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Flash Notes

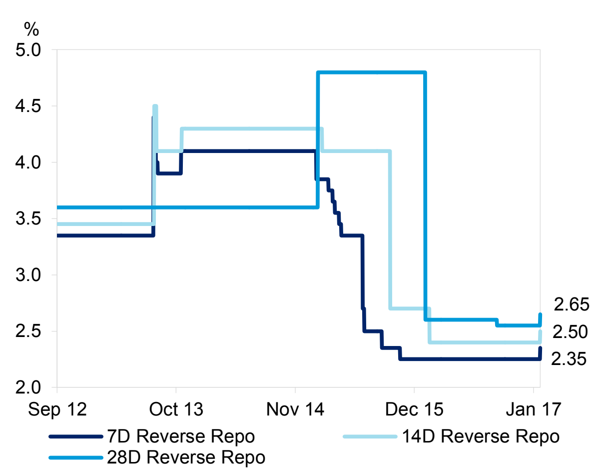
China: PBoC Staying With The Message

Raising Short-Term PBoC Lending Rates

China's central bank got down to business swiftly last Fri (3 Feb) after domestic financial markets reopened from a one-week Lunar New Year holiday break, sending a clear signal that its policy stance is poised to stay tight in the coming months.

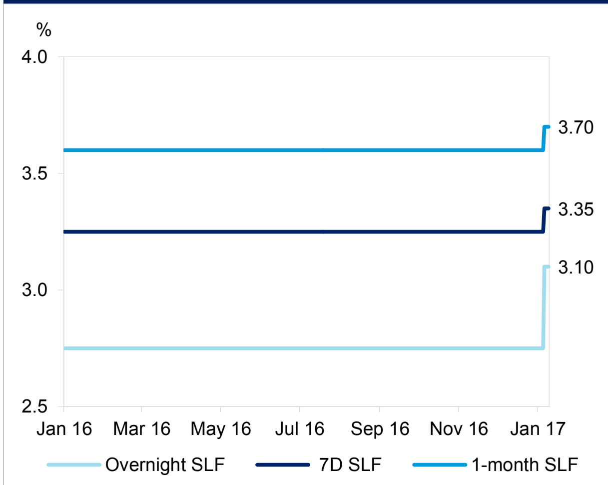
In a continuation of its tighter monetary policy condition since late 2016 and its second "de facto tightening", PBoC last Fri (3 Feb) raised overnight interest rate for its standing lending facility (SLF) loans to 3.1% from 2.75% previously, effective from 3 Feb, and raised 7-day SLF rate to 3.35% from 3.25% previously, and 1-month rate to 3.7% from 3.6% previously. Meanwhile, PBoC also raised the costs of 7-, 14- and 28-day reverse repurchase agreements by 10 basis points each, to 2.35%, 2.5% and 2.65% respectively. This is the first increase since 2013 for the 7/14-day tenors, and the first such move since 2015 for the 28-day contracts. It is also the first time the central bank raised SLF lending rates.

China: PBoC Reverse Repo Rates



Source: CEIC, UOB Global Economics & Markets Research

China: PBoC SLF Interest Rates



Source: CEIC, UOB Global Economics & Markets Research

The post-holiday moves came after PBoC lifted the 6-month and 1-year Medium-term Lending Facility (MLF) rates on 24 Jan, just days before financial markets headed for the one-week holiday break. MLF interest rates went to 2.95% from 2.85% for the 6-month tenor, while the 1Y MLF rate was hiked to 3.1% from 3.0%.

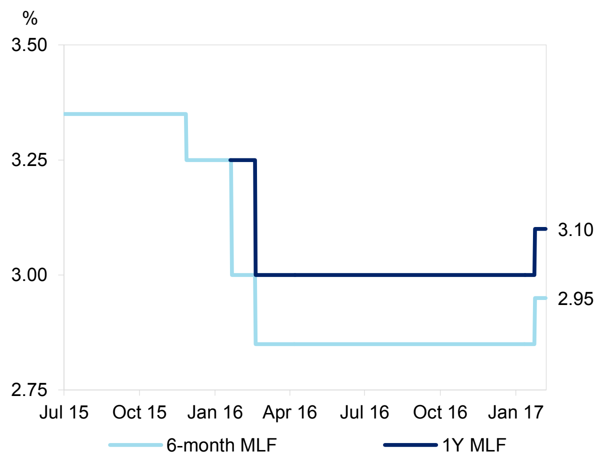
Elevated Market Interest Rates Ahead

As we had cautioned previously, PBoC's tightening stance since late 2016 would be the start of higher interest rate environment into 2017. The "bracketing" of the interest rate "hikes" pre- and post-Lunar New Year is a clear message of PBoC's policy intention. When PBoC took action on MLF rates in January, it was the first "rate hike" in 6 years (PBoC last raised its 1Y lending rate on 20 Oct 2010). The combined rate hikes continued to signal PBoC's moves to deleverage and manage financial risks. At the same time, PBoC is also evolving towards an interest rate corridor regime and using interest rates as signaling mechanism, where repo rates guide the short end and SLF rates act as the ceiling. The hikes suggest that China is also reasonably confident that current economic conditions are steady enough to withstand steps to rein in leverage.

With the latest action, PBoC is again reminding the market that the policy remains "prudent and neutral", with a bias towards tightening. Looking at the historical trajectory for both reverse repo rates and MLF rates, there is indeed plenty of scope for PBoC to tighten further. However, we expect interest rate increases ahead likely to be gradual, and largely for signaling purposes.

While PBoC is expected to continue to ensure sufficient liquidity especially in response to seasonal/festive demand, overall domestic interest rate trend is likely to remain elevated due to the deleveraging process to curb credit expansion, as well as a tightening US Fed policy, which would pressure China's domestic interest rates higher.

China: MLF Interest Rates



Source: Bloomberg, UOB Global Economics & Markets Research

Going forward, we expect China's benchmark interest rates to remain unchanged (at 4.35% for 1Y lending and 1.50% for 1Y depo), while PBoC leans towards using market interest rates to guide market expectations and to influence the traditional "benchmark" interest rates that we have been familiar with. As such, we expect China's broad interest rate environment to continue to see upside pressure in the near term even as benchmark interest rates stay unchanged.

On the currency front, recent strength of the domestic currency (6.86/USD for the CNY and 6.80/USD for the CNH) is mainly attributed to the soft US dollar which is in response to the perceived concerns and uncertainty over US government policy (e.g. immigration ban) and lack of commitment from the US Federal Reserve's FOMC meeting in Jan. We continue to see upside to the US dollar towards end-2017, but likely to be less aggressive than our previous expectation. Among our Asian currencies, we are also reviewing our USD/CNY forecasts of 7.02 for mid-2017 and 7.16 for end-2017.