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Thursday, 01 December 2011

Flash Notes

China: PBoC Moves To Lower Reserve Requirement Ratio

After close of Asian session yesterday (Wed, 30 Nov), PBoC announced a 50bps cut to banks' reserve requirement ratio (RRR), bringing down the ratio from record high to 21% for large banks and 19% for smaller institutions, with effect from 5 Dec. As in previous cases of such moves, this would free up about RMB350bn of funds in banks, thereby relieving some strains that have been in place since China began tightening its policy in January 2010.

This is the first easing in nearly three years and is consistent with a shift in policy stance in most central banks, especially in Asia and other emerging economies, as Eurozone sovereign debt crisis continues to deteriorate. Coincidentally soon after PBoC's announcement, major central banks led by the US Federal Reserve announced coordinated actions to extend US dollar liquidity swap arrangements to 1 Feb 2013 and lower the pricing of existing USD liquidity swaps by 50bps from OIS+100bps to OIS+50bps.

Timing Not A Surprise
While the RRR cut appears to be earlier than expected, we had cautioned previously that such a move (rather than interest rate cuts) would come in sooner rather than later, ever since the credit trouble of China's SMEs and risks of alternative financial channels surfaced earlier, especially reports out of Wenzhou in late Sep/early Oct. Recent reports of PBoC selectively loosening of RRR for some institutions also means that an official reduction would have to be announced soon. Further spurring policy action was the sharp fall in the preliminary HSBC/Markit PMI report last week, which indicates that domestic manufacturing activities could be decelerating faster than expected, while inflationary pressures are expected to be easing off further into 2012. At the same time, Eurozone sovereign debt crisis continues to drag on and puts global economy at risk, as it spreads in these two years from smaller peripheral countries (Ireland, Greece, Portugal), to larger economies recently (Italy, Spain), and is now weighing on core countries (Germany, France) as well, going by the "failed" German bund auction last Wed. With both domestic and external worries mounting, the urgency for PBoC to "fine tune" its policy tools has taken on even more importance.

More RRR Cuts Ahead? And Interest Rate Cuts Too?
Yesterday's announcement marks a reversal in policy stance, as the central bank last raised interest rates less than 5 months ago (6 Jul), and last hiked its RRR on 14 Jun. With the first step in policy "finetuning" taken, we expect more RRR cuts to be in store, although it is likely to be a measured approach as in the case of RRR hikes in the past two years. This means that another 50bps reduction in RRR could be possible by end-2011/early 2012, just before the surge in liquidity demand ahead of Lunar New Year (Spring Festival) period.

Will there be reductions in interest rates as well, soon? Not at this point. One factor is that headline inflationary pressures need to normalize, possibly sustaining at 4-5% (Oct: 5.5%y/y) to justify bringing down interest rates as authorities are still wary of fanning asset price bubbles. Therefore we see current policy interest rates (last hiked on 6 July, to 6.56% for 1Y lending and 3.50% for 1Y deposit) to last at least until mid-January 2012, before the downtrend begins.

In terms of FX policy, China currently has no appetite for any aggressive strengthening of the RMB despite pressures from the US in recent summits (APEC in Hawaii and East Asia Summit in Bali). Therefore the currency remains on track for a moderate 3-5% annual appreciation. We expect USD/CNY at 6.30 at end-2011 and 6.05 at end-2012, from 6.3789 yesterday. RMB is currently up 3.3% YTD against the USD.