China: cautious interest rate cuts

China's central bank, PBoC, cut rates today, but cautiously. The central bank could have some reservations about interest rate cuts for long-term loans. We see this as a move aimed at limiting the amount of money that will go into asset markets.

Source: istock

Rate cuts as expected but by a smaller step

The PBoC cut the 1Y Loan Prime Rate by 10 basis points to 4.05% as expected, following cuts of 10 basis points in the 7D reverse repo and 1Y MLF rates.

What is unexpected is that the central bank cut the 5Y Loan Prime Rate by only 5 basis points to 4.75%, not by 10 basis points.

Smaller interest rate cuts could be positive for the economy

We believe that the smaller interest rate cut for 5Y loans can be viewed positively.

The objective of interest-rate cuts at this time is to help corporates and individuals with their interest service costs during the covid-19 epidemic. There is also a rough consensus that this epidemic will end sometime in 2020.

So cutting the 5Y loan rate to a lesser extent is logical as the rate-cut needs for longer-term loans should not be mixed with critical short-term cash-flow needs.

Moreover, there is history in China that when money is too cheap, it increasingly flows into speculative assets, e.g. during 2009 and 2010. We think this also explains why the central bank is cautious when cutting the 5Y Loan Prime Rate.

More monetary easing expected in 2Q20 but fiscal stimulus is the key

We expect that there will be more monetary policy easing in 2Q20 to support the economy to recover from the ongoing epidemic.

Our projection is a 0.5 percentage point RRR cut and 10 basis points cuts in 7D reverse repo rates, 1Y MLF and 1Y Loan Prime Rates, respectively. The objective, as said, will be to help the economy to recover. As such the cuts will be more broad-based if the epidemic is over.

The main support during the covid-19 epidemic and the recovery from its aftermath will primarily fall on fiscal measures. We expect a fiscal stimulus of 4.5% of GDP in 2020.

Yuan has weakened after the rate cut

USDCNY has gone from around 7.0000 to 7.0170 at 10:38 HKT on the back of today's rate decision. This reaction was not particularly big compared to the currency's movements in response to new cases of covid-19 since 20th January 2020.

We expect that USDCNY will reach 7.0500 by the end of 1Q20 when more workers will be back to work. If the numbers of new confirmed cases begin to increase again, then the yuan will be even weaker against the dollar.