

## China: Interest Rate Hike On Track in 2011

China's central bank PBoC announced yesterday (Tue, 8 Feb) that it will raise its benchmark 1Y deposit and lending rates by 25bps each, effective from today. This is the first interest rate hike in 2011, the second one in just over a month and third move in four months (two previous interest rate hikes were on 19 Oct and 25 Dec last year). The latest announcement will lift the benchmark 1Y lending rate to 6.06% from 5.81%, and the 1Y deposit rate to 3.00% from 2.75%. Other tenors were also raised but in an asymmetric manner.

With China's financial markets resuming today after a week-long break from the Lunar New Year celebrations, this is clearly a negative event and a somber reminder that monetary policy normalization is still on track and there are more tightening measures on tap to curb price pressures and to rebalance the loose credit environment that had been the norm in the last two years. The PBoC's hawkish stance is partly the reason for China's equity market having the worst performance in Asia last year, with a 14% decline.

One key indicator obviously is inflationary pressure in China, which came in at 3.3% in 2010 and is likely to push towards the 5% range in 1Q/2Q before tapering off in the second half of this year, given strengthening demand and the supply squeeze on commodities. With our projection of about 5% for China's overall inflation rate this year, there is still some way for real deposit interest rate to return to positive territory. Furthermore, with credit demand still unacceptably strong (new loan granted in Jan reported to have exceeded RMB1.2tn, vs. RMB1.39 in Jan 2010), there is obviously a critical role for interest rate to play as a pricing mechanism. However, the concern of capital inflows due to interest rate differentials is one main hindrance for more aggressive tightening not just in China, but elsewhere in Asia as well.

As such, we still expect a slightly less forceful posture on the interest rate front. **We continue to look for PBoC to raise interest rates throughout 2011, with another three more 25bps hikes.** 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.

As for reserve requirement ratios (RRR), PBoC would likely favour this tool to manage the liquidity inflows and forex reserves increases. **We continue to see a total of 400bps increase in RRR for 2011 (including the 50bps hike to 19.0% announced on 14 Jan).** This assumes two additional hikes in 1Q11 (to 20.0%), and three further increases in 2Q11 (to 21.5%), before the pace slows down in 2H11, with our RRR forecast of 22.5% for end-2011.

**As for the RMB, the main scenario is likely to be moderate appreciation of 3-5% annually against the USD in the next 1 to 2 years,** as historically the USD/RMB has fallen about 4% annualized during the 2005-2010 period. We also see fairly 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 for its scope and pace, which could have material effect on Asian currencies. 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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