

China liberalises interest rate system, a step closer to free floating currency

China announced liberalisation of its interest rate system on 17th August. This takes it one step closer to a free-floating currency but of course, progress will be slow. Net interest margins for banks (NIMs) will be narrower, but it shouldn't affect the yuan trend.



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China needs banks to quote interest rates linked to market rates

China announced that the Loan Prime Rate (LPR) has to be quoted to customers. And the formation of LPR will be priced on a +/- basis point basis from open market operation interest rates.

Initially, the open market operation interest rate chosen is the Medium Term Lending rate (MLF). The MLF is currently quoted in 1Y mostly but will add a 5Y quote, so that the LPR curve is more applicable to bank loans.

Frankly speaking, we do not think the MLF is a 100% market-based interest rate, but of course more market-based than the 1Y benchmark interest rate, which is a fixed rate announced in the past by the central bank.

Still, we expect further liberalisation of the LPR to be quoted based on SHIBOR for short term loans and based on the China sovereign yield for long term loans.

Impact on banks and borrowers

Such liberalisation is part of a process towards achieving freely quoted bank interest rates to customers.

As such we expect that the material impact on banks will be to:

- adopt a market interest rate mechanism. That is, when quoting interest rate to customers, they will also need to consider liquidity and credit risks.
- face a narrower net interest margin. This is because all banks need to quote according to a more market-based interest rate, competition on loans will increase.
- not benefit small firms. As small firms' credit profile will likely be reflected in higher interest rates and higher borrowing costs quoted from banks.
- affect the deposit rate. As loan rates are quoted according to a more market-based system, deposit rates of each bank will reflect loan demand and other liquidity factors, which will indirectly reflect in deposit rates. This could narrow banks' net interest margins.

What about the policy interest rate?

It is still unclear if the 7D repo is the PBoC's policy interest rate. This is because:

1. This new LPR policy's suggested link to open market operation interest rates is the Medium Term Lending rate (MLF), not a short-term interest rate. We understand that this could be a process towards a "Fed style" interest rate policy, but it seems to us that this process will take a long time.
2. In recent interest rate policy, the central bank used the 7D repo as a policy rate (+/- 5 basis points for each move). But other central banks usually use an overnight rate. This issue is not addressed in this interest rate liberalisation progress.

We are still looking forward to a more complete market-based interest rate quoting system, and a clear policy rate from the central bank.

Will a lower interest rate reflect in a weaker yuan?

We don't believe that lower interest rate system from competition of banks will guide the USDCNY. The USDCNY is still guided by the daily fixing. As such this policy doesn't change our forecast of USDCNY at 7.10 by end of 2019.