

China: Interest rate reform won't stop yuan volatility

China's central bank is forcing lenders to adopt the Loan Prime Rate as the basis of quoting interest rates to borrowers. This will speed up China's interest rate liberalisation process. We discuss how this move is likely to affect monetary policy in 2020



Leading members of the People's Bank of China, including Governor, Yi Gang (waving)

PBoC continues its interest rate liberalisation mission

The People's Bank of China recently announced that banks have to use the Loan Prime Rate (LPR) as the reference rate for lending. Banks can add or subtract points from the LPR to derive the lending rate to customers, with the spread reflecting the risks of a specific loan. The one-year LPR is currently at 4.15%.

This is different from the previous practice of using the one-year benchmark lending rate as a reference point. This rate has not moved since 23 October 2015 and stands at 4.35%.

The usual question we get asked is whether this equates to a rate cut (4.35% vs 4.15%). We'd argue it isn't, because the points that are added/subtracted from the LPR to form the ultimate lending rate should reflect the difference between the 1Y benchmark lending rate and the 1Y LPR, and therefore the final lending rate should stay the same.

What will be the next liberalisation stage?

The PBoC has a formula for the LPR. It is a function of the Medium Lending Facility (MLF). When there's a lower 1Y MLF interest rate, the 1Y LPR should also be lowered.

But the MLF rate is still not market-based. It is an open market operation interest rate involving policy banks and commercial banks, which is in fact controlled by the PBoC.

The next stage of liberalisation will be a more market-based MLF interest rate. But we have to wait until the transmission mechanism between the MLF and LPR is fully established. This could take a couple of years.

What will this mean for interest rate movements in 2020?

This year, borrowers will see their interest rates linked to the LPR rather than the 1Y benchmark rate. We can, therefore, ignore the 1Y benchmark rate (we have ignored it since 2017).

Instead, we should focus on how the PBoC changes the LPR. Even though the LPR is a function of the MLF, this does not necessarily mean that if there's no change in the MLF, there will be no change in the LPR. We have to study how the PBoC structures the LPR. It could also be that the PBoC has to manage market expectations when it comes to the LPR's formation. Clear communication from the central bank is very important.

We believe that at the beginning, the PBoC will keep it simple - when the MLF moves, the LPR will move to the same extent. This should at least be the case during the first half of the year. Later on, the PBoC could try some variation.

Monetary policy in 2020 - further easing to come

We expect that the PBoC will continue to use both interest rates and liquidity policy tools in 2020 to support the economy.

Given that there is unlikely to be a complete rollback of US tariffs, and the technology war has escalated (potentially hitting technology exports), we expect one to two interest rate cuts, each by five basis points on the 7D reverse repo and the 1Y MLF.

With the cuts in the MLF, we expect the same cut in the 1Y LPR and 5Y LPR, at least for the first half of the year, keeping the LPR mechanism straightforward. This should result in an almost parallel downward shift in China's sovereign yield curve, though the liquidity policy tool will change the shape of the curve.

Liquidity injections will put extra downward pressure on the short end of the yield curve, which should make the yield curve appear slightly steeper.

We believe that the PBoC will inject liquidity via open market operations, including the MLF, to smooth out ad hoc liquidity tightness. The central bank has announced it will cut broad-based reserve requirement ratios by 0.5 percentage points, to 12.5% for big banks and to 10.5% for smaller banks in January, to ease liquidity pressures ahead of massive loan demand at the beginning of the year, which is a seasonal pattern within the Chinese banking system.

The yuan should be volatile

The yuan, USD/CNY, has been volatile in 2019, ranging between 6.67 in March and 7.18 in September. This has reflected developments in trade negotiations, rather than the relative monetary policies of China and the US.

We believe the yuan will continue to see volatile trading in 2020 because there is still a lot of uncertainty about the phase one trade deal, which has yet to be signed. And even if it is signed, there are still a number of tariffs imposed on China that will not be rolled back. ([The media has reported](#) that the rollback of tariffs may only be 7.5% on some Chinese goods). The market's focus could also soon shift to a phase two deal, and whether such an agreement is even likely as the US presidential election approaches in November.

In addition to the trade war, there is an emerging technology war against Chinese technology brands operating in the US and Europe, which will add extra pressure to the Chinese economy.

The high degree of uncertainty here suggests the yuan will remain volatile this year. This makes our year-end forecast for 2020 of 6.85 per dollar less valuable than would otherwise be the case.

A volatile yuan in 2019



Source: ING, Bloomberg