China: Mixed messages from the central bank

The People's Bank of China has sent mixed messages about its monetary stance. Here's what we expect for June

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Is the PBoC reluctant to ease?

Before the Two Sessions- China's most important political event of the year - the PBoC removed from its monetary policy report language which described its stance as prudent. The market (myself included) assumed that this meant the central bank would take a more aggressive easing stance to address the economic damage from Covid-19.

However, the PBoC has shown by its actions that this assumption was quite wrong.

1. The central bank did not cut the Loan Prime Rate in May.
2. The size of the innovative re-lending programme announced after the Two Sessions is too small, at a maximum creating CNY 1 trillion loans for SMEs between March and December 2020. By way of comparison, April's one-month new yuan loans came to more than CNY1.6 trillion. That's why we think this programme is too small. Moreover, if exporters and manufacturers do not see an end to the fall in export orders, this re-lending programme will not prevent them from shutting down, and certainly won't encourage them to think

about hiring more factory workers.

3. Although the maturing MLF could be rolled over on 15 June, there has been a net absorption of CNY270 billion liquidity in open market operations between 1-9 June. This is particularly eye-catching because June marks the end of the half year when liquidity has traditionally been very tight. The PBoC seems to be confident that liquidity will be ample at the end of the half year period. As such, we no longer call for a targeted RRR cut or RRR cut of 0.5-1.0 percentage point in June.

In short, the central bank has been reluctant to pump extra liquidity into the financial system, with more focus on SME loan availability.

Still expect one rate cut but the chances are falling

Despite the seemingly tight stance shown by the PBoC, we still expect a rate cut in June of over 50%. We expect one rate cut on the 7D reverse repo, the 1Y Medium Lending Facility and 1Y Loan Prime Rate by 10-20 basis points.

That is because the economy is in poor shape amid weak global demand and the manufacturing sector is trying to turn to the domestic market as external demand falls. A lower interest rate will help corporates to lower their interest costs, as prices of products are more likely to fall than rise in a weak economy.

Though we still expect a rate cut in June, we have to admit that the chance is falling as the PBoC may want to save ammunition for the future if tensions between China and the US increase. The PBoC does not want the policy interest rate to reach a level which is too low and could potentially lead to a liquidity trap in China.

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