Northern Trust

ECONOMIC UPDATE

November 25, 2014

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312.557.8820
ct92@ntrs.com

James Pressler
Senior Analyst
Country Risk
312-444-4109
jap10@ntrs.com

Editor's Note: We will not publish commentary this coming Friday, in recognition of the U.S. Thanksgiving weekend. For those who celebrate the occasion, our very warmest wishes to you and your family for the holiday.

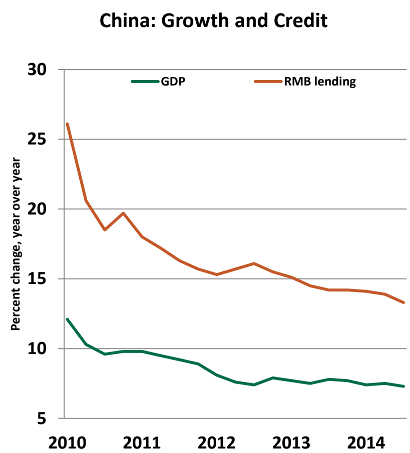
- **China: Surprise Rate Cut Raises Hopes and Questions**

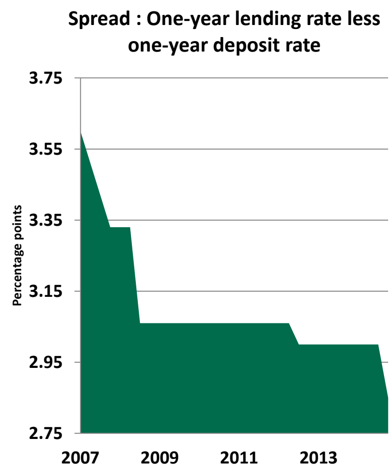
After months of promoting a "fine-tuning" approach, the People's Bank of China (PBoC) lowered two benchmark interest rates significantly after markets closed last Friday. Observers were generally pleased at the step but were left wondering where policy will go from here.

Chinese policymakers reduced the one-year lending rate by 40 basis points to 5.60%, and the one-year deposit rate was lowered by 25 basis points to 2.75%, tightening the spread between these benchmarks to the narrowest range in more than a decade.

With growth moderating, credit growth slowing and renewed concerns about the financial system, the news came as a relief. Chinese inflation has been falling; consumer prices were rising by more than 3% annually a year ago, but that pace has dropped to 1.6% currently. The PBoC does not have an official inflation target, but the resource slack implied by this trend was a clear basis for easing.

Local markets rallied on the belief that the government was finally drawing a line on how far it would let activity slow. However, some have worried that the PBoC's increased aggressiveness reflects official concern that growth will struggle to reach previously-announced targets.





Source: Haver Analytics

The PBoC's rate cuts were combined with an increase in the allowable interest rate banks can offer on deposits, from up to 1.1 times the PBoC benchmark rate (3.00% – 3.30%) to 1.2 times the new rate (2.75% – 3.30%). This minor adjustment, officially described as a liberalization of interest rates, is actually quite telling, as it means the effective one-year deposit rate offered by banks remains steady despite the cut in the benchmark.

This suggests that while the PBoC wants to ease the cost of credit through a lower lending rate, it does not want to reduce the incentive for depositors to keep their funds in banks, and it is willing to force banks to accept tighter spreads in order to reach that end. This is no time to prompt a loss of bank liquidity.

China is trying to balance supporting credit in the short term with controlling credit in the long term.

The PBoC's statement accompanying the rate cut (a rare gesture for the central bank) highlighted concerns about the difficulty some companies were encountering in accessing affordable credit. Reports have highlighted some of the cross-guarantees present in the Chinese lending landscape; this strengthens the collective in good times but can cause contagion in others. Clearly, the PBoC wants to keep the first domino in the string from falling.

Further, local government debt in China has come under some additional pressure, and the drop in interest rates will be helpful to those obligors.

But some would say that easy credit has contributed, in spots, to excesses within the Chinese economy. Analysts at Standard Chartered Bank estimate that China's debt to gross domestic product ratio (which combines public and private obligations) is more than 250%, up from 147% just six years ago. The current level is very close to that of the United States.

Over time, it is the PBoC's stated ambition to encourage moderation in lending. So the action taken last week is at variance with this goal, at least in the short run.

Prior to the announcement, the Chinese currency had been strengthening on world markets. The drop in interest rates might serve to stem that tide. But with Japan already easing aggressively, pressure to follow suit may spread to other developing markets. A currency competition remains a possibility.

Markets are now rallying on expectations that further easing could be on the way. However, the PBoC insists it is not shifting to looser monetary policy but still holding to its "fine-tuning" approach. Yet given the slowdown in the Chinese economy over the past few months and the broader decelerating trend of the past few years, one rate cut and some fine-tuning may not be enough to sustain 7% annual growth.

Ultimately, the PBoC may have to acknowledge the true depth of China's economic challenges and pursue looser monetary policy. Given the importance of China to the world economy, this is a process that bears close watching.