Deutsche Bank
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Asia
China

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Date
18 April 2018

PBoC cuts RRR to avoid over-tightening

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The PBoC announced it will cut reserve requirement ratio (RRR) by 1 ppts for most banks by next week. RRR will be reduced to 16% for big banks and 14% for mid and small banks (Figure 1). This will inject some 1.3tn new liquidity into the banking system. Banks are asked to pay off some 900bn balances from the medium-term lending facility (MLF) on the same day. Net liquidity injection of about 400bn will largely go to small city and rural banks. Lastly, the PBC asks these banks to use the new funding mainly for lending to small businesses.

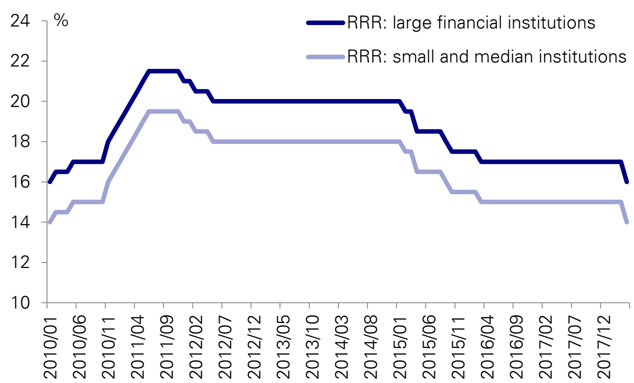
We believe the RRR cut should not be seen as a change of monetary policy stance. The economy is doing well; growth stayed strong at 6.8% in Q1, supported by consumption and property investment (see our note here). Hence there is no need to loosen monetary policy. Indeed the OMO rates were raised just last month (Figure 2). We do not expect PBC to cut policy or OMO rates in the coming months. If anything, OMO rates may be raised further.

The main purpose of the RRR cut, in our view, is to avoid over-tightening on small banks and small businesses. The PBoC will continue to tighten financial regulations and deregulate interest rates under the leadership of the new government. This will lead to higher funding costs, particularly for smaller banks who do not have large deposit base and rely on wholesale funding. Meanwhile, tightening financial regulations, including the expected new regulation on asset management, will affect the shadow banking business. Banks are pressured to move their off-balance sheet lending back on balance sheet (Figure 3). Small businesses are more severely affected in this process, as they have limited access to regular bank loans and rely more on shadow banking. The RRR cut will mainly benefit smaller banks and, with the guidance on lending, will help relieve financing difficulties faced by small businesses.

The PBoC is also attempting to provide more stable liquidity. With RRR held unchanged since early 2016, PBoC has been relying on OMOs, particularly the MLF, as the main policy tool for money creation and liquidity injection. Outstanding MLF balance increased to 4.9tn from 1.3tn in the past two years (Figure 4). This creates a few problems: it asymmetrically benefits larger banks who frequently taps into MLF; OMOs become more cumbersome with large rollover needs; it could also raise short-term funding costs, as banks fear that PBoC may reduce MLF balance rollover some day. The announced RRR cut will reduce MLF rollover needs and inject more stable liquidity into the banking system.

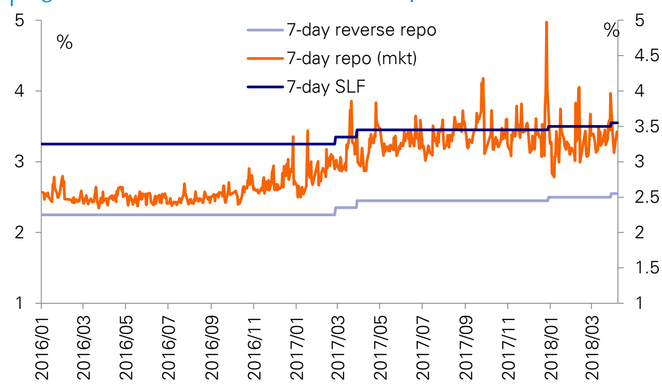
We maintain our macro and policy outlook for 2018. We expect growth to slow only marginally in the next few quarters (Q2-Q4 forecasts: 6.6%, 6.5% and 6.5%). The tightening of fiscal policy will likely be offset by the very strong land sales, which will support both property and infrastructure investments. Our annual growth forecasts remain 6.6% and 6.3% for 2018 and 2019.

Figure 1:PBC cut RRR by 1ppts in April 2018



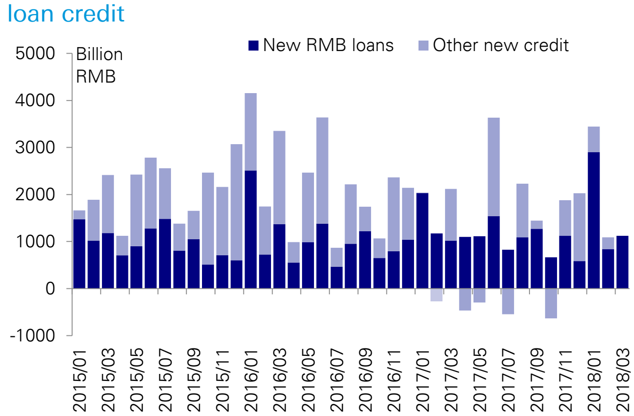
Source: Deutsche Bank, WIND

Figure 2: OMO rates and market repo rate



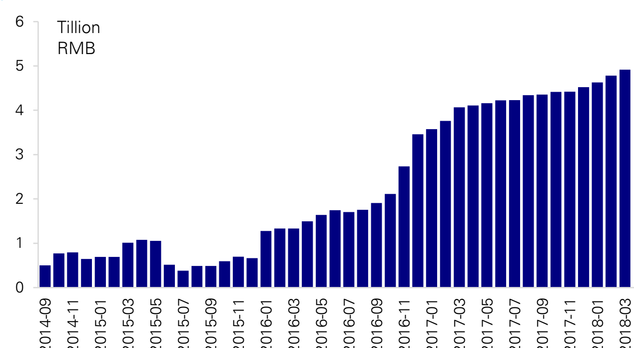
Source: Deutsche Bank, WIND

Figure 3: From off- to on-balance sheet: reduced non-loan credit



Source: Deutsche Bank, WIND

Figure 4: MLF outstanding balance increased since 2016



Source: Deutsche Bank, WIND

Appendix 1

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