Another small step towards lower rates

- The newly-revamped Loan Prime Rate (LPR), the reference point against which banks now price loans, came in slightly lower for September. We think that more decisive cuts will materialize before long.

- The one-year LPR was set at 4.20%, down from the previous rate of 4.25% in August and 4.31% two months ago. This was in line with consensus expectations among economists surveyed by Bloomberg, though we had anticipated a slightly larger 10 basis point reduction. The five-year LPR has remained unchanged at 4.85% since it was first released last month. (See Chart 1.) The LPR recently replaced the PBOC’s traditional benchmark lending rate is published monthly and set based on quotations provided by banks. (See here for details.)

- The decline in the one-year LPR appears to be the result of PBOC easing. Admittedly, earlier this week the PBOC opted not to cut the rate at which it lends to banks via its medium-term lending facility (MLF). This would have been the most direct way for the PBOC to lower the LPR, which is set based on a spread above the MLF rate. However, the PBOC may have still put pressure on banks to narrow this spread in response to the recent cut to banks’ reserve requirement ratios.

- The unchanged five-year LPR – which mortgages will priced upon starting next month – suggests that policymakers remain reluctant to relax financial conditions for the property sector. What’s more, whereas banks are currently able to set interest rates on mortgages below the benchmark lending rate for the safest borrowers, the LPR will soon act as the floor on new mortgages rates. This means that some borrowers could soon face higher mortgage rates.

- While the latest LPR reduction should nudge banks to reduce broader lending rates slightly, the impact on economic activity will be marginal. A decline of only a few basis points is small and will only feed through to borrowing costs on new loans, not outstanding ones. And as interbank repo rates – which lead bank lending rates – have traded sideways recently, bank loans rates are unlikely to move down much further until the PBOC does more to pull down funding costs for banks. (See Chart 2.)

- Since the new LPR is relatively untested, the PBOC appears to be taking a measured approach at first. However, with economic activity likely to come under further pressure in the coming quarters and monetary easing so far failing to generate much of a pick-up in credit growth, we think the PBOC will need to start engineering larger declines in the LPR before long.
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