

China cuts interest rates

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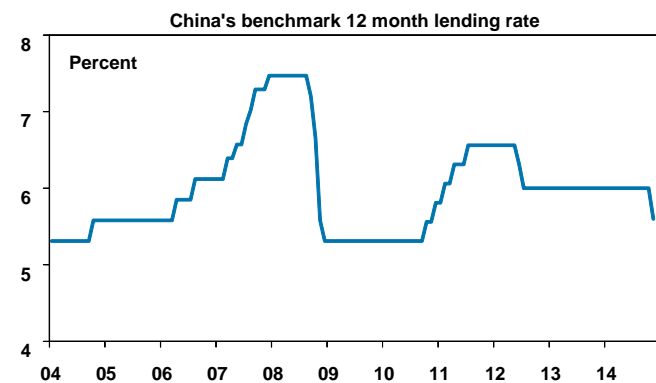


Key points

- > For the first time since 2012 China has cut interest rates. Borrowing costs have been too high in China so rate cuts will help support economic growth. Expect more interest rate cuts ahead.
- > The rate cut is positive for Chinese shares which remain relatively cheap.
- > China's rate cut highlights that global monetary conditions are still easing with monetary easing in Japan, Europe and China taking over from the end of quantitative easing in the US.
- > Chinese easing is also positive for commodities and Australian shares.

Introduction

After resisting traditional monetary stimulus measures in favour of various “mini stimulus” initiatives the People's Bank of China (PBOC) has finally cut interest rates, reducing the 12 month benchmark lending rate by 0.40% to 5.6% and the 12 month benchmark deposit rate by 0.25% to 2.75%.



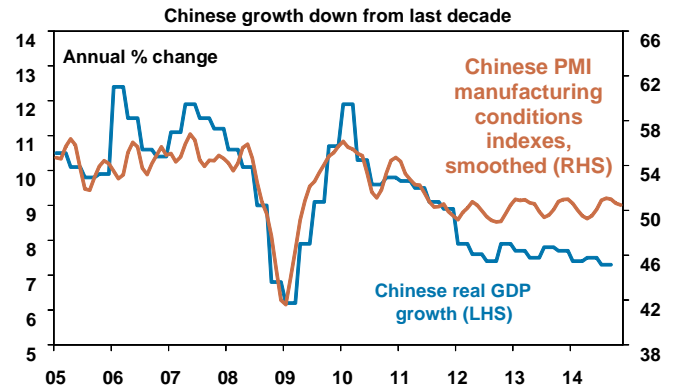
Source: Bloomberg, AMP Capital

Our assessment is that this is a good, overdue move as relatively high interest rates have been holding back Chinese growth this year. This note looks at the main issues and implications for investors.

Chinese growth has slowed

Chinese growth has slowed significantly compared to the 10% plus rate seen last decade and for the last few years has been running around 7 to 8%. The downshifting in growth reflects several factors:

- The Chinese Government has come to the view that 10% plus growth is not sustainable as it has led to various social and economic imbalances in the economy, including strong growth in debt, inequality, pollution and corruption. In particular the new leadership has been focused more on economic reform than growth for growth's sake.



Source: Bloomberg, AMP Capital

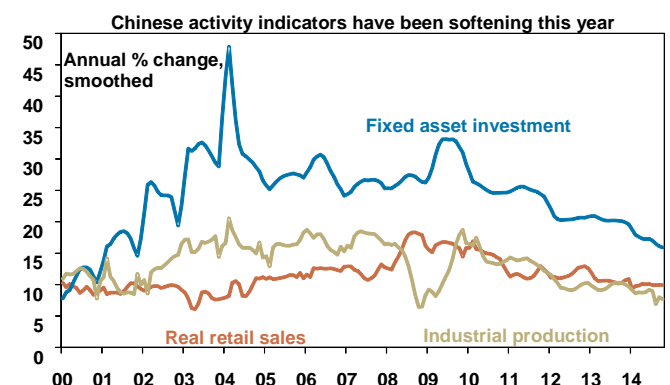
- Soft global growth has weighed on Chinese exports.
- More recently, a downturn in the property market – in terms of construction & prices – has weighed on growth.



Source: Bloomberg, AMP Capital

- Monetary policy has arguably been too tight as the PBOC has sought to rein in growth in credit through the “shadow banking” sector (ie outside of the more regulated banks).

Reflecting the last two factors, the slowdown in growth has become more noticeable this year with a range of indicators losing momentum including industrial production, retail sales, fixed asset investment and money supply and credit.



Source: Thomson Reuters, AMP Capital

While assuring that growth would come in “around” the 7.5% target for this year, the current Government has been keen to distance itself from the previous government and the negative

connotations that the “stimulative policy” response to the global financial crisis has. As such it has focused more on structural reforms to revitalise long term growth and responded to periods of weaker data with “targeted easing” and “mini stimulus” measures. These include: rebuilding shanty towns; increased railway spending; accelerated depreciation and other policy support for small business; the relaxation or removal of measures designed to slow the property market; lower money market interest rates; and liquidity injections into the banks.

However, the continued loss of growth momentum lately despite these measures has suggested that they are not enough and that the risks to growth may be shifting below 7%. In particular with private sector investment slowing rapidly, inflation falling and producer prices in deflation for nearly three years it was clear that monetary conditions were too tight and interest rates too high. For example, anecdotes suggest smaller private firms have been facing an effective cost of borrowing of 15 to 20% from the shadow banking system. While the Government may have been prepared to tolerate this as long as employment growth held up, slowing economic growth will eventually hit employment as it is a lagging indicator, Furthermore, employment readings in business conditions surveys have been trending down.

So at last the PBOC has recognised this and started to cut interest rates. Our assessment is that:

- The rate cut clearly signals that the Chinese Government is determined to support growth.
- More rate cuts are likely as borrowing costs remain too high and in any case the PBOC rarely cuts just once. The lending rate could fall to 4.5% next year.
- Cutting rates is the most effective way to cut borrowing costs as bank lending rates are still largely priced off the benchmark rate and are mostly above it. Rate cuts will benefit private sector companies that have been paying very high interest rates and households with housing debt. It won't stop a gradual structural slowing in Chinese growth (due to demographics and as the industrialisation phase slows) but it adds to confidence that China will avoid the hard landing many still see around the next corner. After growth of around 7.5% this year, expect growth of around 7% next year.
- Reform remains the main focus in China, but it was always contingent on growth holding up.

The China worry list

But what about the China worries we regularly hear about from China bears regarding: the need to rebalance the economy; falling competitiveness; a housing bubble; excessive growth in debt; and the shadow banking system. Our assessment has been that these problems are exaggerated¹. In particular:

The investment/consumption imbalance is exaggerated – as consumption is understated relative to investment in China, investment per capita is low and reducing investment too quickly will only risk China going down the same inflation/trade deficit path seen in many other emerging countries. So any adjustment needs to be gradual.

China is not losing its competitiveness – wages growth is being offset by rapid productivity growth, China is still gaining global export share and inflation is low and falling.

¹ See “Chinese debt worries and growth”, *Oliver's Insights*, February 2014.

There has been no generalised housing bubble – household debt is low at 30% of GDP, house prices have not kept up with incomes and there is an undersupply of affordable housing. Yes there has been excessive development in some cities, but this not the first tier cities.

Rapid rise in debt, with credit up 22% pa over the last decade, is a concern but – total debt relative to GDP is not excessive globally and strong growth in debt reflects China's 50% savings rate with savings mainly being recycled via debt. Lowering lending and hence investment too quickly without first lowering saving will risk recession and deflation.

Finally, China's “shadow banking” system (ie, lending occurring outside the banks) has grown rapidly but – it is still relatively small (30% of banking assets versus 100% in the US), lacks leverage, lacks complexity and lacks heavy foreign exposure. So it's certainly not comparable to the risks around US shadow banking that drove the GFC.

Overall our assessment is that these risks are manageable, provided the Government does not make a policy mistake. Its move to cut interest rate is a sign that it is well aware of this risk. Unlike in western countries, much of what goes on in China is controlled by the Government, and this includes the current slowdown. And the Government has plenty of firepower to ensure growth holds up.

The Chinese share market

After a long bear market since August 2009 which left them very cheap, Chinese share are up around 18% so far this year. Despite this they remain relatively cheap with a price to historic earnings ratio of 10.9 and a forward PE of 9.1. The PBOC rate cut adds to their attractiveness from a valuation perspective and in terms of providing confidence regarding future earnings growth.



Source: Thomson Reuters, AMP Capital

Global and Australian implications

China's rate cut adds to the determination of global policy makers to avoid deflation and support growth. While US quantitative easing may have ended, it's being replaced by QE in Japan and Europe and rate cuts in China. And rate hikes are a fair way off in the US and a long way off in Australia. This in turn augurs well for shares and other growth assets.

The Chinese rate cut and the signal of determination to support growth it provides is also positive for commodity prices and the Australian share market. While a return to a secular bull market in commodities and relative outperformance by Australian shares is unlikely, both have been oversold lately and China's move could provide the trigger for a decent rally into year end.

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