

China cuts reserve requirements for seasonal loan demand

China cut broad-based Reserve Requirement Ratios by 0.5 percentage points. This cut helps smooth out liquidity pressure from massive loan demand at the beginning of the year, which is a seasonal phenomenon. But is this enough to meet the challenges in 2020?



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PBoC announced RRR cut on the first day of 2020

As expected, because of damage from the trade war and the need to finance infrastructure projects and 5G facilities, China's central bank cut its Reserve Requirement Ratio in the first quarter of 2020 by 0.5 percentage points to 12.5% for bigger banks and 10.5% for smaller lenders. The cut is effective from 6 January.

The announcement was made on New Year's Day reflecting the People's Bank of China's concern about a liquidity squeeze from massive loan demand in January.

Is the cut too small or too large for this year's loan demand?

This RRR cut will release long-term funding of more than [CNY800 billion, as estimated by the PBoC](#),

of which CNY120 billion will come from city commercial banks and rural commercial banks, which serve small and medium-sized enterprises.

Whether this RRR cut is too small or too large depends on whether the banks pass on the lower funding costs to borrowers.

Some have commented that this CNY800 billion liquidity release will be absorbed by the maturity of the CNY257.5 billion one-year medium lending facility on 23 January, and therefore the size of the RRR cut is not enough to meet loan demand this month. We don't agree. The central bank could have an MLF injection in mid January to offset the maturity. This is quite possible because there is usually an MLF operation before the 20th of each month to indicate whether there will be a change in the loan prime rate.

LPR cut is expected in 1Q20

We think there's a 50-50 chance of a five basis point cut in the MLF, LPR and 7D reverse repo in January. If there's no action this month, there's a higher chance of rate cuts in February and March.

The advantage of a cut in January is that this is a high period of lending activity and lower rates would benefit borrowers. But we believe that the PBoC could adopt a wait-and-see approach to gauge the impact of the RRR cut on interest rates. If this move lowers interest rates, for example, the 7D repo stays under 2.3% for a week, down from 2.8% before the RRR cut, then there is no need for an LPR cut in the same month.

We expect another RRR cut in 2Q20

With the background of a trade war (even if a phase one deal is signed) and an emerging technology war, China's corporates need more financing support. As such, we believe that the PBoC could cut the RRR by 0.5 percentage points again in the second quarter. This could be accompanied by another five basis point LPR cut.

Don't expect impact on the yuan

The USD/CNY exchange rate has moved in tandem with news on the trade war and the emerging technology war. The RRR cut should not have too much impact on the currency pair. Indeed, we have seen that domestic liquidity conditions and the interest rate path have not really influenced the yuan exchange rate.

Until the trade war worry is gone from a market point of view, we believe the yuan will mostly be moved by developments on this front.

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