China cuts interest rates for the first time since 2008

Manulife Asset Management's Ronald Chan, Head of Equity, Asia shares his insight.

On June 8, the People's Bank of China (PBoC) announced a 25 basis points cut on both commercial banks' benchmark lending and deposit rates. As the first rate cut since December 2008, the move sends a strong signal that the government will be more active in supporting demand and stabilizing growth. The cut will bring down the benchmark one-year lending and deposit rates to 6.31% and 3.25%, respectively.

The PBoC has also given banks more pricing power – banks are now allowed to charge up to 20% less, from 10% less previously, than the benchmark on loans and pay 10% higher, previously from a hard ceiling, than the benchmark to deposits.

What is the significance of the interest rate move?

The rate cut is likely to boost sentiment and will help lower the cost of corporate and local government borrowing and boost credit demand at the margin. To the extent that mortgage rates will also be lowered in line with the benchmark rates, this should help home buyers as well. More importantly, the rate move is an important step toward further interest rate liberalization. The recent policy easing measures, including subsidies to promote sales of energy-saving appliances, appear to confirm the government wants to embed structural reforms in the cyclical policy easing, which is positive from a medium-term perspective. The rate cut should also benefit the cyclical sectors more than structural sectors. Interest rate-sensitive sectors will likely gain from universal easing. Property, utility, machinery, airlines and insurance should see the benefits as a result of this move.

The seemingly symmetric rate cut will likely lead to an asymmetric outcome since banks are now given more flexibility to price their loans and deposits against the benchmark. Given that banks have been fighting to attract deposits, they are likely to use the flexibility to keep deposit rates higher than the benchmark, especially the smaller banks. On the other hand, banks can also further lower their lending rates to encourage credit demand in the current environment. Credit demand has been somewhat weak mainly because the growth outlook was uncertain and corporates were unwilling to borrow and invest when they were battling against falling demand and rising inventories.

Whilst we believe this move will boost market sentiment, more importantly, we believe the government will continue to increase fiscal spending, including on social housing, health and education, and infrastructure projects, this is likely to be more effective in boosting aggregate demand.

So why is consumption growth slowing? Consumption growth follows income growth, which tracks general economic growth, which has slowed visibly. Re-orienting the economy to a more consumption-based growth model requires serious policy measures and takes time. The positive impact will likely be somewhat discounted when the economy goes through a cyclical downturn.

Overall, we see this rate cut as a shift of monetary policy tone that would help lower borrowing cost and improve confidence, increasing the likelihood for the economy to bottom in Q2 and rebound in second half of this year.

Manulife Asset Management

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