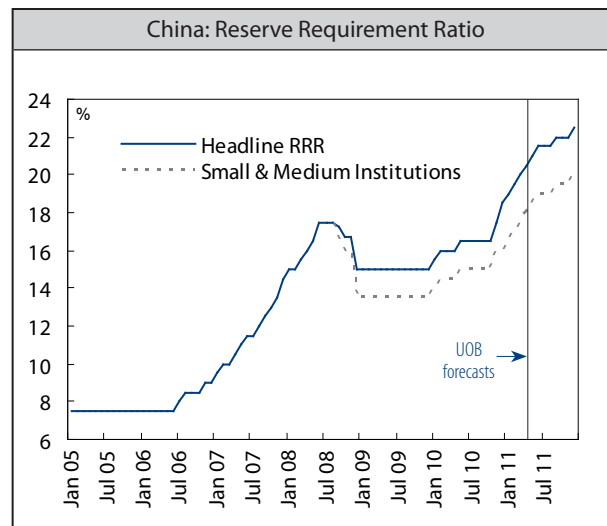


Monday, 21 February 2011

Flash Notes

China: Another RRR Hike To Drain Liquidity

China's central bank PBoC announced last Fri (18 Feb) that it will raise banks' reserve requirement ratios (RRR) by 50bps starting 24 Feb, barely 10 days after its announcement of benchmark interest rate increases. This is the second time so far this year that RRR is raised, having kicked off 2011 with a similar 50bps move on 14 Jan, and after at least 6 rounds in 2010. The latest announcement means that major banks will have to set aside 19.5% (from 19.0%) of their reserves while smaller banks will have to keep 16% of their deposits in reserves, siphoning off about RMB300-350bn of liquidity from going into bank lending.



The aggressive nature on the RRR is a reflection of credit growth that was still strong, as well as inflationary pressures on consumer prices, while a new set of property prices showed little impact from administrative measures and tightening policy moves since last year. Added to this was the G20 FinMin/CenBank meetings set for the weekend in Paris, where China's currency and global imbalances were on the agenda.

New loans granted in January came in at RMB1.04tn, which was certainly too high for PBoC despite the frontloading nature of Chinese credit growth, following the RMB8tn of new loans created in 2010. While China's consumer price index rose a less-than-expected 4.9%/y/y in Jan, it was still higher than the 4.6% pace from last Dec. More importantly, we expect consumer prices to accelerate in the months ahead especially in Feb (Chinese new year effect) and in the context of worldwide increases in commodities prices. We expect overall headline CPI is to hover in the 5% range in the next few months, compared to government's inflation target of 4% for 2011 (CPI in 2010 rose 3.3% for the full year).

Asset prices are hardly dented despite steepening of administrative measures and normalizing of monetary policy since last year. The new set of official property price index launched last Fri showed home prices for Jan rose in all except two of the 70 cities, with prices in Beijing advancing 6.8%/y/y while Shanghai climbing 1.5%, and prices in Haikou having the biggest gain, surging 21.6%, and 10 cities had increases exceeding 10%. This would harden the resolve for more tightenings ahead.

Given the above, the latest announcement was not entirely surprising. We had anticipated at least three hikes each in 1Q11 (which means another one to go for this quarter, possibly starting from 14 Mar, around data releases and after the annual NPC congress) and also in 2Q11, before the pace eases off in 2H11. **As such, we reaffirm our end-2011 forecast for the RRR at 22.5%, for a total of 400bps increase this year.**

On the interest rate front, we expect more to come in terms of hikes even within a context of an aggressive RRR campaign that is still underway. This is mainly because, compared to interest rates, RRR has only an indirect effect in curbing consumer price rises or even on property prices. At the same time, negative real interest rates would continue to be supportive of speculative activities in asset and property prices. **We continue to look for PBoC to raise interest rates throughout 2011, with another three more 25bps hikes over the next three quarters.** In total, this would bring the 1Y lending rate to 6.81% and 1Y depo rate to 3.75%, by end-2011, from 1Y lending rate of 6.06% and 1Y depo rate of 3.00% currently.

While the RMB earlier saw a big jump of 0.21% to close at 6.5732/USD last Fri, the highest since late 1993, it was most likely in response to the G20 FinMin meetings ahead of the weekend. **We see the main scenario for RMB to be moderate appreciation of 3-5% annually against the USD in the next 1 to 2 years**, as historically the unit rose by about 4% annualized during the 2005-2010 period. We also see low risk of a large one-off revaluation given the extremely thin profit margins for exporters. However, internationalization of the RMB / offshore RMB is one key development that should be watched closely, which would have more material effect on Asian currencies (please refer to our report "China: RMB internationalization in progress" dated 14 Feb, for more details). For now, we are keeping our USD/RMB forecast of 6.35 for end-2011, or a 3.6% drop from 6.59 at end-2010.

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