Easing by People's Bank of China

November 21, 2014

In the face of weakening demand and mounting disinflationary pressures, the latest interest rate cuts by People's Bank of China was not a surprise. Capacity utilization is too low and the slack in the labor market is increasing.

Up until now, the government tried selective approaches such as making more credit available to support SMEs and key industries including railroads, but the results have not been encouraging. There is a growing likelihood that the government's target of 7.5 percent economic growth could be missed. Now the officials are willing to use a blunt tool such as across the board cut in the interest rate.

Another concern for the government is the appreciation in the value of the U.S. dollar which has risen more than 10 percent this year compared to key developed market currencies. Since the RMB is mostly tied to the dollar, Chinese exports are adversely affected. During the third quarter, the F/X reserves fell by $103 billion, the largest decline since 2001.

The Xi government has a number of key economic objectives. Economic reform (low tech to hi-tech), rebalancing (investments to consumption), financial market liberalization and the internationalization of the RMB making it a reserve currency are some of the goals.

Before the objectives can be pursued aggressively, the economic growth target must be met. Stay tuned for more economic stimulus measures in China including further monetary easing even though the government will wait and see how the latest action will affect the economy. The economic turmoil in the Eurozone and Japan are additional reasons for possible further stimulus later on.

How the Chinese economy performs is important for the global economy. China imports $2 trillion worth of goods annually. It is the locomotive for the world economy. The actions by the PBOC, the Bank of Japan and the ECB combined with the strengthening dollar could delay the planned interest rate hike by the Federal Reserve.