more give, less take

China Economic Update
by NAB Group Economics

9 December 2014

China's surprise interest rate cuts – easing debt burden or targeting growth?

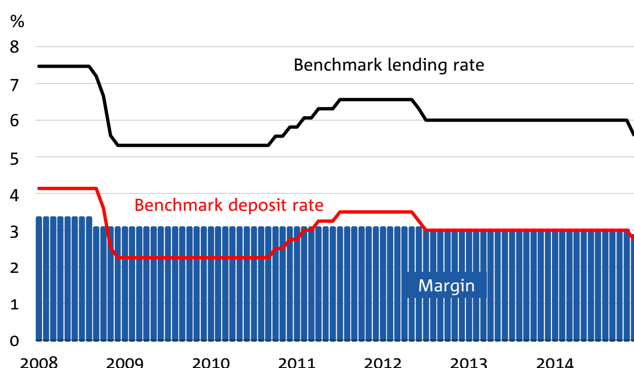
In late November, the People's Bank of China (PBoC) surprised markets with cuts to benchmark interest rates. These changes were the first in over two years – the PBoC had held rates stable since early July 2012. There are competing forces that make the rate outlook uncertain – first is the extent to which Chinese authorities wish to arrest the current slowdown in the economy and the second is the broader goal of controlling growth in debt.

What were the policy changes?

On the lending side, the benchmark one year lending rate was cut by 40 basis points to 5.6%. The actual rates that banks lend to their customers are largely deregulated – following changes introduced in July 2013.

The benchmark one year deposit rate was lowered by 25 basis points to 2.75%. The impact of this change is somewhat diluted by widening the permitted ceiling above the benchmark to 20% (from 10% previously). This meant that the maximum deposit rate remained unchanged at 3.3%.

The asymmetric cut has narrowed the interest margin for China's banks



Sources: CEIC, NAB Economics

The asymmetric nature of these changes theoretically places some additional burden on the banking sector – squeezing the margin between deposit and lending rates – although this assumes that banks will act according to the moves in the benchmarks. Banks may seek to maintain margins by increasing rates on loans.

For example, the Wall Street Journal quoted an official at Bank of China who suggested that rates on existing loans would fall in response to the rate cut, but new loans would be unchanged, due to increasing risk levels in the slowing economy.

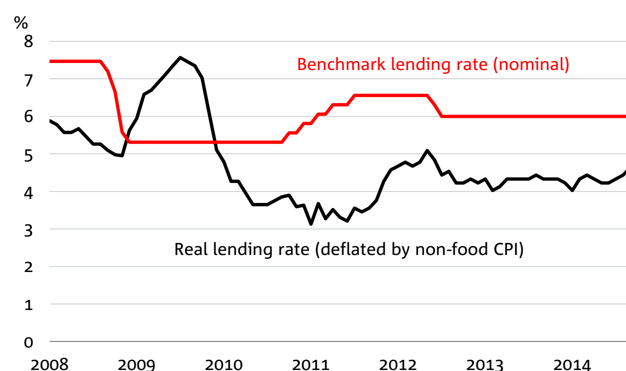
Why were these policy changes surprising?

While economic growth has slowed noticeably over the course of 2014 (with the possibility of China missing its growth target of 7.5%), comments from Chinese authorities indicated a degree of satisfaction with the recent economic performance. The PBoC had held rates stable for an extended period of time, making only minor changes to policies (such as lending facilities and lower reserve requirements for smaller scale banks as well as liquidity injections), while repeatedly commenting that broad stimulus for the economy was not required.

What was the official reason for the changes?

PBoC commentary following the rate cuts emphasised that this change did not signal a shift in their monetary policy stance. The bank argues that policy rates are neutral, rather than stimulatory, and that the cut reflected the recent softening in inflation, which was driving real interest rates higher.

Real interest rates have trended higher in 2014, as non-food price inflation has slowed



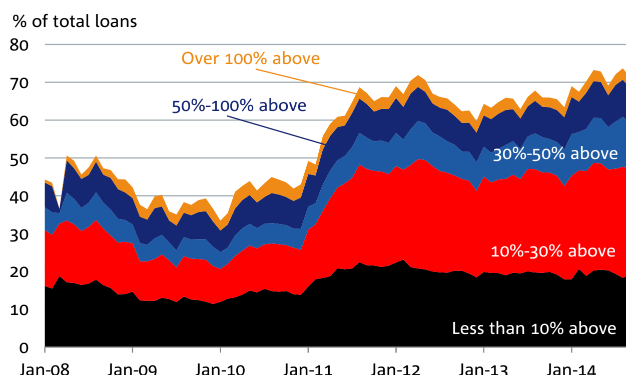
Sources: CEIC, NAB Economics

The policy change is unlikely to boost liquidity in financial markets unless it is accompanied by a cut in the Reserve Requirement Ratio (RRR) for the country's banks. While many analysts are anticipating a cut to the ratio, at the time of writing no move has been made.

The PBoC also noted difficulties in accessing finance and high financing costs for firms, particularly in the SME sector. While this is correct, it is not necessarily the case that lower benchmark lending rates will flow through into financing costs at all, let alone for smaller firms.

In July 2013, Chinese authorities liberalised lending rates, removing the floor below the benchmark. However, since this move, the proportion of banks loans with rates above the benchmark has steadily trended upwards – from around 63% in June 2013 to around 71% in September 2014.

The share of loans priced above the benchmark lending rate has trended up since mid 2013



Sources: CEIC, NAB Economics

Access to bank loans a critical challenge for many firms

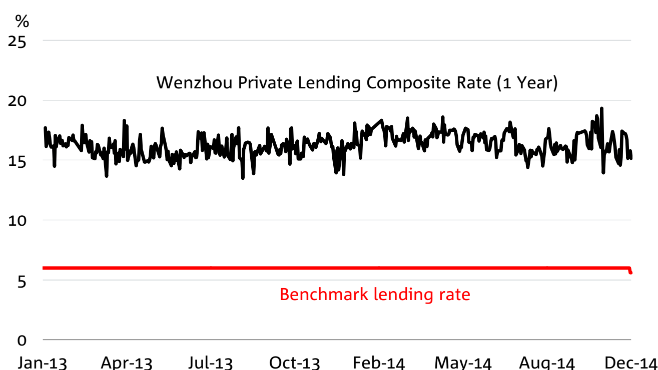
China's state-owned enterprises (SOEs) have long enjoyed preferential access to finance. Estimates published in the Wall Street Journal suggest that only around 30% of corporate loans are directed towards smaller firms (although this share has trended up over the past few years) – highlighting the dominant position of the SOEs in the traditional finance sector. As a result, SOEs are more likely to benefit from the rate cut than smaller firms.

The disproportionately high share of bank loans effectively locks SMEs out of the traditional finance sector. According to a survey of over 1000 SMEs, released at the 2013 Boao Forum, around two-thirds of these firms consider bank loans to be a primary financing measure, but over 62% of these firms had no bank loans.

Poor access to traditional finance has driven many SME firms towards the shadow banking sector, contributing to the growth of this part of the broad finance industry over the past few years. Interest rates for shadow banking products are considerably higher than benchmark loan rates and are unlikely to move as a result of the recent cuts.

According to the Ministry of Industry and Information Technology, funding costs for SMEs rose by around 17.5% in the first half of 2014, with examples of businesses paying interest rates as high as 30%. Private lending rates in the pilot program in Wenzhou remain far above benchmark levels.

The Wenzhou private lending rate far exceeds the benchmark lending rate



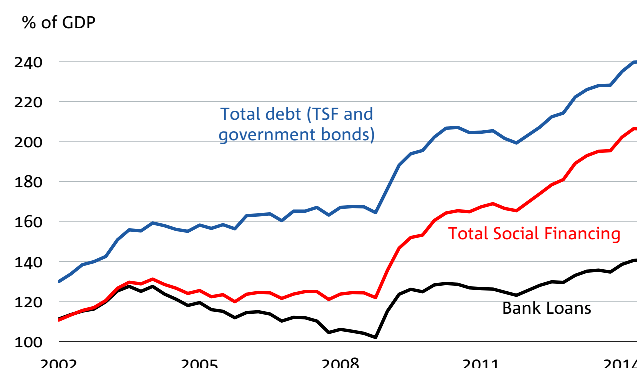
Sources: CEIC, NAB Economics

What are the prospects going forward?

There may be further cuts to the benchmark lending rate in coming months. A report by Reuters following the rate change quoted an unnamed economist at a government think tank who suggested the PBoC was open to further cuts, both to lending rates and RRR.

While further cuts would be a beneficial for highly indebted firms (particularly in China's industrial sector), there are some risks associated with such a move. Significantly easing lending practices would risk refuelling some of the structural imbalances within the economy – such as excessive investment in heavy industry and real estate – and increase the rate of debt growth (which has slowed recently). This would lengthen of time required to address surplus capacity and slow the path of economic reform, particularly for highly indebted SOEs that should be reorganised.

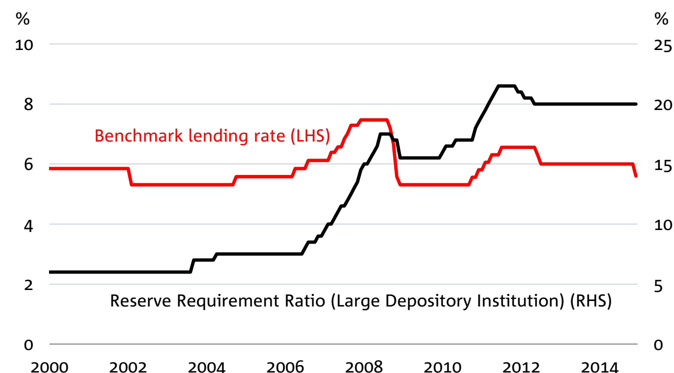
China's 'total' debt levels have continued to trend higher across 2014



Sources: CEIC, NAB Economics

An increasing number of analysts are anticipating cuts to the RRR – possibly as soon as this month. However, given the PBoC's reluctance to introduce broader stimulus, we don't believe that such a change is guaranteed, and may require a weaker than acceptable outcome for economic growth.

China's RRR has increased significantly over the past decade, but may start to ease



Sources: CEIC, NAB Economics

A recent Bloomberg survey anticipates 100 basis points of cuts to the RRR across 2015 – bringing the ratio to 19% (for large depository institutions), with some respondents expecting a rate as low as 18% by the end of next year. If the 100 basis point cut occurs, it would add around RMB 1.1 trillion in liquidity to financial markets.

Conclusion

We expect one further cut to the lending rate in the first quarter of 2015 – bringing the benchmark down to 5.2%. In the absence of a RRR cut, this will have a limited stimulatory impact on the economy – with the Chinese economy expected to record growth of 7.0%.

For more information, please contact

Gerard Burg +613 8634 2788

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Agribusiness
+(61 3) 8634 0198

Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

Karla Bulauan
Economist – Industry Analysis
+(61 3) 86414028

International Economics

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Equities
Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Important Notice

This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances.
NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click here to view our disclaimer and terms of use.