Economic Analysis

April, 2007

A Publication of the BEA Economic Research Department

The Changing Role of China's Interest Rate Policy

Economic data from the first two months of 2007 shows no slackening in China's growth. Despite continued monetary tightening measures, including an additional rise in the reserve ratio and further selling of treasury bills, outstanding bank loans grew by 17.2% in the first two months of this year. Money supply, industrial production and fixed asset investment all grew strongly during the same period.

Moreover, inflationary pressures have also intensified in recent months. Consumer prices jumped from below 2% earlier in 2006 to 2.8% in December, and prices continued to hover near this upper limit of the government's comfort zone in the subsequent two months.

These signals prompted the People's Bank of China (PBOC) to raise both the benchmark one-year lending rate and the one-year deposit rate by 0.27% in March, to 6.39% and 2.79%, respectively. While the pickup in inflation is believed to be the primary concern of authorities, central bank governor Zhou Xiaochuan highlighted that the PBOC's focus is not on the current level of inflation, but rather on inflationary pressure in the pipeline.

Inflationary pressure in the pipeline

The latest jump in the consumer price index (CPI) was mainly led by a surge in food prices, which increased from 2.4% in 2006 to 5.5% in the first two months of 2007. Given the minimum procurement price for grain and the rising pressure from the international agricultural market, grain prices have seen a considerable rise recently and forced the food prices to go up. As one of the government's top priorities at present is to promote social harmony by improving rural living standards, the government is willing to tolerate a rise in grain prices which could help boost farmers' income.

Another factor contributing to the relatively high level of inflation comes from the residence component. Although the yearly price increase of residence slowed to 3.8% in the first two months of this year, it was solely dragged by the easing cost of water, electricity and fuel. The private rentals, however, accelerated along with the soaring property price and remained a threat to inflation. In recent years, most developers have focused on the luxury apartment sector, and the supply of lower-cost housing has been insufficient to meet public demand. Last year, the government introduced a new policy to encourage the allocation of more land to development of middle-to-low priced housing. Nevertheless, it will take some time before there is a noticeable increase in such supply.

Table 1. China's CPI by Category (yoy% change)

	06Q1	06Q2	06Q3	06Q4	07Jan-Feb
Food	1.9%	1.9%	1.5%	4.1%	5.5%
Tobacco, Liquors & Articles	0.2%	0.4%	0.6%	1.1%	1.7%
Clothing	-1.3%	-0.5%	-0.5%	0.0%	0.4%
Household Facilities, Articles & Services	0.6%	0.9%	1.5%	1.8%	2.1%
Health Care & Personal Articles	0.5%	1.3%	1.4%	1.3%	1.4%
Transportation & Communication	-0.7%	-0.1%	0.2%	0.3%	-0.4%
Recreation, Education, Culture Articles	0.1%	-0.1%	-0.5%	-1.1%	-1.6%
Residence	5.0%	4.4%	4.8%	4.5%	3.8%
Total	1.2%	1.4%	1.3%	2.0%	2.5%

Source: National Bureau of Statistics

In fact, it should be noteworthy that the prices of clothing, tobacco and liquors, household facilities and services (Table 1) are also rising, albeit at much slower pace than food and housing. This reflects the strengthening consumer demand and it is probably the inflation trend that most worries the central bank.

While household consumption expenditure grew by 44.1% between 2001 and 2005, the other components of GDP grew twice as fast at 93.8% during the same period. This highlights the conservative spending habits of Mainland consumers, who, with little or no social safety net, tend to save most of their earnings despite low interest rates. Total household savings skyrocketed 91.2% to 14.1 trillion yuan during the period.

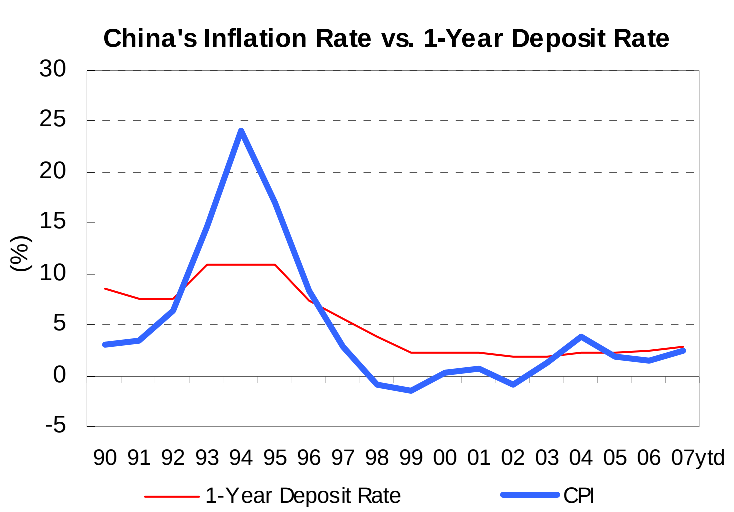
Yet, there are signs that savings patterns are changing, following the rejuvenation of the stock market last year. With the success of the non-tradable shares reform and the return of quality H-shares to Mainland bourses, the Shanghai A-share index soared by 130.6% in 2006, and further surged by 25% since the beginning of 2007. The impressive gains are luring Mainland residents to shift their money from bank accounts to the stock market. The yearly growth of household savings decelerated from 21.1% in January 2006 to 9.3% this January.

Given the upbeat market sentiment, the number of new A-share trading accounts opened per day has reached an average of 115,240 this March, 20 times the daily average over a year ago. It is also very common to see queues in banks for the purchase of investment funds. As the stock market continues to boom, the positive wealth effect is very likely to support an increase in private consumption, further fueling inflation.

Different from the food prices and house rentals that are largely dictated by the supply constraints, this trend of demand-pushed inflation could have the momentum building up. Hence, the government must tighten monetary condition to take a pre-emptive strike against inflation before it takes off. As a result, we expect the government to raise interest rates a further three times each by 0.27% during the rest of 2007.

The role of interest rates is changing

Under the 10th Five-Year Plan that covered the period 2001-2005, government policy favoured investment and export growth. Real economic growth was successfully boosted to an average of 9.4% annually during the Plan period. Meanwhile, inflation averaged only 1.4%, as consumer demand failed to keep up with the rising production capacity created by the increase in investments. This allowed the central bank to maintain an extremely low interest rate environment to facilitate economic development. Given the high saving rate in the country, Mainland depositors subsidized economic growth.



Sources: People's Bank of China, National Bureau of Statistics

However, the inflation outlook is very different with the launch of the 11th Five-Year Plan in 2006. Government's focus has shifted from exports and investments to consumption. The stronger consumer demand started to absorb excess supply, as the prices for consumer durables emerged from a long-term deflationary spiral last year. Since an accelerating private consumption could induce inflationary pressures, the economy is unlikely to maintain the "high growth, low inflation" ideal of the 10th Plan period.

Furthermore, with the continued reform of the banking system, loan decisions have become more market-oriented, closing off a former source of cheap, easy money for many well-connected companies. Meanwhile, the encouraging progress made in stock market reform will prompt more Mainland enterprises to shift their fundraising focus from banks to the markets.

With the economy gradually evolving from a government-led model into a market-driven one, the role of interest rates as a monetary policy tool will become increasingly important. The government also appears to be willing to further relax controls on interest rates in order to develop a more market-sensitive interest rate environment. The introduction of the Shanghai Interbank Offered Rate (Shibor) in January this year was an obvious step in the right direction.

Conclusion

Currently, the potential risk of stock market bubbles presents a difficult task for the Chinese government and it cannot afford to carry on such risk into 2008 when the Olympic Games will be launched in Beijing. However, with years of efforts to revitalize the stock market and the principal goal to boost private consumption, the Chinese government is unlikely to put a heavy dose of medicine which may burst the asset bubbles. Therefore, the biggest challenge this year for the Beijing government will be to make skillful use of interest rate policy to combat inflation and encourage the further growth of a robust and healthy stock market. In the long term, given the need to restrain the upward pressure on demand-led inflation, there would still be plentiful room for further rate hikes.