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CNY – More RRR reductions, but higher interest rates

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Key Points:

- **"*Pre-adjustment*" and "*fine-tuning*" would probably set the tone for PBOC's monetary policy this year**
- **RRR reduction would therefore be restrictive and pre-emptive, with limited liquidity impact**
- **If the two precedents are any guide, the next RRR reduction could come effective as early as in July this year**
- **OMO rates would be probably be increased with small adjustment, i.e., 5 to 10 basis points each time, following the Fed's rate hike announcement, and the next one is likely to be on 13 June**
- **The benchmark lending rates would probably be kept unchanged for the rest of the year, but the executed lending rates have been increasing**
- **Higher financing costs, strong refinancing demand and rising credit risks could put a pause to the deleveraging campaign**
- **We hope authorities will avoid the easy way out = short term gain, long term pain**

Reading the tea leaves

Reading the tea leaves from China's credit and money supply figures for April and the People's Bank of China (PBOC)'s monetary policy report for 1Q (1Q report) provides two key future monetary policy clues.

1. More RRR reductions to come, albeit with limited liquidity impact

In 2018, PBOC have already reduced reserve requirement ratio (RRR) two times for most banks, with one announced last September and the more recent one in mid-April, which increased net liquidity of about CNY 450 billion and CNY400 billion respectively, totaling CNY 850 billion.

Three key common characteristics of RRR reductions could be:

(i) Covering most but not all banks

(ii) Having limited liquidity impact

(iii) Coming effective in the first month of a new quarter

There are three key common characteristics of the two RRR reductions that could offer some future policy guidance:

(i) **Restriction**: Both reductions are restrictive, i.e., covering most but not all banks, with some specific purposes and criteria, but one common key objective is to provide credit support for small and micro-enterprises.

(ii) **Limited liquidity impact, without changing PBOC's "*prudent and neutral*" monetary stance**: The net liquidity injection each time is relatively small in scale, which is only about half of that in case of an unrestrictive RRR reduction of 0.5%, thereby having a rather muted liquidity impact. Since both announcements came after some good data releases, unlike the past announcements that would typically come before or after some weaker data releases. This would help convince markets that RRR reduction shouldn't be seen as monetary policy easing to bolster growth, and PBOC also reiterated its "*prudent and neutral*" monetary stance in both of the Q&A press release.

(iii) **Pre-emption**: Both reductions came effective in the first month of a new quarter. This one-off liquidity injection in the first month of a new quarter would provide a better position for PBOC to manage market liquidity for the rest of the quarter, when adjusting market liquidity (if needed) via almost daily open market operations (OMO) and some other tools, such as other lending facilities (e.g., medium lending facility (MLF), pledged supplementary lending (PSL),) and contingent reserve arrangement (CRA).

The next restrictive RRR reduction could come as early as in July

All this came in line with the 1Q report, indicating that PBOC would "*strengthen the pre-adjustment and fine-tuning"* (*加强预调微调*) of both monetary policy tools (in terms of both prices and quantities) and macro-prudential policies. "*Pre-adjustment"* could be interpreted as to act pre-emptively, i.e., effective in the beginning of a new quarter (if needed), while "*fine-tuning"* could be seen as a combination of restrictive RRR reduction and small net liquidity provision. **If the two precedents are any guide, the next restrictive RRR reduction could come effective as early as in late July, and/or in late October, in the light of seasonal liquidity demand.**

PBOC'S LAST TWO RRR REDUCTIONS: SUMMARY

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

Source: PBOC, MUFG Bank

Three key reasons for PBOC to pursue further RRR reductions

Apparently, reducing RRR would free up banks' reserves, thereby improving market liquidity. Apart from liquidity management, we reckon that there are three key reasons for PBOC to pursue further RRR reductions in the future:

The current dual-track interest rate system could increase financial systemic risks in China

(i) **Reducing potential systemic risks in banking system**: Freeing up more banks' reserves would probably lower banks' funding costs, which would probably help address the slower increase in deposits (chart 1) in the face of the current dual-track interest rate system which benchmark lending and deposit rates and market rates co-exist in China. According to the feature article entitled *PBOC's interest rate adjustment and transmission* in the 1Q report, PBOC acknowledged the weakness of the dual-track interest rate system which has, to a certain extent, been driving banks to increase their short-term liability via tapping interbank markets, resulting in lower funds' stability and higher costs for banks. Hence, **reducing RRR appears to be a quick fix to fend off temporarily the systemic risks in the banking system**.

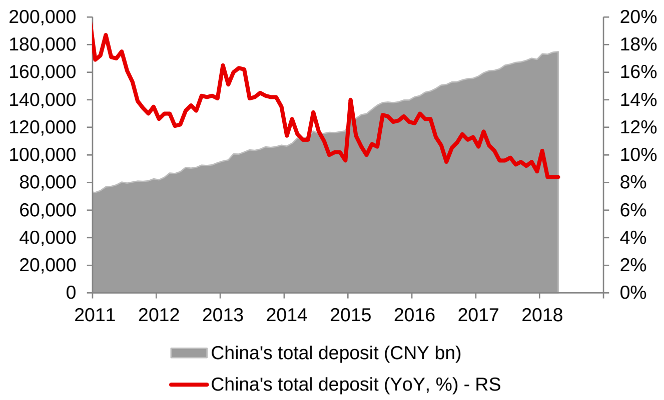
The lower the RRR, the stronger the monetary transmission

(ii) **Improving monetary transmission**: **Following interest rate liberalization, the dual-track interest rate system is expected to be gradually merged into a single interest rate system**, according to the 1Q report. Monetary transmission is crucial for an effective single interest rate system, while the strength of monetary transmission is inversely related to RRR. In other words, the lower (higher) the RRR, the stronger (the weaker) the monetary transmission. As a result, **lowering RRR could help pave the way to an effective single interest rate system**.

Financial regulatory tightening is trading short-term pain for long-term gain

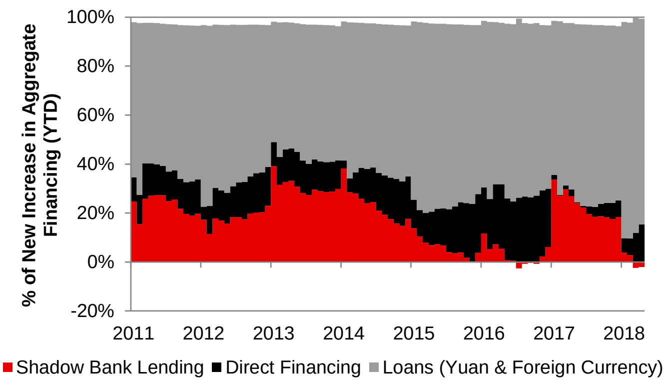
(iii) **Minimizing short-term pain amid regulatory tightening**: Banks' asset quality in China is expected to improve, amid *financial regulatory tightening* as part of the banking sector reform. The more restrictive rules are expected to be included in the PBOC's quarterly macro-prudential assessment (MPA) on banks, with **the latest plan to include negotiable certificates of deposit (NCDs) by financial institutions with assets of CNY 500 billion or below in MPA from the first quarter of 2019**, according to the 1Q report. In addition, the recently announced rules on asset management business of financial institutions[1] (a draft of which was published last November), aims to close loopholes that have allowed regulatory arbitrage, reduce leverage levels to curb asset price bubbles and rein in shadow banking activity. The transitional period of the rules is 18-month longer than suggested in the draft i.e., until the end of 2020, but **measured shadow bank lending has already started to decline** (chart 2). Regulatory tightening would probably be painful in the short term, weighing on liquidity, but with longer-term benefits. Lowering RRR would help minimize the short-term market pain and at the same time improve domestic banks' competitiveness, especially when the Chinese finance sector is set to open up further to foreign investment.

CHART 1: MODERATING DEPOSIT GROWTH



Source: *CEIC, MUFG Bank*

CHART 2: DECLINING MEASURED SHADOW BANK LENDING



Source: *CEIC, MUFG Bank*

[1] On 27 April 2018, PBOC, CBIRC, CSRS & SAFE jointly issued the rules on asset management businesses of financial institutions 《关于规范金融机构资产管理业务的指导意见》.

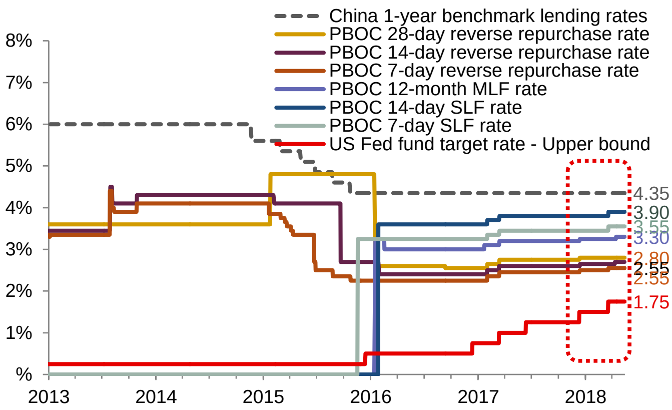
2. Higher interest rates

Against the backdrop of the Fed's rate normalization, PBOC has so far been keeping its benchmark lending and deposit rates unchanged, while adjusting slightly its OMO rates on a discretionary basis (chart 3). Since February 2017, PBOC hiked its OMO rates four times, with an adjustment of 5 to 10 basis points each. The latest two rate hikes in March and last December were of only 5 basis points each, following strictly the timing of the Fed's rate hikes of 25 basis points each. In the 1Q report, PBOC said **the small upward adjustment to OMO rates "*matched market expectations*"** (*符合市场预期*)**, and was also a "*normal market reaction towards the Fed's rate hike on 21 March*"** (*也是市场对美联储3月21日再次加息的正常反应*)**.**

PBOC would probably increase OMO rates by 5 to 10 basis points whenever the Fed hikes its policy rate by 25 basis points this year

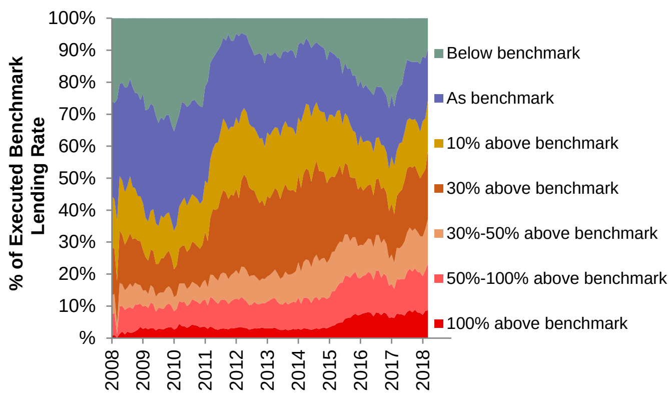
With the rather muted upward inflationary pressure, PBOC would probably continue to make a small upward adjustment to its OMO/MLF/SLF rates, likely to be in a range from 5 to 10 basis points each time this year, following the Fed's rate hike announcement. The Fed is widely expected to have its next rate hike of 25 basis points on 13 June, and there would probably be at least one more rate hikes in the second half of the year, probably in September and/or December this year.

CHART 3: HIGHER OMO RATES



Source: Bloomberg, MUFG Bank

CHART 4: HIGHER LENDING RATES



Source: CEIC, MUFG Bank

Lending rates: Benchmark vs. Executed

Unlike the OMO rate hike expectations, **PBOC would probably keep the benchmark lending rates unchanged for the rest of the year**. As mentioned above, the current dual-track interest rate system would probably be merged gradually into a single interest rate system. For this reason, China's benchmark lending and deposit rates would probably be gradually phased out.

Steady benchmark lending rates do not necessarily mean steady actual lending rates

The actual lending rates in China have been increasing (chart 4). In March, **74.35% of the bank loans, an all-time high proportion of the loans, were granted with an interest rate above the benchmark rates**, in relative to 64.41% and 58.57% last December and March. In particular, 23.21% of them, again an all-time high proportion of the loans, were granted with more than 1.5 times the benchmark rates (combining both red and pink areas in chart 4), and 8.68% of the bank loans with more than double the benchmark rates, i.e., above 8.70% for 1-year loans (red area in chart 4). Under those circumstances, **an increasing proportion of bank loans with an interest rate above the benchmark rates would in reality suggest a hike to the benchmark lending rates, even without PBOC's official announcement**.

Fewer and fewer SOEs can enjoy preferential loan rates

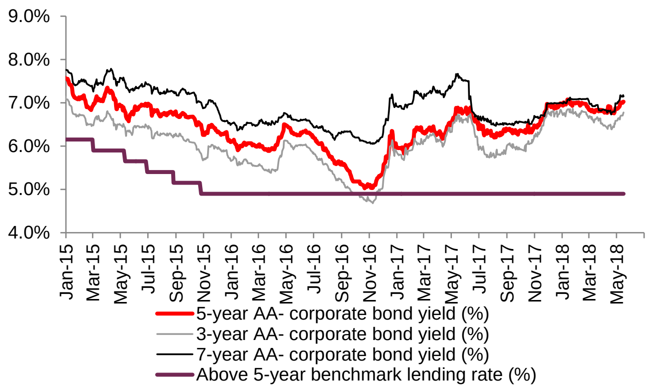
It is worth noting that only 9.61% of the bank loans were granted with preferential rates, i.e., below the benchmark rates, in March, in relative to 14.28% and 23.3% last December and March (green area in chart 4), respectively. Hence, fewer state-owned enterprises (SOEs) would probably continue to enjoy such privilege. Without any surprise, PBOC highlighted **the relatively high financing pressure borne by corporates, especially for SOEs**, in the 1Q report.

Bond financing is unlikely to be an easy solution

Strong refinancing demand under a higher interest rate environment would probably pose challenges to borrowers

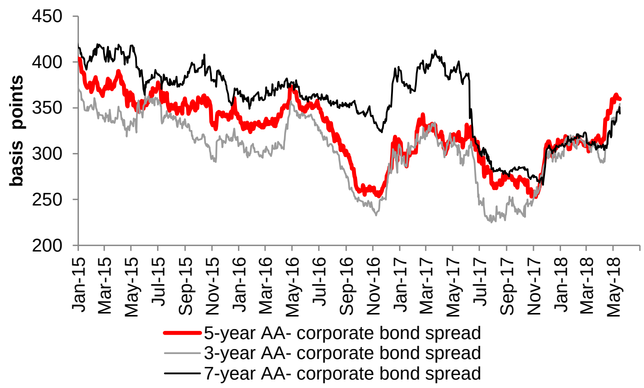
With higher loan rates, more corporates started to seek for direct financing (black area in chart 2), in particular bond financing this year. Yet, China's bond markets also face a refinancing challenge amid **USD 409 billion of onshore and offshore bonds maturing in 2018, followed by USD 619 billion in 2019 and USD 664 billion in 2020**, according to Dealogic[2]. New debts would probably be more expensive under the current higher interest rate environment, which corporate bond yields have so far been steadily higher this year in relative to last year (chart 5).

CHART 5: STEADILY HIGHER CORPORATE BOND YIELDS



Source: CEIC, MUFG Bank

CHART 6: WIDENING CREDIT SPREADS



Source: CEIC, MUFG Bank

Credit risks are rising, with more corporate defaults and more bond issuance cancellation

Credit risks in China are also rising (chart 6), amid falling corporate profits and higher financing costs. **The value of bond defaults rose by more than a third in the first four months of the year**, and more than 10 companies, several of them listed, from a variety of industries have defaulted on 15 bonds worth more than CNY 12.8 billion[3]. And the issuance of more than 300 batches of bonds worth nearly CNY 182 billion has been canceled so far this year (as of 14 May 2018).

The new suggestions to ease the current liquidity crunch in domestic bond market seem to be one-step backwards

All this caught the attention of the Chinese authorities, which a front-page commentary of Economic Daily Information today[4] called for government effort to provide liquidity supply to private enterprises to ease the current liquidity crunch in the domestic corporate bond market, **advising them to offer support to heavily indebted companies when necessary**, and **to shift from "*tight credit*"(*紧信用*) in the previous quarter to "*loose credit*" (*宽信用*)**. These suggestions, undermining the previous effort that the Chinese authorities spent on closing down zombie companies, appear to be one-step backwards especially when China is opening its bond market to foreign investment. The Chinese authorities' determination to corporate deleveraging, which has yet to be reflected in data (Chart 7), would also be in doubt.

[2] *China faces refinancing crunch with $2.7tn of bonds bearing down*, 29 January 2018, FT

[3] *China's private firms default on US$2 billion bond repayments as Beijing's deleveraging efforts bite*, 14 May 2018, SCMP

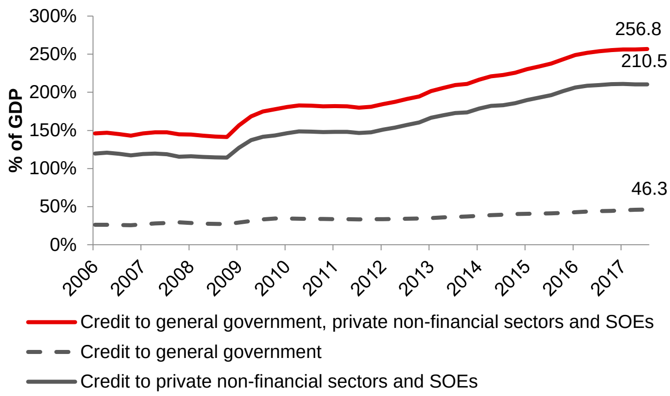
[4] Three ways to relieve the bond market risks (*从三方面入手纾解信用债市场风险*), 17 May 2018, Economic Information Daily

So far, so good

As briefly discussed in *Asia Cross Current: CNY – Regulatory tightening with new credit normal*, 16 January 2018, tighter financial regulations on shadow bank lending, quality-focused direct financing, and ongoing financial deleveraging would probably result in slower overall growth for aggregate financing and steady growth for new yuan loans (black solid and dotted lines in chart 8) this year. This would help explain why **PBOC has become more confident on corporate deleveraging with an expectation for a steady and even declining macro leverage ratio** (grey line in chart 7), in the feature article entitled "*new changes in China's macro leverage ratio*" in the 1Q report.

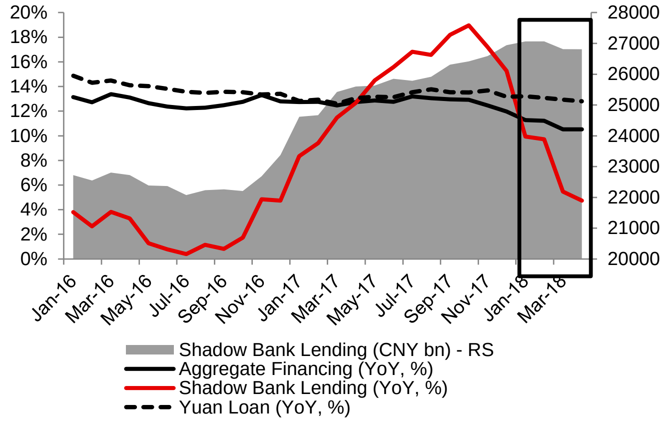
Should the new suggestions be adopted, the so far moderating credit growth would probably reverse later this year. It would be short-term gain for long-term pain, which we hope that the Chinese authorities will avoid it. Otherwise, USD/CNY would probably go further north.

CHART 7: DELEVERAGING IS YET TO BE SEEN



Source: BIS, MUFG Bank

CHART 8: SLOWER CREDIT GROWTH



Source: CEIC, MUFG Bank

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