PBOC First Rate Cut Since 2012 Signaled in Swaps: China Credit

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By Justina Lee

Oct. 17 (Bloomberg) -- The cost of locking in Chinese borrowing costs is poised to drop below the central bank’s savings benchmark for the first time since 2012 as speculation mounts that interest rates will be cut.

The one-year swap, a fixed payment to receive the floating seven-day repurchase rate, has fallen 2.13 percentage points so far in 2014 and ended yesterday at 3.09 percent, near the official 12-month deposit rate of 3 percent. The last time the contracts were lower than the benchmark was in 2012, when the People’s Bank of China reduced savings and loan costs twice.

Asia’s largest economy is forecast to report third-quarter growth of 7.2 percent next week, the least since 2009, after data for September showed overall financing missed estimates and inflation eased to the slowest since 2010. While the central bank lowered the rate on 14-day repurchase agreements this week, a cut in the benchmark is the most direct way to shrink financing costs, the China Securities Journal said in a commentary yesterday. Credit Agricole CIB says there’s a 40 percent likelihood of a reduction.

“The chances are significant because you have a simultaneous growth slowdown and a decline in inflation, which opens the door for policy makers to address slower growth,”

said Dariusz Kowalczyk, a strategist at Credit Agricole in Hong Kong. “Most lending is benchmarked off the PBOC’s rate rather than that of the market. It’s precisely because they’ve kept the benchmark lending rate steady that credit growth isn’t that strong.”

Credit Gauge

China’s benchmark one-year lending rate has been 6 percent since July 2012, when it was cut for a second time that year.

The central bank allowed commercial lenders the freedom to set their own loan costs last year, while the deposit rate remains capped at 1.1 times the PBOC’s 3 percent targeted level.

Aggregate financing came in at 1.05 trillion yuan ($171 billion) last month, missing the 1.15 trillion yuan median estimate in a Bloomberg survey and below last year's monthly average of 1.44 trillion yuan. Data earlier this week showed consumer prices climbed 1.6 percent in September, the slowest pace in 4 1/2 years.

The PBOC cut the interest rate on 14-day repo contracts to

3.4 percent this week, compared with 3.5 percent on Oct. 9. and

3.7 percent on Sept. 16. The seven-day repurchase rate averaged

3.05 percent this month, the lowest since May 2012.

'Price In'

"It looks like the market has priced in a rate cut or some more policy easing," said Hua Changchun, an economist at Nomura Holdings Plc in Hong Kong. "It looks like the intention of policy makers is to have lower interbank rates at this stage. If that doesn't work, it could be followed by targeted rate cuts or possibly a broader rate cut."

While a universal decrease isn't in Nomura's baseline scenario, the bank expects a reduction in reserve requirements for all of the nation's banks this quarter, Hua added.

New yuan loans plunged to the least since 2009 in July as the benchmark money-market rate rebounded to an average 3.84 percent after exports and manufacturing showed signs of a recovery in the previous month. This time, the central bank may allow funding conditions to remain ample for a while, said Linan Liu, a rates strategist at Deutsche Bank AG in Hong Kong.

"The PBOC has given a clear signal that it's willing to anchor expectations for flush liquidity to stay," Liu said.

"Hopefully that will create a monetary-policy environment that will allow banks to continue lending to corporates at relatively reasonable levels."

While she doesn't expect the PBOC to deploy any universal easing measures, it may reduce the 14-day repo rate by another

20 basis points before the year-end and the seven-day repo rate may stay between 2.5 and 3 percent, Liu said.

'Prudent' Policy

PBOC Governor Zhou Xiaochuan last weekend reiterated the need for “prudent” monetary policy amid “steady” economic expansion. China prefers reform to economic stimulus, Premier Li Keqiang said last week, while adding that the nation should ensure that its 2014 economic goals are met.

While total financing fell short of expectations, it was still up from 957 billion yuan from August. Money supply grew

12.9 percent, accelerating from 12.8 percent. The yuan strengthened 0.05 percent to 6.1231 versus the dollar in Shanghai yesterday.

The central bank has so far opted for targeted measures to bolster growth, including RRR cuts for smaller banks and a 500 billion yuan provision for the nation’s five largest banks. Debt ballooned after the government rolled out a stimulus campaign amid the 2008 financial crisis, while shadow banking, which encompasses off-balance-sheet lending including trusts, also expanded beyond policy makers’ direct control.

Cut ‘Necessary’

“Although the lending rate is liberalized, many loans still follow the benchmark, so cutting that will be effective,”

said Xu Gao, a Beijing-based economist at Everbright Securities Co. “With such low inflation, the real interest rate has increased, so a rate reduction is necessary. But the PBOC’s attitude is clear: It doesn’t want to cut.”

Barclays Plc maintains its forecast for a 25 basis point lowering of the benchmark lending rate this quarter and another in the next three months because this is the only way to meaningfully reduce borrowing costs, economists Jian Chang in Hong Kong and Bill Diviney in Singapore wrote in a note yesterday.

“China’s official growth target of 7.5 percent for this year matters to the government,” said Nomura’s Hua. “When Premier Li talks about his policy-change agenda, one precondition is that the economy is operating within a reasonable range. If you really go below that band, the government will react with further policy easing.”

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