

China: Simultaneous Rate Cuts And Interest Rate Liberalization

China's PBoC announced late Fri (23 Oct) its sixth interest-rate cut in a year, with 25bps reduction to both lending and deposit rates. At the same time, PBoC also announced a 50bps cut in banks' reserve requirement ratio (RRR) and an additional 50bps reduction for some institutions, the fourth RRR cut this year. The simultaneous rate cuts followed a similar move on 25 Aug. All these rate changes took effect on Sat (24 Oct).

The 1Y lending rate fell to record low of 4.35% from 4.60%, while the 1Y deposit rate dropped to new low of 1.50% from 1.75%. The reduction in RRR for major banks to 17.5% from 18.0% — partly in response to capital outflows — is estimated to release about RMB600-650 billion of liquidity into China's banking system, taking into account of the additional targeted RRR reduction for smaller financial institutions.

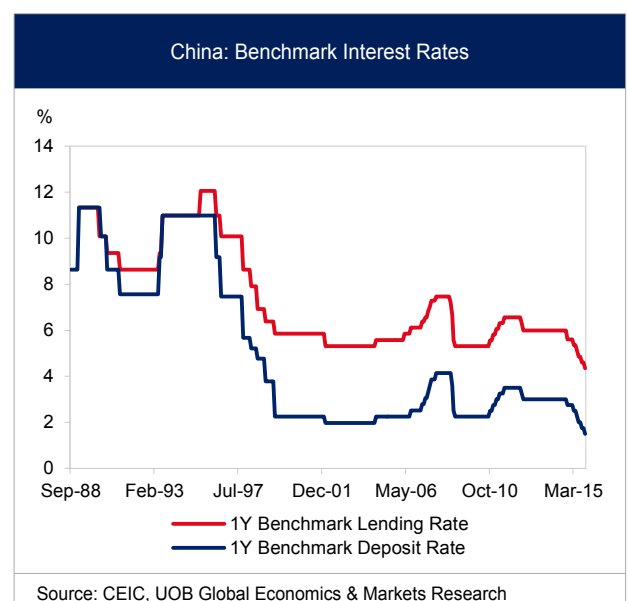
China: Benchmark Interest Rates			
-	From 24 Oct 2015 (New) %	From 25 Aug 2015 (Old) %	Change bps
Demand Deposit	0.35	0.35	0.00
Fixed Deposit	-	-	-
3 Months	1.10	1.35	-25.0
6 Months	1.30	1.55	-25.0
1 Year	1.50	1.75	-25.0
2 Years	2.10	2.35	-25.0
3 Years	2.75	3.00	-25.0
Lending Rates	-	-	-
1 Year or Less	4.35	4.60	-25.0
Above 1 Year to 5 Years	4.75	5.00	-25.0
Above 5 Years	4.90	5.15	-25.0

Source: PBoC, UOB Global Economics & Markets Research Calculations & Estimates

More importantly, and as we had anticipated, PBoC announced the removal of remaining ceiling on deposit rates (i.e. 1.5x cap for savings rates and rates for fixed deposit less than 1 year), allowing financial institutions the freedom to set rates for deposits and loans as China moves towards market-based pricing, which is an important technical element for IMF as it evaluates the possibility of RMB's inclusion in the Special Drawing Rights (SDR) basket of currencies by the end of 2015.

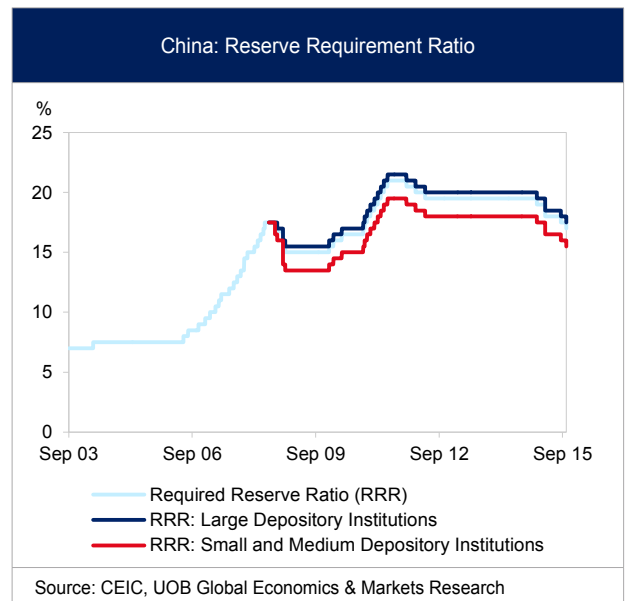
With the latest move to abolish the deposit rate cap, PBoC had deemed that China's financial institutions were ready for such an eventuality and the process would be smooth, given that pricing for banks' assets have been completely market-based for sometime, and that at least 90% banks' liabilities have been market determined prior to the announcement, according to PBoC's assessment.

However, PBoC noted in its Q&A that even with liberalization of interest rates, it would still play a role in guiding interest rates, via market-based monetary policy tools and instruments, and transmission mechanism, and PBoC's existing benchmark interest rates would still be a valuable



guide. For guidance of short term interest rates, repo operations and SLF (Standing Lending Facility, 常备借贷便利) will be playing an important role, and mid- to long-term interest rates guidance will be through facilities such as relending, MLF (Medium-term Lending Facility, 中期借贷便利), and PSL (pledged supplementary lending, 抵押补充贷款), among others, as well as market-based instruments such as Shibor, repo rates, and government bond yields. As for interest rate transmission mechanism, PBoC said it is still enhancing such process, from FX market to bond market, and to credit market, and then to the real economy.

The latest announcement is within our expectations for their timing and quantum of reductions, as well as the deregulation of deposit interest rates. These developments would further reduce the risks of hard landing in China and would be supportive of our outlook for China 2015 and 2016, as well as “risk on” trade. Namely, **we are keeping our 6.9% GDP growth projections for China in 2015 and 2016** (for details, please refer to our report “China: 3Q15 GDP Report Reaffirms Economic Rebalancing” dated 19 Oct 2015).



We still see further room for interest rate and RRR cuts ahead, especially if low inflation/deflationary conditions persist in China, capital outflows accelerate as capital accounts are liberalized further ahead, and easing policy bias continues in ECB and BoJ, notwithstanding expectations that the US Federal Reserve could see interest rate “liftoff” before end-2015. PBoC would also undertake these actions to ensure economic growth staying within a reasonable range.

For the remainder of 2015, we believe PBoC is basically done with interest rate cuts, and will look to 2016 for further actions on interest rates. However we are still penciling **one final 25bps reduction in RRR before the year is out**. All in we see PBoC’s easing actions continue into mid-2016, at the least (please refer to table of forecasts below).

As for the RMB, such easing action is likely to put downward pressure on the currency in the near term, but the impact is unlikely to be lasting, as the upcoming SDR decision should be positive on the currency. **We are still projecting end-2015 USD/CNY forecast of 6.40 and end-2016 projection of 6.45.**

Despite the recent market turmoil in the equity and FX markets, China once again showed its determination in carrying out market reforms by dismantling its last controls on the deposit rates and moving towards market-based interest rates. The clearing of this critical hurdle should be a positive signal to the IMF as it moves into the review phase of the SDR. **Together with the softening tone of US Treasury’s latest semiannual report on currencies, this should lift the chances of RMB’s inclusion in the SDR. We think the probability has now tilted towards the 70-80% region in favour of China, compared to our previous assessment of 60%.**

China: Interest Rate and RRR Forecasts							
%	2Q15	3Q15	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F
1-year Benchmark Lending Rate	4.85	4.60	4.35	4.10	3.85	3.85	3.85
1-year Benchmark Deposit Rate	2.00	1.75	1.50	1.25	1.00	1.00	1.00
Reserve Requirement Ratio	18.50	18.00	17.00	16.00	15.00	14.00	13.00

Source: UOB Global Economics & Markets Research Estimates

Links

中国人民银行决定下调存贷款基准利率并降低存款准备金率
PBoC Interest Rate and RRR Cuts announcement, 23 Oct 2015
<http://bit.ly/pbc-20151023-ratecuts>

央行有关负责人就降息降准以及放开存款利率上限答记者问
Q&A: PBoC Interest Rate and RRR Cuts announcement, 23 Oct 2015
<http://bit.ly/pbc-20151023-ratecuts-qa>

FX Outlook						
-	26-Oct-15	End 4Q15F	End 1Q16F	End 2Q16F	End 3Q16F	End 4Q16F
USD/JPY	121.1	124	126	127	128	129
EUR/USD	1.10	1.12	1.13	1.13	1.14	1.14
GBP/USD	1.53	1.58	1.60	1.61	1.62	1.63
AUD/USD	0.72	0.71	0.71	0.70	0.69	0.70
NZD/USD	0.68	0.62	0.61	0.60	0.60	0.61
USD/SGD	1.40	1.43	1.45	1.46	1.44	1.42
USD/MYR	4.27	4.40	4.18	4.15	4.06	3.96
USD/IDR	13,641	14,700	14,800	14,900	14,700	14,500
USD/THB	35.6	35.5	35.8	36.0	36.0	35.8
USD/PHP	46.7	47.0	46.0	45.0	43.0	42.0
USD/INR	64.8	66.0	65.0	64.0	63.0	62.0
USD/TWD	32.4	33.3	33.9	34.1	33.9	33.6
USD/KRW	1,136	1,250	1,300	1,300	1,250	1,200
USD/HKD	7.75	7.75	7.80	7.80	7.80	7.80
USD/CNY	6.35	6.40	6.45	6.51	6.47	6.45

Source: Bloomberg, UOB Global Economics & Markets Research Estimates



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