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China Economics Update: An indication of RRR cut, how far will China's monetary easing go?

国常会再提降准，货币宽松空间有多大?

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The State Council's latest indication of a likely RRR cut signals a dovish turn. However, as recovery has been broadly on track and corporate and financial market liquidity is solid, a targeted RRR cut is more likely than broad easing through a rate cut, should the government follow through on the dovish indication.

The government has deployed targeted RRR cuts in recent years to lower bank lending rates to the real economy, especially towards SMEs. Unless accompanied by other monetary easing, the net liquidity impact and the effect on interbank rates from the targeted easing have been limited. We expect a similar effect this time around.

While the dovish policy signal and renewed global uncertainties concerning the new variants of the virus are likely to put downward pressure on China's interest rates in the near-term, we expect economic recovery to sustain and interbank rates to rebound in 2H21F. A widespread outbreak of a new coronavirus variant and/or vaccination ineffectiveness are the main risks that could extend the decline in rates.

7 月 7 日，国务院常务会议释放出“适时运用降准等货币政策工具”的鸽派信号。不过，经济复苏总体稳健，企业和金融市场整体流动性充裕，再加上通胀上行的压力，意味着定向降准的可能性相对较大。货币政策难以全面转向宽松。

近年来，央行多次实施定向降准，以降低银行对实体经济尤其是中小企业的贷款利率。除非伴随其他货币宽松政策，定向降准对整体流动性注入和银行利率的影响较为有限。我们认为此次如实施定向降准，效果将会与之前情况类似。

新病毒变种增加全球复苏的不确定性，再加上国内鸽派的政策指引，短期内国内利率预计承压。但疫苗对抗新变种的有效性较高，全球经济大幅封锁的可能性不大，预计下半年经济仍可持续复苏。在海外和国内基本面支持下，银行同业拆借利率应该会在下半年反弹。新病毒变种的广泛传播和疫苗接种效率不及预期是主要风险情形。

Chinese government indicates a likely RRR cut, a dovish surprise

The State Council announced last night that, in light of rising commodity prices, a RRR cut might be considered to support the real economy, as such a cut would lower average funding cost for the real economy, especially that of small- and medium-sized enterprises. However, State Council also stressed large monetary stimulus should be avoided and monetary policy should aim for stability and effectiveness.

China last cut the RRR over a year ago during the pandemic. Since the economic recovery in 2H20, China's monetary policy has moved towards normalization with the RRR kept steady (Fig 1). While the State Council indicated a RRR cut last June, the cut did not materialize in the months following as the economic recovery continued apace. Reflecting the policy stance, short-term interest rates rebounded during the second half last year, before moderating this year amid more dovish liquidity guidance due to debt concerns.

Aside from economy-wide liquidity management, in the past few years RRR cuts have been increasingly relied upon as a structural tool to promote lending to specific sectors. A cut to RRR helps lower average bank funding cost, especially for small banks that have a heavy reliance on central bank liquidity or interbank borrowing as a source of funding, which in turn may help lower the lending rate by these banks. Since 2019, three rounds of targeted RRR have been granted to financial institutions that had met certain criteria for SME lending. The liquidity injection from targeted easing has been relatively modest. For instance, during the last two rounds of RRR cuts in early 2020, around RMB400-550b funding was injected each round, lower than half of the PBoC's monthly gross liquidity injection through OMOs.

Demand recovery on track despite near-term uncertainty, liquidity abundant

Economic conditions and the outlook for the financial market suggest that while data could be subject to near-term downward pressure, broad economic momentum has not lost steam and the need for broad liquidity support is small. A targeted RRR cut is more likely than a broad cut should the government follow through on its dovish signals for several reasons:

First, demand indicators are still solid, though some near-term pull-back is possible. May data points to continued strength in manufacturing and trade, and further normalization of consumption. In particular, external demand is strong and trade indicators are likely to stay buoyant (Fig 3). In contrast, domestic services may have been subject to downside pressure due to the lockdown in Guangdong. Transportation slowed in June and service PMI eased more than expected (Fig 4, 5), yet both remain in an expansionary range, and we expect a steady recovery. Latest data on property and car sales show that both have eased from their earlier highs, though the high base in last year may be playing a role.

More broadly, corporate sector liquidity is strong, limiting the need for large policy support. Corporate profits rose 83% in Jan-May YoY or 53% if compared with pre-pandemic levels. Strong commodity prices boosted upstream profits and capex. In the meantime, profitability of downstream sectors has held up, suggesting that price pressure represents more a positive demand shock than a negative cost impact (Fig 6).

Second, interbank liquidity is abundant and interest rates are well below those before the pandemic (Fig 2). The PBOC injected more liquidity at end-June to ease seasonal liquidity pressure. That said, maturing MLF will be large in 2H21F. Should the government commit to lowering bank funding costs, it is possible that an RRR cut will be used to replace the maturing MLF, without a net liquidity injection.

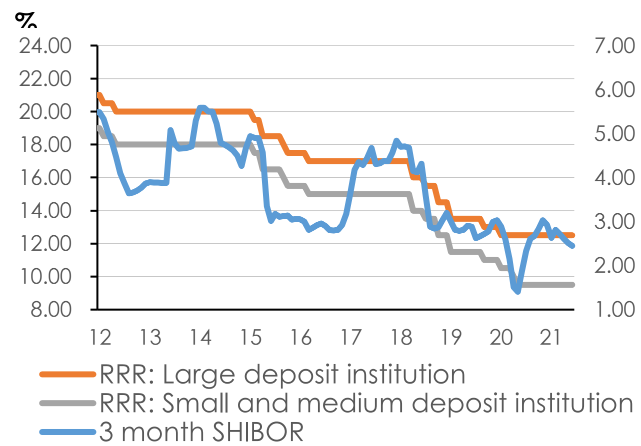
Third, given the economic recovery, fiscal expansion is likely to stay modest, reducing overall credit expansion and net bond supply. Local government new bond issuance only accounted about 35% of the annual debt quota in 1H21, in part due to the improvement in the national fiscal stance and reduced pressure to support economic growth. While government bond issuance is likely to accelerate in 2H21F to meet the annual quota of more than RMB4t, part of the new bonds issued is likely be put towards refinancing higher cost hidden debt, thereby limiting net new supply. Total social financing is likely to continue on a downward trend.

What policies to expect?

Given the cyclical pattern and recent track record, we see a higher likelihood of the government rolling out a targeted RRR cut as part of continued structural adjustments while refraining from a rate cut or broad RRR cut in light of the sustained recovery and concerns about PPI inflation. As was the case last June, RRR cut discussions at the State Council indicate a possible tool under consideration, and there remains a small chance that it will not be implemented should the concerns about growth or market turbulence ease in coming days.

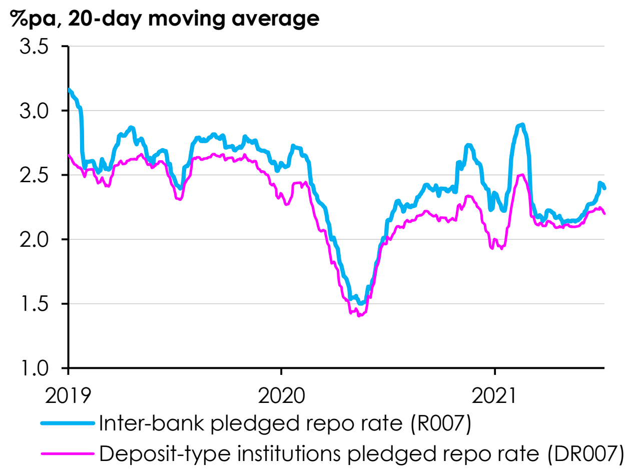
The direct impact of targeted easing of interbank rates is likely to be small. Indeed, the incremental impact of the targeted RRR cut on interbank rates has been muted since 2019. For instance, the seven-day repo and three-month interest rate held up in 3Q18-3Q19, despite consecutive RRR cuts. Indications of a dovish policy together with renewed uncertainties stemming from new pandemic variants are likely to put downward pressure on China's interest rates in the near-term. We expect a rebound in interbank rates in 2H21F amid an economic recovery. A widespread outbreak of a new coronavirus variant and/or vaccination ineffectiveness are the main risks that could extend the decline in rates.

Fig 1: PBoC has kept RRR unchanged since last April, interbank rate has recovered



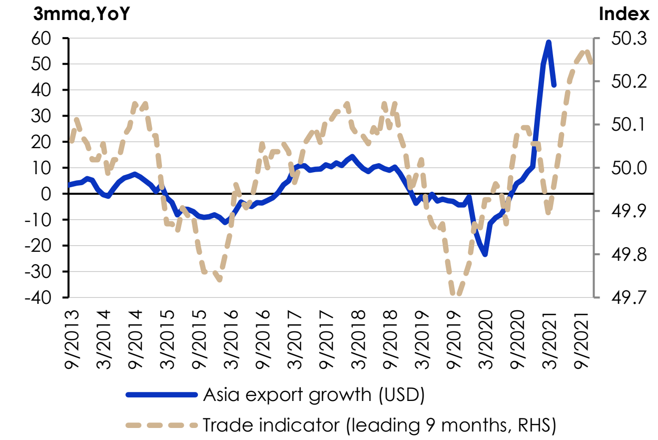
Source: CEIC, CCBIS

Fig 2: Interbank rates edged up in recent weeks



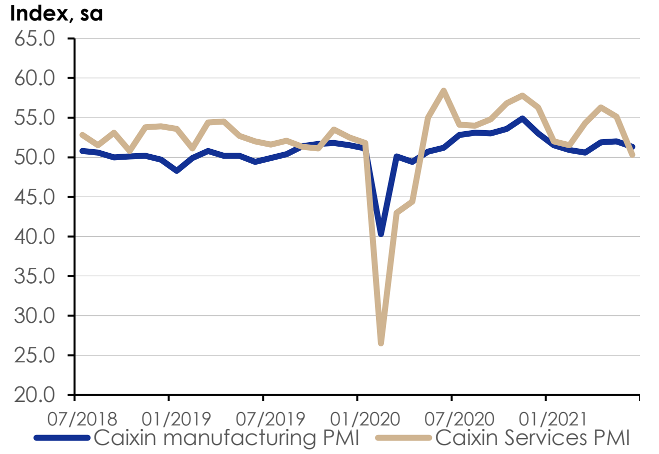
Source: CEIC, CCBIS

Fig 3: Leading Indicator points to strong Asian exports in months ahead



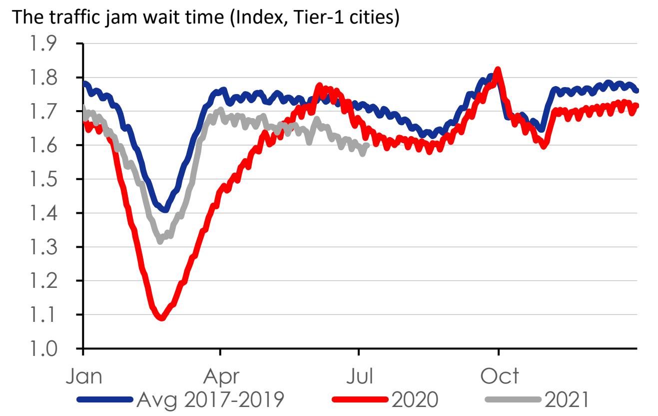
Source: CEIC, CCBIS

Fig 4 Service PMI eased more than expected in June



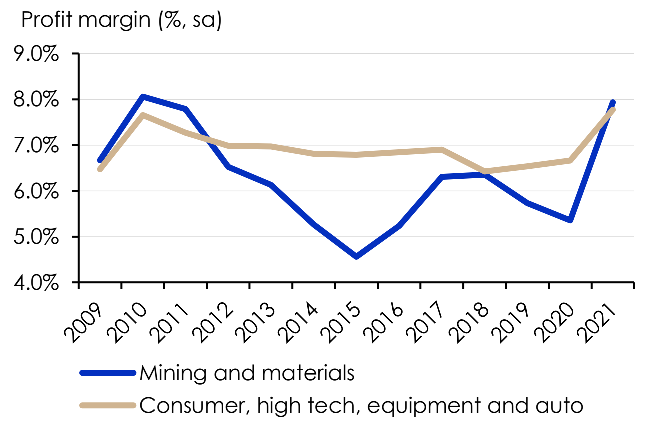
Source: CEIC, CCBIS

Fig 5: Domestic traffic yet to recover to pre-Covid levels



Source: CEIC, CCBIS

Fig 6: Profit margins of downstream industries remain firm despite rising costs



Source: CEIC, CCBIS

Rating definitions:

Outperform (O) – expected return > 10% over the next twelve months
Neutral (N) – expected return between -10% and 10% over the next twelve months
Underperform (U) – expected return < -10% over the next twelve months

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