Economic Analysis

Another rate cut hinted an imminent completion of interest rate liberalization

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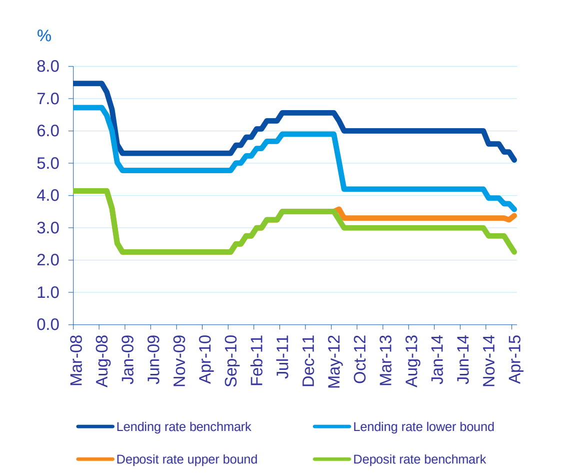
The People's Bank of China (PBoC) cut the benchmark interest rates last Sunday, the third time since November 2014 and effective from May 11. Both the one-year benchmark lending and deposit rates were trimmed by 25 bps (to 5.1% and 2.25% respectively). Moreover, the PBoC expanded the permissible floating range of customer deposit rates to 50% (versus 30% previously) above the benchmark rates, raising the cap of one-year customer deposit rate to 3.38% from 3.25% previously. As such, this move has constituted an additional step in interest rate liberalization and reaffirms the authorities' resolution to push for structural reforms. (Figure 1) Indeed, it has observed from the past two interest rate cuts that more banks tended to set their deposit rates at a level below the regulatory cap. With the newly implemented national deposit scheme in place, time is ripe for the authorities to lift the cap on the deposit rates to complete the long-lasting process of interest rate liberalization.

The interest rate cut came on the heels of a slew of sluggish activity indicators in Q1 and April, reflecting the authorities' deep concerns for the significant slowdown of the growth momentum. Q1 GDP growth slowed down to 7.0% y/y from 7.3% y/y previously, which, albeit in line with BBVA and market expectations, registered the lowest reading since 2009 Q1. In April, the NBS PMI (50.1) marginally stayed above the watershed level of 50 while the HSBC PMI slid a 12-month record low of 48.9 (Figure 2). In the meanwhile, the deflation risk loomed large. April headline CPI came out at 1.5% y/y (Consensus: 1.6%; Prior: 1.4%) while the PPI growth rate dropped to -4.6% y/y (versus: -4.6% y/y in March), staying in a negative territory for consecutive 38 months. Apart from weak commodity prices in the international market, the overcapacity problem in some domestic industries continued to weigh on firms' wholesale prices. (Figure 3) The performance of the external sector is also lackluster in April. Exports growth declined to -6.4% (Consensus: 1.6%; Prior: -15%) while import growth fell to -16.2% y/y (Consensus: -12.2%; Prior: -12.7%), reflecting that both domestic demand and external demand were weak in April. (Figure 4)

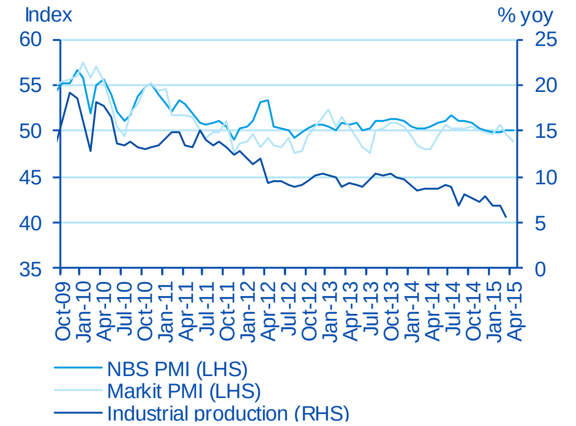
All in all, growth is losing steam at a faster-than-expected pace despite the loosening monetary measures implemented since November, including two interest rate cuts, two RRR cuts as well as other targeted initiatives. Looking ahead, we anticipate more easing measures in the coming months to offset a number of the growth headwinds such as hovering external uncertainty, the fiscal consolidation at the local government level as well as the anemic property market. In this respect, we envisage that the PBoC will implement some additional interest rate cuts of total 50 bps in the second and third quarters, which is likely to be accompanied by a cumulative 100-bps reduction in the RRR. The PBoC can also resort to unconventional monetary policy tools with the aim to inject liquidity to the banking system, namely "Chinese QE", as we predicted in our recently published China Economic Outlook.

Figure 1
The PBoC deployed an asymmetric interest rate cut for the third time of last 6 months…



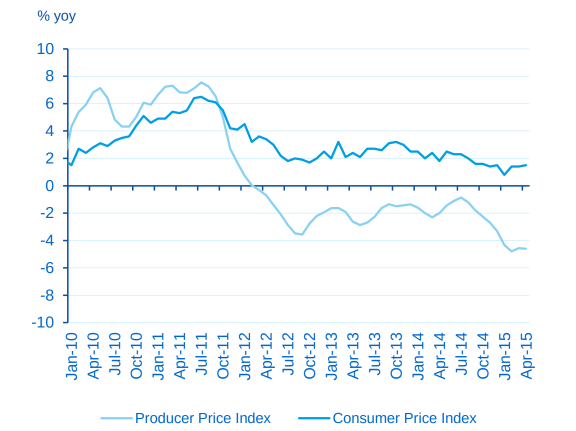
Source: CEIC and BBVA Research

Figure 2
… responding to weak economic performance of Q1 and April



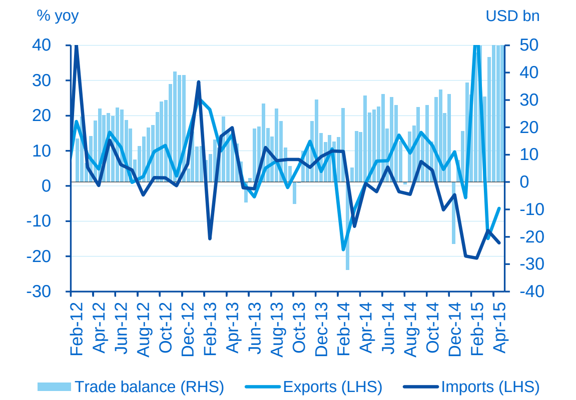
Source: CEIC and BBVA Research

Figure 3
Deflation risk is on the rise…



Source: CEIC and BBVA Research

Figure 4
… while external demand remains sluggish



Source: CEIC and BBVA Research