Henderson Global Investors

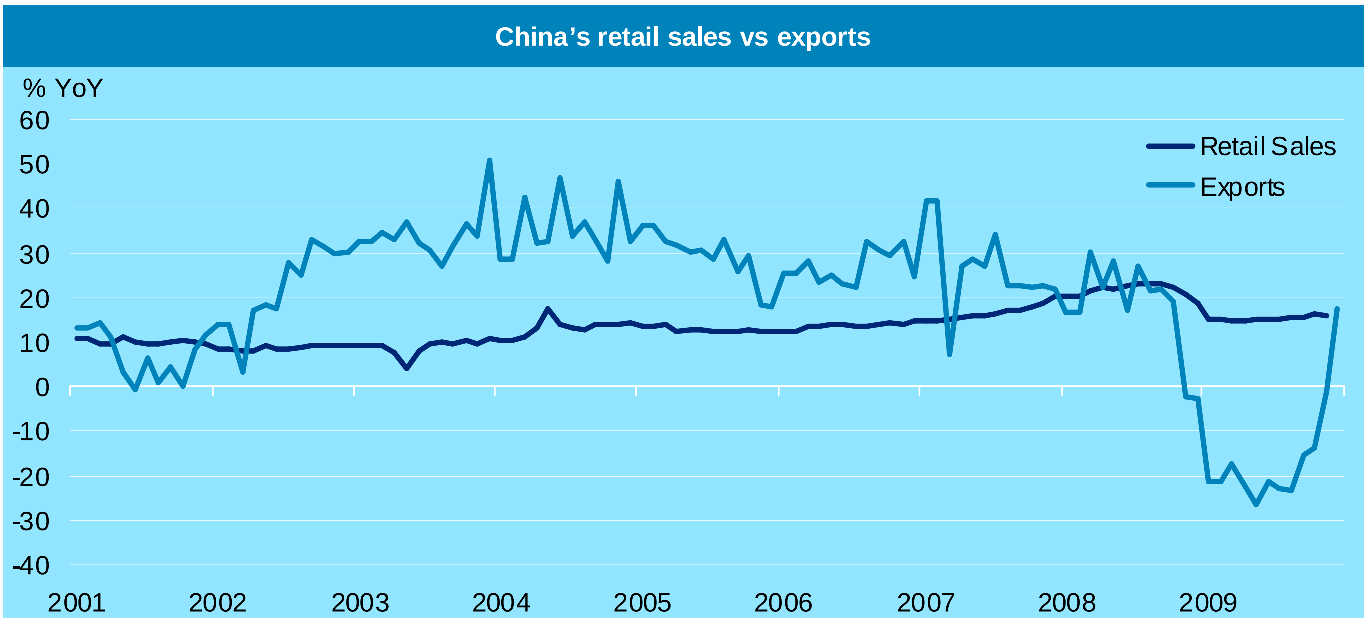
Henderson Horizon China Fund

China's government hopes to strike fine balance between growth and liquidity

In this update Caroline Maurer, co-manager of the Henderson Horizon China Fund, examines the potential impact of recent measures in China to remove excess liquidity from the market, and longer term prospects for the Chinese economy.

China's economic recovery shows no signs yet of abating, according to the most recently released economic data. Industrial production (IP) has accelerated sharply since November on a year-on-year basis and the most recent Purchasing Managers' Index (PMI) survey data indicated that both internal and external demand is on the rise. More significantly, the export sector, the segment which has lagged in the recovery due to the weak external environment, appears to be following domestic China back to health with exports rising sharply in December for the first time in 14 months (see chart below). Though it will take another couple of quarters to decide whether the rise is driven by inventory rebuild or end consumer demand, attention is turning to how quickly the Chinese government looks to withdraw its loose monetary policy.

In early January, China's central bank, the People's Bank of China (PBOC) took its first steps to remove excessive liquidity in the system, both through open market operations – including raising the yield on the three-month bill and one-year bill – and by raising the reserve requirement ratio (RRR) for commercial banks by some 50 basis points. Given that the big four Chinese commercial banks (Industrial and Commercial Bank of China, China Construction Bank, Bank of China and Agriculture Bank of China) are state-owned enterprises, the Chinese government certainly has better control over the supply of credit than most other countries in the world.



Source: Merrill Lynch Research, 1 Jan 2001 to 31 Dec 2009

We view this move by the PBOC as the beginning of the 'normalisation' process, rather than a more meaningful tightening of monetary policy. Part of the reason behind raising the RRR is to ensure that the continued supply of bank credit does not drive asset prices to unsustainable 'bubble' type levels. Consensus estimates for 2010 put the new bank lending at RMB 7-8 trillion, still a significant amount, though at a more constrained level compared to around RMB 10 trillion in 2009. Therefore we expect the PBOC will continue to hike RRR over the course of the year, using it as a safety valve whenever excessive liquidity becomes a concern. Raising the interest rate now will induce capital inflows as the US interest rate remains at a low level. Therefore PBOC is likely to face the challenge of striking a balance between sustaining economic growth and managing liquidity later in the year.

The long-term prospects for the Chinese economy have long been predicated on the government striking a balance between the country's dependence on capital investment for growth and the need to stimulate domestic consumption. The latest financial crisis has rightly pushed policymakers into taking a more proactive approach to achieve their aims. We expect the market to continue to be driven by strong earnings growth and a deepening of the economic recovery. Companies should also benefit from the initial stages of inflation. Nevertheless, volatility is likely to remain a common feature given the uncertainty surrounding the pace of recovery, the extent of domestic inflation and the consequent government policy responses. There is never a lack of scepticism towards China's future economic development. However, based on the government's track record over the last three decades, when it comes to effective policymaking, perhaps it deserves to be given the benefit of the doubt in this instance.

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For further information on the Henderson Horizon fund range please contact your local sales office or visit our website: www.henderson.com

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