

PBOC surprises markets with an off-schedule 20bp cut to the MLF

After keeping the medium-term lending facility (MLF) unchanged earlier this month, the PBOC surprised markets today by suddenly cutting the MLF by 20bp



Source: istock

2.30% China's medium-term lending facility
20bp cut

What's behind the PBOC's sudden off-schedule MLF cut?

It's been a busy week for the PBOC. After cutting the 7-day reverse repo rate on Monday, and seeing banks lower their loan prime rates and deposit rates, the PBOC continued its easing with a 20bp cut to the 1-year medium-term lending facility (MLF) rate, bringing the MLF down from 2.5% to 2.3%.

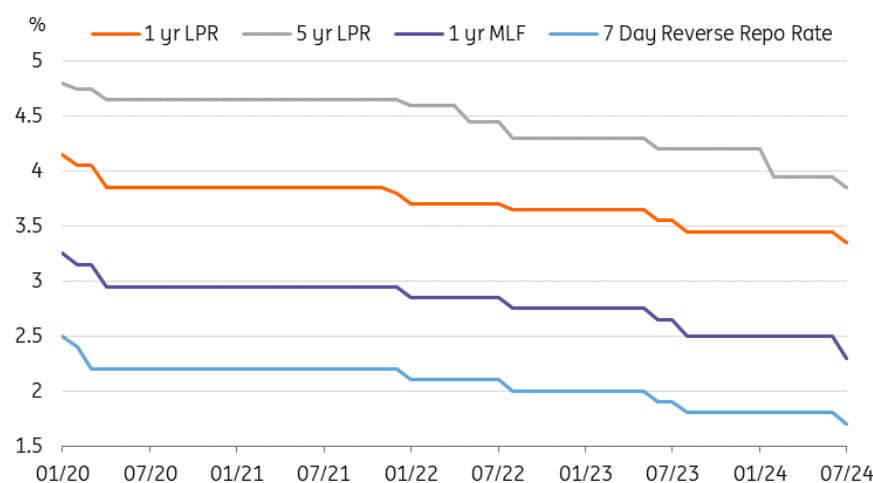
This decision came as a surprise to markets for two reasons:

1. the timing and
2. the scale.

On the timing, the PBOC has previously been on a somewhat reliable schedule of announcing the MLF monthly. After keeping the MLF unchanged earlier this month, most had assumed monetary policy would likely remain unchanged this month. However, the PBOC followed up no change in the MLF with a cut to the 7-day reverse repo rate on Monday, and we subsequently saw banks lower their LPR and deposit rates in response. We flagged in our note on Monday that [the PBOC may be signalling the 7-day reverse repo rate's new status as the primary policy rate](#) if other rates soon followed, and it looks like this is the case. It is likely no coincidence that the PBOC started off this recent round with a cut to the 7-day reverse repo rate first. Most were expecting the MLF to be lowered at next month's decision, but given the broader direction of monetary policy easing, as well as needs from the real economy, there was no need to wait.

On the scale of the cut, the initial response notes that it was a 20bp cut instead of a 10bp cut to the 7-day reverse repo rate, and 10bp reductions of bank LPRs. On the policy rate side, it is not uncommon to see some divergence, as one is a short-term rate and the other is a medium-term rate and they do not always move in perfect synchrony. A larger cut to the MLF relative to the LPR could also provide some support to banks' interest margins, though it is possible that the LPR may be further lowered as an immediate impact from the MLF cut instead.

MLF cut of 20bp was larger than similar rate reductions earlier this week



Sources: PBOC, ING

MLF collateral reductions signal the PBOC's intention to cool the bond market

Additionally, the PBOC also announced this week that it would reduce the collateral requirements for institutions drawing upon the MLF.

The aim of this was to increase the scale of tradable bonds and alleviate the pressure on supply and demand in the bond market by allowing for banks to sell those bonds instead of needing to hold them as collateral for MLF needs. This move, following earlier measures announced that the

PBOC would start to borrow bonds to sell, may be another step in cooling the bond market.

Long-term bond yields have remained low as investors continued to seek out low-risk sources of yield amid limited risk appetite; with falling deposit rates and still limited willingness of investors to return to equity or real estate markets, government bonds continue to offer appeal to investors despite the current low yields and signals from the PBOC warning against a bond market bubble.

Another aspect of this collateral adjustment may be allowing for banks without the requisite collateral to draw upon the central bank rates, which could also help lower the funding costs of certain institutions and could act as a boon to some Chinese banks which continue to face significant pressure under shrinking interest rate margins and rising non-performing loans.

Overall, this week's monetary policy easing should come as a welcome signal as China faces a more challenging second half of the year on its road toward the 5% annual growth target. Real interest rates have been too high for the current strength of the economy and were one of the factors behind the contraction of new loans in the year to date. While cuts are still relatively modest in size, they should still be more effective in supporting the economy relative to reserve requirement ratio (RRR) cuts. In particular, the MLF continues to see significant usage and it should have a more direct and immediate impact on actual lending rates to the real economy.

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