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Hands-On China Series

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HANDS-ON CHINA REPORT  
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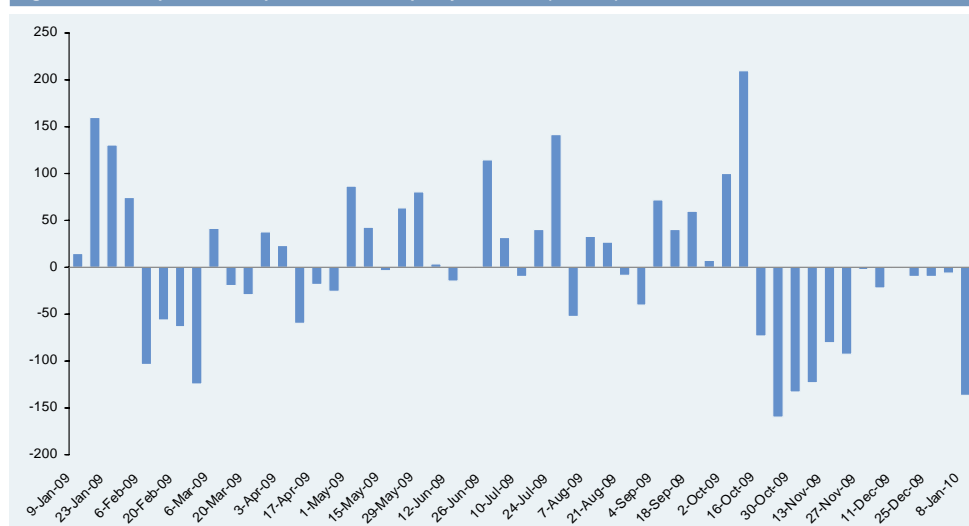
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## China Adopts More Prudent Liquidity Policy

The PBoC today increased banks' reserve requirement ratio by 50 basis points (effective January 18) – the first adjustment since November 2008. Earlier in the day, the central bank sold one-year bills at a higher interest rate for the first time in 22 weeks, following an increase in the three-month central bank bills rate last week. This series of moves by the central bank provides a clear sign that policymakers are following through on their pledge to guide credit in order to preempt rising inflation and avoid asset price bubbles. China's central bank sold RMB 20 billion in one-year bills at a rate at 1.8434% compared with 1.7605% between August 11 and January 5. This coincided with the draining of RMB200 billion in liquidity from money markets through bond repurchase agreements (last week's net drain in liquidity was the largest since October 23, 2009 – see Figure 1), and followed recent reports in Chinese media claiming that new bank lending surged to RMB 600 billion in the first week of the New Year.

Figure 1: PBOC Open Market Operations – Net Liquidity Additions (RMB bn)



Source: CEIC

The message coming out of China in recent weeks has been quite clear - policymakers are becoming more concerned about overheating in certain sectors and the risk of asset price bubbles as a result of last year's aggressive expansion of credit. We have already seen some scaling back of incentives that have spurred record sales in the domestic property sector and authorities have made clear that they will step up scrutiny of property lending to curb "overly rapid" price gains in some cities. The prospect of rising policy risk has led J.P. Morgan's property research team to believe the Chinese property sector will continue to underperform the HSCEI in the run-up to the National People's Congress meeting in March.

The first half of 2010 is likely to be characterized by gradual policy tightening, chiefly through administrative measures. Concerns about capital inflows and the health of the export recovery will limit the scope for interest rate tightening, but we do expect to see a moderation in bank lending growth on the order of approximately 20-30% from 2009 levels, and the use of reserve requirements to manage the volume of money supply.

As opposed to the state of market sentiment a year ago, investors now seem to have priced in a fairly positive Chinese economic growth outlook. We continue to

see some catalysts that should support Chinese equities performance in the first quarter. A fresh infusion of liquidity and earnings revisions should support the market in early-2010. However, the second half may prove more challenging if China's monetary policy stance turns more neutral.

Looking to the full year - as the pace of investment growth decelerates from very high levels and money supply growth slows down from last year's rate, the momentum that propelled Chinese stocks in 2009 may gradually slow, in spite of resilient domestic demand and an improving external environment.

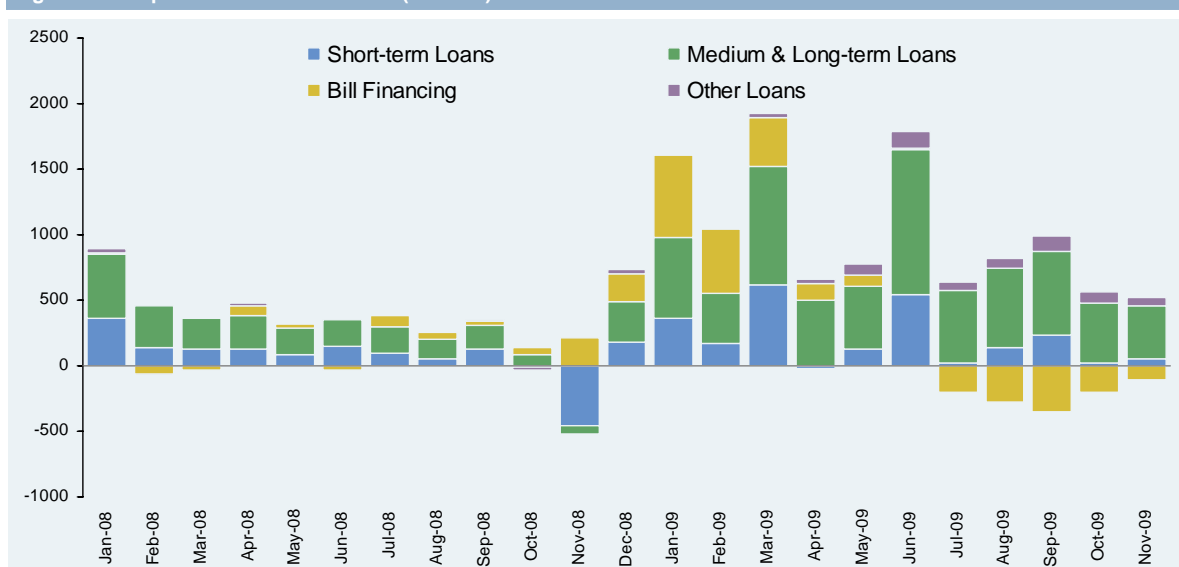
The forces that will shape Chinese equity markets and the economy in the medium term can be broadly defined in three themes:

### ■ I. Reacceleration of Loan Growth in 1Q10

Although policymakers are cautioning lenders not to overindulge, Chinese banks will continue to front-load new lending at the start of the year. Chinese media have reported that domestic banks extended RMB600bn in new loans in the first week of January. The traditional rush to book loans in the first quarter should alleviate any concerns about an aggressive tightening of credit. In 2009, approximately 45% of new loans were extended in the first quarter (vs. 34% of new loans in the 2005-2008 period). While overall loan growth should moderate in 2010, lending activity should remain relatively strong to provide financing for ongoing infrastructure projects and growth industries benefiting from government support.

The structure of new lending should continue to exhibit a shift towards medium and long-term loans to support real economic activity (see Figure 2).

Figure 2: Composition of net new loans (RMB bn) \*

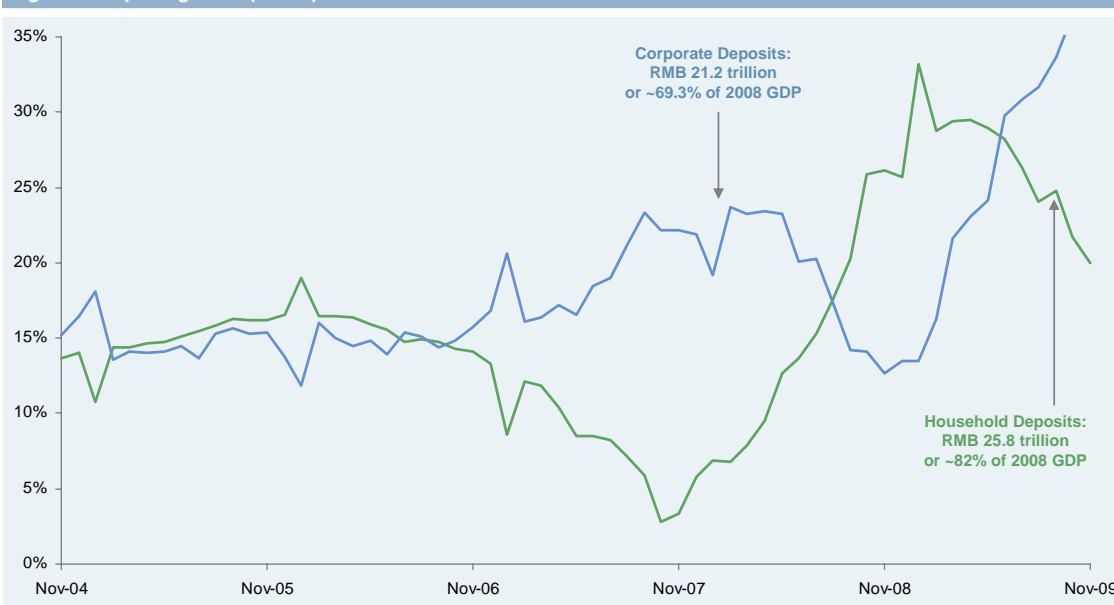


Source: PBoC \*Local and foreign currency loans

Despite an overall moderation in new lending by Chinese banks in 2010, liquidity is expected to remain relatively abundant due to strong corporate cash balances and improving earnings (Chinese industrial enterprises posted a 7.8% improvement in profits during the first eleven months on 2009). Growth in corporate deposits rose from 13.5% in January 2009 to 37.3% in November, partly reflecting unused funds from loans extended last year.

Meanwhile growth in household deposits has fallen from 29.5% in April 2009 to 19.9% in November, indicating a higher allocation of funds for consumption and investment (see Figure 3).

Figure 3: Deposit growth (YoY%)



Source: PBoC, BCA Research, CEIC

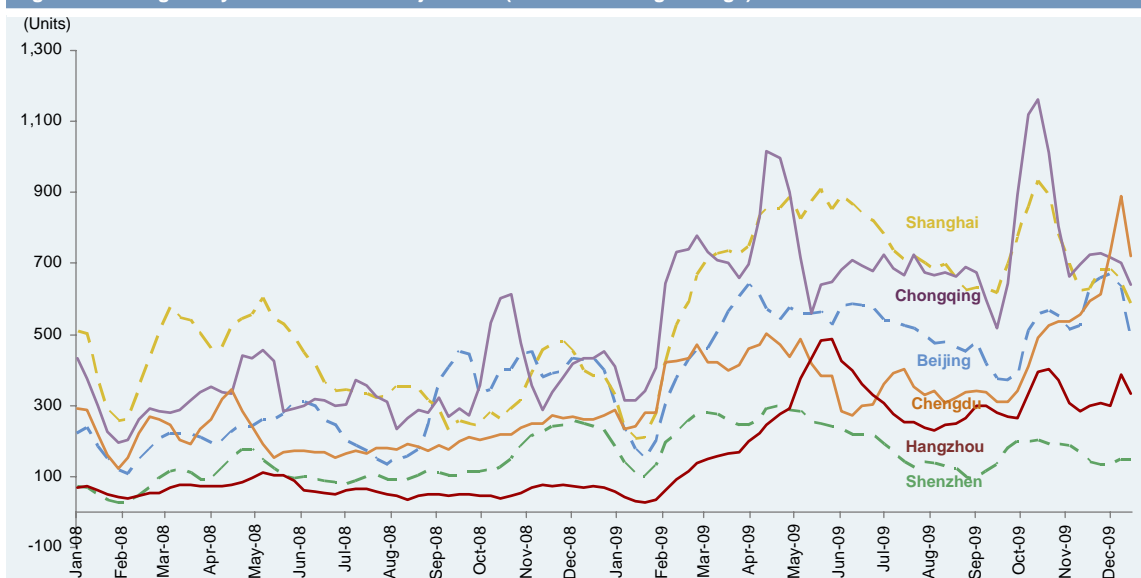
## ■ II. Policy Shifting To Forestall Asset Price Bubbles

Record property prices and housing sales in 2009 have put policymakers in a dilemma between the need to maintain relatively strong transaction volumes (in light of the housing sector's importance to investment, consumption and employment) and the need to prevent rapid housing price increases. According to J.P. Morgan property analysts, the amount of new residential floor space sold in 2009 grew 35% YoY in 2009, with ASP growth of 16-27% in first-tier cities.

Policymakers have already begun scaling back some incentives that have spurred record sales, and are taking measures to increase the costs of property speculation. On December 28, Chinese Premier Wen Jiabao stated that "property prices have risen too quickly in some areas and we should use taxes and loan interest rates to stabilize them." The property holding period has been restored to 5 years, from 2 years, with a 5% business tax applied to the consideration from resale within this period. The nationwide minimum down payment on land purchases has also been lifted to 50% from 20-30% and developers must completely pay off land purchases from the government within one year of agreement. There is also growing speculation that a new property tax system may be introduced in the medium-term to clam down on hoarding in the housing market.

Local governments are also acting to deter speculation – eg, the Shenzhen Government has launched a 3-month campaign to curb illegal presales, false advertisements, property hoarding and contract scams. The fine-tuning of property policy may benefit ordinary homebuyers – through an increase in the supply of smaller residential units and subsidized housing. Cities with high prices are likely to see an increase in the stock of low-cost housing, according to a statement by an official with the Ministry of Housing.

Figure 4: Average daily sales volume at major cities (1-month moving average)



Source: Centaline, City real estate trading centres, J.P. Morgan Research \*First-tier cities in dotted line

### ■ III. Promotion of private consumption remains a high priority

The aim of boosting private consumption has gained new urgency in the face of last year's collapse in external demand, and the authorities appear to be continuing various consumption stimulus policies initiated in 2009 – but some adjustments have been made in response to concerns about excessive capacity.

- In an effort to boost sales and curb emissions, subsidies for owners who trade in old vehicles for new ones have been increased by a range between 20 - 200%. Since last August, China has offered trade-in subsidies of RMB3000-6000. Now, the maximum subsidy has been tripled to RMB18,000 (for heavy trucks / large cars).
- The preferential vehicle purchase tax for cars with an engine size 1.6 liters has been renewed in 2010 at a rate of 7.5% (compared to 5% in 2009 and 10% in 2008).
- China's rural home appliance/electronics stimulus program has been renewed and expanded to cover more regions (from only 9 cities/provinces in 2009). In 2009, household appliance sales linked to the government's "old-for-new" purchase initiative amounted to RMB14.1bn, accounting for 20% of total household appliance sales.
- In recent days, the CBRC has approved plans by the Bank of China, Bank of Beijing and Bank of Chengdu to launch the country's first consumer-finance companies. Last May, the CBRC released a draft plan allowing domestic and foreign consumer-finance companies to extend financing for consumer travel, education and purchases of durable goods. Such companies may not lend for property or auto purchases.

Meanwhile, a host of long-term initiatives dealing with healthcare, education and the national pension program aim to enhance China's social safety net, thereby supporting consumption. Reform of the household registration system could encourage spending by rural migrants and boost demand for affordable housing.

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