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THE PEOPLE'S BANK OF CHINA: <u>STAND BY ! INTEREST RATES ARE ON THE RISE !</u>

<u>Does The Central Bank of The PRC Have An Option ?</u>

The People's Bank of China, which is The Central Bank of the People's Republic of China (PRC), with the power to control monetary policy and regulate financial institutions, is expected to start raising interest rates in the very near future.

How aggressive will The People's Bank of China increase interest rates in the coming months will depend, entirely, on how effective are its actions in curbing inflation in the world's most-populous country with one of the highest industrial growth rates in the world, today.

In the past, The People's Bank of China had been content to raise reserve requirements at banking institutions, but it has been seen and demonstrated that this action has not had the desired effect.

Hence, more urgent and imperative actions are required for the long-term benefit of the country.

It is quite likely that many people, especially PRC-domiciled equity investors and home-owners, paying monthly mortgage payments to banks of the PRC, will not be too enamoured by the actions of The People's Bank of China.

But there appears to be no alternative for The Central Bank of the PRC.

The People's Bank of China will, undoubtedly, have to adopt a shift in its thinking: From fanning industrial growth in the country to containing inflation.

Inflation, clearly, is going to continue, apace, not just in the PRC, but in other parts of Asia: It will not disappear over the period of a fortnight or so, following the similar pattern of the way in which an upper respiratory complaint clears up in a child.

The immediate effect of an aggressive lifting of interest rates in the PRC will be to see volatility in the equity markets of the country – at The Shanghai Stock Exchange and The Shenzhen Stock Exchange.

Share prices are likely to fall, initially, and the knock-on effect will be felt in the Hongkong Special Administrative Region (HKSAR) of the PRC where a large proportion of the population *'play'* at The Stock Exchange of Hongkong Ltd, often on a daily basis.

There, really, appears to be no viable alternative for The People's Bank of China because to allow inflation to escalate in the PRC will, eventually, come to mean a material erosion of the entire economy of the country.

Such a retrograde step is unacceptable.

The United States of America has been trying, for many months, to get the PRC Government to permit its currency, the renminbi, to float or, alternatively, to revalue the currency, officially.

The United States of America claims, inter alia, that the actions of The People's Bank of China, in respect of the containment of the currency of the country at its present translation value, to be grossly undervalued.

It, also, is said to give an unfair advantage to PRC manufacturers and, as a consequence, to be very unfair to the country's trading partners, specifically, of course, the United States of America.

The United States of America is the largest single market for the goods, produced in the PRC, at this time.

Today, it appears that the economic outlook for Asian equity markets is contingent upon the actions of the central banks in the region.

To attack foreign-exchange translation values, only, is unlikely to be effective in the battle against inflation, in **TARGET**'s opinion.

This is because to target, only, foreign-exchange translation values will be to undermine the economies of the region, permitting negative, real interest rates to persist.

High inflation will encourage consumer spending, leading to consumer credit growth.

This must increase debt levels, which are relatively low at this time, relative, that is, to the debt levels of, say, the United States of America and/or most parts of Europe.

Initially, the above scenario will be a support for many a company's earnings.

This may well result in investors, flocking to equity markets in order to buy the scrip of those companies which are benefitting from the situation – short term.

The companies with high earnings, in turn, will increase their leverages and, thus, the return on equity will likely appear to rise.

However, on the downside from this seemingly happy picture, the macroeconomic view is that external balances will start to deteriorate.

Demand in Asia may well continue to be strong, but, in the rest of the world, it will be wrestling with a combination of low, economic growth rates and high inflation levels.

It is likely that many current account surpluses will turn out to be current account deficits, in the most extreme cases.

Rising commodity prices are, already, cutting a swath through many of Asia's economies and, by the looks of things, this situation is likely to continue for a while.

High persistent inflation results in high significant costs to any and all economies.

It augurs in demands by labour to higher wages in order to meet the higher living costs.

The higher costs of doing business result in the spiral of businesses, having to raise prices to consumers because management cannot absorb the higher demands from labour as well as suppliers' price increases.

Profit margins are squeezed … then, slashed and, then, for many businesses, they may have to close their doors.

Thus, the competitiveness of Asia is eroded on the world stage.

To ignore inflation, short term, might appear to be beneficial, but, in the intermediate to long term, it is akin to imagining that a cancer will go into remission without chemotherapy or incising the cancer from the host.

Central banks of Asia, such as The People's Bank of China, if they abandon the myth that the main problem with their economies are their respective, undervalued currencies, and, then, turn their full attention to the matter of raising interest rates, aggressively, in order to contain inflation, the material increase in interest rates, that will be totally necessary, will have a deleterious effect on equity investors.

In short, equity prices will start to fall, smartly, volatility in daily turnovers on equity markets will increase, and many tens of billions of dollars will be lost with the erosion of share prices.

Domestic economic growth will, inevitably, slow as borrowing costs rise and demand falls off, dramatically.

This is not a very happy scenario, one may comment at this juncture.

In the past few decades, The People' Bank of China has been looking at making the fledgling industries of the PRC competitive in the world.

The PRC has been successful in this undertaking and, today, the country is the world's tailor shop, the largest manufacturer of refrigerators, microwave ovens, shoes, electronics, etc, etc, etc.

The target of the PRC's Central Bank has been exchange rates, disregarding the horrors of inflation to a great extent.

Well, now the penny has dropped.

In a world of low inflation, an undervalued currency is an edge for an economy.

In a world where inflation has become an urgent problem, other measures must be taken by the governors of central banks in order to counter the changing circumstances with which they are faced.

That is where the PRC Government stands, today.

The actions of The People's Bank of China will have major implications for the country for the remainder of this year and into at least the first half of 2009.

Low interest rates are required if a country is determined to maintain a relatively weak currency, relative, that is, to the currencies of a country's major trading partners.

As The People's Bank of China starts to increase interest rates, aggressively, it will become increasing difficult to contain the current, foreign-exchange translation values.

Thus, the price of export products will rise, cutting into the country's competitiveness.

Currency appreciation will come to mean lower economic growth.

Long term, this will be a boon for the PRC.

Wait and see.

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