

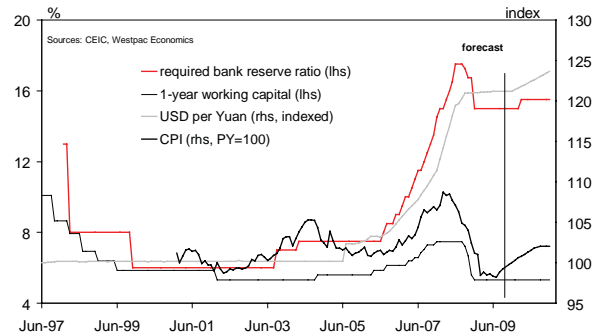
17 November 2009

- The People's Bank rattled a few cages last Wednesday evening, when they stated that "international capital flows and the trends of major currencies" would be taken into account as they perfect the exchange rate determination mechanism. Some jumped towards a corner solution immediately: that a step revaluation was in the mix, to be followed by a more flexible regime managed against a basket of currencies. Against a backdrop of an APEC draft communique talking of "market oriented exchange rates" (that phrase didn't make the final copy), a re-acceleration of hot money flows, Obama coming to town and a firming activity recovery, many felt the extreme view added up.
- **Phat Dragon's** take is that the signal was preparatory for a less accommodative approach to the management of liquidity more broadly, with the exchange rate expected to contribute marginally to that goal in coming quarters once inflation is back in positive territory. As yet there are few signs of an emerging tightening bias in the PBoC's open market operations, either in terms of new issuance stepping up to the levels required to at least neutralise expiring repos and maturing bonds on bank balance sheets, or in the multipliers backed out of the monetary aggregates. But with foreign capital flooding back into the country, reserves rising rapidly, asset prices on the move, the activity revival looking embedded and the major banks having plenty of headroom in their loan-to-deposit ratios, it is prudent for the PBoC to be considering an exit strategy from the extraordinary level of accommodation observed over the last year.
- A major conundrum facing the authorities is what to do with bank required reserve ratios (RRR) in the normalisation phase. Recall that the large banks are operating at a disadvantage (a 200bp higher RRR) vis-a-vis the rest of the system and that smaller operations have collectively gained loan market share in the first half credit splash. So the obvious initial policy is to equalise RRR across the system. Or is it? With the return of strong capital inflows - that are generally intermediated by the large banks - the stimulus to money supply emanating from this angle will not be impacted by an equalisation of RRR brought about by raising that of small banks. Furthermore, as RRR became the preferred method of mopping up excess liquidity late in the boom, one would expect this tool to again play an active role. Hypothetically, the PBoC could raise the RRR for large banks by 50bps (in say both March and April) with the RRR for small banks hiked three times by 100bps in March, April and May. That would be quite aggressive though and would cut quite swiftly into the level of excess reserves of the small banks. It is not an easy situation to exit at all - not least because RRR were not cut very far in the first instance.
- While perusing the Consensus Forecasts publication from October 12, **Phat Dragon** noted that the top of the range forecast for calendar 2009 was 9.4%. A little reverse engineering shows that this "forecast" requires the published Q4 number to print at 14.5%yr with a 25% saar outturn in the quarter itself, up from 8.9%/9.1% saar in Q3. We know there are some bulls out there, but seriously ...
- **Stats of the week:** Just 16,348 inward foreign direct investment contracts have been signed in the year to September - by far the fewest agreements this late in a year during the post-WTO era.

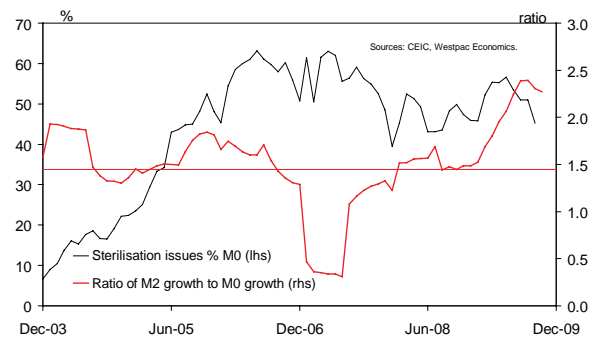
Phat dragon

a weekly chronicle of the Chinese economy

Chinese monetary policy & inflation



China: the money multiplier & sterilisation



FX reserves: the twin surplus is back

