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Markets Research

Asia
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Strategy

China Macro Strategy Update

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Breaking News

China's rate cut and liberalization

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Just hours ago, the PBOC announced that it decided to cut the benchmark lending and deposit rates and to expand the bands within which lending and deposit rates can float. Overall, we see this as a welcome policy response to the on-going weakness in economic activities; it should help lift demand for loans and effectively reduce the funding costs for corporates. The commencement of interest rate liberalization should also, in the longer term, help improve the allocation of financial resources, although it may generate short-term pressure on banks' NIM.

The PBOC decided to cut the one-year benchmark lending and deposit rates by 25bps and reduced benchmark rates for other maturities. After the cut (to be effective tomorrow), the one-year benchmark deposit rate will be 3.25% and the one-year benchmark lending rate will be 6.31%. Simultaneously, the PBOC announced that commercial banks are now allowed to set lending rates at or above 0.8x the benchmark rates (previously, the lower bound was 0.9x benchmark rates), and can set deposit rates at levels at or below 1.1x the benchmark rates (previously, deposit rates were not allowed to exceed benchmark rates).

The direction of these policy moves is generally in line with our expectations (see our May 26 note that discussed these two options); the interesting difference is that, instead of an asymmetric benchmark rate cut that we thought made more immediate sense, the PBOC decided to symmetrically cut the one-year benchmark rates but introduced effective asymmetric rate changes by expanding the interest rate bands. The net impact on banks' NIM and on corporates should be similar to that of an asymmetric benchmark rate cut.

More specifically, we see the following implications of these decisions.

- The forthcoming May economic data release on Saturday may surprise to the downside. That is, IP and investment growth may remain weak, although yoy export growth may improve on calendar effects. CPI and PPI inflation should also decline further. The weakness in both real economic data and inflation justify this pre-emptive move by the PBOC.
- A 25bp cut to lending rates could effectively reduce funding costs for many highly leveraged sectors and improve demand for loans. For example, a 25bp reduction in lending rates should boost the power sector's annual profit by about 7%. The positive earnings impact on property, transport and raw materials sectors could also be significant as they are also quite leveraged. The lending rate cut should also help lift demand for loans, at least marginally. Note that the weakness in loan demand has been a major downside risk to investment growth.

Figure 1: Net debt to equity ratio by sector of listed companies, %

Company name	Ticker	Sector	Net debt over equity
Huadian Power	1071.HK	Utilities	411%
Datang Int'l Power	0991.HK	Utilities	326%
China Power Int'l	2380.HK	Utilities	257%
Huaneng Power Intl	0902.HK	Utilities	250%
Longyuan Power	0916.HK	Utilities	146%
China Resources Power	0836.HK	Utilities	125%
China Shipping Development Co. Ltd.	1138.HK	Transportation	125%
Beijing Cap Int'l Airport	0694.HK	Transportation	107%
China Cosco Hldgs	1919.HK	Transportation	62%
Guangzhou R&F Prop	2777.HK	Real Estate	90%
Evergrande	3333.HK	Real Estate	81%
China Resources Land	1109.HK	Real Estate	67%
CNBM	3323.HK	Materials	194%
Maanshan-H	0323.HK	Materials	77%
CR Cement	1313.HK	Materials	68%
China Shanshui Cement	0691.HK	Materials	65%
West China Cement	2233.HK	Materials	60%
China Railway Group	0390.HK	Capital Goods	75%
Sinoma	1893.HK	Capital Goods	72%
China Comms Construct	1800.HK	Capital Goods	61%

Source: Deutsche Bank

- Our banking analysts believe banks may bid up deposit rates immediately (i.e., tomorrow) due to competition between banks for deposits and competition from wealth management products. Assuming all banks push up deposit rates by 3.575% (the new cap) tomorrow, while the lending rate only declines by 25bps in line with benchmark rate cut, the banking system's net interest margin should fall by about 19bps from the current 250bps. This would reduce the current earnings forecast for 2012 for the banking sector by 10-11%.

- Another possibility is that given the implicit state guarantee, larger banks do not need to raise deposit rates as much as the smaller deposit-taking institutions, which are generally perceived as less safe by depositors. As a result, larger banks may gain market share from smaller banks or outperform smaller banks due to less contraction in NIM.

- Over the longer term, we believe interest rate liberalization will provide the basis for more efficient financial resource allocation and form an important condition for China's capital account liberalization. These fundamental reforms should eventually improve the performance of the economy.

Overall, we believe that although the short-term impact of the PBOC decisions may be negative for banks' margin, they are positive for the real economy by limiting the downside risk to investment growth and will eventually help improve the efficiency of the economy through market-based pricing for financial resources. Highly leveraged sectors such as power, real estate, transport and materials should benefit the most.

Appendix 1

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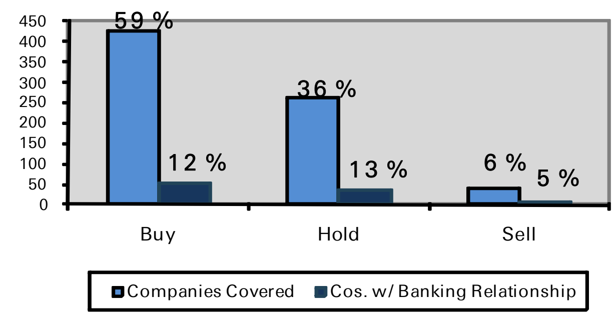

Asia-Pacific Universe

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