China Flash

Latest interest rate cut signals authorities' resolve in arresting growth slowdown

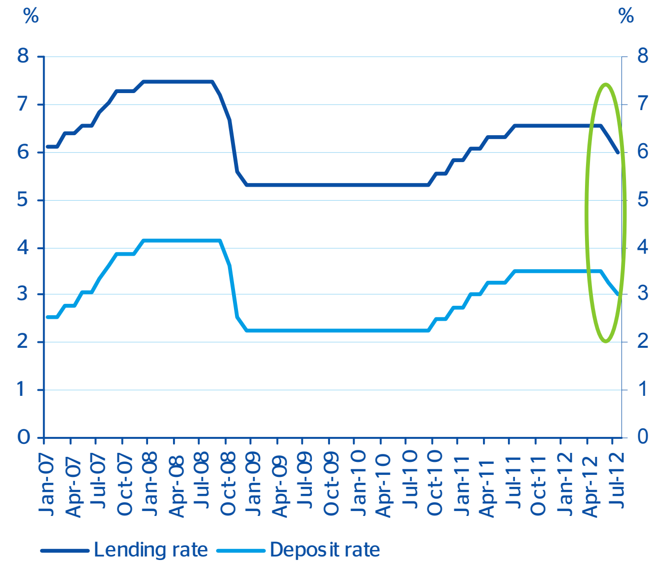
China's central bank announced late yesterday an asymmetric cut in its benchmark one-year deposit and lending rates by 25bps and 31 bps respectively, along with a further widening of the allowable lending rate discount to 30% (from 20%). This is the second interest rate cut within a month, and brings the deposit and lending rates to 6.00% and 3.00% respectively (Chart 1). We had been expecting another rate cut during the course of Q3, although the advanced timing of the cut, rather than an RRR cut as has been widely anticipated (Chart 2), came as a surprise. As such, it may signal the authorities' awareness that the economic indicators to be released next week—including Q2 GDP, and June retails sales, industrial production investment, and exports—may be on the weak side. Given recent moderating trends in the pace of growth and inflation, and the authorities' resolve in stimulating activity, we believe that 2-3 more cuts in the RRR are likely during the remainder of the year, along with another 1-2 interest rate cuts depending on the evolution of the external environment (which would still leave rates above the lowest levels in 2008-09). Markets have generally not responded favourably, perhaps due to their focus on weakening global growth trends, and in China, on the adverse implications for bank profitability of a narrowing in interest rate margins.

- **The interest rate cut becomes effective today, and is the second cut in two months.** The PBoC last announced a rate cut on June 7, and introduced greater flexibility in banks' interest rate settings by introducing a 10% allowable premium on deposit rates and widening the allowable discount on lending rates to 20% from 10% previously. The latest move continues in the direction of interest rate flexibility by further expanding the lending rate discount to 30%. However, it is unlikely that banks will make full use of this expanded room to cut lending rates since the floor has not been a binding constraint (in contrast to the deposit rate cap, which is binding).
- **Slowing growth and inflation provide room for further rate cuts (Chart 3 and 4).** We expect Q2 GDP to weaken to 7.4% y/y (from 8.1% y/y in Q1), and inflation for June to decline to 2.4 y/y. As such, we see room for further declines in interest rates, along with additional cuts in the RRR in light of tightening liquidity conditions. We await the release of next week's batch of key data (July 9-13). The more authorities' more aggressive approach to easing monetary policy could also signal that currency appreciation during the rest of the year could be more limited than previously expected. If the external environment stabilizes in the coming months, we still see scope for some modest appreciation, of around 1% against the USD by the end of the year.
- **The timing of the rate cut, along side the easing moves just announced by the ECB and BoE, has raised speculation of possible policy coordination**. On balance, we believe that explicit coordination is unlikely to have taken place. The high-level and political decision-making nature of rate cuts in China make inter-central bank coordination difficult at a technical level. However, it is nevertheless possible that the authorities took advantage of the time window of the ECB's and BoE's policy meetings to make their announcement.

Stephen Schwartz
Chief Economist for Asia
stephen.schwartz@bbva.com.hk
+852 2582 3218

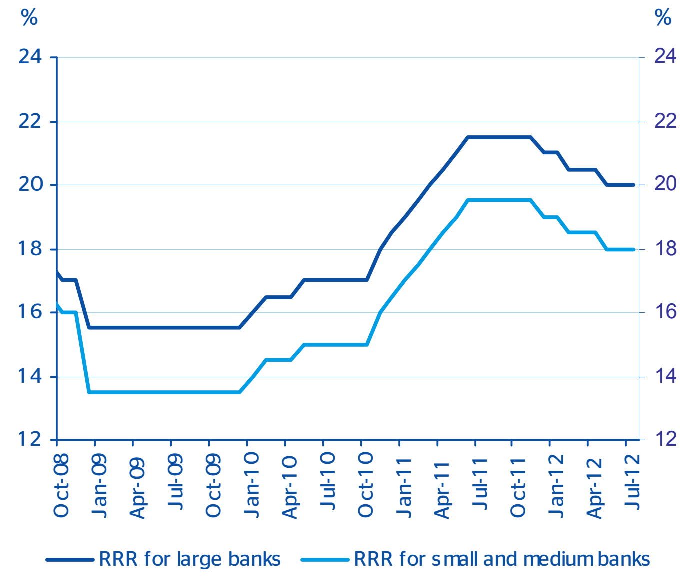
Zhigang Li
Senior Economist
Zhigangi.li@bbva.com.hk
+852 2582 3162

Chart 1
China announces a second monthly cut in interest rates



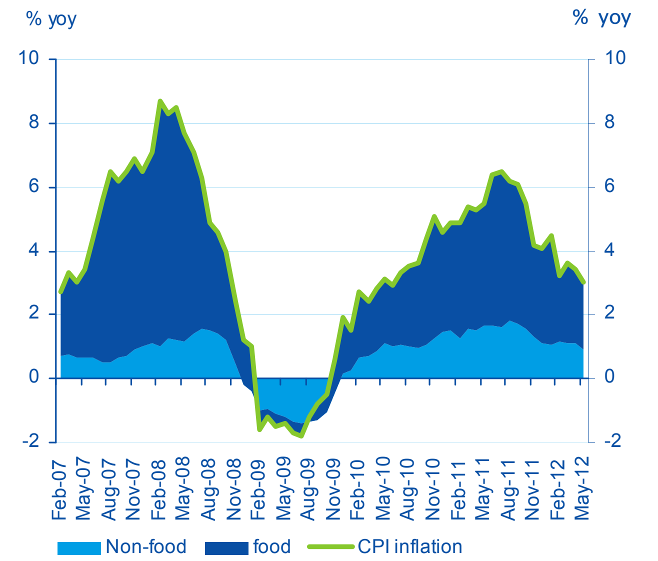
Source: CEIC and BBVA Research

Chart 2
Further cuts in the RRR are expected



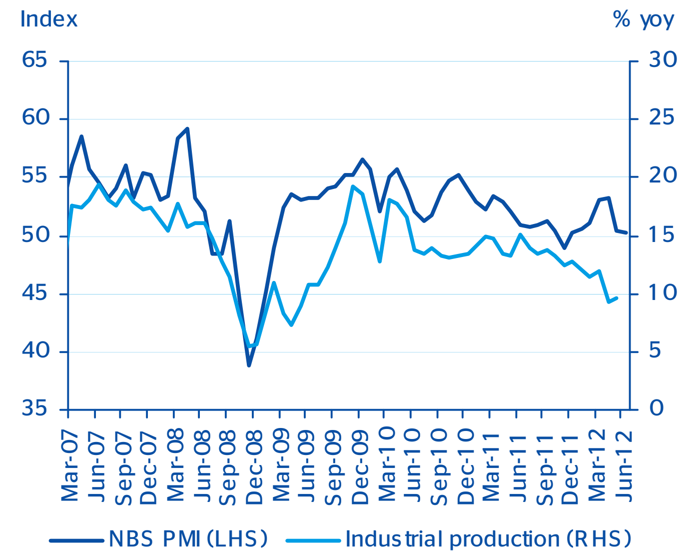
Source: CEIC and BBVA Research

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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| 43/F., Two IFC, 8 Finance Street, Central, Hong Kong | Tel.: +852 2582 3111 | www.bbvaresearch.com

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