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China Accelerated Stimulus Exit Signals Higher Rates (Update1)

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By Bloomberg News



Jan. 13 (Bloomberg) -- An unexpected shift by China's central bank to restrain lending may foreshadow higher interest rates and a relaxation in the nation's currency peg against the dollar.

The People's Bank of China yesterday raised the proportion of deposits that banks must set aside as reserves by 50 basis points starting Jan. 18. Economists hadn't anticipated the move until at least April, the median of 11 forecasts in a Bloomberg News survey showed last week.

Policy makers may follow up by raising their benchmark rate in coming months, rather than waiting until the second half of the year as most economists in the survey had projected. By moving ahead of the Federal Reserve, which plans to keep rates near zero for an "extended" period, pressure will rise to allow the yuan to appreciate for the first time since mid-2008.

"Higher benchmark lending rates and a stronger yuan will also need to be part of the package," **Brian Jackson**, senior emerging markets strategist at RBC Capital Markets in Hong Kong, said after yesterday's decision. "Early action now" is "more likely to prevent the need for very sharp tightening further down the road," he said.

Impact on Stocks

Stocks fell after the announcement late yesterday, with the **MSCI Asia Pacific Index** losing 0.4 percent to 125.94 as of 8:37 a.m. in Hong Kong. Japan's 225 Stock Average dropped 0.3 percent, and the Standard & Poor's 500 Stock Index closed down 0.9 percent in New York.

"Authorities had reason for concern because the banks in China clearly had not gotten the message to clamp down on lending," **Eswar Prasad**, a senior fellow at the Brookings Institution in Washington, said in an interview on Bloomberg television from Hong Kong.

Banks lent about 100 billion yuan (\$14.6 billion) each day last week, the official China Securities Journal reported this week. That compares with 294.8 billion yuan for all of November.

Along with the reserve ratio, the PBOC has increased rates at bill auctions in the past week. The bank guided three-month bill yields higher for the first time in 19 weeks a Jan. 7 auction and followed with a similar step at a sale of one-year bills yesterday. The central bank has kept the benchmark one-year lending rate unchanged at 5.31 percent since late 2008.

'Pre-empt' Bubbles

"This series of moves by the central bank provides a clear sign that policy makers are following through on their pledge to guide credit in order to pre-empt rising inflation and avoid asset price bubbles," said **Jing Ulrich**, chairwoman of China equities and commodities at JPMorgan Chase & Co. in Hong Kong.

Along with further reserve-ratio increases and lifting the benchmark rate, officials may let the yuan climb by 3 percent to 5 percent this year, **Zhu Jianfang**, chief economist at Citic Securities Co. said in an e-mailed note. Jackson at RBC forecasts the currency will strengthen about 5 percent, to 6.5 per dollar.

Authorities have kept the yuan at about 6.83 per dollar since July 2008 after letting it appreciate 21 percent over three years. Bets that the exchange rate will strengthen have contributed to inflows of money from abroad -- China's foreign exchange reserves, the world's largest, surpassed \$2 trillion last year.

'Hot Money'

Part of that currency build-up may be speculative capital or "hot money," **Fan Gang**, the academic member of the central bank's monetary policy committee, said on Dec. 28. Such inflows "will cause asset bubbles," he said. **Zhang Xiaoqiang**, deputy head of the National Development and Reform Commission, said on Jan. 5 that the nation may see "huge" inflows of hot money as foreign investors step up bets on yuan gains.

The existing reserve-ratio **level** for big banks is 15.5 percent, and 13.5 percent for smaller banks. China began reducing banks' reserve requirements in September 2008 from a high of 17.5 percent as the global financial crisis deepened, part of a monetary loosening that included the biggest single interest-rate cut since the 1997-98 Asian financial crisis.

In November 2008, the central bank named Industrial & Commercial Bank of China Ltd., Agricultural Bank of China, Bank of China Ltd., China Construction Bank Corp. and Bank of Communication Co. as among those classed as bigger lenders for reserve requirements.

Wen's Pledge

The decision indicates increasing concern in Premier **Wen Jiabao's** government that a continuation of the record 9.21 trillion yuan of **loans** in the first 11 months of 2009 will create a bubble in property and stock prices. Wen pledged Dec. 27 to curb excessive property-price gains in some parts of China after the biggest nationwide increase in 16 months in November.

China's large amount of maturing bills, along with its stimulus measures, mean it has more liquidity than other nations, a People's Bank of China official said on condition of anonymity yesterday. Policy makers are stepping up measures to address financial risks, the official said.

Yesterday's decision will help remove about 300 billion yuan of liquidity, according to estimates by **Xing Ziqiang**, an economist in Beijing at China International Capital Corp., the top-ranked China local brokerage by Asiamoney magazine last year. It will help ease the risk of a flood of cash into the economy when about 1 trillion yuan of PBOC bills mature from mid-January to mid-February, Xing said.

Inflation Outlook

Inflation risks are rising in China as the economy picks up speed. Exports rose for the first time in 14 months in December, trade data showed on Jan. 10. A government report this month is forecast to show **gross domestic product** increased 10.5 percent in the fourth quarter from a year before, the most since January-to-March 2008, a Bloomberg News survey indicates.

The International Monetary Fund forecasts China's economic expansion will accelerate to 9 percent this year from 8.5 percent last year.

Economists are ratcheting up 2010 inflation forecasts for China. Citic Securities Co., the nation's biggest listed brokerage, raised its estimate to 3.2 percent from 2.6 percent in a report dated yesterday. Bank of America Merrill Lynch last week increased its forecast to 3.1 percent from 2.5 percent.

Yesterday's announcement "sends a pretty strong signal that a more substantive tightening is probably coming," said **Mark Williams**, senior China economist at Capital Economics Ltd. in London, who worked at the U.K. Treasury as an adviser on China from 2005-07. "It warns banks and it warns firms that

they're going to face higher interest rates down the road."

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