

China cuts 5Y Loan Prime Rate more than expected

China has cut its five-year Loan Prime Rate more than expected while keeping the one-year rate the same. Why? Supporting the property market may be part of the answer



China cuts 5Y Loan Prime Rate by 15bp

Banks have cut the 5Y Loan Prime Rate (LPR) by 15bp to 4.45% while leaving the 1Y rate unchanged at 3.7%.

The Medium-Term Lending Facility rate (MLF), which is a variable in the formula for setting the LPR, did not change on Monday as the People's Bank of China seemingly does not want to lower interest rates for the whole financial system. The Loan Prime Rate is decided by banks. There have been suggestions by the government that since banks have lowered deposit rates, they should therefore have more room to cut lending rates.

But why cut the 5Y LPR so much - each cut is usually just 5 to 10bp - while leaving the 1Y LPR unchanged? As mortgage rates are linked to the 5Y LPR this could be supportive to mortgagors who will now face lower financing costs. But is this the complete answer?

Mortgage rate is only part of the answer, infrastructure completes the picture

We believe that lowering mortgage rates linked to the 5Y LPR is just part of the reason behind the large rate cut. As long-term loans are also usually linked to the 5Y LPR, infrastructure financing should benefit from this rate cut, too.

It should be clear that this rate cut is not designed to help property developers ease their financing needs. Instead, it is aimed at helping individuals to get a mortgage at a lower interest rate. This could increase sales of residential property, which will help property developers to increase their cash flows from sales and allow them to repay debt. As such, the leverage ratio of indebted property developers should go down.

What about leaving the 1Y LPR unchanged?

In the central bank's 1Q22 monetary policy report, it stated that the 1Y LPR is a benchmark interest rate for the loan market, without mentioning the 5Y LPR. This should be the underlying factor for keeping the 1Y LPR unchanged as the PBoC may want the interbank rate to be stable so that the policy does not significantly increase leverage in the economy.

Looking forward

We expect there will be more re-lending programmes for SMEs to ease their difficult financial situation. For now, the sum of the re-lending programme as of April was only a bit higher than CNY400bn, which is small compared to the amount of new yuan loans.

With the re-lending programme in place, and the PBoC wanting to avoid a significant increase in leverage, cutting the broad-based RRR seems to be less likely than cutting the targeted RRR by 0.5 percentage points for smaller banks between May to July.

Further rate cuts in the MLF would seem to be a very low probability event as that would lower interest rates in the interbank. But cutting the LPR could continue in the next quarter.

All these estimates are based on the Covid situation in China. If there are only a few short lockdowns (e.g. seven days) then the damage should be small and a lot of monetary policy support may not be needed. We believe that to help the economy recover from Covid, fiscal measures should play a bigger role.