UOB Economic-Treasury Research
Company Reg No. 193500026Z

Suan Teck Kin Suan.TeckKin@UOBgroup.com

Monday, 24 November 2014

Flash Notes

China: Surprise Interest Rate Cuts To Support Growth

- PBoC unexpectedly cut its interest rates for the first time in more than 2 years, with asymmetric reductions for deposit and lending rates, and liberalizing further the interest rate market by raising deposit rate ceiling

- The central bank acknowledged downside risks to growth and high costs of borrowing for businesses as key factors for the move, though the move was largely aimed at lowering of borrowing costs after deposit rate ceilings are taken into account.

- With the latest adjustments, overall demand conditions are unlikely to be significantly affected. As such, we expect our growth forecast of 7.4% for 2014 and 7.5% for 2015 to be on track, as we expect further market liberalization and (targeted) interest rate/reserve requirement rate cuts into 2015 to keep growth steady.

Surprise Interest Rate Cuts

After keeping interest rates unchanged for more than two years, PBoC announced last Fri evening (21 Nov) unexpectedly its first interest rate cuts for the first time since July 2012, with asymmetric reductions for deposit and lending rates, and at the same time liberalizing further the interest rate market by raising the deposit rate ceiling. The changes took effect the following day, on 22 Nov.

As shown in the table below, the reductions were asymmetric with deposit rates cut by 25bps (except for the 2-year tenor), and the lending rates were reduced by 40bps. At the same time, PBoC also announced further interest rate liberalization, by increasing the deposit rate ceiling to 1.2 times of benchmark rate, from 1.1x previously that was announced in June 2012.

China: Benchmark Interest Rates

	From 22 Nov 2014 (New) %	From 6 July 2012 (Old) %	Change bps
Demand Deposit	0.35	0.35	0.0
Fixed Deposit			
3 months	2.35	2.60	-25.0
6 months	2.55	2.80	-25.0
1 year	**2.75**	**3.00**	**-25.0**
2 years	3.35	3.75	-40.0
3 years	4.00	4.25	-25.0
Lending Rates			
1 year or less	**5.60**	**6.00**	**-40.0**
Above 1 year to 5 years	6.00	6.40	-40.0
Above 5 years	6.15	6.55	-40.0

Source: PBoC, UOB Global Economics & Markets Research

Another Targeted Move: Deposit Rates Largely Unchanged

Of note though is that, after taking into account the new deposit rate ceiling (now 1.2 times above benchmark deposit rate, from 1.1 time prior to Friday), the announcement turns out to be more targeted in nature than it first appeared and was clearly aimed at reducing borrowing costs while preserving the purchasing power of savers as China shifts towards a domestic demand model.

The 1-year deposit rate is nominally lowered by 25bps to 2.75%. In the current competitive environment for deposits, banks are likely to pay the maximum 1.2 times above the benchmark rate, which would be 3.30% for the 1-year rate. This is exactly the same 1-year deposit rate prior to Friday's change with the 1.1x ceiling, as shown in the table below. For other tenors and after applying the ceilings, deposit rates have stayed largely the same as before (except for the 2 to 3 year tenors).

China: Comparison of Changes Deposit Interest Rates (With Ceilings)					
	From 22 Nov 2014 (New) %	After Applying 1.2x Above Benchmark %	From 6 July 2012 (Old) %	After Applying 1.1x Above Benchmark %	Change (After Applying Ceilings) bps
Demand Deposit	0.35	0.42	0.35	0.39	3.5
Fixed Deposit					
3 months	2.35	2.82	2.60	2.86	-4.0
6 months	2.55	3.06	2.80	3.08	-2.0
1 year	**2.75**	**3.30**	**3.00**	**3.30**	**0.0**
2 years	3.35	4.02	3.75	4.13	-10.5
3 years	4.00	4.80	4.25	4.68	12.5
Source: PBoC, UOB Global Economics & Markets Research					

What Motivated PBoC?

It is clear that last Friday's announcement was biased towards lowering of loans interest rates while keeping deposit interest rates stable especially if commercial banks apply the maximum allowed ceiling of 1.2x to compete for deposits.

In certain sense, this could be interpreted as just another "targeted" policy move, along the line of previous measures on reserve requirement ratios (RRR), loan-to-deposit (LD) ratios, and a slew of liquidity tools (including Standing Lending Facility (SLF), Medium-term Lending Facility (MLF), Pledged Supplementary Lending (PSL)) etc, rather than broad-based interest rate cuts or a shift towards outright monetary stimulus.

Indeed, in the Q&A accompanying the PBoC statement, high borrowing costs, as well as difficulty of getting loans, especially for smaller enterprises, were highlighted as a major factor for the rate cuts, though the central bank emphasized that the overall policy stance remains stable. While it acknowledged downside risks to growth and also difficulty in these early stages of economic restructuring, the size and resilience of the economy, ample market opportunities, and flexibility in the economic restructuring mean that there is no need for stimulus policy, and the central bank would maintain its current policy stance.

Implications

In taking to interest rate cuts, the PBoC was clearly wary of the high borrowing costs faced by businesses, as well as the soft economic data going into the fourth quarter of 2014, which was heightened by the flash manufacturing PMI for Nov last Thur (20 Nov) that came right smack at the 50 level, and at the lowest in 6 months.

However, the PBoC did not go full out like in previous years, and instead continued with the "targeted" approach, once deposit rate ceilings are taken into account. This is likely to be the approach going into 2015, and we expect more targeted cuts in RRR and interest rates, as well interest rate liberalization, as we head into the new year. We expect at another 50bps cut to the 1Y lending rate by end-2015, to 5.10%, accompanied with smaller reductions for the deposit rates.

As for our growth forecast, we continue to maintain our projections of 7.4% for 2014 (with 7.4% expansion already achieved in the first three quarters of 2014) and 7.5% for 2015. While we believe that monetary policy is likely to keep economic growth on track, downside risks to our forecasts remain significant for 2015

This should reaffirm our expectations that there is little room for appreciation for the RMB going into 2015, and instead more two-way volatility should be expected for the currency as the PBoC is more calibrated in its policy measures, and the US Fed shifts to interest rate "normalization". We maintain our end-2014 USD/CNY forecast at 6.10, and at 6.03 for end-2015, and the near term effect is likely to be negative for the RMB with the lowering of yield differential.

PBoC statements on latest interest rate cuts (in Chinese)

Announcement
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2014/20141121181257976774319/20141121181257976774319_.html

Q&A
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2014/20141121183605673923201/20141121183605673923201_.html