China Flash

China cuts interest rates amidst weak economic data, and introduces greater rate flexibility

The PBoC announced a 25bp cut in interest rates late today after Asian markets had closed (Chart 1). The move is in line with our expectations of up to two interest rate cuts in the coming quarters, in addition to further cuts in the RRR in view of recent weak economic indicators, falling inflation, and the deteriorating global environment. Nevertheless, the rate cut may take many market observers by surprise, especially those who had expected the PBoC to refrain from rate cuts in favour of further reductions in the RRR. Importantly, greater rate flexibility has been introduced (see below).The rate cut as the latest policy move by to support growth, along with various fiscal initiatives including recent subsidies to home appliance and auto purchases. We expect such policies to help ensure a soft landing, although there are downside risks to our previous 8.3% GDP growth projection for 2012. We will be watching closely for the next batch of monthly indicators for May due out this Saturday, June 9. The timing of today's announcement could indicate that the authorities expect the data to be on the weak side. We expect another 25bp rate cut and 100 bp cuts in the RRR during Q2/Q3.

- **The interest rate cut may lead to a narrowing of bank lending margins**. Although the lending and deposit benchmark rates were cut symmetrically, by 25bp each, to 3.25 percent and 6.31 percent respectively, changes in the discounts and premiums banks are allowed to offer imply a narrowing of lending margins. Specifically, banks can now offer a 20% discount from the benchmark lending rate (rather than 10% previously), and a 10% premium on the deposit rate cap (from zero previously). The move is a step toward greater interest rate flexibility, and is in line with plans for gradual interest rate liberalization. The effective narrowing of lending margins also follows better-than-expected profit outturns in the banking industry for 2011, and is in line with our outlook for reduced profitability in the coming years (see our latest Banking Watch).

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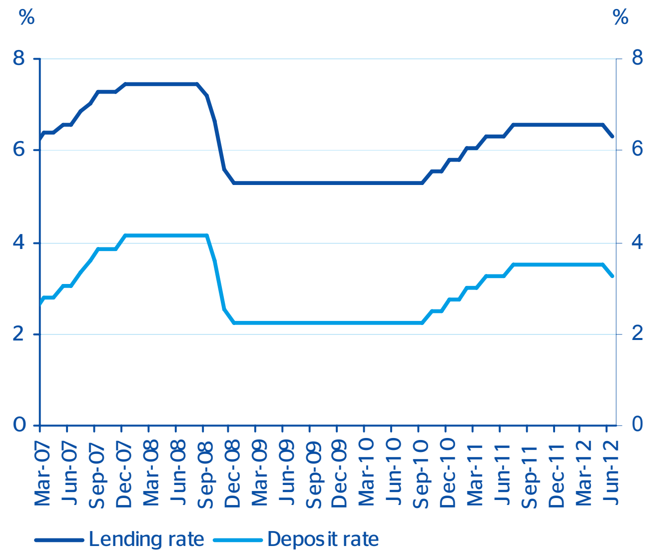
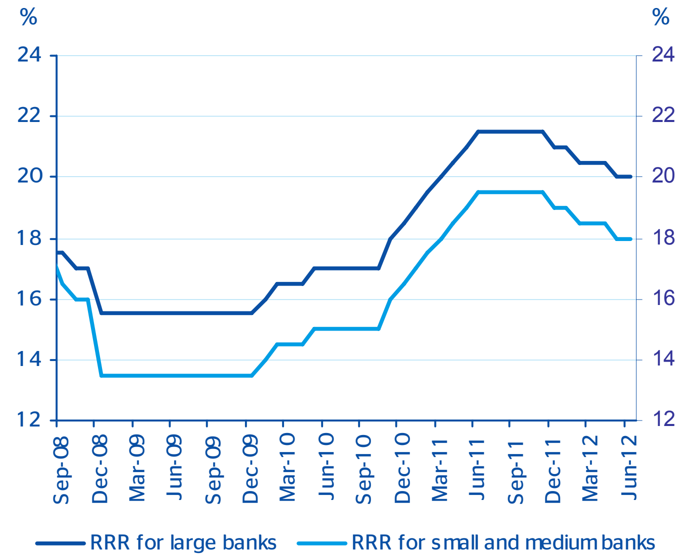
Chart 1
Interest rates are cut for the first time since 2008



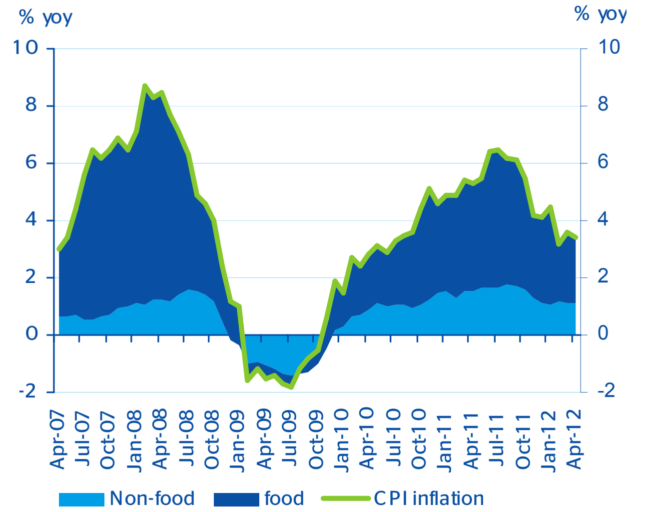
Source: CEIC and BBVA Research

Chart 2
Further cuts in the RRR are expected



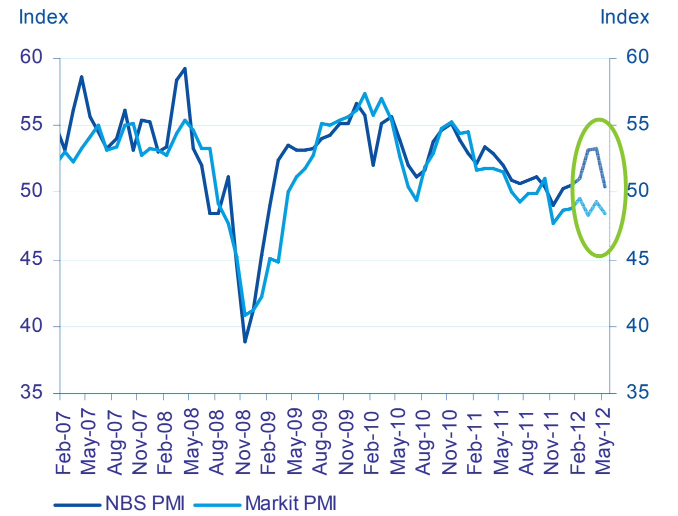
Source: CEIC and BBVA Research

Chart 3
Falling inflation provides room for policy easing…



Source: CEIC and BBVA Research

Chart 4
…to support slowing growth indicators



Source: CEIC and BBVA Research

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