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Flash Notes

China: Hiking RRR For The Fourth Time This Year

PBoC on Sunday (17 Apr) announced its fourth increase of the reserve requirement ratio (RRR) this year, by 50bps to a record high 20.5% for major banks, with effect from 21 Apr. So far, the RRR has been increased a total of 500bps or 10 times since the PBoC began its policy normalization in Jan 2010.

The latest announcement on RRR hike did not come as a surprise both in terms of timing and quantum, as we had flagged an imminent RRR move after last Friday's data releases, which were too "high/fast" for the key ones watched by PBoC/govt. To recap, 1Q11 GDP headline growth came in at 9.7%y/y, vs consensus of 9.4% and hardly changed from 9.8% in 4Q10, while CPI for March rose 5.4%y/y vs. average of 4.9% in Jan-Feb, and non-food prices, as reflected in PPI, are also showing signs of upward pressures. These data show that China's monetary policy normalization has yet to have a significant effect on growth or prices, and tightening measures are expected to continue in the months ahead.

Implications

So far, the trajectory on RRR is very much on track of what we have been expecting. **In addition to yesterday's announcement, PBoC has raised RRR three times in 1Q11 (the previous one was on 18 Mar). Going forward we should see another 2x 50bps moves in 2Q11, 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 was quoted by Bloomberg as saying on 16 Apr that there was "no absolute" limit on how high RRR can go, it should be noted that the weigh of these RRR hikes is increasingly heavy, and that the burden would 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) this year. With the last interest rate increase coming in just 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 USD/RMB moved in line with our expectation in 1Q, ending at 6.5486/USD, or 0.6% lower (our expectation was 6.53) or annualized 2.6%. This is consistent with our and consensus view that the RMB would appreciate at a 3-5% annual rate against the USD and we continue to see such measured pace through the remainder of 2011 (note that 1Y nondeliverable forward (NDF) market was pricing in a RMB appreciation of 2.3% late Fri). One key factor underpinning our view is the continued internationalization of the RMB, which is taking some of the appreciation pressure off the currency. The development of the offshore RMB is gathering speed, as RMB deposits in HK surged to another new high of RMB407.7bn at end-Feb 2011, a gain 10%m/m and the 16 months of increases since Oct 2009. We maintain our forecast for USD/RMB at 6.47 by end-2Q11, and 6.35 at end-2011, vs. the 6.5310 fixing this morning (fixing was 6.5301 on Fri).