

China: PBoC surprise rate cut to avoid financial crisis

China's central bank (PBoC) cut the 7D interest rate to avoid a financial crisis



Leading members of the People's Bank of China, including Governor, Yi Gang (waving)

PBoC unexpectedly cut 7D rate

China's central bank (People's Bank of China) cut the 7D reverse repo from 2.4% to 2.2% when it injected CNY50 billion into the interbank market this morning. The cut is deeper than the 5bp reductions usually seen in the past and also the previous cut of 10bp.

This rate cut was unexpected. But the liquidity injection was even more of a surprise. The PBoC has not only stopped injecting any liquidity into the system since the 16 March but even withdrew CNY 33 billion of liquidity on 28 March, just one working day before this injection.

Pre-emptive move to avoid a financial crisis

We see this rate cut as a move to avoid a financial crisis because liquidity has been ample in the Chinese interbank market. The concern falls along the following two lines:

1. Though China's financial system is quite isolated from the global financial system due to its semi-closed capital account, it is impossible to completely insulate it from global financial

market volatility.

2. Domestically, part of the jobs market is affected by the lockdown of many cities within China as the Covid-19 spread from January to March. It is reported that there is an increase in "past-due" payments in consumer finance.

Even though we think the chances are extremely small, these global and domestic sources of volatility could potentially turn into a financial crisis in China. We believe that the central bank is trying to keep this probability as low as possible by cutting the 7D rate pre-emptively.

More cuts are coming

With the cut in 7D reverse repo rates, we expect that there could be a cut in the 1Y Medium Lending Facility on or before 20 April and the 1Y Loan Prime Rate on 20 April so that the whole lending curve shifts downwards.

We do not expect any cut in the benchmark deposit interest rate, which is a retail interest rate, as this would be a backward move in interest rate liberalisation. This is not the time to protect bank profitability.

Instead, regulators could be thinking about protecting financial institutions by increasing bank's capital buffers.

USD/CNY forecast at 7.25 by end of 2Q20

Directly, the rate cut should have little impact on the USD/CNY exchange rate. But the underlying concerns driving the cut (i.e. financial crisis), could move the dollar higher due to flight to safety, and therefore the yuan weaker.

We forecast the USD/CNY at 7.25 by the end of 2Q20.