China: Broad-based RRR cut sends bad signal

The Chinese government has unexpectedly announced a broad-based RRR cut to be effective 15 July. This is not the targeted cut mentioned in an important government meeting, and sends a bad signal. So why does China need this cut? What's wrong with the economy?

Leading members of the People's Bank of China, including Governor, Yi Gang (waving)

How much liquidity does this RRR release?

It's surprising that this RRR cut is broad-based and not targeted at SMEs, which was mentioned in an important government meeting. And even more surprising given that the overall economy appears to be quite strong - a standard post-Covid recovery story.

Let's go through the policy step-by-step in order to draw some insights.

- This is a 0.5% required reserve ratio cut, which will release long-term liquidity of around CNY1 trillion. This compares to CNY185.5 trillion of total loans outstanding at the end of June 2021. The major banks' RRR will be 12% after the cut.
- This is a broad-based cut, not the targeted cut mentioned in the government meeting. So in essence, all bank deposits can enjoy a 5% reduction in required reserves. As most deposits eventually turn into loans, banks will enjoy larger profit margins, if lending interest rates do

not change.
- It also gives room for banks to cut lending interest rates. If many banks cut these rates, the whole economy's interest rate should fall.

What's wrong with the Chinese economy that it needs such a cut?

My own view is that the main intention of this cut is to help banks with their capital and liquidity requirements. From the Q&A written by the People's Bank of China, we understand that this RRR cut aims to increase financial institutions' capital and liquidity, and lower their cost of doing lending business.

This gives me a sense of unease. Are banks under stress? If this is the case, it implies there could be more bad loans.

These bad loans could stem from the recent deleveraging reform. Banks have not be able to lend to real estate developers as easily as before and have shrunk their mortgage business. Fintechs, which banks also lend to, have also been subject to deleveraging reform, and this may have had some impact.

> *"China may need another RRR cut in the fourth quarter. If bank troubles spread to the real economy, e.g. they are unable to provide loans to solid companies due to constraints of capital and liquidity, both the RRR and interest rates may need to be cut."*

Let's assume that this RRR cut solves the problem

After this RRR cut, banks should have more breathing room on capital and liquidity.

But what's next for the PBoC and for banks?

Banks cannot change the lending framework for real estate developers. But they could step into micro lending left by fintechs, though this is a risky business.

This means banks will continue to suffer from the same issues. And while they have some breathing room for now, this may only last for another quarter or so given that the release of liquidity is quite small compared to loans outstanding.

China may need another RRR cut in the fourth quarter.

Does China need a rate cut?

If the problem is bank capital and liquidity, then a rate cut may not be necessary.

But if bank troubles spread to the real economy, e.g. they cannot provide loans to solid companies due to constraints of capital and liquidity, both the RRR and interest rates may need to be cut.

A decision on the Medium Lending Facility (MLF) is due on 15 July and I expect the PBoC to provide even more liquidity to the market. If the government really thinks the economy is not doing as well as expected, the 1Y MLF interest rate could be lowered to 2.7% from 2.95%.

Impact on the market

This surprise could be read as a negative signal about how the economy is doing. CNY should be softer, and 10Y China sovereign bond yields should go down.

Let me be plain, this RRR cut is not a positive signal. Volatility in the market could well increase.

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