

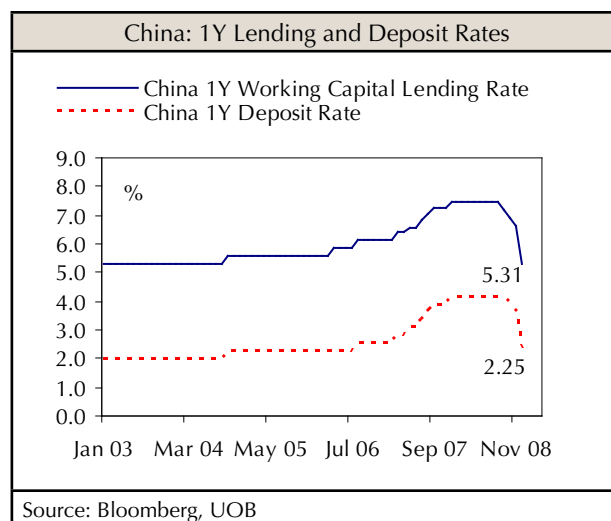
Tuesday, 23 December 2008

China: PBoC Wraps Up 2008 With Its Fifth Interest Rate Cut

In what looks like the last policy move for the year, China's central bank yesterday (22 Dec) announced its fifth interest rate cut since the easing cycle began in mid-Sep. Compared to the aggressive move in November, PBoC's latest announcement returns to the normal rate adjustment quantum, with 27bps cuts to both its benchmark one-year lending and deposit rates - to 5.31% and 2.25%, respectively. At the same time, PBoC also cut banks' reserve requirement ratio (RRR) by 50bps. Recall that on 26 Nov, it announced an unusually large 108bps cut to both its benchmark lending and deposit rates.

The latest announcement was widely anticipated as the US Federal Reserve and Bank of Japan last week lowered their benchmark interest rates. The latest quantum suggests that the aggressive move in November is likely to be a one-off affair that meant to bolster the RMB4tn fiscal stimulus plan (announced on 9 Nov).

We therefore see PBoC normalizing its interest rate cuts back the 27-54bps mode in the months ahead. Specifically, there is still plenty of room for China to cut its interest rates to narrow the spread with its US counterparts as domestic growth decelerates on the back of the collapse in end-demand from G3. At the same time, the sharp retreat in domestic consumer prices in recent months (+2.4%/y in Nov vs. +4.0% in Oct) suggests that deflation is fast taking shape, as we look for China's full year CPI inflation at -1% in 2009 vs. +6.0% estimated for 2008.



The decline in headline consumer prices is expected to pressure PBoC to ease interest rates, as such we are leaving our forecasts largely unchanged as detailed in our Quarterly Global Outlook 1Q09 report, issued last Friday (19 Dec). To recap, we expect PBoC to frontload its rate cuts in 1H09, bringing the benchmark 1Y lending and deposit rates to 2.34% and 1.44% respectively, by end-2009. For the 1Y lending rate, we expect 108bps move each in 1Q09 and 2Q09, 54bps in 3Q09, and then 27bps in 4Q09. For the 1Y deposit rate, the moves are likely to be more gradual, with 27bps cut each in 1Q09 to 3Q09, as we believe the authorities are wary of excessively low deposit rates for a nation of savers.

As for the RMB, the latest PBoC's rate cut announcement has not altered our view of a small gain for the currency against the USD, as articulated in our 1Q09 Quarterly report. In short, its strength on a trade-weighted basis, the collapse in exports a demand issue, its status as a stabilizing currency in Asia, and continued US political pressures suggest a low possibility of RMB depreciation against the USD in 2009. We continue to look for the RMB at 6.82/USD at end-2008, 6.80 by mid-2009, and 6.76 by end-2009, against close of 6.8377 on 22 Dec.

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