20 November 2019
Article

China: Three rate cuts, one adjustment

The People's Bank of China controls several interest rates and has cut most of them by five basis points. But the maturities have all been different, meaning that we've really seen just one move to adjust the yield curve. Will there be more?

Content

So many rate cuts but they amount to just one

The People's Bank of China has cut interest rates three times this month:

- 5 November: One-year Medium-term Lending Rate cut by five basis points to 3.25%.
- 18 November: 7D reverse repo cut by five basis points to 2.50%.
- 20 November: 1Y and 5Y Loan Prime Rate also cut by five basis points to 4.15% and 4.80%, respectively.

However, we should really see all these cuts as just one cut of five basis points. The policy implication is that the interest rate curve from the short rate to the five-year rate should reflect these cuts.

Why the PBoC needs to control so many interest rates?

The methodology by the PBoC to move almost the whole interest rate curve by cutting interest rates of various maturities means that the interest rate transmission mechanism in China does not function very well.

We expect the PBoC to live with this until the MLF rate is truly market-based, at which point the PBoC can leave the MLF rate and the LPR to the market. By then, the policy interest rate will be the short-term interest rate alone.

Rate cuts will be data dependent

"Data-dependent" monetary policy is quite unusual in China because most of the time, the PBoC seems to have an interest rate path in mind for the year ahead. But the trade war has changed how the central bank projects its policy.

A positive outcome from the trade war would mean the central bank can stay put on monetary policy, but the reverse will mean it needs to loosen further. The trade war has also resulted in massive infrastructure investments, which should enter into the production stage from the investment stage in the coming months. This will also affect how the PBoC manages monetary policy.

As such, we expect the central bank to be more data-dependent than in the past.

RRR cut is still an important policy tool

Aside from its interest rate policy, the PBoC also has a policy of managing liquidity. Cutting the reserve requirement ratio is a major tool here. Others include the injection or absorption of cash in the interbank market via the MLF and daily open market operations.

After the RRR cut in September which injected CNY800 billion into banks, there were further targeted RRR cuts, which released CNY100 billion on 15 October and 15 November. Additionally, net liquidity injections between September and 20 November amounted to CNY55 billion. The total was an injection of CNY955 billion over just three months.

This highlights that liquidity management is an important tool to guide interest rates lower.

Impact on yuan

As we've said before, there is no direct relationship between the interest rate and the exchange rate in China.

- The capital account is not fully open and there are only small arbitrage opportunities on interest rate differentials between China and the rest of the world.
- The yuan exchange rate is guided by the daily fixing rate, which may not reflect the PBoC's looser monetary policy. For example, after the PBoC announced the five basis point cuts in the 1Y and 5Y LPR, the yuan strengthened from 7.0336 to 7.0305, as of this writing.

The yuan's path is tied more to news on trade talks and will continue to do so until there is a complete trade agreement.

We confirm our view that the USD/CNY will reach 7.0 by the end of 2019.

Iris Pang
Economist, Greater China
+85 22 848 8071
iris.pang@asia.ing.com