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Flash Notes

China: Rate Cuts In Response To Soft Data

Interest Rates Cut To Levels In 2008

China's PBoC announced on Sunday (10 May 2015) its third interest rate cut in six months, as recent data releases show economic growth momentum remaining tepid. While we had expected PBoC to cut interest rates this quarter, the timing was marginally earlier than our expectation.

The central bank lowered China's one-year lending rate by 25 basis points to 5.10% and benchmark deposit rate by the same amount to 2.25%, effective Monday, 11 May 2015.

China: Benchmark Interest Rates

-	From 11 May 2015 (New) %	From 1 Mar 2015 (Old) %	Change bps
Demand Deposit	0.35	0.35	0.0
Fixed Deposit	-	-	-
3 Months	1.85	2.10	-25.0
6 Months	2.05	2.30	-25.0
1 Year	**2.25**	**2.50**	**-25.0**
2 Years	2.85	3.10	-25.0
3 Years	3.50	3.75	-25.0
Lending Rates	-	-	-
1 Year or Less	**5.10**	**5.35**	**-25.0**
Above 1 Year to 5 Years	5.50	5.75	-25.0
Above 5 Years	5.65	5.90	-25.0

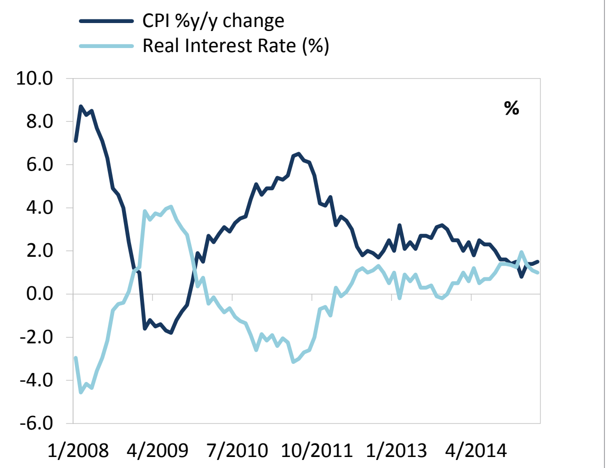
Source: PBoC, UOB Global Economics & Markets Research

The latest move has brought the benchmark lending rate to the lowest level since 1991 and surpassing the low of 5.31% in December 2008, while the deposit rate matches the low seen in December 2008, which was also at 2.25% (the lowest 1-year deposit rate was 1.98%, in February 2002).

As PBoC mentioned in its statement on Sunday, the motivate for the interest rate reductions was to reduce costs of funding, to respond to downward pressure on economic growth, and to accommodate lower inflation rates/persistently high real interest rate, as shown in the chart on the right.

Indeed recent data releases suggest that 2Q15 is likely to prolong the weak momentum in 1Q15. Last week, China reported that consumer inflation grew by 1.5%y/y in April vs. 1.4% in March, while producer prices declined by the same pace as in March at -4.6%y/y, the 36th consecutive negative reading for factory gate prices. China's exports fell 6.4%y/y in dollar terms, vs. -15% in March and market expectation of a

China: Inflation Rate and Real Interest Rate



Source: CEIC, UOB Global Economics & Markets Research

+2.5% increase. China's imports fell 16.2%y/y, extending its 12.7% decline in March.

Interest Rate Liberalization Staying On Track

Along with the interest rate cut announcement, PBoC also raised the deposit rate ceiling by the largest quantum so far, to 1.5 times from 1.3 times over the benchmark, instead of the 0.1 time increment each time in previous announcements. This hints that PBoC is inching closer to fully liberalize interest rate market, as it commented that there have been signs of increased differentiation in rates offered by banks to customers, and incidents of deposit rates floating to the ceiling have been reduced.

As shown in the table below, it would be detrimental to banks, especially smaller ones, if deposit rates are offered at the maximum allowed, which actually end up far higher than before the current rate cuts. For instance, the one year deposit rate would be at 3.38% after applying the 1.5x ceiling, which is actually higher than the previous maximum allowable rate of 3.25%.

China: Comparison of Changes Deposit Interest Rates (With Ceilings)

-	From 11 May 2015 (New) %	After Applying 1.5x Above Benchmark %	From 1 Mar 2015 (Old) %	After Applying 1.3x Above Benchmark %	Change (After Applying Ceilings) bps
Demand Deposit	0.35	0.53	0.35	0.46	7.00
Fixed Deposit	-	-	-	-	-
3 months	1.85	2.78	2.10	2.73	4.50
6 months	2.05	3.08	2.30	2.99	8.50
1 year	**2.25**	**3.38**	**2.50**	**3.25**	**12.50**
2 years	2.85	4.28	3.10	4.03	24.50
3 years	3.50	5.25	3.75	4.88	37.50

Source: PBoC, UOB Global Economics & Markets Research Calculations & Estimates

We had noted previously ("China: PBoC Cut Interest Rates Ahead Of NPC", dated 02 Mar 2015) that China is moving closer to fully liberalizing its deposit rate and that there is a limit to how much it can raise the deposit rate ceiling.

It seems that PBoC is reaching close to the limit on deposit ceiling especially with an aggressive move this time, as shown in the table below. Assuming that PBoC reduce its benchmark interest rates further, the deposit rate ceiling at most could only reach 1.7x. This is because interest rate margins would actually begin to rise with deposit rates falling and the deposit ceiling would lose its potency. As the limits on ceiling get near, full interest rate liberalization would just be around the corner, especially with deposit insurance system already in place since 1 May 2015.

China: Assessing The Next Interest Rate Cuts

%	A 1Y Lending Rate %	B 1Y Deposit Rate %	C Deposit Ceiling times	D = B x C Effective 1Y Deposit Rate %	E = A -D Interest Rate Margin %
6 July 2012	6.00	3.00	1.1	3.30	2.70
22 Nov 2014	5.60	2.75	1.2	3.30	2.30
1 Mar 2015	5.35	2.50	1.3	3.25	2.10
11 May 2015	5.10	2.25	1.5	3.38	1.73
Forecast T+1: 25bps cut	*4.85*	*2.00*	*1.6*	*3.20*	*1.65*
Forecast T+2: 25bps cut	*4.60*	*1.75*	*1.7*	*2.98*	*1.63*
Forecast T+3: 25bps cut	*4.35*	*1.50*	*1.8*	*2.70*	*1.65*
Forecast T+4: 25bps cut	*4.10*	*1.25*	*1.9*	*2.38*	*1.73*
Forecast T+5: 25bps cut	*3.85*	*1.00*	*2.0*	*2.00*	*1.85*
Forecast T+6: 25bps cut	*3.60*	*0.75*	*2.1*	*1.58*	*2.03*
Forecast T+7: 25bps cut	*3.35*	*0.50*	*2.2*	*1.10*	*2.25*
Forecast T+8: 25bps cut	*3.10*	*0.25*	*2.3*	*0.58*	*2.53*

Source: PBoC, UOB Global Economics & Markets Research Calculation & Estimates

What's Next?

With PBoC embarking on a series of aggressive moves – the larger than usual 100 bps cut in reserve requirement ratio (RRR) on 19 April (second RRR cut this year), and three interest rate reductions in 6 months – there is certainly room for further policy flexibility ahead. **In particular, there is a long way to go for the RRR at current level of 18.5%, which is ahead of the previous low of 15.5% (2009) and record low of 6% (1999-2003). We see risks of another round of RRR cut at 50bps, most likely in 3Q 2015.**

However, on the interest rate front, it is more challenging for PBoC with the 1Y interest rates at or near historic lows, and also the possibility of the US Fed "normalizing" its interest rates. To reap, China's 1Y lending rate is already at the lowest level since 1991 and surpassing the low of 5.31% in December 2008, while the 1Y deposit rate matches the low seen in December 2008, and not much further from the record low of 1.98% in February 2002. **For now, we see just one more round of interest rate cuts, which are likely to take place in 3Q 2015 as well, as we expect signs of stabilization in broad Chinese data by second half of 2015.**

The RMB could come under pressure on Monday, on the back of lowered Chinese interest rates as well as the US nonfarm payroll report last Friday. However, the bigger picture of IMF's Special Drawing Rights (SDR) should dominate and supportive of the RMB. As such, we are maintaining our USD/RMB exchange rate forecasts intact, at 6.22 for end-2Q15, and at 6.20 for end-2015.

China: Interest Rate and RRR Forecasts						
%	1Q15	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F
1-year Best Lending Rate	5.35	5.10	4.85	4.85	4.85	4.85
1-year Deposit Rate	2.50	2.25	2.00	2.00	2.00	2.00
Reserve Requirement Ratio	19.50	18.50	18.00	18.00	18.00	18.00
Source: UOB Global Economics & Markets Research Estimates						

References:

PBoC Interest Rate Cut Announcement (10 May 2015)
中国人民银行决定 下调金融机构人民币贷款和存款基准利率并扩大存款利率浮动区间上限
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150510161404293722914/20150510161404293722914_.html

PBoC's comments on interest rate cuts and further liberalization (10 May 2015)
央行有关负责人就下调人民币贷款及存款基准利率 并进一步推进利率市场化改革答记者问
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150510163357696844307/20150510163357696844307_.html

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