

China's First Reserve Ratio Hike in 2008

After market close yesterday (Wed, 16 Jan), China's PBoC announced the year's first reserve requirement ratio (RRR) hike. The central bank said it will raise the ratio by the usual 50bps to a record high of 15%, effective 25 Jan. This is the 11th consecutive increase in the RRR, extending the 10 hikes in 2007.

The latest move by the PBoC is a clear manifestation of the monetary policy tightening stance that was formalized in late 2007 as pressures on domestic price prices continued to build up. The move also came ahead of the latest batch of data releases over the next week and are expected to show CPI data still staying high. Recall that Nov CPI rose an 11-year high of 6.9%/y and Reuters yesterday reported a "whisper number" of 6.5% for Dec, which would still be unacceptably high for policymakers. Recent government actions to establish price controls on essential commodities suggested the severity of consumer price increases, as a result of both international commodities prices as well as loose liquidity domestically.

However, with risks remaining of the US economy going into recession and US rate cuts likely to continue well into end of 2008, we could see the PBoC to turn more cautious in its policy tightening. One key factor is the rate differential between US and China which could further exacerbate capital inflows into China should PBoC over tighten. As such, we expect the pace of RRR hikes to be somewhat slower in 2008, compared to the 10 hikes seen in 2007.

Beside RRR, we expect China to continue pursue interest rate policy, loans growth target, as well as RMB to curb inflationary pressures. On the currency front, we continue to maintain our forecast of about 7% gain for the full year in the RMB to 6.86/USD by end-2008, a similar pace to 2007. However, the risk to the RMB remains on a faster acceleration to curb pressures from international commodities prices but we expect any pick up in RMB gains to stay inside below the 10% rate for the full year.