

## Box 1

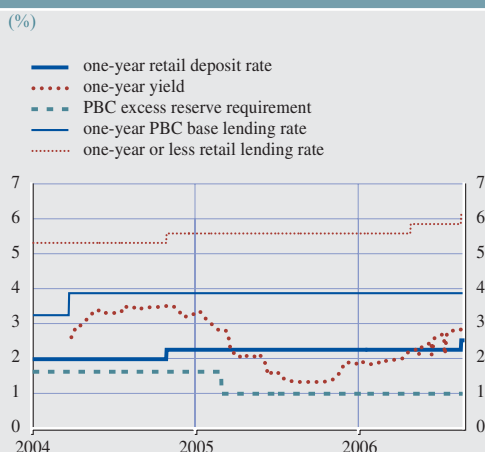
### RECENT DEVELOPMENTS REGARDING CHINA AND GLOBAL IMBALANCES

The single largest vulnerability to a disorderly correction of global current account configurations arising from EMEs continues to stem from a number of downside risks to the Chinese economy. Though still notable, the risks in this context since the completion of the June 2006 FSR appear to be on an incipient downward trend in spite of the upturn in domestic economic activity over the same period. Five developments underlie this assessment:

First, vulnerabilities posed by large short-term speculative inflows betting on a large renminbi appreciation declined after May 2006, at least in the short term. The difference between the Chinese basic balance – the sum of the trade surplus and foreign direct investment (FDI) inflows – and foreign exchange reserve accumulation can provide an indication as to the extent of speculative inflows into China. In the year up to July 2006, the basic balance accounted for about 80% of the increase in foreign exchange reserves, up from 68% over the same period a year earlier. This suggests that recent patterns in foreign exchange reserve accumulation have been primarily driven by fundamental factors, and at an increasing rate. At the same time, market expectations of a further renminbi appreciation declined, as reflected in the RMB/USD non-deliverable forward market. In this connection, as long as bond yields remain lower in China than in the US, speculation via carry-trades between the US and Chinese government bonds is likely to be curbed. However, speculative inflows could resurface if the Chinese authorities were to encounter difficulties in managing expectations of a gradual and orderly renminbi appreciation.

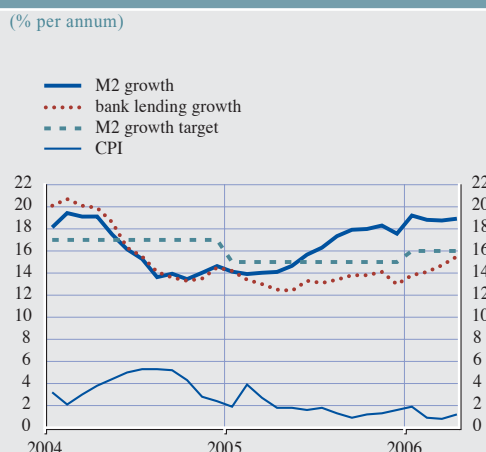
Second, large foreign exchange interventions have continued to pose a major challenge for domestic monetary management and banking sector stability. Although the People's Bank of China (PBC) sterilised 63% of the increase in base money resulting from foreign exchange interventions in the first half of 2006, these still accounted for 43% of the growth of broad money (M2). From June 2005, M2 growth continuously overshot the central bank's target of 16% for 2006, expanding by 18.4% year on year in July. Bank credit also continued to grow above target, recording 16.3% year-on-year growth in July 2006, against a target of 13%. In response, the PBC took a number of additional measures to rein in liquidity, the most important being two successive 0.5 percentage point hikes in the bank's reserve requirement ratios in July and August, and two 27 basis point hikes in retail lending rates in April and August. Coupled with stepped-up issuances of sterilisation bonds, these measures succeeded in raising the benchmark one-year

Chart B1.1 Chinese money market, retail and deposit rates



Source: CEIC Data.

Chart B1.2 M2, credit growth and inflation in China



Source: CEIC Data.

bond yield just above the retail deposit rate. However, bond yields still remained below their early 2005 levels (see Chart B1.1). Banks – in particular large state-owned ones – continue to have to remunerate deposits at rates not far below the returns they receive from their rising bond portfolios. At the same time, they are coming under increasing pressure to cut down on the growth of their higher yielding loan assets. This could ultimately weaken the condition of banks by reducing their net interest income. It is still too early to judge what impact the latest tightening measures will have on M2 and lending growth. However, although there has been no discernible inflationary impact of the liquidity influx so far (see Chart B1.2), the authorities seem more concerned with curtailing the accelerating trend of liquidity growth (particularly that of lending) than with complying with the much lower target levels which had originally been set. This is because the PBC is keenly aware of the fact that banks need to find uses for excessive deposit levels and liquidity flowing from foreign exchange interventions, in order to avoid any short-term damage to their balance sheets. The PBC also has to ensure that credit keeps flowing to sectors that have been earmarked for support by the government.

Third, policy challenges stemming from rising sterilisation costs also remained contained in the six months after the finalisation of the June 2006 FSR. Although sterilisation bonds amounted to 16% of 2005 GDP, one-year Chinese yields were still more than 200 basis points below one-year US Treasury yields, implying that the PBC could continue to profit from its sterilisation operations. However, the large share of foreign exchange reserve assets on the central bank's balance sheet (60% of total assets) has left it vulnerable to a large renminbi appreciation.

Fourth, in spite of the buoyant pace of investment in China, the risk of a hard landing appears to be on the decline. Although investment rebounded strongly in the course of 2006, its composition became more balanced, and it was supported by an upturn in profit growth. Moreover, unlike in 2003-2004, the rebound was not led by sectors notorious for overcapacity problems, and instead was more driven by the contribution of light industries.

Fifth, in light of the importance of Chinese import demand as a driver of export growth in Asia and around the globe, the slower than expected growth of Chinese imports in the face of accelerating GDP growth during H1 2006 remains a matter of concern. There are a number of competing explanations for this development, including i) a deceleration of export growth, which has dragged down imports consisting of intermediate goods and components destined for processing and re-export (which account for nearly 50% of total imports); ii) the somewhat changed composition of investment, with less import-intensive light industrial sectors leading the investment rebound; iii) the enhanced ability of some domestic producers to substitute for previously imported goods; and iv) the official investment figures, which possibly overstate the true extent of investment growth. It is still too early to assess the relative weight of each of these factors in explaining the recent moderation of imports. However, the extent to which investment rebounds in the import-intensive heavy industrial and construction sectors will, to a large extent, determine whether or not imports gain momentum in the remainder of the year.