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## Tightrope balancing effort

*The following article by Jing Ulrich appeared in the China Daily on Jun 10*

Liquidity squeeze, tabs on speculative property buys and the European debt crisis have made Chinese investors risk averse

Having implemented the most effective stimulus program during last year's global economic downturn, the Chinese government in recent months has been engaged in a balancing act of controlling inflation and deflating asset bubbles without dampening growth excessively.

The current climate of domestic policy shifts and perceived external vulnerabilities has given investors ample cause for concern. Developments in China's economy have never drawn more global attention, as evidenced by unprecedented numbers of delegates expected at JP Morgan's annual China Conference.

Investors from all over the world remain very committed to understanding how developments in China might influence their strategies.

Recent liquidity tightening initiatives, restrictions on speculative property investments and intensifying concerns about the European debt crisis have weighed on Chinese equities markets, bringing a reduction in risk appetite and a preference for defensive sectors.

Despite a reasonably strong medium-term corporate earnings outlook, the benchmark CSI 300 index of domestic Chinese stocks has declined 22.9 percent year-to-date, while Hong Kong "H" shares have shed 12.8 percent.

The sectors that saw the greatest benefit from abundant liquidity in 2009 - namely property, construction, materials and banks - have corrected sharply, with a number of these names now valued at a significant discount to historical averages.

Uncertainties also exist with respect to the domestic liquidity environment. After encouraging the nation's banks to issue a vast amount of loans in 2009, the government has set a target of 7.5 trillion yuan in new loans in 2010 (as compared to 9.6 trillion yuan last year).

Meanwhile, the official target for broader money supply growth has been set at 17 percent for 2010 - a level that implies significant deceleration from an

average 23.9 percent monthly M2 growth in January-April. Such a reduction of domestic liquidity would mean less "surplus funds" to be channeled into asset markets.

Beyond merely controlling the volume of credit growth in 2010, the government also aims to manage the pace of lending. The extension of new loans in 2009 was heavily skewed towards the first and second quarters. A mismatch between the infusion of credit and the actual deployment of funds earmarked for stimulus projects facilitated some degree of speculation in asset markets.

Regulators have now asked banks to issue 30 percent of new loans in each of the first two quarters of 2010, and 20 percent in each of the latter two quarters. In actuality, the pace of lending has run ahead of official guidelines. If policy-makers hold firm, Chinese banks may be asked to pare lending in the months ahead.

Authorities have opted to leave interest rates unchanged since late-2008, erring on the side of caution in using broad policy tools to adjust monetary conditions. Uncertainties surrounding the sovereign debt crisis in Europe may have prompted policy-makers to slow the pace of tightening, delay interest rate adjustments and suspend the introduction of more aggressive administrative controls.

Although the countries at the center of the European sovereign debt crisis - Greece, Ireland, Portugal, Spain and Italy - account for only 3.5 percent of China's exports, the risk of contagion cannot be ruled out. If the problems affecting these economies were to spill over to major European countries, China's export-related industries, including consumer product and component manufacturing could be adversely impacted by weaker external demand. As a whole, Europe accounted for 22 percent of China's exports in 2009.

Already, the sharp appreciation of the euro relative to the yuan has affected Chinese exporters that settle trade in euro. Cyclical upstream sectors leveraged to global growth may also suffer if resource prices and freight volumes decline.

Aside from hampering exporters' competitiveness, the rapid decline of the euro has complicated any potential move to allow the currency to appreciate against the dollar. Under normal circumstances, a mild appreciation of the renminbi relative to the dollar would have limited impact on exports, in light of Chinese exporters' rapid productivity gains.

Allowing the Chinese currency to appreciate against the dollar at this juncture would further drive up its value against the euro. We believe Chinese authorities are likely to tread carefully while assessing the health of external demand.

No discussion of China's economic policy can ignore issues surrounding the property sector. The current round of tightening has clearly dampened housing transaction volumes, driving buyers to the sidelines. There have been signs of prices softening on the secondary market and several instances of price reductions by developers.

Although housing prices have corrected only modestly, we believe the government's main intent is to restrain price increases rather than engineer a sharp correction or dampen activity. Additional austerity measures emerging from the local-government level appear to have been less severe than policies introduced in Beijing and remain supportive of owner-occupied home purchases.

In light of curbs on property investment, we believe domestic investors may gravitate towards equity investments once the primary sources of economic concern are allayed. Any easing in property tightening measures or signs of EU stability should provide a boost in sentiment and shift investor focus towards valuations that are undemanding in historical context.

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