China lowers rate by 5 basis points

China lowers interest rates on the 1Y Medium Lending Facility by 5 basis points. This should put downward pressure on the loan prime rate (LPR) to be announced every 20th.

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PBoC finally lowers interest rates

The People's Bank of China (PBoC), China's central bank, cut 5 basis points off the 1-year Medium Lending Facility (MLF) as expected, bringing the pause in monetary policy from September to an end.

This is a return to the slow rate cut trend that existed before the September pause. 3M repo rates have increased from a range of 2.55%-2.9% in 1Q19 to around 2.80% to 3.3% since September.

The main lending rate will face downward pressure

The main lending rate, which is now the Loan Prime Rate (LPR), should face downward pressure on 20th November. According to the PBoC, the Loan Prime Rate should reference market rates, including the MLF, and consider adjustments on the 20th of every month.

As such, we expect the LPR to fall by 5 basis points for 1-year loans from 4.20% to 4.15%.

For 5-year rates, they have stayed at 4.85% since the start of the formation of the LPR. It seems to us that the central bank would like to avoid the curve flattening, but as liquidity has tightened since September's pause, it is also possible that the central bank will cut the 5-year LPR from 4.85% to 4.80%.

RRR cut is a question mark for PBoC

As liquidity has tightened, there is also pressure on the PBoC to also cut the reserve rate requirement (RRR) in November or December. But we also think that the central bank might be reluctant to do this as it would like to avoid excessive liquidity. In the absence of strong loan demand, this might be used for asset speculation. And that could lead to a repeat of 2009 when the result was a speculative surge in property prices.

Consequently, we expect that the PBoC will adopt a wait-and-see approach to see if the cut in the LPR will transmit to lower interbank rates. If the transmission mechanism is smooth then the PBoC may save RRR cuts for another time.

Looking forward

We expect the slow rate cut trend to continue into 2020 but with slower momentum, as we expect some progress to be made in the trade talks. At the same time, we expect the trade war will still persist, with no complete trade agreement.

The Chinese economy will face higher interest costs as risk premiums increase with slower economic growth. Rate cuts are a quick solution to lower interest costs, but the central bank could also use the daily open market operations (OMO) to inject short-term liquidity into the financial system and achieve the same result.

We see that the central bank prefers OMO to frequent interest rate cuts and RRR cuts as these policies are longer-term in nature, and may bring China's interest rate to a very low level, which the PBoC wants to avoid.

To conclude, we expect one more rate cut of 5bps and two more RRR cuts (each of 0.5 percentage points) in 2020. The lower interest rate in China has little to do with the exchange rate as the capital account is still semi-closed. Arbitraging activities are to move the yuan softer against the dollar are thin.

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