



Economic Observatory

23 December 2008

PBOC's second rate-cut within a month: A step to prevent deflation risk

The People's Bank of China (PBOC) announced yesterday that it would cut the one-year benchmark lending and deposit rate by 27 basis points effective from 23rd December, the second rate-cut within a month of time. In addition, PBOC will also reduce the reserve requirement ratio (RRR) imposed on commercial banks by 50 basis points effective on 25th December.

This cut follows those by other major central banks in the world, first by the sharp rate cut in the US and then by the Bank of Japan within a short period of time.

Looking forward, we expect the PBOC will have room to cut RRR by up to 750 bps. Pending on the outlook of the RMB exchange rate, the PBOC may be able to cut interest rate further by a range of 135 to 405 bps.

- Yesterday's interest rate cut and RRR reduction was widely expected by the market, after US' surprise rate cut that Fed fund target rate was lowered to 0-0.25% in the last week.
- The rate cut was the second time within a month, reducing the benchmark policy lending to 5.31 percent and the benchmark deposit rate to 2.25 percent. Meanwhile, the reserve requirement ratio (RRR) imposed on commercial banks by 50 basis points effective on 25th December. Specifically, the RRR for small and medium banks is to be cut to 14% and that for six large commercial banks (ABC, BOC, CCB, ICBC, BOCOM, and Postal Bank) is to be cut to 16%.
- The RRR reduction is equivalent of injecting RMB229.2 billion (or USD33.5 billion) additional

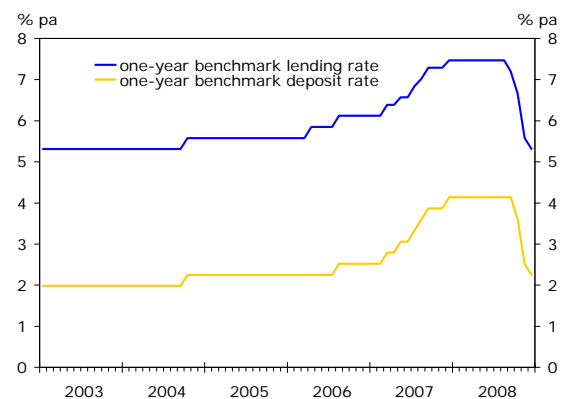
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Chart 1: Benchmark Interest Rates



Source: PBOC.

liquidity into the banking system.

- Since the risk of deflation increased, we expect more aggressive monetary eases will be down the road. China's November CPI inflation fell further to 2.4% yoy, while PPI inflation eased sharply to 2%. In addition, the corporate good prices registered a decline of 0.4% yoy. If these price trends were to continue, China will enter deflation again in mid 2009.
- But how much more is needed for the monetary eases down the road? At this moment, China's reserve requirement ratio imposed on commercial banks is still as high as at 15.5%, although already lowering from 16%. We calculate that if the People's Bank of China were to reduce the reserve requirement ratio by further 7.5 percentage points, together with this round of RRR cut, this is equivalent to releasing liquidity of RMB 4 trillion to the banking system while still keeping the RRR at 8%, a level in mid-2006. The increased liquidity conditions in the banking system will certainly help ease interest rate rises caused by the expected large government debt issuances.
- For the interest rate cuts down the road, we look at interest rate parity condition for guidance as mentioned in our China Economic Observatory on November 26.
- Since US Fed rate has been cut to 0-0.25% and is expected to keep at this level during 2009, the PBOC may be able to cut interest rate further by a range of 135 to 462 bps under various RMB exchange rate assumptions and using China's one-year sovereign spreads, which are at 150 bps.
- For the RMB exchange rate, we assume two scenarios: The first one is that the RMB will be stabilized at the current level for the next year. The second one is that the RMB will depreciate by 2.5% according to the one-year RMB/USD rate in the NDF market.
- Given these assumptions, we can then calculate the "equilibrium" level of Chinese policy rate. If the RMB exchange rate were to stabilize at the current level of RMB6.8 per USD, the estimated "equilibrium" policy rate will be at around 1.5-1.75%. Subtracting from the current interest rate at 5.31%, this then implies that the PBOC will be able to cut interest rate further by another 378-405 bps points in the next year also.
- If the RMB exchange rate were to depreciate according to the one-year NDF implied depreciation of 2.5%, the estimated "equilibrium" rate will be 4.0-4.25%. Subtracting from the current interest rate at 5.31%, this implies that the PBOC will have limited

Table 1: RRR developments

Date of Announcement	Date of Change	Before the change	After
22-Dec-08	25-Dec-08	14.0***	13.5****
26-Nov-08	05-Dec-08	16.0**	14.0***
08-Oct-08	15-Oct-08	16.5*	16.0**
15-Sep-08	25-Sep-08	17.5	16.5*
07-Jun-08	25-Jun-08	17.0	17.5
07-Jun-08	15-Jun-08	16.5	17.0
12-May-08	20-May-08	16.0	16.5
16-Apr-08	25-Apr-08	15.5	16.0
18-Mar-08	25-Mar-08	15.0	15.5
16-Jan-08	25-Jan-08	14.5	15.0
08-Dec-07	25-Dec-07	13.5	14.5
10-Nov-07	26-Nov-07	13.0	13.5
13-Oct-07	25-Oct-07	12.5	13.0
06-Sep-07	25-Sep-07	12.0	12.5
30-Jul-07	15-Aug-07	11.5	12.0
18-May-07	05-Jun-07	11.0	11.5
29-Apr-07	15-May-07	10.5	11.0
05-Apr-07	16-Apr-07	10.0	10.5
16-Feb-07	25-Feb-07	9.5	10.0
05-Jan-07	15-Jan-07	9.0	9.5
03-Nov-06	15-Nov-06	8.5	9.0
21-Jul-06	15-Aug-06	8.0	8.5
16-Jun-06	05-Jul-06	7.5	8.0
24-Mar-04	25-Apr-04	7.0	7.5
23-Aug-03	21-Sep-03	6.0	7.0

Source: PBOC.

Notes: *For small and medium sized banks only, while the RRR for the big four, Bank of Communications, and the Postal Savings Bank of China remained unchanged.

**The required reserve ratio (RRR) for small- and medium-sized financial institutions will be 16.0%, and 17.0% for the six largest banks.

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****The required reserve ratio (RRR) for small- and medium-sized financial institutions will be 13.5%, and 15.5% for the six largest banks.

Table 2: Estimated Chinese Interest Rates under Different Assumptions

Assumption on RMB exchange rate	$(E^e - E)/E$	ρ	R^*	Estimated R
RMB stabilises current level	0.0	1.5	0-0.25	1.5-1.75
1-year NDF implied depreciation	2.5	1.5	0-0.25	4.0-4.25

Source: BBVA.

Note: For $(E^e - E)/E$, "+" represents RMB depreciation and "-" is RMB appreciation

room to cut interest rate. The maximum amount that can be cut will be about 135-162 bps over the next year.

- In sum, we expect the PBOC will have room to cut RRR by at least up to 750 bps. Pending on the outlook of the RMB exchange rate, the PBOC may be able to cut interest rate further by a range of 135 to 405 bps.