Good MornING Asia - 9 September 2019

The People's Bank of China cuts banks' RRR by 0.5 percentage points in a bid to lower the interest costs of small firms and stave off defaults as intensified trade war with the US depresses growth outlook

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EM Space: Softer data warrants greater policy accommodation

- **General Asia:** Weakening economic data reinforces the need for stimulus by major central banks -- Fed's Powell pledging to act if needed, the People's Bank of China (PBOC) trimmed RRR after trade figures disappointed, and the ECB is likely to follow on the easing path at its meeting this week. There is plenty of economic data from Asia to keep markets busy this week, though the key highlight of the week will be Bank Negara Malaysia's policy decision, which is too close to call.
- **Philippines:** The gross international reserves (GIR) hit a record high of $85.6bn in August as the Bangko Sentral ng Pilipinas (BSP) is building its stock of foreign currency amidst swirling headwinds from the trade war. Meanwhile, the minutes of the most recent BSP policy meeting pointed to a benign inflation outlook given base effects and improved supply chains but it also warned of risks from the global slowdown. We expect another round of BSP rate cuts in September and a reserve requirement reduction in the fourth quarter.
- **Indonesia:** Bank Indonesia's Deputy Governor Destry Damayanti downplayed the risk of capital outflows as yields continue to be attractive to foreign investors. She also highlighted the economy's strong fundamentals reflected by rising foreign reserves to $126.4 billion in August, or equivalent to 7.1 months of imports and short-term debt, as the central bank

stockpiles to fend off speculative attacks on the currency.

What to look out for: China inflation and ECB meeting

- Taiwan trade (9 September)
- Philippines trade (10 September)
- China inflation (10 September)
- Malaysia industrial production (11 September)
- US PPI and wholesale inventories (11 September)
- Singapore retail sales (12 September)
- India inflation and trade (12 September)
- ECB meeting (12 September)
- Malaysia central bank meeting (12 September)
- Thailand GIR (13 September)

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China central bank to lower interest rate via RRR cut

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Source: Shutterstock

PBoC cuts RRR

The PBoC announced a 0.5 percentage point cut to the RRR effective on 16 September and an additional targeted RRR cut of 0.5 percentage on both 15 October and 15 November. This matches our expectation. The central bank estimates that the cash released will be around CNY900 billion, of which CNY 100 billion will come from the targeted RRR cut.

The RRR cut should reduce interest rates

As the cut will release CNY900bn, which is equivalent to 85% of new yuan loans in July, the impact on interest rates should be obvious.

We expect that the SHIBOR curve will shift downward. As we expect another RRR cut in the fourth quarter, the SHIBOR curve should fall more at the front end than the back end, which should mean a flatter curve.

The same should apply to China's sovereign bond curve.

But will it benefit small firms?

To benefit small firms, the prerequisite is that:

- Either small firms have already borrowed a loan linked to SHIBOR. This doesn't seem very popular for small loans, so we expect few small firms to benefit from this channel
- Or small firms are willing to borrow, in which case they would benefit from the lower interest rate.

But then we need to ask one more question. What will small firms do with the money borrowed? Two possibilities here:

1. Repay debts with these new loans, which will save some interest costs and avoid defaults on payments. But this would not boost economic activity.
2. Build new production lines and hire more employees. This is only possible if small firms are not affected by the trade war and can tap the right sector of the domestic or global market. As domestic growth is slowing and global growth doesn't seem to be doing well, we believe this won't be the main usage of the loans.

Frankly speaking, the RRR cut's main impact will be to lower interest costs of small firms, as they are more likely to use the cash to repay existing loans than to spend on new production activities.

Impact on USD/CNY

As we expect the RRR cut to reduce interest rates, this raises the question of whether USD/CNY will be affected. We think the correlation between interest rates and the exchange rate in China is still weak due to its capital controls and semi-open capital account.

Even if there is some impact on the exchange rate through the semi-open capital account, this will likely be offset by a possible Federal Reserve interest rate cut in 4Q19.

As such, we keep our forecasts for USD/CNY at the end of 2019 at 7.20 and the range forecast at 7.05-7.50.

We expect one more RRR cut to be announced in 4Q19

The next RRR cut announcement may be made in December, and the effective date could be in January 2020, as the trade war continues to hit the Chinese economy. The impact will be the same, i.e. to lower interest rates in general to prevent small firms from defaulting.

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Hong Kong hit with a downgrade

Fitch has downgraded Hong Kong to AA from AA+ with a negative outlook. Though we agree that the governance has deteriorated recently, we believe the situation will change when there is an election of the next Legislative Council in September 2020

Source: Shutterstock

Fitch downgrade cites worries about governance

Fitch has downgraded Hong Kong from AA+ to AA with a negative outlook, citing the international perception of weak governance and rule of law.

Fitch also claims that stronger integration with the mainland could lead to a narrower rating between Hong Kong and China (A+/Stable).

Other rating agencies have not changed Hong Kong's rating so far. S&P holds a AA+ rating while Moody's rating stands at Aa2, both with a stable outlook.

Where we agree with Fitch and where we don't

We agree with Fitch only partially.

The Hong Kong government has been slow to respond to the protests, which could give the impression that governance is weak. But we think perceptions about the rule of law should improve now that Hong Kong's Chief Executive, Carrie Lam, has officially withdrawn the extradition bill.

Fitch noted that the outlook is negative because "a degree of public discontent is likely to persist". We think that the free expression of public discontent in Hong Kong could be seen as positive. But we agree that protests will continue until the government can successfully build a channel of dialogue, which seems difficult at the moment. We think protestors will express their views through the election of the Legislative Council in September 2020, which will help to rebuild the communication channels between the people and the government.

Impacts on the economy

The material impact of this downgrade should be small as Hong Kong is still rated investment grade. But we can't rule out the possibility that some investors will stay away from Hong Kong for a while, particularly in sectors directly affected by the protests, such as tourism, local spending and transportation. This, together with the impact from the trade war with the US, will keep Hong Kong in recession (i.e. negative quarter-on-quarter growth) for four straight quarters this year. We still expect *year-on-year* GDP growth to be 1.0% in 2019 and 1.4% in 2020.

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