

PBoC Turns Aggressive on Reserve Requirement Hike

- China's central bank PBoC last Saturday (7 Jun) announced on its website an aggressive two-step 100-bp hike in banks' reserve requirement ratio (RRR), from the current rate of 16.5% to 17.0% effective from 15 Jun, and then to a record high of 17.5%, effective 25 Jun. While it represents a two 50bps moves, it nevertheless is spread over the same month. This latest announcement represents PBoC's 5th move on the reserve requirement so far this year - turning into an almost monthly affair - after hiking in 2007 the RRR 10 times and interest rates 6 times.
- Continued flush liquidity in the banking system and domestic inflationary pressures underscore the aggressive tone in the latest move. China's flush liquidity conditions in the banking system continue to persist, as the gain in forex reserves of US\$154bn in 1Q08 (to US\$1.68tn), far outpaced the trade surplus (US\$58bn) and FDI (US\$35bn) in the Jan-Apr period. This suggests that hot money flows continue to persist. Of note is that unlike previous announcements, this one came just before the release of major data releases for May, suggesting that the May inflation data could be worse than 12-year high reading of 8.5% in April, in view of record high crude oil prices as well as the impact from the Sichuan earthquake on 12 May.
- With China's financial markets closed for a public holiday today, its equity markets are expected to face downward pressure on Tue, even after having fallen 35% YTD. However, the PBoC's tightening stance is expected to remain for sometime given the persistent nature of capital inflows and inflation. Currency will be PBoC's remaining tool in the current environment. We continue to see room for further downside for the USD/RMB pair (down 5.5% YTD to post-reval low of 6.9230), and we maintain our end-2008 USD/RMB target of 6.60, or about 11% slide for the full year vs. 6.9% in 2007.