February 9, 2011 Emerging Markets unit

Summary: China's central bank announced another interest rate hike late yesterday (after regional markets had closed), the third hike since October. The current hike raises the benchmark deposit and lending rates by 25 basis points each, and is effective today (the first business day following the extended Chinese New Year holiday). While the exact timing had not been anticipated, the move itself is not a surprise given our and broader market expectations of further monetary tightening in China to slow credit growth and tame rising inflation. Markets in Asia were down slightly in early trading today, but have mostly taken the rate hike in stride. Looking forward, we expect more monetary tightening measures in the coming months, including two rate hikes and at least another 100 basis points of increases in reserve requirements. We are maintaining our GDP growth projection of 9.2% in 2011 in line with our baseline scenario of a soft landing.

Another rate hike, in line with expectations

- The People's Bank of China (PBoC) raised its one-year benchmark lending and deposit rates by 25 bp each, effective today. It is the third rate hike since October. As was the case in the two previous interest hikes (in October and December), deposit rates were raised by relatively more at other maturities (about 30 to 40 bps), meaning that the rate hike is asymmetric, and should result in an effective narrowing of net interest margins. The rate hike comes on top of a series of recent hikes in required reserve ratios (Chart 2), all of which have signaled a more aggressive monetary tightening stance in response to rising inflation and faster than expected GDP and credit growth indicators.

- This interest hike comes ahead of next week's release of January activity and price indicators, including headline inflation, new loans, M2 growth, industrial production, retail sales, urban fixed asset investment, and trade. We expect January inflation to rise above last month's 4.6% y/y print, to at least 4.9% y/y (consensus: 5.3% y/y), although the timing of the rate hike could indicate the authorities are expecting a higher outturn. Rising food prices are likely to continue driving headline inflation, although pressure have spread to non-core items as well.

- Looking forward, we expect more monetary tightening measures ahead, including two more rate hikes in 2011, mostly likely in Q2 and Q3, along with additional 100bp increases in the RRR, likely to be front-loaded in the first half of the year. Nevertheless, given the strong growth momentum and supportive fiscal policy in 2011, we anticipate strong growth to continue, at 9.2% for 2011, in line with our soft landing scenario.

Chart 1 Interest Rate Hikes

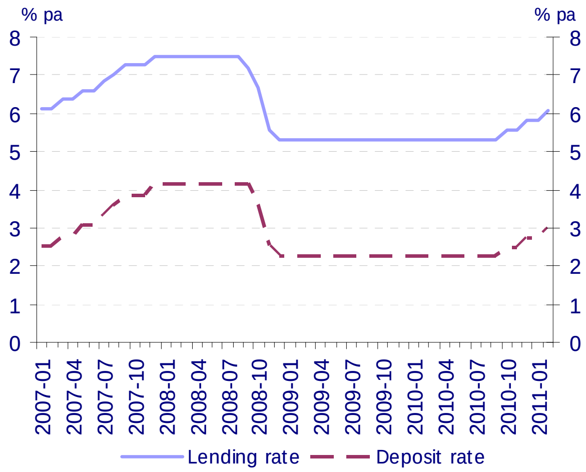
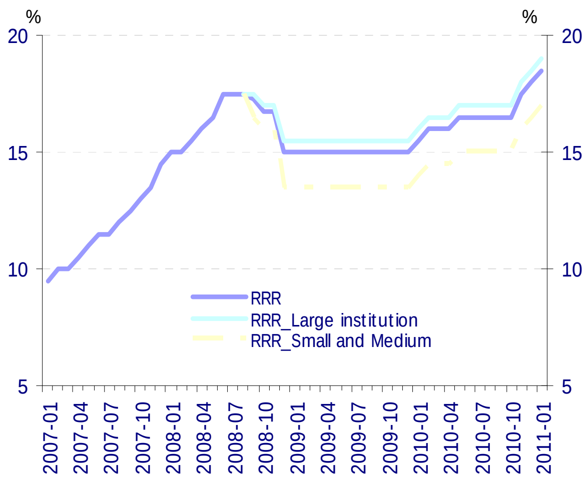


Chart 2 RRR level



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