

China: Taking Its First Step Towards Policy Reversal

China's central bank PBoC announced on its website yesterday evening (Tuesday 12 Jan) a 50bps hike in reserve requirement ratio (RRR) for large banks, from 15.5% to 16.0%, effective Monday 18 Jan. Smaller banks' RRR (currently 13.5%) is not affected by this latest announcement. This is the first increase in the RRR since June 2008 and obviously carries a significant message, although the official announcement was brief (only 3 lines) and did not provide any explanation or rationale for the increase.

Despite earlier signs (raising of central bank bill yields this week and lowering of loan growth target), the decision by PBoC to hike RRR came as surprise by its (earlier-than-expected) timing, as Bloomberg reported market consensus (including ourselves) was looking for a hike in RRR only from 2Q10. In addition, the move came just ahead of the typically strong liquidity demand period prior to Chinese New Year (Feb this year), and also the annual National Peoples' Congress sessions in March.

The earlier-than-anticipated move suggests that indicators are sufficiently urgent/critical for the authorities to take concrete actions to steer towards unwinding of the loose monetary policy. These indicators are well known: new loans granted in China has increased a record RMB9.21 trillions for the first 11 months in 2009 (more than 3x the annual average of RMB2.9tn between 2004-2008), "bubble" like conditions in China's real estate prices, exports rose for the first time in 14 months in December, and nascent signs of increases in consumer prices, especially for food and energy.

Implications

As highlighted in our latest Quarterly Global Outlook (released on 22 Dec 2009), we had expected China to raise RRR (in 2Q) before moving on to hike its benchmark interest rates later in the year in 3Q10. While the timing is off, we still continue the quantum to remain, i.e. RRR heading towards 18.5% by end-2010 (6x increases in total at 50bps each) as we explained in the Quarterly report, with the risk now certainly on the upside. This suggests that PBoC policy reversal could be earlier and more aggressive than we anticipated in terms of interest rate increases, which we had projected to rise to 5.85% by end-2010, from 5-year low of 5.31% currently (for the benchmark 1Y lending rate). We will adjust our interest rate forecasts should the RRR hikes come in faster than we expected.

Despite this latest announcement, the RMB is likely to remain relatively benign in the 3-6 month horizon given the various considerations. Among others, China is certainly concerned about the impact of currency moves on its forex reserves and the impact of a large move on the USD itself (our latest Quarterly Global Outlook outlined the difficulties for a substantial move in RMB). We continue to expect the USD/RMB pair to ease slightly towards 6.81 by mid-2010 and then to 6.77 by end-2010, from current 6.827 level.

On the equity market front, China's stock markets are likely to react negatively today to the RRR announcement, which signals the winding down of "cheap and easy money", and has come earlier than expected and could also bring forward the schedule and extent of monetary policy reversal. However, PBoC still needs to balance between liquidity tightening, meeting growth target, and orderly deflation of asset bubbles. This means policy moves ahead are still going to be cautious and measured.

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