China’s latest rate hike may not be the last, despite slowing growth indicators

China’s central bank (PBoC) announced another rate hike yesterday evening, after the market close. The move is the fifth rate hike since last October, on top of a series of hikes in required reserve ratios (RRR) as the authorities seek to rein in inflation.

Although the rate hike may have surprised some observers who thought the tightening cycle had ended, especially after Premier Wen Jiabao’s remarks last week declaring “victory” in the battle against inflation, most analysts had anticipated it ahead of next week’s data release, which is expected to show a rise in June inflation to above 6% (BBVA: 6.1%y/y; consensus: 6.2% y/y).

The move is also in line with our baseline projection, in which we now expect one more interest rate and one more RRR hike during the remainder of the year.

- The People’s Bank of China (PBoC) announced a 25bp interest rate hike yesterday evening. The move follows a rate hike in April, and is the fifth since last October (Chart 1). It comes on top of six hikes in the required reserve ratio (RRR) this year (Chart 2), as the authorities implement an aggressive tightening campaign to rein in inflation. There was relatively little market reaction, as the move had been rumored.

- It is notable that the current interest rate hike is symmetric, with lending and deposit rates increased in tandem. Last April’s hike was also broadly symmetric, in contrast to previous months in which rate hikes were tilted toward deposit rates. The symmetric nature of the rate hike will help preserve banks’ interest margins, and probably reflects the authorities’ growing concern about bank profitability as the economy slows, and after the series of RRR hikes which tend to dent bank returns.

- As with previous rate hikes, the timing of the current move comes ahead of the release of important data, including June inflation and Q2 GDP along with other activity and credit indicators (to be released on July 15). We expect Q2 GDP growth to ease to 9.5% y/y from 9.7% y/y in Q1 2011, and CPI inflation in June to rise to 6.1% y/y from 5.5% y/y in May (Chart 3).

- We believe the rate hike is intended to keep inflationary expectations in check, as a signal of the PBoC’s commitment to maintaining a tight monetary stance ahead of next week’s high inflation figure. That said, with activity indicators slowing, the PBoC is now likely to adopt a more cautious approach, and we expect only one more interest rate and RRR hike during the remainder of the year.

- While some analysts predict no more rate hikes given expectations of easing of inflation in the months ahead, we believe that underlying inflation and growth remain sufficiently strong to warrant some further modest tightening. We believe there is currently little room for further aggressive RRR hikes given tighter liquidity conditions (short-term interest rates have risen sharply in recent weeks.), although that could change if capital inflows, and hence liquidity, increase.

- Looking ahead, we expect the CPI to decline gradually in the coming months due to the impact of monetary tightening, base effects and lower commodity prices. We expect inflation to average around 5.0% for the full year, well above the official target 4.0% target.

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Chart 1: Five interest hikes since last October to rein in inflation

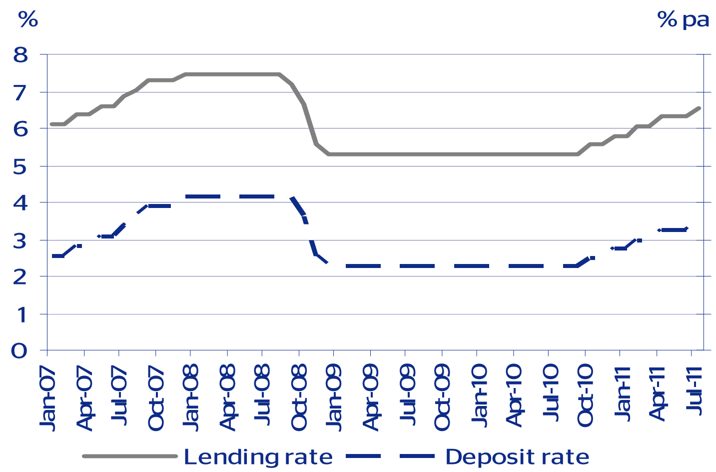


Chart 2: The RRR has been hiked on a monthly basis so far in 2011

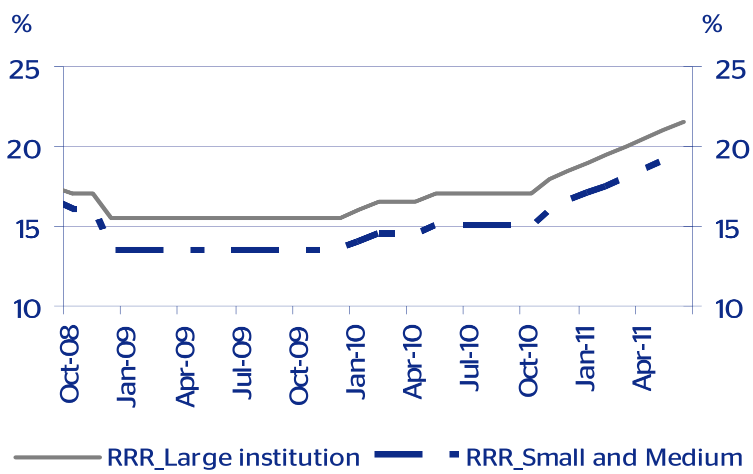
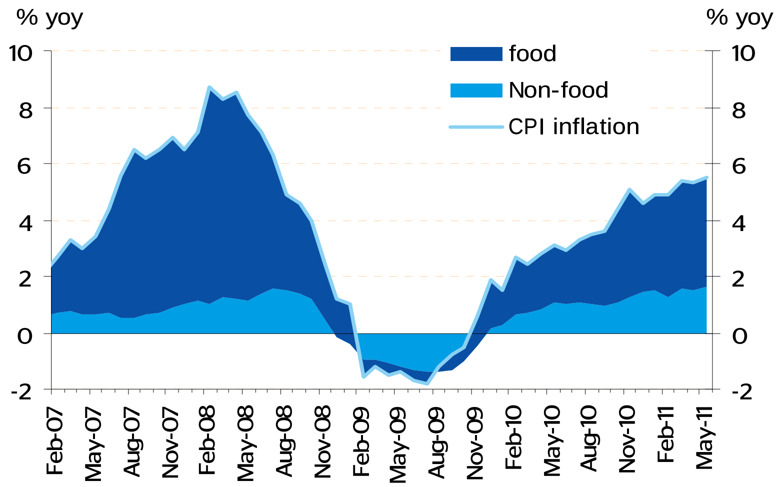


Chart 3: Inflation has been rising and is expected to peak in June



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