Economic Analysis

The PBoC aggressively cut interest rate and the RRR to support growth and stabilize the stock market

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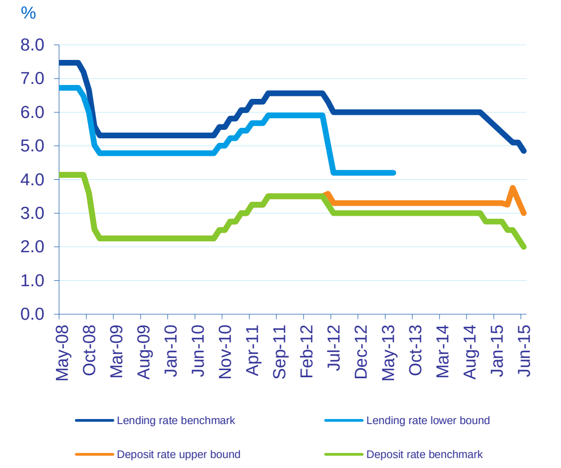
The People's Bank of China (PBoC) cut its benchmark interest rate by 25bps last Saturday, the fourth time since November 2014 and effective from June 28; at the same time, a targeted cut in the Reserve Requirement Ratio (RRR) was deployed (also effective from June 28) to provide more liquidity to banks focusing on SMEs businesses and the agriculture sector. (Figure 1) Although the monetary policy easing has been well anticipated, it is quite rare for the PBoC to cut interest rates and the RRR simultaneously (the last time of the similar practice can be dated back to the global financial crisis in late 2008). It indicates the authorities' deep concerns on the continuing economic slowdown, the stock market crash as well as the elevated tensions between the Eurozone and Greece. Looking ahead, we envisage that the PBoC will implement an additional interest rate cut of 25 bps in the third quarter, which is likely to be accompanied by a 50-bps universal reduction in the RRR.

- **The combined interest rate and RRR cuts came on the heels of the sluggish activity indicators**. In June, the HSBC PMI edged up to 49.6 from 49.2 in the previous month, which remains below the watershed level of 50 (Figure 2). Meanwhile, the deflation risk is still on the rise: May headline CPI decreased to 1.2% y/y (Consensus: 1.3%; Prior: 1.5%), while the PPI growth rate dropped to -4.6% y/y (versus: -4.6% y/y in April), staying in negative territory for 39 consecutive months. (Figure 3) Moreover, firms' real financing costs (measured by nominal interest rates minus inflation rate) are significantly higher than a year ago, mostly due to the long-lasting low inflation rate. Put together, the sluggishness in the economy entailed the PBoC's moves on further lowering interest rates and providing more liquidity.

- **The combined cuts are also aimed to temper last week's stock market meltdown and boost market confidence.** The Shanghai Composite decreased by 7.4% last Friday, wiping hundreds of billions of dollars off the total market capitalisation of the index. More than two-thirds of the companies listed in Shanghai hit the 10% daily downward limit on Friday. The market has been corrected by 18.8% from its recent high in the mid-June whereas the market has still gained almost 30% since the beginning of the year. (Figure 4) The combined cuts, a hasty response to last Friday's stock market crash, signalled to the market that the authorities will avert any stock market crash.

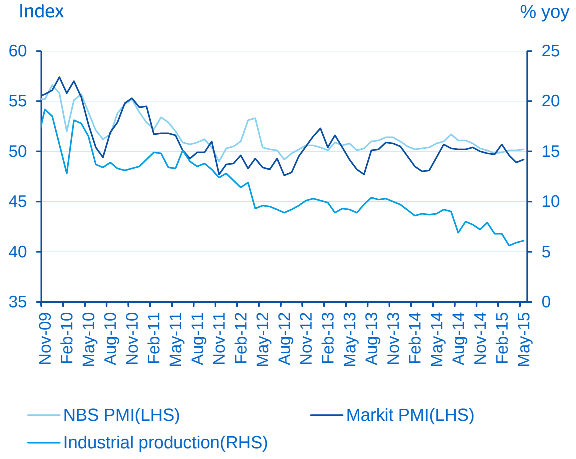
- **Moreover, the combined cuts reflect the authorities concern regarding the external uncertainties.** The heightened external uncertainty, centring around the "Grexit", also prompted the PBoC to loosen the monetary policy. As EU is the largest trade partner of China (China's exports to EU is 15.8% of China's total exports and imports from EU is 12.5% of the total imports in 2014), the Greece's possibility of exiting EU may add more uncertainties to China's exports to EU, which has already been sluggish due to Euro depreciation in the past months, ultimately affecting China's growth momentum.

Figure 1
The PBoC deployed cuts in interest rates and the RRR simultaneously…



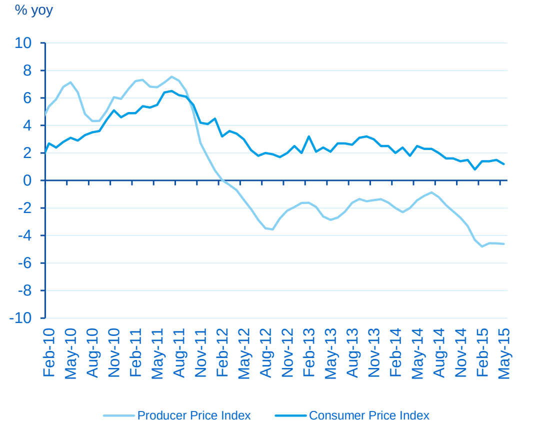
Source: CEIC and BBVA Research

Figure 2
… responding to weak economic performance of the first half of 2015



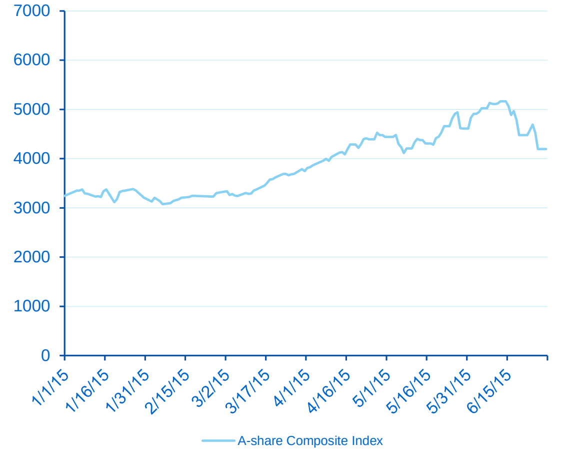
Source: CEIC and BBVA Research

Figure 3
Deflation risk is on the rise as well



Source: CEIC and BBVA Research

Figure 4
…also, responded to the stock market crash on the last Friday



Source: CEIC and BBVA Research