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Flash Notes

China: PBoC's Simultaneous Easing Actions

China's central bank PBoC on Sat (27 Jun) announced simultaneous reductions in benchmark interest rates, as well as targeted reserve requirement ratios (RRR) for financial institutions. effective from 28 Jun.

The one-year benchmark lending rate was lowered by 25 basis points to 4.85%, and one-year benchmark deposit rate by 25 basis points to 2%. RRR for banks that have met certain standards in lending to the agricultural sector and small and medium-sized enterprises (SMEs) was cut by 50 basis points, and RRR for finance companies was slashed by 300 basis points.

China: Benchmark Interest Rates

-	From 28 Jun 2015 (New) %	From 11 May 2015 (Old) %	Change bps
Demand Deposit	0.35	0.35	0.0
Fixed Deposit	-	-	-
3 Months	1.60	1.85	-25.0
6 Months	1.80	2.05	-25.0
1 Year	**2.00**	**2.25**	**-25.0**
2 Years	2.60	2.85	-25.0
3 Years	3.25	3.50	-25.0
Lending Rates	-	-	-
1 Year or Less	**4.85**	**5.10**	**-25.0**
Above 1 Year to 5 Years	5.25	5.50	-25.0
Above 5 Years	5.40	5.65	-25.0

Source: PBoC, UOB Global Economics & Markets Research

The targeted RRR cut is estimated to release about RMB450bn of liquidity into the financial system. This is less than the case of a 50 basis points cut in broad RRR, which would unleash about RMB645bn in liquidity based on total bank deposits of RMB128.99 trillion at end-May 2015. This suggests that PBoC remains cautious of unleashing excessive liquidity into the system.

This is the first time in nearly 7 years (since Oct 2008) that PBoC reduced both interest rates and RRR simultaneously (although this time, it is the "targeted" RRR and not system-wide RRR), when the global financial markets were at the depth of the subprime financial crisis.

From the accompanied official release and Q&A documents, costs of funding and guiding loans towards the agricultural sector and SMEs appear to be the main focus. PBoC explained in the Q&A that it did not reduce broad-based RRR at this time as liquidity remained abundant in the system despite short-term demand such as IPO funding, with banks' excess reserves expected to hover at the high mark of RMB3tn at end-Jun 2015, even after the aggressive 100bps reduction in RRR announced on 19 Apr 2015.

For cost of funding (mentioned at a considerably high frequency of 9 times in the Q&A document), PBoC noted that in May 2015, weighted average costs of new loans were at 6.16%, 91 basis points lower from the same period a year ago, and at the lowest level since 2011, following the 90bps cut in benchmark lending rates to 5.10% by May 2015 in the same period. At the same time, PBoC pointed out that deposit rates have also fallen along with central bank's guidance, and that a competitive price setting mechanism was taking shape. This appears to suggest that further interest rate reductions from PBoC may be limited, and we believe there is only more round of interest rate cuts for 2015. Similarly for the system-wide RRR, we think that there is at most 100bps reduction for 2015.

The aggressive nature of the announcement is likely a response to continued weak economic data releases and partly to stabilize market sentiment following a 19% plunge in the Shanghai Composite index over the last two weeks that wiped out a reported US$1.25tn of market capitalization, and the biggest 2-week drop since Dec 1996. It is arguable that the PBoC's move was to "rescue" the domestic equity markets, given the concerns of moral hazards. However, the development over the same weekend that paved the way for a potential exit of Greece from the Eurozone certainly raises uncertainty in the market and possible financial contagion globally, and PBoC could very well be positioning itself preemptively.

Data Releases Point To Sub-7% 2Q GDP

More importantly for PBoC, at the half way mark of 2015, domestic data releases have largely been disappointing and could be at risk of falling way short of the 7% growth target for the full year.

For instance, the PMI headline figures so far have been hovering around the 50-mark in 2015, which is well below historic average. In contrast, from 2005 to 2013, the average reading for the headline official PMI is 52.6, and for the HSBC PMI index is 51.4, including the period of global financial crisis. Since 2014 however, both versions of PMI figures have averaged just 50.5 for the official PMI and 49.7 for the Markit PMI, 2.1 points and 1.7 points below the long term averages, respectively. The fact that the PMI reports are barely holding on to the middle ground of 50 suggests the downward pressure for the manufacturing sector as a result of the confluence of both domestic factors ("new normal") and external factors (poor global recovery momentum). This is a reflective of the industrial production data, which has been staying well below the long run average of 13%y/y (Jan 1995 - Dec 2013) for the second consecutive year, with the figure for May at 6.1%y/y, marginally higher than the 5.9% gain in Apr. The implication of these weak data is that 2Q15 GDP report – due for release on 15 July – is likely to bias towards the downside. We are currently penciling in headline growth of 6.8%y/y for 2Q15, vs. the 7.0% rate in 1Q15. For the full year, we are keeping our GDP forecast at 6.8% for 2015, from 7.4% in 2014.

It is also interesting to note that there was no mention of deposit rate cap in both the announcement and the Q&A document in the latest announcement. The silence on this matter suggests that the deposit rate ceiling is staying at 1.5x for now and may matter less to banks, given a slew of recent announcements (such as the launch of large-denomination, floating-rate tradable certificates of deposit (CD) to individuals and companies in early Jun 2015). As we had argued in earlier reports, the deposit rate cap has run into its limits and becoming less meaningful (see table below for illustration), as the theoretical interest rate margin has already turned higher despite the latest round of interest rates cuts.

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 Jul 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
28 Jun 2015	4.85	2.00	1.5	3.00	1.85
Forecast T+1: 25bps cut	*4.60*	*1.75*	*1.6*	*2.80*	*1.80*
Forecast T+2: 25bps cut	*4.35*	*1.50*	*1.7*	*2.55*	*1.80*
Forecast T+3: 25bps cut	*4.10*	*1.25*	*1.8*	*2.25*	*1.85*
Forecast T+4: 25bps cut	*3.85*	*1.00*	*1.9*	*1.90*	*1.95*
Forecast T+5: 25bps cut	*3.60*	*0.75*	*2.0*	*1.50*	*2.10*
Forecast T+6: 25bps cut	*3.35*	*0.50*	*2.1*	*1.05*	*2.30*
Forecast T+7: 25bps cut	*3.10*	*0.25*	*2.2*	*0.55*	*2.55*
Forecast T+8: 25bps cut	*2.85*	*0.00*	*2.3*	*0.00*	*2.85*

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

This means that a full liberalization of deposit rates could be announced anytime now as the calendar ticks over the half way mark of 2015. It would most likely take the form of a straightforward and simple manner such as that for the lending rate reform. Recall that back on 19 Jul 2013, PBoC announced the removal of lending rate floor in a one-page document (Liberalization of Interest Rates, 20 July 2013 http://bit.ly/1bCo4jM).

Limited Room For Interest Rate Cuts

All things considered, we think there is very limited room for further interest rate actions, and this is affirmed in the Q&A document stating that loan rates are at the lowest since 2011, and would fall further with the latest interest rate reduction over the weekend. Instead, PBoC's focus would be on further deposit rate reform ahead (removal of deposit ceiling), fostering greater competition in the financial sector, and guiding loans to sectors that are deemed to need credit. In addition, further reductions in deposit rates will also hurt savers and impact on consumption.

As such, we believe there is only one more round of interest rate cuts at the most for 2015. Similarly for the system-wide RRR, we think that there is at most 100bps reduction for 2015, and we think the probability is in favour of just another 50bps cut in broad RRR.

As for the RMB, the appearance of the aggressive nature of this weekend's announcement could add downward pressure to the currency. Although at this point, China's focus on achieving the admission to IMF's Special Drawing Rights (SDR) basket of currencies should keep the currency stable. We are keeping our end-2015 USD/RMB forecast of 6.20 and maintain our view that further widening of the RMB trading band this year remains a possibility.

As a matter of perspective, the weekend's announcement is the fourth interest rate cut since the cycle started in November 2014. China last cut interest rates on 10 May. It last cut the RRR for all commercial banks by 100 basis points on 19 Apr, the largest single RRR reduction since the depth of the global financial crisis in 2008, following a 50-basis-point cut in RRR in February. The central bank has cut benchmark lending rate by a total of 115 basis points since November 2014, deposit rate by 100 basis points, on top of a total of 150 basis points in system-wide RRR.

China: Interest Rate and RRR Forecasts

%	1Q15	2Q15	3Q15F	4Q15F	1Q16F	2Q16F
1-year Best Lending Rate	5.35	4.85	4.60	4.60	4.60	4.60
1-year Deposit Rate	2.50	2.00	1.75	1.75	1.75	1.75
Reserve Requirement Ratio	19.50	18.50	18.00	18.00	18.00	18.00

Source: UOB Global Economics & Markets Research Estimates

PBoC Targeted RRR and Interest Rate Cuts announcement中国人民银行决定定向降低存款准备金率并下调贷款和存款基准利率 27 Jun 2015 http://bit.ly/pbocratecuts-20150627

PBoC Q&A on Targeted RRR and Interest Rate Cuts央行有关负责人就定向降准并结合下调存贷款基准利率答记者问 27 Jun 2015 http://bit.ly/pboc-qa-20150627