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China cuts rates and pumps in liquidity

Ben Bland and Josh Noble in Hong Kong and Claire Jones in Frankfurt


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China's central bank cut interest rates on Tuesday and said it would pump liquidity into the banking sector in an attempt to boost the slowing economy and stem a slump in share prices that has alarmed global investors.

The People's Bank of China said after the market close that it had reduced its benchmark one-year lending rate 25 basis points to 4.6 per cent with immediate effect, the fifth time it has cut rates since November.

The bank also cut the one-year savings rate by 25bp to 1.75 per cent and said it would lower the reserve requirement ratio for large banks 50bp to 18 per cent from September 6, effectively injecting liquidity into a banking sector that has become reluctant to lend.

The move followed a day of turmoil on global markets, as an

8.5 per cent slump in Chinese shares sparked panic about the state of an economy that accounts for 15 per cent of the world's gross domestic product and has long been seen as an engine of global growth. Those concerns had been rising since China surprised markets by devaluing the renminbi on August 11.

In response to Monday's share plunge in China, European stock exchanges saw their sharpest falls since the 2008 financial crisis and the Dow Jones Industrial Average plunged more than 1,000 points on opening.

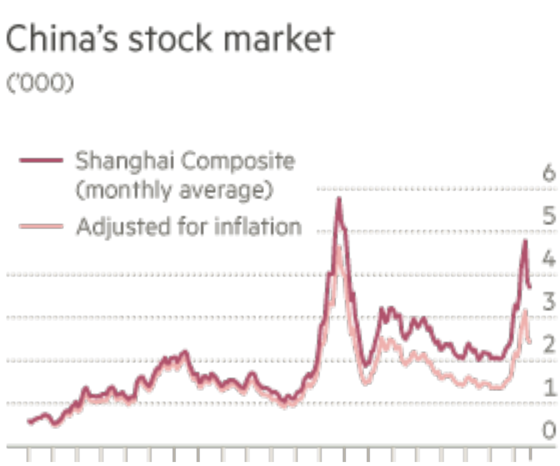
Chinese stocks resumed their fall on Tuesday, dropping a further 7.6 per cent to reach their lowest level since December. The Shanghai market has fallen 22 per cent over the past four trading sessions, marking its fastest retreat since daily price move limits were introduced in 1996.

European shares clawed back their losses, with the FTSE 100 closing up 3.1 per cent and the FTSE Eurofirst 300 up 4.2 per cent. But a rally in US markets unravelled shortly before the closing bell, with the S&P 500, which entered a correction on Monday, falling back into negative territory.

Meanwhile, investors pulled money out of haven assets such as US Treasuries, German government bonds and gold. Emerging market currencies rallied and commodities, which had been trading at their lowest levels since the financial crisis, rebounded.

A leading European Central Bank official played down the Chinese share plunge, signalling the eurozone's policymakers are unlikely to respond to this week's stock market volatility.

Vítor Constâncio, ECB vice-president, said China's economy was "not decelerating so much to justify the rout in the stock market". He added that the size of the country's stock market was "not so big" and "not so connected" with activity on the ground.



In a statement announcing the interest rate cut, the PBoC said: "China's economic growth is still facing downward pressure, and the task of stabilising growth, adjusting institutions, advancing reform, benefiting people's lives and preventing risks is still extremely arduous."

"Global financial markets have also recently displayed relatively large fluctuations, and there is a need for more flexible use of

Source: Thomson Reuters Datastream

monetary policy tools and for the creation of a monetary policy environment that is more conducive to economic restructuring."

Before the announcement, more than 2,000 companies listed across China's two exchanges had dropped the maximum 10 per cent daily limit, while only 24 stocks rose. One of those falling 10 per cent was PetroChina, China's biggest company by market capitalisation, while ICBC, the largest mainland lender, shed 5.1 per cent.

Analysts said the PBoC move was designed to boost investor confidence. But they questioned the effectiveness of monetary easing without further reform of China's troubled financial system.

"The PBoC has decisively entered a new phase of aggressive monetary easing with the combination of an exchange rate devaluation, interest rate cut and reduction in the required reserve ratio," said Eswar Prasad, an economics professor at Cornell.

"The challenge the PBoC faces is whether these measures will gain much traction at a time of slipping confidence and weakening growth momentum."

Liu Li-gang, an economist at ANZ in Hong Kong, argued that Chinese banks were wary of lending because of the heightened risk of defaults at a time when economic growth has slowed.

"In this kind of environment, normal monetary policy may not have much impact on the real economy," he said. "The government needs to use this opportunity to engage in further financial liberalisation."

The PBoC has cut interest rates repeatedly over the past nine months as it tries to help ensure that the government meets its GDP growth target of "around 7 per cent" this year.

Additional reporting by Peter Wells

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