

Monday, 17 January 2011

# Flash Notes

## China: PBoC Ushers In New Year with RRR Hike

China's central bank PBoC last Fri (14 Jan) announced after market close to raise banks' reserve requirement ratio (RRR) by 50bps, bringing the rate to 19.0% for biggest banks, from 18.5% previously. This is the fourth RRR hike in a little over two months (the three previous moves were on 10 Dec, 19 Nov, and 10 Nov last year), and the seventh official increase so far in the cycle. In its typical one-liner statement, PBoC said the increase will take effect from 20 Jan, right on the day of China's key data releases for Dec, including CPI, production, investment, as well as 4Q GDP. The latest move is expected to freeze around RMB350bn of funds in the banking system.

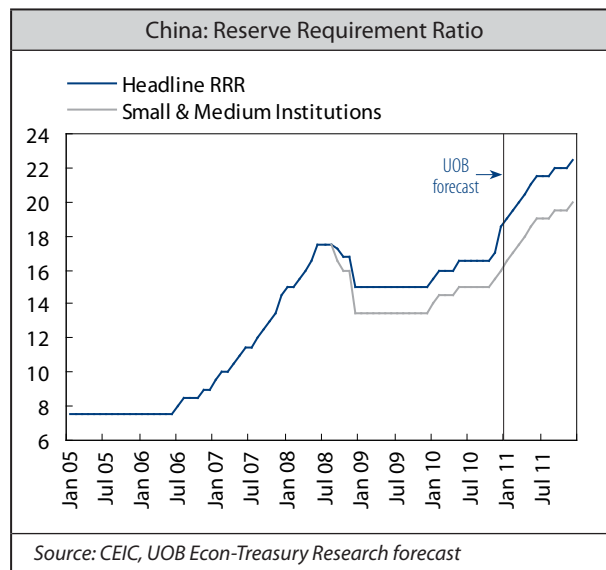
Why is the PBoC so aggressive in its tightening posture, especially having tightened benchmark interest rates just about a month ago on 25 Dec? One factor is the continued strong credit growth, with media reported earlier that Chinese banks have granted RMB500bn of new loans in the first week of Jan 2011, after the surprisingly strong RMB481bn new loans in Dec 2010 (Nov: +RMB564bn). Needless to say, the new loans target of RMB7.5tn for 2010 has already been breached, coming in at RMB7.85tn. However, with the shifting towards a "dynamic RRR" regime for Chinese banks, whereby the usual loans quotas is eliminated and that individual banks will be faced with differentiated RRR depending on operating capability, it is likely that RRR will be even more important in terms of managing liquidity conditions. In addition, PBoC would be inclined to tighten further in the months ahead given that Chinese banks typically front load their lending at the beginning of the year (e.g. new loans growth in Jan 2010 was RMB1.4tn). While there is no formal loans target for 2011, we expect new loans to come in at around RMB5-7tn in the current tighter environment, although the beginning of the 12th 5-year plan (2011-2015) would continue to support lending activities.

Another key driver for PBoC's aggressive moves is the increase in forex reserves, which rose by US\$199bn during 4Q10, to US\$2.95tn, translating to an additional RMB1.3tn of liquidity in the banking system. This would mean that PBoC would need to tighten at least two more times via RRR in the months ahead to offset a significant portion of this increase in liquidity, in addition to its regular open market operations. This is a continued theme of the current RRR hike cycle, which saw the six RRR hikes (prior to the current one) draining off bulk of the forex reserves increase of about US\$250bn in first three quarters of 2010, which translates to RMB1.7tn of additional funds.

With new loans activities likely to stay strong and the need to drain off liquidity from the accumulation of forex reserves, the risks are for further increases in RRR. This is in addition to the worries of inflation due to both domestic demand conditions as well as upward pressures on prices on commodities globally. **As such, we are raising our expectations of RRR hikes to a total of 200bps for 2011, including the latest move, from our earlier call of just a total of 100bps. We see another two additional hikes in 1Q11, to 20.0%, and three further increases, to 21.5% in 2Q11, before the pace tapers off in 2H11, with our RRR forecast of 22.5% for end-2011.**

As for benchmark interest rates, we expect slightly less forceful posture as the main focus is on containing liquidity. **Post the 25 Dec interest rate hike, we continue to expect PBoC to raise interest rates throughout 2011 with four more 25bps hikes.** This would bring the 1Y lending rate to 6.81% and 1Y depo rate to 3.75%, by end-2011, from the current 1Y lending rate of 5.81% and 1Y depo rate of 2.75%.

On the currency front, we continue to see a moderate 3-5% move annually for the RMB despite continued pressures from the US and the upcoming China Pres Hu Jintao's state visit to the US this week. We expect China to hold its ground on the currency issue in terms of pace and quantum of adjustment as it continues to internationalize RMB via other channels. We are keeping our USD/RMB forecast of 6.35 by end-2011.



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