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China's Triple Whammy Policy Moves - RMB Reval Next?

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After the close of Asian markets on Fri (18 May), China's central bank PBoC in one fell swoop announced a trio of monetary policy moves: i) raising benchmark interest rates; ii) raising banks' reserve requirement ratio (RRR); and iii) widened the USD/RMB trading band.

Briefly, China's Latest Monetary Policy Actions:

i) Benchmark deposit and lending rates were raised, with 1Y deposit ceiling rising by 27bps to 3.06% from 2.79%, and the 1Y lending rate rising by 18bps to 6.57% from 6.39%, effective 19 May. China's interest rates were last raised on 17 Mar 07 and Fri's move was the fourth increase in interest rates since 27 Apr 2006.

ii) Banks' RRR is raised another 50bps, to 11.5% effective 5 Jun. The latest hike came less than a month from the last increase (29 Apr), and is the fifth RRR hike this year and the eighth since June 2006.

iii) USD/RMB daily trading band is raised to +/-0.5% from +/-0.3% effective Mon 21 May.

Why Did China Take Such Drastic Steps?

These unusual steps of a "triple whammy" are essentially in response to domestic conditions and external political pressures (mostly US) for a stronger Chinese currency to address global imbalances.

Domestically, China's stock market has become increasingly frothy over the past six months, notwithstanding the sharp correction (and subsequent recovery) at end-Feb. Official concerns have been getting louder and clearer, especially with recent comments from Premier Wen and PBoC Gov. Zhou.

Data wise, the latest batch of figures for Apr, released in the last 2 weeks, continued to point firm growth in almost all areas, i.e. inflation, monetary, production, trade, investment, and property sectors.

External pressures on China's currency have also intensified. The currency band widening was a pre-emptive move before the weekend's G8 Finance Ministers meeting in Postdam, Germany, and more importantly a gesture of goodwill ahead of this week's (22-23 May) high-level Second US-China Strategic Economic Dialogue in Washington, DC.

In particular, China was wary of threats of trade legislation in the US that have been rising since the midterm elections in the US last Nov. The latest was US Senate's rare joint hearing earlier (9 May) to discuss "currency manipulation" by China and Japan. Currently, US Senate Finance Committee Chairman Max Baucus and Sen. Charles Grassley are working with other senators on a bill to address these concerns about Chinese trade and currency practices.

Comments/Implications:

The hikes on interest rates and RRR have been well anticipated given that the latest set of data continues to indicate firm economic growth and strong liquidity in the system. However, the surprise was lending rate actually rose a smaller than expected 18bps, instead of the usual 27bps. This means that further interest rate hike is still likely, possibly in the second half, and **we look for at least another 2 more interest rate hikes of 18bps each, to bring 1Y lending rate to 6.93%. Likewise, for the RRR there is still room to move higher for at least another 2 increases of 50bps each to bring the rate to 12.5%.**

Widening of the USD/RMB trading band was a surprise as the probability of such a move had been fairly low. We see the band widening a largely symbolic/goodwill gesture to bring to the US later this week for the Strategic Economic Dialogue. It could deflect political pressure for appreciation somewhat, although this would just be a temporary relief for China. In reality, the old +/-0.3% daily band - which has been in place since early 1990's - has yet to be tested and there was no good reason to make any changes at this point. Thus we expect little impact of the new +/-0.5% band on the daily trading of USD/RMB, and could mean relatively muted impact for Asian currencies as well at this point.

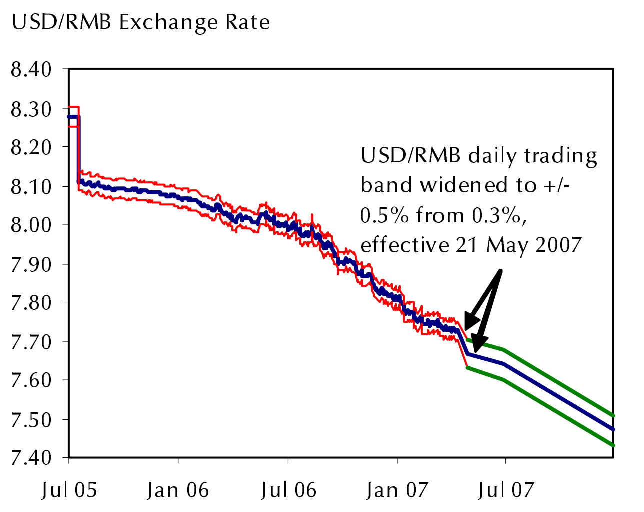
For now, we maintain our gradual appreciation trend of around 4% annually for the RMB, and continue to see RMB strengthening to 7.64/USD by end-2Q07 and 7.47/USD by end-2007, from new record high of 7.6686/USD on Fri close. Ironically, the NDF market late Fri was pricing in a smaller, annual appreciation of 5.5% for the RMB against the USD vs. 6% range earlier.

However, with the band widening, we are watching out for signs of potentially even more significant move on the RMB as trading volatility is likely to rise sharply. We think the risk of a one-off revaluation has nudged up somewhat as a result of the likely higher volatility. One key sign would be how the RMB's daily moves would fare post-band widening. A rising frequency of daily moves beyond the 0.3% range could be a possible signal for a revaluation on the USD/RMB rate, possibly in the order of a 4-5% move (at least doubling the 2.1% reval in Jul 2005).

On the equity front, China's market is likely to respond with a soft bias and in more volatile fashion when trading reopens today (Mon 21 May) after these weekend announcements. Regional bourses likewise would react negatively at least temporarily to the new uncertainty. However, these policy steps are unlikely to cause significant downward adjustment as China's market is possibly "immune" to such a long campaign of hikes since Apr last year.

However, market-specific measures such as capital gains tax and taxes of securities trading on China's equity trading could be more potent in terms of curbing the "market bubble" and would have sharp knock-on effect on regional markets, as the Feb episode demonstrates.

RMB Trading Band Widened - More Volatility Ahead



Source: Bloomberg; UOB forecasts