Economic Analysis

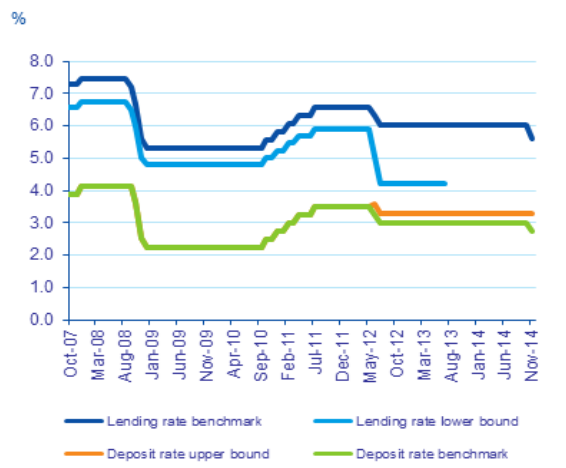
China's authorities reverted to conventional rate cuts to prevent a sharp drop in growth

Le Xia and Jinyue Dong

The People's Bank of China (PBoC) cut the benchmark interest rates last Friday, the first time since July 2012 and effective from November 22th. The cut is asymmetric in the sense that the one-year benchmark lending rate was lowered by 40 bps to 5.6% while the one-year deposit benchmark rate was trimmed to 2.75% from 3.0%. Meanwhile, the PBoC announced that the permissible floating range of deposit rates is expanded to 20% (versus 10% previously) above the benchmark deposit rates, which also constitutes an additional step in interest rate liberalization and reaffirms the authorities' resolution to push for structural reforms. As a result, the effective deposit rates (the highest rates that banks can offer to their depositors) will remain at 3.3% unchanged. (Figure 1) The interest rate cut is a welcome development although its effectiveness might be limited by tight liquidity condition. We therefore maintain our growth projection of 7.3% in 2014 and 7.0% in 2015.

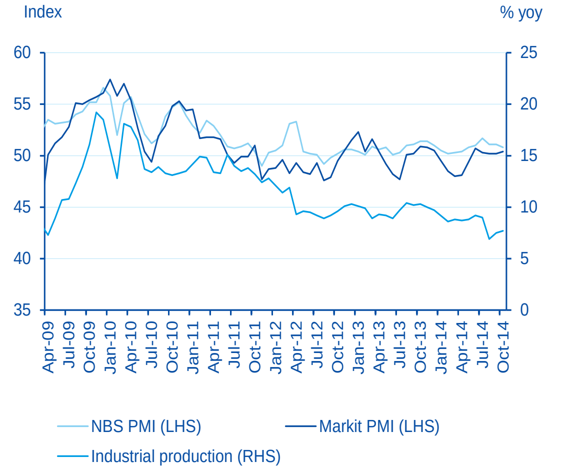
- **The interest rate cut was triggered by recent lacklustre activity indicators amidst of intensified structural and cyclical headwinds.** In particular, recent PMI and industrial production index showed that the ongoing economic slowdown could be steeper than expected. (Figure 2) Moreover, the interest rate cut comes on the heels of a small-sized liquidity squeeze in the interbank market last Wednesday. The cut signals that the authorities have shifted back to these conventional policy tools from their previously targeted-easing practice (through innovative instruments such as selective reserve requirement cuts, Standing Lending Facility, Medium-term Lending Facility, etc.) in a bid to spur credit supply and underpin economic growth. In the meantime, the paralleled liberalizing measure suggests that the authorities are still wary of the risk of the shadow banking activities which could otherwise rebound on lower (effective) deposit rates.
- **Nevertheless, the real effectiveness of interest rate cuts is still questionable.** Given that the lending rates were fully liberalized in July 2013, the impact of the benchmark lending rate cut could be limited. Indeed, it is reported that the Loan Prime Rate (LPR), which is another benchmark lending rate formed by loan markets, only declined by 20 bps on Monday, indicating that the pass-through of the lending rate cut is limited. On the side of deposit rates, till now, except for the five biggest commercial banks, about one-third of commercial banks have announced that their deposit rates will be at the new upper bound as we expected. It is believed that more banks will follow suit.
- **Looking ahead, we anticipate more easing measures in the coming months.** The small liquidity squeeze in the interbank market last week showed that the liquidity condition could hamper banks from extending more and cheaper loans as the authorities intended to do. The cut is likely to set off a series of conventional monetary loosening measures in the coming months to prevent a sharp drop in growth. Given the government's revealed preference of price policy tools, we project that they will cut interest rates by one or two times additionally. On the other hand, we deem the usage of quantitative tools unavoidable. In this respect we forecast that the authorities will trim the Reserve Required Ratio (RRR) at least twice between now and the end of next year, compared to our previous projection of four cuts in RRR but with no cut in interest rates.

Figure 1
PBoC cut the benchmark lending and deposit rate effective on November 22th



Source: CEIC and BBVA Research

Figure 2
The interest rate cut was mainly promoted by recent economic slow-down



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