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Flash Notes

China: PBoC Cut Interest Rates Ahead Of NPC

- PBoC lowered its interest rates for the second time in 3 months and right before the annual NPC/CPPCC session, with symmetric reductions of 25bps for both deposit and lending rates, and liberalizing further the interest rate market by raising deposit rate ceiling
- The deposit rate ceiling is getting close to its inflexion point based on our assessment on the interest rate margins, which mean that full interest rate liberalization could happen by the next 1-2 interest rate cut announcements
- Going forward, we expect another round of interest rate and RRR reduction, and we maintain our view of a weaker RMB ahead, towards 6.28/USD at end-1Q15 and 6.33/USD at end-2Q15, with the likelihood of a widening of trading bands from 2% currently to 3% sometime this year

PBoC's Second Interest Rate Cuts In 3 Months

China's central bank announced on 28 Feb 2015 a symmetric 25bps cut to its benchmark interest rates, as well as raising the deposit rate ceiling to liberalize further the interest rate market. These will take effect from 1 Mar 2015, just days before the annual National People's Congress (NPC) and Chinese People's Political Consultative Conference (CPPCC) are scheduled to begin. The move was within our expectation as we had penciled in at least one round of interest rate cuts each for both 1Q15 and 2Q15.

Unlike the previous interest rate reductions (announced on 21 Nov 2014), this time round the cut was symmetric at 25bps for both lending and deposit rates. These bring the 1Y lending rate to 5.35% from 5.60% previously, and the 1Y deposit rate to 2.50% from 2.75% previously. However after applying the new 1.3x deposit rate ceiling, the effective 1Y deposit rate is 3.25%, which is 5bps lower than the previous effective rate of 3.30% (with 1.2x ceiling applied), thus diluting the full impact of the 25bps reduction.

China: Benchmark Interest Rates

-	From 1 Mar 2015 (New) %	From 22 Nov 2014 (Old) %	Change bps
Demand Deposit	0.35	0.35	0.0
Fixed Deposit	-	-	-
3 Months	2.10	2.35	-25.0
6 Months	2.30	2.55	-25.0
1 Year	**2.50**	**2.75**	**-25.0**
2 Years	3.10	3.35	-25.0
3 Years	3.75	4.00	-25.0
Lending Rates	-	-	-
1 Year or Less	**5.35**	**5.60**	**-25.0**
Above 1 Year to 5 Years	5.75	6.00	-25.0
Above 5 Years	5.90	6.15	-25.0

Source: PBoC, UOB Global Economics & Markets Research

Local media reported that some of the city commercial banks responded swiftly to the latest PBoC announcement and set their deposit rates to the to the new 1.3x ceiling within hours, suggesting a tight funding condition for the smaller banks which generally have weaker bargaining power and narrower deposit base than their much larger and better funded national banks.

China: Benchmark Interest Rates

-	From 1 Mar 2015 (New) %	After Applying 1.3x Above Benchmark %	From 22 Nov 2014 (Old) %	After Applying 1.2x Above Benchmark %	Change (After Applying Ceilings) bps
Demand Deposit	0.35	0.46	0.35	0.42	3.5
Fixed Deposit	-	-	-	-	-
3 months	2.10	2.73	2.35	2.82	-9.0
6 months	2.30	2.99	2.55	3.06	-7.0
1 year	**2.50**	**3.25**	**2.75**	**3.30**	**-5.0**
2 years	3.10	4.03	3.35	4.02	1.0
3 years	3.75	4.88	4.00	4.80	7.5

Source: PBoC, UOB Global Economics & Markets Research

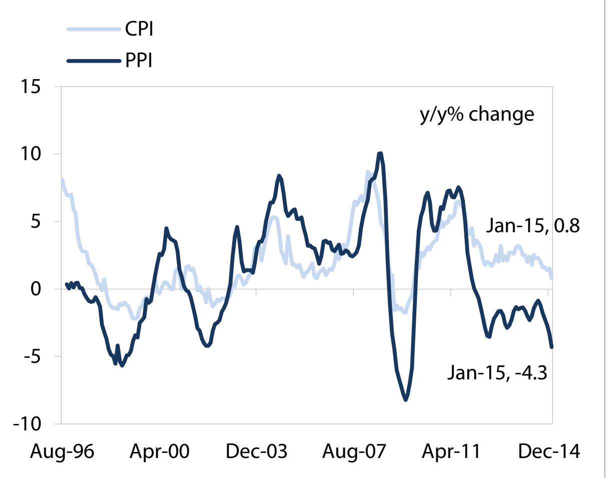
Softening Inflation Rate Offers PBoC Greater Flexibility

This latest interest rate cut announcement from PBoC was no surprise and well within our expectation. The official manufacturing PMI report for Feb (which was released on 1 Mar), which shows the sector staying below-50 (i.e. contraction) for the second consecutive month, highlights once again the challenging economic environment China is facing as it shifts into the "new normal" mode of reforms and rebalancing. Timing wise, the move that came just ahead of the annual NPC/CPPCC sessions (or "Lianghui") shows that the central bank is proactive in providing policy support to the government's reform agenda, and in responding to the global phenomenon of falling inflation.

As with most parts of the world, China is also facing general decelerating inflationary pressure. This is partly due to the declines in commodities and crude oil prices since mid-2014, and compounded by slowing domestic growth. Like other central banks, the lack of inflation has prompted the PBoC to adopt a more flexible approach in in its monetary policy. PBoC acknowledged this line of thinking on inflation in the Q&As accompanying the statement (see links below), by noting the effect of falling inflation in pushing up real interest rates.

As shown in the chart, China inflation rate has been decelerating since peaking at 3.2%y/y in Oct 2013, breaking below the 2% pace in Aug 2014. The downward momentum has been unbroken and a worrying trend, and we expect the PBoC to continue to watch this closely.

China: CPI and PPI



Source: CEIC, UOB Global Economics & Markets Research Estimates

Interest Rates: Getting Closer To Full Liberalization?

One of the recent features of PBoC's interest rate announcements have been the implementation of deposit rate ceiling. Starting from the 7 Jun 2012 announcement of 1.1x deposit rate ceiling, this has progressed to 1.3x after the 28 Feb 2015 announcement. This certainly is tied to PBoC's aim in liberalizing the interest rate market, by allow banks more flexibility to set their own interest rate pricing based on their own assessments. PBoC moved first with abolishing interest rate floor for lending rates at its 19 Jul 2013 announcement, completing the process that started in 1996. PBoC's Q&A on 28 Feb 2015 also touched on the necessity of liberalizing interest rates to allow for proper pricing of resources as well as pressure from alternative financial and wealth management products which are already being driven by market pricing.

The central bank is pushing forward its aim at fully liberalizing the deposit rates, with the gradual increase in deposit rate ceiling. With China's deposit insurance scheme slowly taking shape, this ceiling will one day be removed entirely and we believe that the day is getting closer, most likely within this year.

When will the deposit interest rate ceiling will abolished/deposit insurance scheme be implemented? We think this could be as soon as next one or two interest rate cut announcements, by looking at how interest rate cuts affect banks' interest rate margin going forward, by assuming the symmetric interest rate cuts of 25bps and an increased in the interest rate ceiling, as illustrated in the table below.

China: Illustration of Banks' Interest Rate Margins (With Ceilings)					
%	A 1Y Lending Rate %	B 1Y Deposit Rate %	C Deposit Ceiling times	D = B x C Effective 1Y Deposit Rate %	E = A -D Interest Rate Margin %
6 July 2012	6.00	3.00	1.1	3.30	2.70
22 Nov 2014	5.60	2.75	1.2	3.30	2.30
1 Mar 2015	5.35	2.50	1.3	3.25	2.10
Forecast T+1: 25bps cut	*5.10*	*2.25*	*1.4*	*3.15*	*1.95*
Forecast T+2: 25bps cut	*4.85*	*2.00*	*1.5*	*3.00*	*1.85*
Forecast T+3: 25bps cut	*4.60*	*1.75*	*1.6*	*2.80*	*1.80*
Forecast T+4: 25bps cut	*4.35*	*1.50*	*1.7*	*2.55*	*1.80*
Forecast T+5: 25bps cut	*4.10*	*1.25*	*1.8*	*2.25*	*1.85*
Forecast T+6: 25bps cut	*3.85*	*1.00*	*1.9*	*1.90*	*1.95*
Forecast T+7: 25bps cut	*3.60*	*0.75*	*2.0*	*1.50*	*2.10*
Forecast T+8: 25bps cut	*3.35*	*0.50*	*2.1*	*1.05*	*2.30*
Forecast T+9: 25bps cut	*3.10*	*0.25*	*2.2*	*0.55*	*2.55*
Forecast T+10: 25bps cut	*2.85*	*0.00*	*2.3*	*0.00*	*2.85*
Source: PBoC, UOB Global Economics & Markets Research Calculation & Estimates					

As shown in the table, interest rate margins for banks will fall to 2.10% from 2.30% previously with the latest interest rates effective 1 Mar 2015, using 1Y rates as illustration.

For the next interest rate cut (Forecast T+1), which we think is likely to be in 2Q15, the margin will fall below the psychological 2% mark, assuming another 25bps move and deposit ceiling raised to 1.4x.

If we continue with this line of 25bps cut each time accompanied with stepped up deposit ceilings, the inflexion point will be at Forecast T+4, after which interest rate margins will start to rise as deposit rates go toward zero and deposit rate ceiling loses its meaning and impact.

As such, as far as deposit interest rate ceiling is concerned, the table shows clearly that its effect will gradually diminish as interest rates fall. We think that the window for PBoC to remove the ceiling altogether will likely be the next 1-2 interest rate announcements, and concurrently it would announce the implementation of deposit insurance scheme as it liberalize its interest rate market fully.

In other words, the day of full interest rate liberalization is indeed getting near.

One More Round Of Cuts Before Pausing?

With both interest rate cuts and reserve requirement ratio cuts (announced on 4 Feb 2015) in 1Q15 within our expectation, we maintain our view that PBoC would make another round of cuts in 2Q15 before pausing to see how the effect would pan out for the broader economy (see table of forecasts below).

The uncertainty in this outlook is how fast the deceleration in the inflation rate would turn out. Clearly, a sharp decline in consumer prices could mean a sharper response from PBoC, although one should keep in mind the negative effect on savers as deposit rates fall toward the zero bound.

China: Interest Rate and RRR Forecasts					
%	4Q14	1Q15F	2Q15F	3Q15F	4Q15F
1-year Best Lending Rate	5.60	5.35	5.10	5.10	5.10
1-year Deposit Rate	2.75	2.50	2.25	2.25	2.25
Reserve Requirement Ratio	20.00	19.50	19.00	19.00	19.00
Source: UOB Global Economics & Markets Research Estimates					

As for the RMB, we maintain our view that the currency will be on a weakening path against the USD, as the US Fed is poised on normalizing its interest rates and the spread between US and China interest rates turn further against the RMB. However, we believe that the depreciation of the RMB is likely to be contained, and a sharp devaluation is a low probability scenario for now. A substantial decline in the RMB would be problematic for China in terms of international relations (the US Treasury for certain would be watching closely), credibility of internationalization of the RMB, and capital outflows.

We are maintaining our forecasts for RMB at 6.28/USD for end-1Q15, 6.33/USD at end-2Q15, and at 6.29/USD for end-2015. We also think a widening of trading bands from 2% currently to 3%, could take place before the end of the 2015.

FX OUTLOOK	As of 02 Mar 15	End 1Q15F	End 2Q15F	End 3Q15F	End 4Q15F
USD/JPY	119.8	121.0	125.0	126.0	127.0
EUR/USD	1.1162	1.10	1.09	1.09	1.08
GBP/USD	1.541	1.50	1.48	1.49	1.50
AUD/USD	0.779	0.75	0.73	0.72	0.70
NZD/USD	0.754	0.69	0.67	0.65	0.65
USD/SGD	1.364	1.37	1.39	1.40	1.40
USD/MYR	3.631	3.65	3.68	3.70	3.68
USD/IDR	12,932	12,900	13,000	13,000	13,000
USD/THB	32.36	34.1	33.7	33.5	33.4
USD/PHP	44.10	45.0	44.0	43.0	42.0
USD/INR	61.84	63.7	64.9	66.3	67.8
USD/TWD	31.50	32.3	32.5	32.6	32.4
USD/KRW	1,098.4	1,140	1,150	1,150	1,150
USD/HKD	7.75	7.75	7.75	7.75	7.75
USD/CNY	6.270	6.28	6.33	6.34	6.29

Source: Reuters, UOB Global Economics & Markets Research

Links:
PBoC interest rate cuts announcement 28 Feb 2015
中国人民银行决定下调金融机构人民币贷款和存款基准利率并扩大存款利率浮动区间
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150228174618250187756/20150228174618250187756_.html

PBoC Q&As on rate cut decision 28 Feb 2015
央行有关负责人就下调人民币贷款和存款基准利率并扩大存款利率浮动区间答记者问
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150228175132212974778/20150228175132212974778_.html

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