China central bank to lower interest rate via RRR cut

The People's Bank of China announced RRR cuts of 0.5 percentage points. This policy action aims to lower the interest costs of small firms and stave off defaults

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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.