

China's central bank to cut the targeted RRR again and again

China's central bank plans to cut the targeted Required Reserve Ratio again, but this time only for smaller banks. We look at how effective this policy will be, and what the People's Bank of China could do next



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Targeted RRR cut but on a smaller scale

China's central bank, the PBoC, announced it will cut the targeted RRR by 0.5 percentage points on 15 April and again on 15 May, amounting to a full 1 percentage point cut. This time, the RRR cut is only targeting smaller banks, so it will release a smaller amount of liquidity than the previous cut of CNY 500 billion. The PBoC estimated that each targeted RRR cut could release CNY 400 billion.

The PBoC also announced that it will lower the interest rate paid for excess reserves from 0.72% to 0.35%.

Effectiveness at helping SMEs is in question

The cut suggests that damages from the coronavirus outbreak globally could linger at least until May. So the effectiveness of policy is highly important to gauge the speed of the economic recovery.

Just how effective this targeted RRR cut will be, however, is questionable.

After this move, some of the small banks face a reserve ratio of only 6%. This is indeed very low. But even without these two targeted RRR cuts, the reserve ratio for these banks is just 7%, which is already low.

The cuts are aimed at smaller banks to encourage them to lend to SMEs. But banks have been reluctant to lend to SMEs that are facing difficulty in this pandemic. This could be especially true for exporters who are facing order withdrawals from the west. The Easter holiday is an important export season for China. With the lockdown and increased social distancing in Europe and the US, sales in western markets are expected to be dismal.

Are banks willing to take high credit risk to lend to SMEs that are facing a cash flow problem? This may be unlikely.

Effectiveness at pushing down interest rates is high

Frequent targeted RRR cuts that release long term liquidity to the market mean that longer-term interest rates should fall, if global risks do not increase suddenly.

Though this would not benefit SMEs, which are the most in need, it will ease the interest costs of other corporates that could contribute to the recovery of the economy, even if liquidity is already ample.

This lower interest rate effect should have a short-term impact on the yuan. We expect the USD/CNY to go from 7.10 to 7.20 by early May and to 7.25 by the end of June, as the recovery should be slow and the market is looking at the chance of the second wave of coronavirus infections.

Further easing is certain but how?

The central bank may find it difficult to encourage banks to lend to those most in need without government loan guarantees.

Even though we expect there to be more targeted RRR cuts for smaller banks, and rate cuts on the 7D, 1Y Medium Lending Facility (MLF) and 1Y Loan Prime Rate (LPR), these policies would be more beneficial to solid companies, as their credit profiles are much better than small manufacturers, service providers and exporters. These weak credit profile borrowers could be supported by fiscal stimulus including tax and fee cuts.

A combination of monetary policy and fiscal policy is necessary at this time.