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CNY – "Target" RRR reduction is broad-based?

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Key Points:

- **PBOC's target RRR reduction is two-tier, based on certain requirements for "inclusive finance", by a range of 0.5% to 1.5%, starting in 2018.**
- **The unprecedentedly long duration between the announcement date and effective date could be**
  1. **to better prepare banks and lenders for MPA next year, and**
  2. **to ensure a broad coverage of banks and lenders to become qualified for an at least RRR cut of 0.5%.**
- **PBOC denied this reduction as a signal of monetary easing, while reiterating its "prudent and neutral" monetary stance.**
- **Deleveraging would probably remain the focus, so PBOC's task into 2018 is now more urgent on the interest rate front than on the exchange-rate front.**
- **Interest rates in China would probably be higher next year.**

PBOC's target RRR reduction: Two tiers and three levels

On 30 September 2017, a day before the beginning of the 8-day national holiday, the People's Bank of China (PBOC) announced, with "*great urgency*" ("*特急*" in simplified Chinese) that it would **reduce the reserve requirement ratio** (RRR) **for banks and lenders that meet certain requirements for "*inclusive finance*"** ("*普惠金融*" in simplified Chinese) **by a range of 0.5% to 1.5%, starting in 2018.**

PBOC'S TARGET RRR REDUCTION: SUMMARY

	Tier 1	Tier 2	Others
RRR reduction	0.5%	1.5%	1%
Estimated liquidity increase	CNY 550 to 660bn	CNY 20 to 60bn	
Ratio of eligible "inclusive finance" to outstanding or newly added loans for the previous year	1.5% to 10%	More than 10%	N/A (At least 10% of new lending is local)
Beneficiary banks and lenders	All large and medium-sized banks, 90% of city commercial banks and 95% of non-county rural agricultural commercial lenders	Some city commercial banks and county rural agricultural commercial lenders (?)	County rural agricultural commercial banks, cooperative banks, credit union and village banks

Source: PBOC, MUFG

This is **the first RRR reduction since February 2016**, and there are three key differences in relative to its past RRR reductions:

Tier 1 reduction is almost unrestrictive, given that majority of banks and lenders would be qualified

1. **PBOC estimated that the tier-1 target RRR cut of 50 basis points would benefit "*all large and medium-sized banks, 90% of city commercial banks and 95% of non-county rural agricultural commercial lenders*".**

   In the past, the target group used to include small and micro enterprises and famers only. But this time, PBOC expanded the scope of the target group and defined a new term "*inclusive finance*" as "*loans below CNY 5 million that are issued to small and micro enterprises, sole-proprietor, farmers, start-ups (for venture guarantees), registered impoverished groups (for consumption) and students (for study)".*

   As such, **the tier 1 target RRR reduction is estimated to allow banks and lenders to place up to about CNY 660 million of deposits less as reserves, and the total RRR reduction** (i.e., combining tier 1, tier 2 and others) **might free up even more banks' reserves totalling CNY 720 million, which would be just CNY 115 million[1] less than an unrestrictive one**.

An unprecedentedly long duration between the announcement date and effective date better prepares banks and lenders for a) MPA next year and b) being qualified for such reduction

2. **Although the announcement was made with great urgency, banks and lenders will not benefit from this target RRR reduction until next year**. This is quite unusual, as the previous RRR reductions would normally be effective from the next working day.

   Two possible reasons behind this lagged implementation

   a) **To better prepare banks and lenders for MPA**

      In August, PBOC said it would start to **include negotiable certificates of deposit (NCDs), tenors within one-year, issued by banks with assets of more than CNY 500 billion in its quarterly macro-prudential assessment (MPA) from the first quarter of 2018**[2]. The change is expected to reduce the reliance of banks and lenders on wholesale funding by a return to retail funding.

      PBOC appears to be confident that the impact of the new NCD rule on liquidity would probably be limited. According to an article written by Xu Zhong, head of *PBOC's* research bureau, "*as of 2Q 2017, most banks above CNY 500 billion asset size already complied with 33% interbank liabilities cap after including interbank CDs, and* ***gap for those non-complying banks was within 3%.*** *Therefore, the overall system impact should be limited given an 8 month grace period." (Caixin, 15 August 2017).*

      However, given the timing of the effective date of the target RRR reduction and the great urgency of this announcement, it is hard to rule out the possibility that further liquidity buffer for banks and lenders might be urgently needed to better prepare for MPA next year. And **lowering RRR which is very high among international standard[3], for banking sector reform, such as the new change of MPA, seems to be inevitable.**

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[1] The total deposit (including both local and foreign currency) was CNY 167.0 trillion (as of August 2016, Source: *CEIC cited PBOC*), a 0.5% RRR cut means that banks and lenders could hold CNY 835 million less as reserves .

[2] Source: *PBOC monetary policy implementation report 2017 Q2* (simplified Chinese), released on 11 August, 2017

[3] China's current banks' RRR for large depository institutions is 17% (Source: PBOC) vs.1% in Eurozone (Source: ECB); and Canada, the United Kingdom, New Zealand, Australia and Sweden have no reserve requirements.

b) **To allow more banks and lenders to become eligible in this target RRR reduction**

If **banks and lenders satisfy the key requirement of getting Grade B or above in MPA for at least three straight quarters last year**, they will almost be qualified for the tier 1 target RRR reduction, with the good use of the coming 3 months for loan portfolio restructuring.

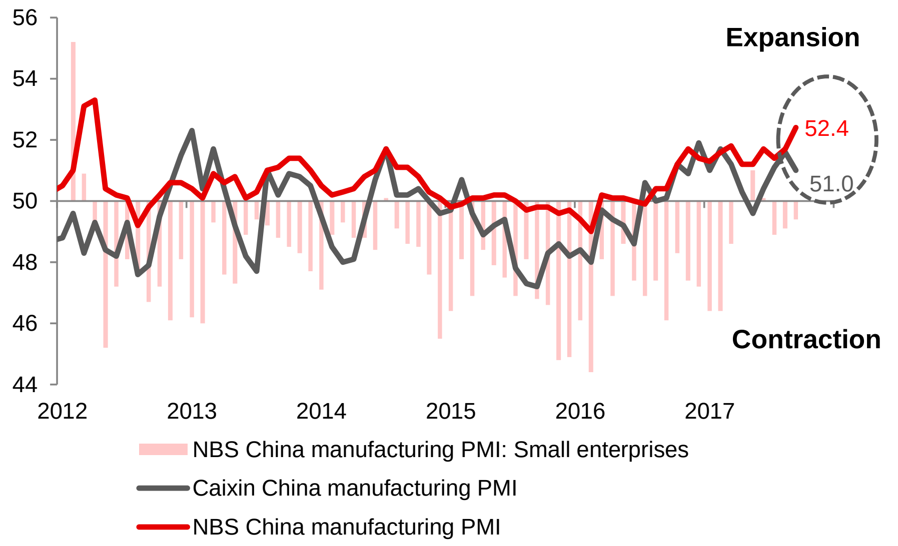
3. **The announcement came after the surprisingly good headline PMIs for September**, while the past announcements would typically come before or after some weaker data releases.

NBS manufacturing PMI (released on 30 September 2017) surged to a 5-year high to 52.4 in September from 51.7 in August, exceeding consensus expectations of 51.6. NBS services PMI also jumped to 55.4 in September, the highest since June 2014, from 53.4 in August. This probably signals **that the growth momentum in China is holding up well heading into the last quarter of the year, despite some cooling signals in July and August**.

Despite the strong growth momentum, smaller enterprises appear to be struggling

NBS manufacturing PMI's small enterprise sub-index rose slightly to 49.4 in September (> last 49.1) but **stayed below 50 for a third straight month, indicating activity contraction**. This in part explains why **Caixin manufacturing PMI, covering smaller firms and exporters, declined to 51.0 in September, a 3-month low,** from 51.6 in August. All this confirms our views that economic reforms have been weighing more on smaller enterprises than on larger enterprises. As such, **this target RRR reduction mainly focuses on encouraging banks and lenders to provide more credit support for small and micro enterprises.**

DIVERGENT MANUFACTURING PMIS, DUE TO STRUGGLING SMALLER ENTERPRISES



Source: Bloomberg, MUFG

No changes to PBOC's "prudent and neutral" monetary stance; muted market impact so far

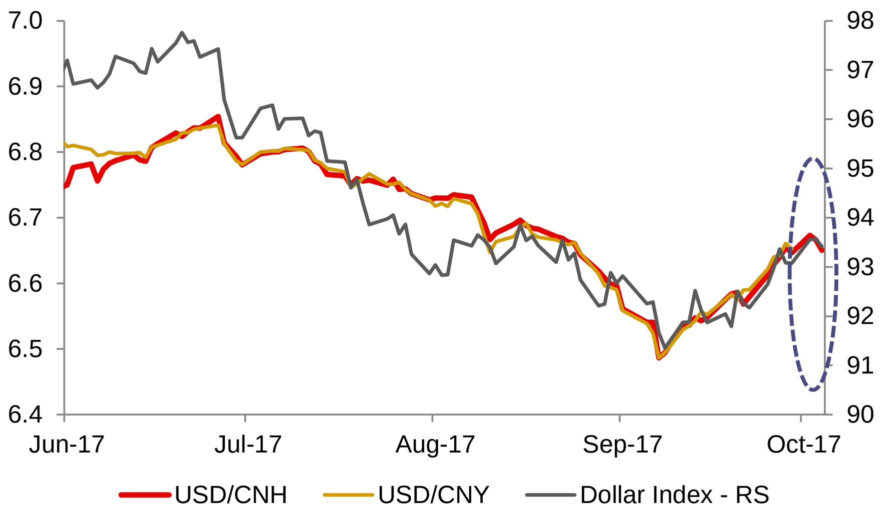
PBOC's "prudent and neutral" stance

PBOC reiterated that they will maintain its "prudent and neutral" stance in its Q&A press release[4], but **this announcement might send a strong monetary easing signal to markets, weighing on the Chinese yuan**. After the announcement, the

[4] PBOC's target RRR reduction Q&A, 30 September 2017 (simplified Chinese)

onshore market is closed for the 8-day national holiday and will open on 9 October 2017. Without the guidance of the USD/CNY fixing, **the offshore Chinese yuan, CNH, has been tracking closely the movement of the dollar index**. Thus, the market impact of the target RRR reduction appears to be muted.

MUTED IMPACT OF THE TARGET RRR REDUCTION ON USD/CNH



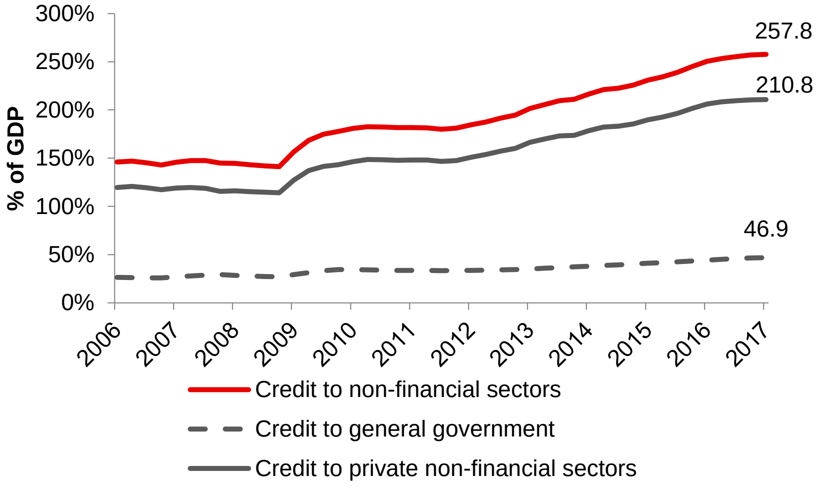
Source: Bloomberg, MUFG

Would deleveraging be compromised?

Deleveraging would probably remain the focus in the near to medium term

Some analysts might worry that this target RRR reduction would send a confusing signal towards the strongly emphasized "deleveraging" campaign, especially when the effort of the Chinese authorities has so far been undermined by the credit rating agencies. Both Moody's and S&P downgraded the China's sovereign ratings by one notch to A1 on 24 May 2017 and A+ on 21 September 2017, respectively. (Please refer to our *26 September pm call note*, and *Asia Cross Current: CNY – Moody's Downgrades China, 24 May 2017* for details). In addition, the latest credit figures provided by the Bank for International Settlements (BIS) (last updated on 17 September 2017) have yet reflected such effort.

DELEVERAGING HAS YET TO BE GRAPHICALLY VISIBLE



Source: BIS, MUFG

Deleveraging is likely to remain the focus in the near and medium term, and this target RRR reduction might serve as pre-emptive measure to the most affected parties in this campaign in the future, because

1. This target RRR reduction would encourage banks and lenders to provide more credit support to the most affected smaller enterprises in the near future.
2. The potential liquidity squeeze before the MPA in 1Q 2018 would probably be eased, so as to smoothen the structural shift of the funding source of banks and lenders from wholesale to retail, without compromising the stability of the financial system.

PBOC will probably hike its rates towards the end of the year or early 2018.

Assuming the Fed hikes for a fifth time in December, we are watchful whether PBOC hikes its OMO/MLF/SLF rates accordingly.

- A "**Yes**" would indicate **strong determination by PBOC towards deleveraging** which would improve the outlook for the Chinese yuan in the longer term.
- A "**No**" will mean a narrower interest rate differential between China and the US, possibly **weighing on the Chinese yuan**.

If we had to guess, we'd say **PBOC's task into 2018 is now more urgent on the interest rate front than on the exchange-rate front**[5]. As such, we expect that PBOC will probably hike its OMO/MLF/SLF rates towards the end of the year or early 2018, and **interest rates in China would probably be higher next year**.

Disclaimer

[5] Please refer to P12-13, *Monthly Foreign Exchange Outlook, October 2017*, for details.