CHINA ECONOMICS UPDATE

RRR cut not a major easing move

- **The People's Bank (PBOC) has just announced a cut to the required reserve ratio (RRR). This will provide a bit of financial relief for China's large and medium-sized banks. It may also help nudge down lending rates slightly. But given the wider signs of policy restraint, we doubt it will have a significant and lasting impact on monetary conditions or credit growth.**

- Effective 27th March, Chinese banks will receive a 0.25%-pt RRR reduction. However, this does not apply to banks that already enjoy a RRR at the regulatory floor of 5%, which includes all small banks. As a result, **the weighted-average RRR for the banking system will fall by 0.20%-pts**, from 7.80% to 7.60%. This is the fifth RRR reduction this policy cycle, following 25bps cuts last April and December.

- **Interpreting RRR adjustments in China is not straightforward as their impact on monetary conditions has become less clear-cut over the past decade**. They are sometimes still used to push down interbank rates, as was the case when COVID-19 struck in early 2020. But the RRR now often serves a narrower purpose as a tool to influence bank behaviour and manage liquidity, with little lasting impact on monetary conditions. **Interbank rates actually rose following the most recent RRR cut in December**. (See Chart 2.)

- Most likely, the liquidity freed-up by the latest RRR cut will push down market interbank rates somewhat in the short-run. But rates don't have far to fall before they drop back below the PBOC's policy rates. (See Chart 3.) At that point, it will become less attractive for banks to rollover funding from PBOC lending facilities, causing liquidity conditions to gradually tighten again until interbank rates return in line with PBOC policy rates. **In order for the PBOC to engineer a sustained decline in interbank rates it needs to cut policy rates too**. That's possible but seems unlikely given the neutral monetary stance signalled at the recently concluded National People's Congress and the regulatory concerns around mortgage prepayments.

- **Even if the RRR cut has no lasting impact on liquidity conditions, it will still act as an indirect tax cut for banks** by lowering the share of their assets that need to be held as reserves, which pay at most 1.62% interest, allowing them to increase the share of higher-earning assets. When announcing previous RRR cuts, the PBOC has often made it clear that it expects banks to pass on much of this windfall to borrowers by reducing lending rates. But there was no such window guidance this time, which leads us to think that **one motivation for the latest RRR cut is to take some pressure off of the banks**, whose profitability has taken hit from the property downturn and wider economic weakness.

Chart 1: Required Reserve Ratio (%)

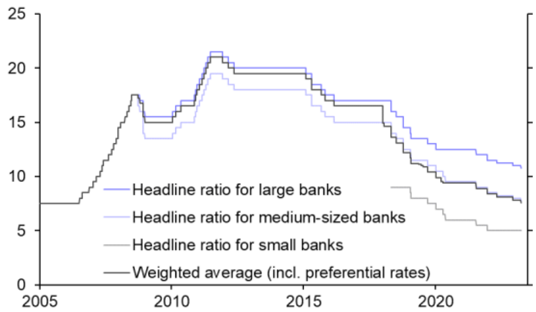
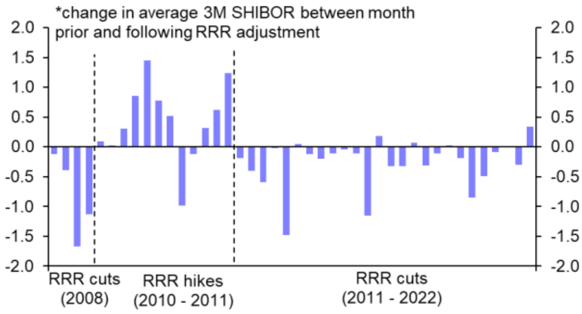


Chart 2: Impact of RRR Changes on Interbank Rates*



Sources: CEIC, Refinitiv, Capital Economics

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- To the extent that banks do pass on the RRR cut to borrowers, any reduction in lending rates will only affect new borrowers – a cut to the Loan Prime Rate is required to push down interest costs on existing loans. And **any decline in new lending rates resulting from a 25bp RRR cut alone will be too marginal to make much of a difference to credit demand**.
- **Much more important will be the extent of the recovery in consumer and business confidence following the dismantling of the zero-COVID policy**. Most signs suggest that appetite for borrowing is bouncing back quite quickly. As such, we expect lending to be strong in the near-term. But it could soon run up against the loan quotas set by regulators, which are usually the key constraint on the pace of bank lending. These quotas are opaque in nature, making them hard to track. The best proxy we have comes from a PBOC survey of banks in which they report how loose or tight loan approvals are. (See Chart 4.)
- It's not uncommon for RRR cuts to presage big jumps in credit growth but that's because they are usually combined with wider efforts to push down interbank rates and relax loan quotas. Whenever these wider efforts have been constrained by conflicting policy objectives such as deleveraging, as they were in 2018-19, then the impact of RRR cuts has been far less impressive. (See Chart 5.) **For now, most signs still suggest that the PBOC intends to take a restrained approach to policy support**, akin to 2018-19.
- For those hoping that the RRR cut will give Chinese equities a boost, it's worth noting that **there is no clear link between RRR announcements and near-term stock market returns**. (See Chart 6.) If anything, the correlation is negative. Historically, the Hang Seng Index and CSI300 have, on average, both fallen slightly over one-day, seven-day and one-month horizons after RRR cuts were announced.

Chart 3: 7-day Collateralised Repo Rates (%)

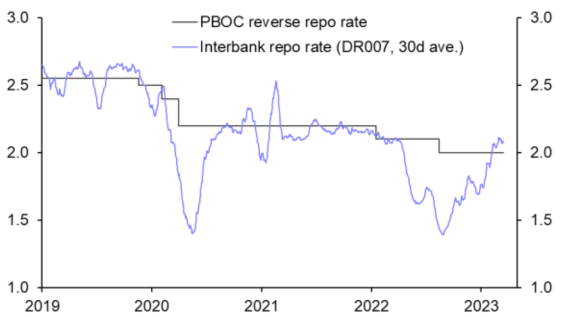


Chart 4: Bank Lending & Loan Approval Conditions (%)

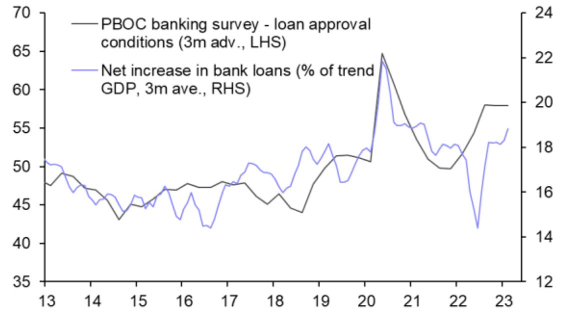


Chart 5: Net Increase in Broad Credit (% of trend GDP, SA)

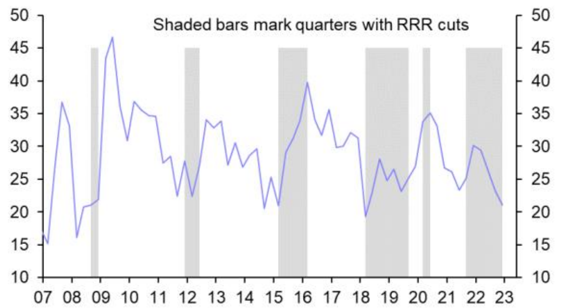
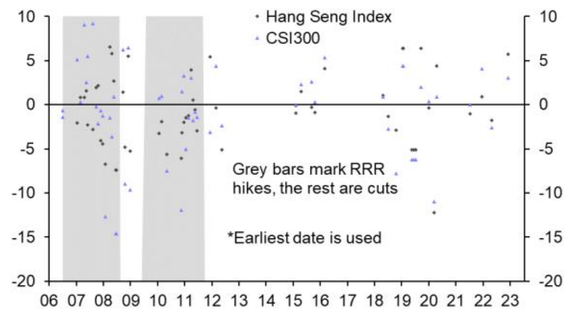


Chart 6: Change in Equity Prices in Week following RRR Announcements by State Council or PBOC* (%)



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