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CNY – PBOC: Shooting at the wrong target?

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Key Points:

- **PBOC announced its fourth target RRR reduction this year, with the net liquidity injection of CNY 750 billion, the highest among the four target RRR reductions**
- **Market reaction: Yuan weakened and Chinese stock markets plunged, signaling that the role of RRR reduction announcement as a one-day optimistic boost to equity market failed (again)**
- **Despite its effectiveness, PBOC's growth-biased fine-tuning would imply more RRR reductions to come**
- **Unsurprisingly, some further fiscal stimulus would probably come**
- **Yet, drivers behind our CNY depreciation expectations stay unchanged**
- **Perhaps, US-China trade war could be a game changer**

PBOC's fourth target RRR reduction this year

PBOC announced its fourth target RRR reduction this year, effective 15 October 2018

On Sunday (7 October), the last day of the week-long national day holiday in China, **the People's Bank of China (PBOC) announced to reduce reserve requirement ratio (RRR) for some banks by 1.0%, effective 15 October 2018**[1]. This is the fourth target RRR reduction this year, which comes broadly in line with our expectations, as discussed previously in *Asia Cross Current: CNY – Milder and more restrictive RRR reduction, but unleashing more liquidity?*, 25 June 2018 and *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 four RRR reductions effective this year are summarized in the table on Page 4.

PBOC's pre-emptively fine-tuning effort strengthened

Total liquidity injection of CNY1.2 billion = CNY 450 billion replacing the maturing MLF loans + **Net liquidity injection of CNY 750 billion** (offsetting tax payments)

This target RRR reduction, like the one in April, will have part of the injected liquidity spending on offsetting the maturing medium-term lending facility (MLF) loans which is about CNY 450 billion, half of the level in April. As such, the net liquidity injection amid this reduction will be unsurprisingly higher, of CNY 750 billion, which is 67% higher than the net liquidity injection of the April's cut. More importantly, **the net liquidity injection this round is the highest among the four target RRR reductions**, **signaling that PBOC has stepped up efforts on "*pre-emptively fine-tuning*" its measures in order to ensure reasonably ample liquidity.**

PBOC also said, the additional liquidity is intended to offset tax payments later this month, and to encourage banks to boost credit support for small and micro-enterprises, **private sector and innovation-related enterprises**. Apart from the usual target group, small and micro-enterprises, PBOC also hope to flag loan support for private sector and innovation-related enterprises.

[1] PBOC's target RRR reduction announcement 中国人民银行决定下调部分金融机构存款准备金率置换中期借贷便利, 7 October 2018

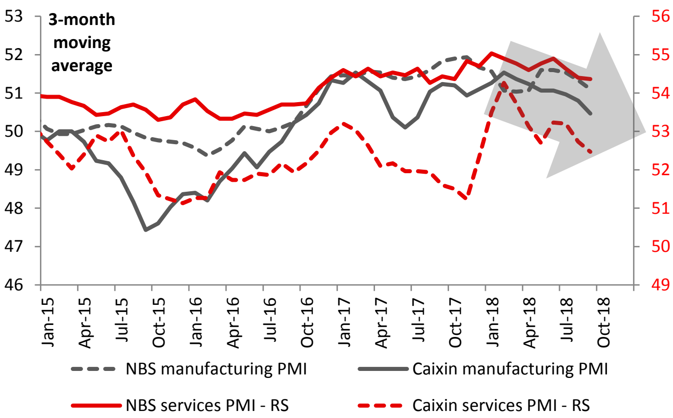
PBOC's prudent and neutral monetary stance has remained unchanged, albeit with **growth-biased fine-tuning**

With **the wider scope that PBOC hopes to boost loan support for, and the explicitly explanation from PBOC to bolster the growth momentum of domestic demand** (*增强内生经济增长动力*), PBOC's future measures fine-tuning should have been shifted to bolster growth (Chart 1), without changing its prudent and neutral monetary stance.

PBOC would probably have some further RRR reductions with higher amount of net liquidity injection, even though we remain skeptical over its effectiveness

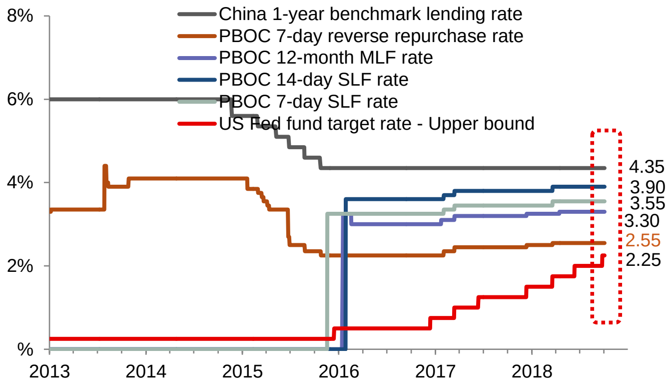
Going forward, **PBOC would probably continue to maintain its money market rates and benchmark lending rates**, despite the US Fed's rate normalization (Chart 2). Since PBOC has shifted to strengthen its fine-tuning effort in order to bolster growth, it would be quite likely to **see some further RRR reductions with higher amount of net liquidity injection.** The next RRR reduction could come as early as before the end of the year. That said, **we remain skeptical about the impact of RRR reduction, a liquidity management tool, on bolstering growth or restoring market confidence, especially when the credit transmission mechanism has been clogged**.

CHART 1: DOWNTREND MANUFACTURING AND SERVICES PMIS, SIGNALING SLOWER GROWTH



Source: Bloomberg, MUFG Bank

CHART 2: STEADY INTEREST RATES, DESPITE FED'S RATE HIKES



Source: Bloomberg, MUFG Bank

Prompt market reaction: Yuan weakened and Chinese stock markets plunged

Our expectation for a weaker yuan this year and next year remains intact

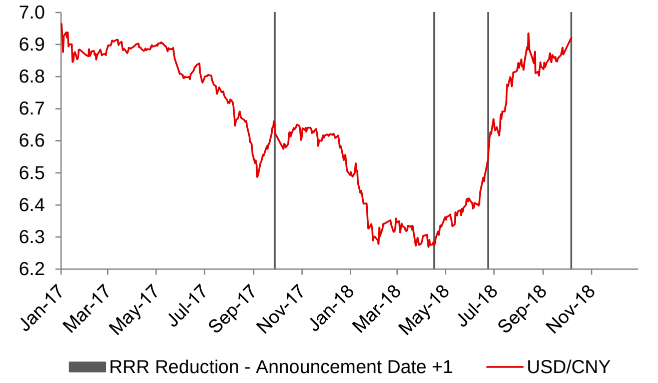
Despite **PBOC's reassurance that this RRR reduction would not form CNY depreciation pressure, the first time in the PBOC's target RRR reduction announcements,** USD/CNY jumped 0.5% to 6.9135 (official close at 16:30 HKTD) and further rose to 6.9234 (as of 17:12 HKT) today – Chart 3. Our expectations for CNY depreciation would probably remain, with the same key drivers: Slower growth; narrower interest differentials with USD; and continuing credit problems, as highlighted in our *October 2018 Foreign Exchange Outlook* (Page 12-13).

The role of RRR reduction as a one-day optimistic boost to equity market failed again

CSI 300 Index lost 4.3% today, in part due to the plunge in emerging assets last week that MSCI Emerging Markets Index dropped 4.55%. It is worth noting that **PBOC's target RRR reduction announcements have not successfully changed the trend of stock markets** (Chart 4), while some one-day optimistic boost that played well in the first two announcements has also been vanished, as indicated by today's drop and a decline of 1.34% on the day after the third announcement. Besides, foreign investors also dumped net CNY9.7 billion of A-shares through the Shanghai-Hong Kong and Shenzhen-Hong Kong stock connects today.

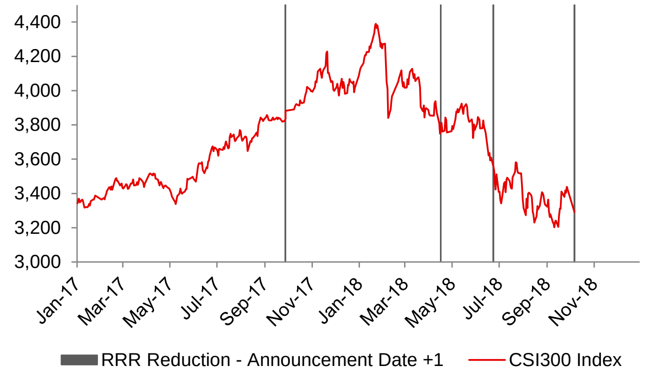
All this would probably reflect **a collapse in Chinese stock market investors' confidence**, even though FTSE Russell announced last month that China's A-share market will be included in the FTSE's global equity benchmarks from June 2019 and MSCI is considering significantly increasing the weight of China A shares in its global indexes from next year, as well as adding ChiNext.

CHART 3: CNY/USD VS. RRR CUT ANNOUNCEMENT



Source: Bloomberg, MUFG Bank

CHART 4: CSI 300 INDEX & HS INDEX VS. RRR CUT ANNOUNCEMENT



Source: Bloomberg, MUFG Bank

More proactive fiscal policy

As PBOC's growth-biased measure fine-tuning has so far failed to restore market confidence and improve credit growth, we expect some more fiscal stimulus. Yesterday (7 October), **China's Finance Minister, Liu Kun, said they are *working on more measures to cut taxes and fees*,** according to Xinhua[2]. China has already rolled out fiscal measures to reduce taxes and fees, which according to Liu will help reduce enterprises' burden by more than CNY 1.3 trillion this year.

Some further stimulus could render some support to the slowing growth, but China's fiscal deficit would probably come over the budget deficit target of 2.6% of GDP for 2018, and it would also be quite likely to see **a higher budget deficit target next year**.

A final thought

Perhaps, US-China trade war could be a game changer.

- *Asia Cross Current: CNY/CNH – Tit-for-tat tariffs + relief measures = prolong uncertainties + a weaker yuan?* (11 September 2018)
- *Asia Cross Current: USD/CNY – US/China Begin a Technology Arms Race (25 June 2018)*

[2] *China to adopt more proactive fiscal policy: finance minister, Xinhua, 7 October 2018*

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="3">7 Oct 2018</td><td rowspan="3">15 Oct 2018</td><td rowspan="3">750</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 on 15 October, which are about CNY 450 billion</td></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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