated its commitment to conduct 'prudent' monetary policy, through controlling monetary aggregates and improving the overall financial market structure, with price stability and managing inflation expectations the key objectives of policy.

Review

The report notes that China's economic growth has remained resilient in early 2011, with stable consumer demand, strong investment growth, resurgent trade (recording a quarterly trade deficit for the first time since 2004), improving agricultural and industrial production, and stable income growth. On inflation, the PBC judged that domestic inflationary pressures were at least driven partly by rising global commodity prices on continued loose monetary policy in major [advanced] economies and the gradual global economic recovery.

As part of its efforts to contain inflation, the PBC has been gradually normalizing its monetary stance, and reported that money and credit growth had slowed in the first quarter. While the new concept of 'total social financing' better maps the different sources of financing for investment, its introduction does not imply a new approach to the conduct of policy.

Managing risks in the property market has been a key policy focus – albeit more for fiscal authorities than the PBC – and received special attention in the quarterly report. Following a series of macroeconomic reforms since 2011, the market appears to be stabilizing, and growth in mortgage credit has eased gradually.

Outlook and policy focus

The report is optimistic on the domestic economic outlook, and highlights some of the main risks as relating to the rebalancing of growth, weakness in innovation, resource constraints, and an acceleration of working-age population decline. It notes a range of 'trend' and 'structural' risks for inflation, including surging capital inflows (a pressing concern for many emerging markets) rising commodity prices and global inflationary pressures, and higher domestic labor costs as a result of population ageing.

On monetary policy, the PBC affirmed its commitment to effectively implement 'prudent' monetary policy, with maintaining price stability and managing inflation expectation as the primary objectives of macroeconomic policy. It emphasized five key areas of action:

1. Strengthen liquidity management. The central bank will continue to use a range of quantitative- and price-based instruments including open market operations, (differentiated) reserve requirements, and

benchmark lending and deposit rates to promote moderate money and credit growth, adjust capital needs and investment and savings behavior.

2. Improve the macroprudential framework. Macroprudential policy is the focus of much international work – particularly at the IMF and FSB – and the PBC has been broadly supportive of these efforts. The report states that macroprudential tools can complement conventional policy instruments to enhance systemic risk prevention.

3. Strengthen support for the real economy. The PBC intends to improve innovation in financial products and services, and promote financing to key areas including the green industry, R&D, agriculture, SMEs and consumer credit. The authority is also at the heart of implement 'differentiated' housing credit policies in mortgage finance aimed at managing the housing market risks.

4. Promote reforms of the interest rate market and the RMB exchange rate mechanism. For some time now, the PBC has claimed to pursue a policy of gradually allowing supply and demand conditions to form the basis of RMB exchange rate determination. It reiterated this policy, adding that it looks to accelerate the development of foreign exchange market, promote currency risk management, expand the RMB's role in cross-border trade and investment, continue to reform the currency management system, and severely crack down on 'hot money' and other illegal financial inflows.

5. Continue to promote healthy financial market development, and deepen reforms of financial institutions. The PBC aims to improve direct financing channels, such as equity and debt instruments, and will continue to reform state-owned banking institutions, including the Agricultural Bank and Import-Export Bank.

DE's Bottom Line: no departure from current strategy is outlined--or suggested. In our assessment, such strategy would include: continuing lending restraint (with higher reserve requirements and strict administrative/political oversight), additional (but probably declining) use of interest rate tightening, plus a gradual appreciation of the nominal exchange rate that would actually belie a more significant gain in real trade-weighted terms.

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