

PBoC Hiked Reserve Ratio Again to Rein in Liquidity

China's central bank PBoC on Monday afternoon announced a 50bps hike in banks' reserve ratio requirement (RRR) to 16.50%, effective 20 May. This is the fourth hike in RRR so far this year, and signaled the central bank's focus on tightening liquidity and lending growth, and indirectly curbing inflationary pressures. Recall that the PBoC in 2007 hiked RRR 10 times and interest rates 6 times.

Just like in its previous RRR hike on 16 April, the central bank's latest move came in response to a major data release in the morning. In this case, the April inflation data released in the morning showed continued upward pressures on consumer prices, especially food-related items. The headline inflation for April rose 8.5%/y, slightly ahead of expectation of 8.4% and the 8.3% increase in March. Particularly worrying for policymakers were food prices, which rose 22.1%/y, up from 21.4% gain in March and led by meat and poultry prices which accelerated 47.9%/y and vegetable prices which rose 13.6%. Non-food prices however held steady at 1.8%/y, the same pace as in March. While food prices may stay under pressured in the months ahead, the gradual improvement in supply especially for pork and poultry should offset some of the pressures, as surveys done by the Ministry of Commerce have shown food prices falling on a weekly basis since early April.

The PBoC is likely to stay on heightened alert over the potential anchoring of inflation expectations, even though its tools may not be able to directly address problems created by high global commodity prices and disruption in domestic supplies due to diseases and winter storms earlier this year. Given China's low loans-to-deposit ratio (0.66 in March), there is still ample room for the central bank to hike the **RRR**, and see opportunity for **at least two more rounds of 50bps hikes by end of 3Q08, to 17.50%**.

On the **interest rate front**, With 1Y deposit interest rate at 4.14% and lending rate at 7.47%, we expect the PBoC to see positive real interest rate as a policy objective. This means there is room to hike a minimum of another two rounds in 2008 (each at 27bps for depo rate and 18bps for lending rate), based on our CPI forecast of 5.2% for 2008. **This would mean end-2008 projection of 4.68% for deposit and 7.83% for lending rates.**

The currency is now the most effective tool that the PBoC has to tackle inflation and trade imbalances. We note the **RMB** has accelerated its gains vs. the USD since late December last year, and the USD/RMB has breached the psychological 7.00 level back in April. Although the RMB's moves against the USD have since stabilized, the upcoming China-US Strategic Economic Dialogue in June could stir up some action again. We still see room for further downside for the USD/RMB pair (down 4.4% YTD), and **we maintain our end-2008 USD/RMB target of 6.60, or about 11% slide for the full year vs. 6.9% in 2007.**