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CNY – Milder and more restrictive RRR reduction, but unleashing more liquidity?

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Key Points:

- **Soft short CNY rates today do not appear to be sustainable, for two key reasons:**
1. **The milder and more restrictive target RRR reduction with the liquidity release under PBOC's close surveillance via MPA could hardly be interpreted as monetary easing**
2. **The estimated size of the liquidity release from PBOC appears to be on the high side, given the level and restriction of this latest move**
- **The reasoning and factors of target RRR reductions in our 17 May note still stand**
- **Our views remains the same, expecting the next target RRR reduction to be effective in October, in the light of banking sector reform, and PBOC's "prudent and neutral" monetary stance would probably remain**

Soft short CNY rates today amid PBOC's third target RRR reduction does not appear to be sustainable

PBOC announced its widely anticipated third target RRR reduction this year, effective 5 July 2018

Yesterday (24 June), the People's Bank of China (PBOC) announced to reduce reserve requirement ratio (RRR) for some banks by 0.5%, effective 5 July 2018[1]. This is the third target RRR reduction this year, which comes broadly in line with our expectations, as discussed previously in *Asia Cross Current: CNY – More RRR reductions, but higher interest rates*, 17 May 2018, especially in terms of the characteristics of RRR reductions:

(i) Covering most but not all banks
(ii) Having muted liquidity impact, without changing PBOC's "prudent and neutral" monetary stance
(iii) Coming effective in the first month of a new quarter

Some brief details of the three RRR reductions effective this year are summarized in the table on Page 4.

State Council announced some measures earlier this month to boost credit support for small and micro-enterprises

The announcement is also widely anticipated by markets, as State Council released a statement on the executive meeting chaired by Premier Li Keqiang **on 20 June 2018**[2], signaling the use of monetary policy tools, including RRR reduction for some banks, in addition to **the announcement of some other policies supporting small and micro-enterprises**, such as

(i) To raise rediscount quotas and cut relending rates,
(ii) To exempt interest income from credit of up to CNY 5 million for eligible small and micro-enterprises firms and households, from 1 September 2018 to the end of 2020, and

[1] PBOC's target RRR reduction announcement 中国人民银行决定通过定向降准支持市场化法治化"债转股"和小微企业融资, 24 June 2018

[2] State Council's statement on executive meeting chaired by Premier Li Keqiang to ease the financing difficulties of small and micro enterprises 李克强主持召开国务院常务会议 部署进一步缓解小微企业融资难融资贵等, 20 June 2018

(iii) To include loans to small and micro-enterprises with a credit quota lower than CNY 5 million as eligible collateral for PBOC's medium-term lending facility (MLF).

Markets see the latest move as monetary easing, which we disagree

A 0.5% RRR reduction could unleash liquidity of CNY 700 billion with restrictive use?

At the first glance, this latest move appears to be quite mild, as 0.5%, instead of 1% previously, would be reduced in RRR. Yet, PBOC's estimated size of liquidity injection is CNY 700 billion, which is more than the net liquidity injection of the previous two rounds this year of CNY 400 billion in April and CNY 450 billion in January. In other words, **this 0.5% RRR reduction seems to be more effective in terms of unleashing liquidity, according to PBOC's estimation**, which we remain a bit skeptical, especially considering the restrictive use of the liquidity (which we will discuss below) and the milder than expected level of reduction. Thus, the estimated size of the liquidity release from PBOC appears to be on the high side.

Restrictive use of the injected liquidity, closely monitored by PBOC via MPA

The latest move aims to support mainly the market-oriented eligible DES projects, and to a lesser extent bolster financing needs of small and micro-enterprises

Apart from the usual key objective of the target RRR reduction, i.e. to provide credit support for small and micro-enterprises, **PBOC for the first time aims to make room for the five state-owned banks, and 12 joint-stock commercial banks to implement the market-oriented debt-to-equity swap (DES) programme**, and puts a stronger emphasis on supporting theses eligible DES projects, as **CNY 500 billion** out of the total net liquidity injection of CNY 700 billion is estimated to be unleashed, to boost the so far rather slow DES development.

DES projects with equity structure but debt in nature and/or involving zombie corporates are excluded

To avoid sending a confusing market signal of easy credit, PBOC states the criteria of eligible DES projects[3], explicitly **ruling out those DES projects that are named as equity investment but debt in nature (*不支持"名股实债"的项目)* and those involving zombie corporates (*不支持"僵尸企业"债转股*)**, while supporting those market oriented DES projects with private sector involvement which will take an active management in a DES company, albeit without investing no more than 50% of capital of a DES project.

PBOC would monitor closely the use of the fund via MPA

Not only does PBOC list out the eligibility criteria of the DES projects, but PBOC would also monitor closely and evaluate how beneficiary banks and lenders would spend the liquidity release via its quarterly macro prudential assessment (MPA).

Monetary easing? Not yet

Thus, **this milder and more restrictive target RRR reduction with the liquidity release under close surveillance via MPA could hardly be interpreted as monetary easing, which drove short CNY rates lower today.**

Considering the rather decent credit and money supply figures for the first five months of the year, with declining measured shadow bank lending (chart 1) and stably slower credit growth (chart 2), in addition to the more restrictive than expected target RRR reduction (in particular ruling out DES projects involving zombie companies), we reckon that **the Chinese authorities seem to stay determined to achieving corporate and financial deleveraging**, even though credit risks are rising with more corporate defaults and more bond issuance cancellation this year.

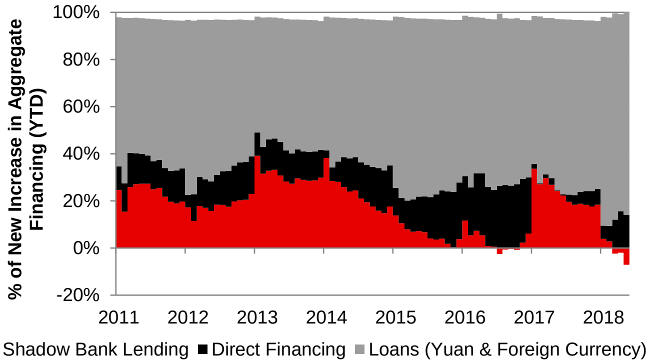
PBOC's "prudent and neutral" monetary stance would probably remain

Our previous discussion on the three key reasons why PBOC will pursue further RRR reductions, apart from liquidity management, in *Asia Cross Current: CNY – More RRR reductions, but higher interest rates*, 17 May 2018, appears to remain valid, so

[3] Details of the criteria of eligible DES projects can be found in PBOC's target RRR reduction announcement Q&A release 中国人民银行有关负责人就定向降准支持市场化法治化"债转股"和小微企业融资答记者问, 24 June 2018

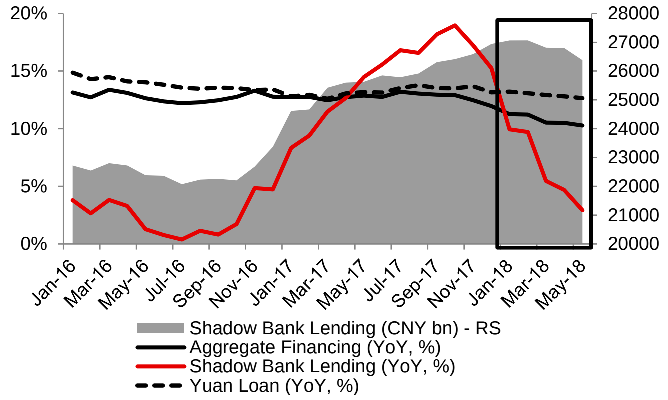
we maintain our expectations that **PBOC's "prudent and neutral" monetary stance would probably remain.**

CHART 1: DECLINING MEASURED SHADOW BANK LENDING



Source: CEIC, MUFG Bank

CHART 2: SLOWER CREDIT GROWTH



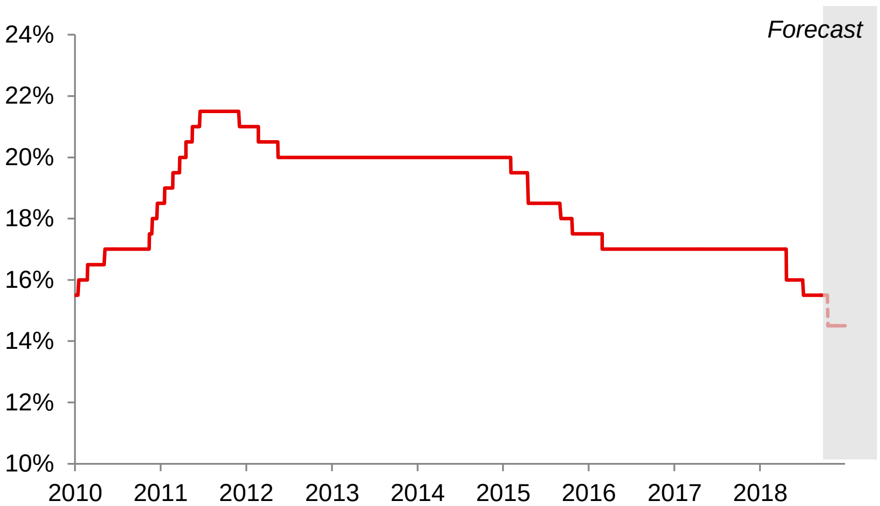
Source: CEIC, MUFG Bank

As the level of China's RRR, even after the latest move, is still very high among international standard[4], we maintain our expectations of more RRR reductions in the light of the banking sector reforms and liquidity management.

The next restrictive RRR reduction could come effective as early as in October

The next RRR reduction, the fourth one this year, is expected to come effective, as early as in October (chart 3), and would probably have the three characteristics summarized on Page 1, unleashing the net liquidity of a range of CNY 500 billion and CNY 800 billion, as ***pre-adjusting*** **(*预调*) and *fine-tuning* (*微调*) the comprehensive use of its monetary policy tools (in terms of both prices and quantity) and macro-prudential policies would probably continue to set the tone for PBOC's monetary policy this year** and perhaps also next year.

CHART 3: RRR FOR MAJOR BANKS



Source: Bloomberg, MUFG Bank

[4] China's banks' RRR for large depository institutions would become 15.5%, effective 5 July 2018 (Source: PBOC) vs.1% in Eurozone (Source: ECB); and Canada, the United Kingdom, New Zealand, Australia and Sweden have no reserve requirements.

PBOC'S RRR REDUCTION: SUMMARY

<table>
<tr><th>Announcement date</th><th>Effective date</th><th>PBOC's estimated net liquidity increase (CNY billion)</th><th colspan="7">Details</th></tr>
<tr><td rowspan="2">24 Jun 2018</td><td rowspan="2">5 Jul 2018</td><td rowspan="2">700</td><td>RRR reduction</td><td colspan="3">0.5%</td><td colspan="3">0.5%</td></tr>
<tr><td>Beneficiary banks and lenders</td><td colspan="3">5 state-owned banks, and 12 joint-stock commercial banks</td><td colspan="3">Postal Savings Bank of China, city commercial banks, rural commercial banks (excluding county-level), and foreign lenders</td></tr>
<tr><td rowspan="3">17 Apr 2018</td><td rowspan="3">25 Apr 2018</td><td rowspan="3">400</td><td>RRR reduction</td><td colspan="6">1%</td></tr>
<tr><td>Beneficiary banks and lenders</td><td colspan="6">All large commercial banks, joint-stock banks, city commercial banks, rural commercial banks, and foreign lenders</td></tr>
<tr><td>Requirement</td><td colspan="6">Beneficiary banks and lenders have to repay their medium lending facility (MLF) loans, which are estimated to be CNY 900 billion</td></tr>
<tr><td rowspan="4">30 Sep 2017</td><td rowspan="4">25 Jan 2018</td><td rowspan="4">450</td><td></td><td colspan="2">Tier 1</td><td colspan="2">Tier 2</td><td colspan="2">Others</td></tr>
<tr><td>RRR reduction</td><td colspan="2">0.5%</td><td colspan="2">1.5%</td><td colspan="2">1%</td></tr>
<tr><td>Ratio of eligible "inclusive finance" to outstanding or newly added loans for the previous year</td><td colspan="2">1.5% to 10%</td><td colspan="2">More than 10%</td><td colspan="2">N/A
(At least 10% of new lending is local)</td></tr>
<tr><td>Beneficiary banks and lenders</td><td colspan="2">All large and medium-sized banks, 90% of city commercial banks and 95% of non-county rural agricultural commercial lenders</td><td colspan="2">Some city commercial banks and county rural agricultural commercial lenders</td><td colspan="2">County rural agricultural commercial banks, cooperative banks, credit union and village banks</td></tr>
</table>

Source: PBOC, MUFG Bank

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