

China: Fifth RRR Hike This Year

China's PBoC announced after close of market yesterday (Thur, 12 May) its fifth increase of banks' reserve requirement ratio (RRR) this year, by +50bps effective 18 May. This elevates major banks' RRR to a new record high of 21.0%, surpassing previous historic high of 20.5% (last hiked on 17 Apr). In all, RRR for major banks has gone up by a total 550bps since the current cycle began in Jan 2010.

The latest PBoC move was not a surprise as data releases over the past few days have been stronger than expected despite monetary and administrative measures to rein in prices. Three particular pieces of data stood out from these reports: 1) the larger-than-expected trade surplus for Apr (US\$11.4bn vs. consensus forecast of US\$4.2bn and US\$0.1bn in Mar). 2) CPI for Apr moderated only slightly to 5.3%/y/y from 5.4% in Mar, with food price inflation rising at 11.5%/y/y in Apr after the 11.7% rise in Mar. 3) China's new loan in Apr expanded by RMB739.6bn, significantly above the RMB679.4bn increase in new loans in Mar. Taken together, it was just a matter of time before PBoC came up with another policy announcement.

So far, the trajectory on RRR is very much on track of what we have been expecting. Including yesterday's announcement, PBoC has raised RRR twice in 2Q11 (the previous one was on 17 Apr). Going forward we expect one more 50bps move in this quarter, and then slowing down to 2x 50bps moves in 2H11. This should bring RRR to 22.50% by end-2011, or a total of 400bps for the year. While PBoC Gov Zhou Xiaochuan had said earlier that there was "no absolute" limit on how high RRR can go, it should be noted that the weight of these RRR hikes is increasingly heavy, and that the burden should eventually shift to pricing, rather than quantity, of credit. Nevertheless, we continue to see RRR to be the main instrument of choice for now, mainly because of lower cost (i.e. about 1.62% paid on required reserves vs. 3%+ on 1Y bills) and flexibility (with the adoption of dynamic RRR).

As for key interest rates, we are on the lookout for PBoC to move at least another two more rounds (at 25bps each time) this year. With the last interest rate increase on 5 Apr, the next one should be sometime towards end of 2Q11. In all, we see China's 1Y lending rate at 6.81% and 1Y depo rate to 3.75%, by end-2011, after its latest interest rate hike announcement on 5 Apr which upped 1Y lending rate to 6.31% and 1Y depo rate to 3.25%.

On the currency front, the annual US-China Strategic and Economic Dialogue ended on Tue (10 May) without any major policy breakthrough as we had anticipated. One main factor was that the meetings were only at ministerial level, instead of at the Head of State level, thus diluting the significance of this latest encounter and quelling speculation earlier of a major change in RMB exchange rate policy. We continue to stay with our view of a gradual appreciation trend for the RMB of 3-5% p.a. at least for this 1-2 year, as the internationalization of RMB is the space to watch. We maintain our forecast for USD/RMB at 6.47 by end-2Q11, and 6.35 at end-2011, vs. the 6.5005 central parity on yesterday morning (6.4948 on Wed).

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