Economics

China: recalibrating monetary policy

DBS Group Research

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- **Prudential monetary management remains the guiding principle**
- **The intention of policy is to support growth at an acceptable minimum threshold rather than to engineer a sharp rebound**
- **Asset prices are likely to matter more to policy decisions in the future**
- **We expect one more 25bps rate and a further 100bps of reductions in the RRR in coming months**

Premier Li Keqiang announced in March that the nation's economic growth target had been lowered to around 7% from 7.5% last year (Table 1). In so doing so he clearly signaled the government's willingness to accept slower growth as it presses ahead with structural reforms.

The inflation target was also lowered to around 3% from around 3.5% in 2014. Given that inflation of 1.8% is widely expected this year, many believe much room exists for monetary stimulus. Nevertheless, the government has stressed the importance of "monetary prudence" despite decelerating domestic demand. Nowadays the intention of monetary policy is not to engineer a V-shaped rebound but to support a minimum acceptable level of growth. This is an important departure from past macro-management philosophy.

So too is the new way of dealing with debt and credit-driven growth. The Global Financial Crisis left a legacy of massive local government debt, overcapacity and a property bubble, with domestic debt almost reaching 250 percent of GDP in 2014. Faced with this, the central government chose not to tread its usual policy path. Instead it introduced new prudential macroeconomic management measures.

Even though GDP growth has run below 8.0% since 2012 and decelerated to 7.4% in 2014, monetary loosening has remained restrained. The central bank has been offsetting temporary liquidity crunches with a combination of short-

Monetary loosening has remained largely restrained - although annual GDP growth has dipped below 8.0% since 2012

Table 1: Key macroeconomic targets announced

	2015	2014
Real GDP growth	around 7%	around 7.5%
CPI	around 3%	around 3.5%
M2 growth	around 12%	around 13%
Total exports and imports growth	around 6%	around 7.5%
Fixed assets investment	15%	17.5%
Retail sales	13%	14.5%
Registered urban unemployment rate	not to exceed 4.5%	not to exceed 4.6%
Budget deficit to GDP	2.3%	2.1%

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term operations, standing lending facilities, and medium-term lending facilities. It has also lowered the reserve requirement ratio (RRR) for some banks to boost lending to rural and small businesses. Moreover, the few interest rate cuts – one each in Jun12, Jul12, Nov14, and Feb15 – have been counterbalanced by the lifting of the deposit rate ceiling, which furthers interest rate liberalization.

This approach differs markedly from the past

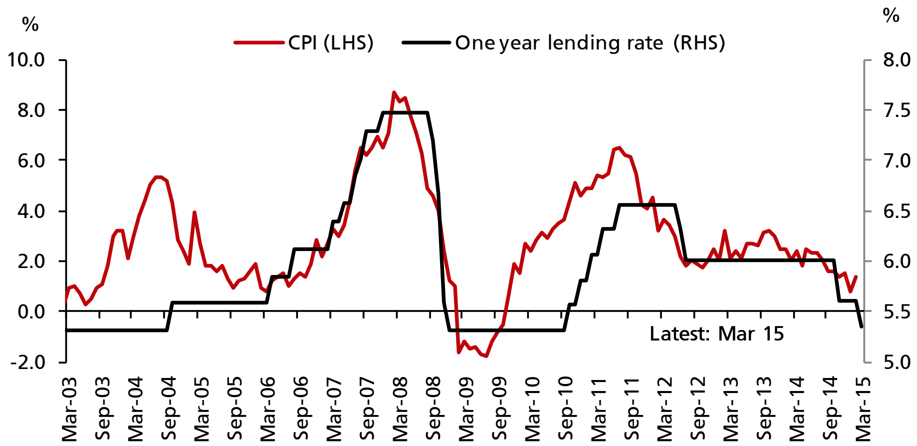
Today's RRR stands at a high of 19.5%. In 1998, it was just 8%

Back in 1997, benchmark lending and deposit rates were cut by 144 basis points (bps) and 180 bps respectively after GDP growth fell from 9.7% YoY in 4Q96 to 8.0% in 3Q97. The PBOC lowered the RRR to 8% from 13% at one go in March 1998 when GDP growth was 7.2%. Compared to that, today's easing has been practically nonexistent – the RRR remains at 19.5% after a 50 bps cut in February 2015.

Another shift is how the PBOC approaches property prices in the context of inflation. Historically, interest rates were cut in response to sharp falls in the CPI (Chart 1). In 2008 for example, the PBOC cut rates to 5.31% from 7.47% (216 bps) within four months of a drop in inflation to 1.2% in December from 7.1% in January that year.

While interest rate decisions will still largely hinge on inflation, there is reason to believe the government will place more emphasis on property prices in the near future. After all, the real estate sector makes up about 25% of China's GDP, and the slowdown in the sector poses serious risks as much of China's debt is tied to real estate. The fact that property prices in many cities have recorded month-on-month declines continuously since May 2014 was probably what triggered the rate cuts in Nov14 and Feb15.

Chart 1: Benchmark lending rate and CPI



We expect one more rate cut and another 100bps reduction in the RRR

Given property prices are still moderating across the country, we expect one more rate cut and a further 100bps reduction in the RRR in the months ahead.

Reforms in the financial sector produces long term benefits

China's deposit insurance scheme will be introduced on 1May, bringing the country another step closer to full liberalisation of bank deposit rates. Deposits of up to RMB500,000 will be covered. PBOC governor Zhou Xiaochuan told March's NPC that deposit rate liberalisation might be completed in 2015. This looks increasingly likely.

When this occurs, competition among the banks will likely drive up deposit rates. The central bank may wish to bring down the cost of capital to aid business. But in this scenario banks could face rising risk premiums and higher funding costs which could prevent the lending rate from coming down.

Furthermore, banks may be reluctant to lend to the extent they become more risk averse. That would be tough for would-be borrowers initially, but ultimately it would lift asset quality. Taking everything into account, it is not surprising that China's 2015 growth target has been lowered to 7%. The idea is to support a modicum of growth while restructuring proceeds, not to stimulate the economy per se.

Sources

Data are sourced from CEIC and "Report on the Work of the Government in 2015". Transformations and forecasts are by DBS Group Research.

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