Why China’s central bank has cut its required reserve ratio

China cut its RRR today by 25 basis points. We think this is partly to help the economy and provide a cushion against global market turmoil

The People's Bank of China is the central bank of China

PBoC cuts RRR

China's central bank, the People's Bank of China, cut its required reserve ratio by 25bp to 10.75%. This releases yuan liquidity of 500 billion.

Why does the PBoC need to inject liquidity in the money market during an on-track recovery?

The economic data is not as good as expected. Retail sales grew 3.5% year-on-year, year-to-date, which was slower than market expectations. But this was mainly driven by the discontinued subsidies for electric cars. We believe that the RRR cut will hardly help to boost EV sales.

However, the cut could help to lower market interest rates, which could help to lower bond issuance interest costs. This may benefit real estate property developers and local government financial vehicles for their funding needs.

Another reason for the cut, which should be a supplementary one, could be to provide a cushion against any potential negative impact from global market turmoil. If foreign investors need cash and there are sudden capital outflows from China, there is at least some immediate cushion. Surely in such an event, the PBoC would inject more liquidity into the market.

RRR cut should have negligible impact on USD/CNY

The CNY exchange rate usually follows the dollar index closely. This is especially true right now when market players are watching the market very closely.

As such, this RRR cut should not affect the USD/CNY exchange rates to a large extent. There might be some softening of the yuan briefly. We keep our forecast of USD/CNY at 6.90 by the end of this quarter

We do not expect the PBoC to cut interest rates or the RRR any further in the first half of this year unless global market conditions become extreme, as the economic recovery is on track.

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