

Flash Comment

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China: Cut in interest rates

The Peoples Bank of China (PBoC) today surprisingly cut both its benchmark lending and benchmark deposit interest rates by 108 bp to 5.58% and 2.52% respectively. In addition the reserve requirement ratio (RRR) for smaller commercial banks was cut by 200 bp to 14% and the RRR for major banks was cut by 100 bp to 16%. The size of the interest rate cut was a surprise. Our expectation has been that the lending and deposit rate would be cut four times during the next six months, bringing us back close to the bottom from the previous easing cycle (see chart 1).

The very aggressive move by PBoC underlines both the Chinese leadership's increasing concerns about growth and its current attempts to maximize the psychological impact on financial markets from its policy moves. Although the impact from lower interest rates is highly uncertain and works with a considerable lag, it does make sense to cut decisively now rather than later, because the Chinese economy will remain very vulnerable in the short run where the impact from the recently announced fiscal stimulus package will be modest. The current weakness in the Chinese economy is due to the twin blows from the slowdown in exports, and the lagged impact from earlier monetary tightening in China when fighting inflation was the main priority. Weaker real estate construction has been just as important as slower export growth in explaining the recent economic slowdown in China. With all credit restrictions removed and today's interest rate cut, most of the monetary tightening has been removed (RRR still has some way to go). Hopefully it will contribute to turning Chinese construction activity around, as this would be decisive for the authority's ability to manage a soft landing for the economy given the current bleak outlook for the global economy.

Outlook: Despite the aggressive move by PBoC we are not going to make a similar aggressive change to our forecasts. To some degree interest rate cuts have been front loaded by today's move. However, we have added another two 27 bp cuts in both the benchmark lending and deposit rates, bringing interest rates back to the bottom from the recent interest rate cycle most likely within the next three months. RRR will be cut aggressively, most likely below 10% by year end 2009.

The move has no impact on our forecast for CNY. We still expect CNY to appreciate by about 3% against USD during the next year, however with most appreciation back-loaded in H2 09. As long as China has considerable policy flexibility and a reasonable hope of a soft landing, this will be China's contribution to global stabilization (as during the Asian crisis) and a good relationship with the new U.S. administration. In the negative "everyone for themselves" scenario, in which China's economy experiences a very hard landing and domestic social stability becomes the main concern, a major depreciation of CNY cannot be completely ruled out.

Charts on next page

Chart 1: Leading policy rates:

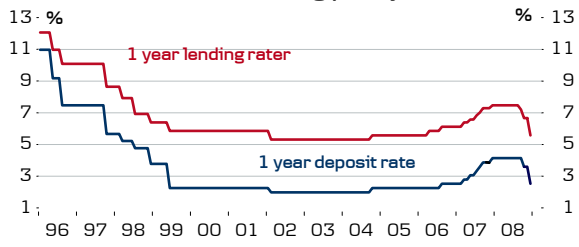


Chart 2: Reserve requirement (smaller banks)

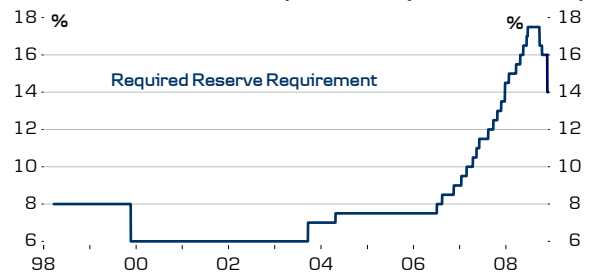
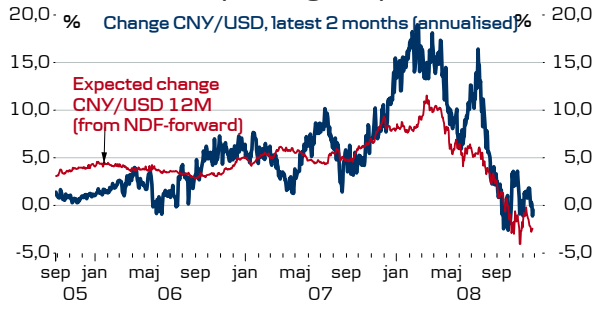


Chart 3: Markets expect slight depreciation



Source: Ecwin

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