China Flash

Four Reasons why the PBoC should lower the RRR

Latest activity indicators show that China's economic slowdown continued after registering a disappointing 7.4% year-over-year growth in Q1. Industrial production, urban fixed asset investment and retail sales all expanded at a slower-than-expected pace in April, suggesting that growth headwinds come from both supply and demand sides. New loans and the Total Social Financing (TSF), which is a broader gauge of credit supply including part of shadow banking activities, also moderated in April, partly due to the authorities' clampdown against shadow bank activities.

Many market analysts (including us) believe that more stimulus measures are needed to sustain growth within the reasonable range (7.0%- 7.5%) as the authorities emphasized. The Premier Li Keqiang, in his speech last week, also indicated that the authorities might loosen monetary policy further to support growth. It still remains a question whether the PBoC will lower the Required Reserve Ratio (RRR) in the coming months as part of new stimulus measures. People against the RRR reduction argue that it might deliver a too strong signal of monetary easing and contradict the authorities' stance of avoiding any large-scale stimulus package. However, from our point of view, there are a good number of reasons for the authorities to place the RRR adjustment in their to-do list for growth stimulus:

- **First of all, the RRR needs to be adjusted in response to the change of cross-border fund flow.** The existing high RRR in China (20% for large banks and 18% for small-and-medium-sized banks) is a result of the government's continuous sterilization over the past decade. That said, the authorities had to use RRR hikes to soak up excess liquidity caused by strong fund inflows through current and capital accounts. However, some far-reaching changes loom for cross-border fund flow, necessitating the RRR adjustment in the opposite direction. China's current account surplus narrowed during the past three years, thanks to both currency appreciation and sluggish external demands. More importantly, capital inflows to China are set to slow significantly as the US Fed started to reverse its ultra-loose monetary policy. Looking ahead, slowed fund inflows will substantially drain the liquidity in the banking sector. To offset the adverse impact of less capital inflows and smaller trade surplus, the authorities need to cut the RRR to ensure the liquidity adequacy.

- **Second, a reduction in the RRR can help to mitigate housing market risks.** China's property sector has been one of the important drivers for its rapid economic growth, especially in the aftermath of the 2008-2009 global financial crisis (GFC). However, the sector seems to be losing its momentum recently, as housing transactions in many cities declined sharply. Even worse is that banks, after experiencing two liquidity squeezes in the interbank market last year, have started to tighten their credit to long-term borrowing, particularly mortgage loans. It is reported that even large banks have raised their mortgage rates above the benchmark interest rate, significantly higher than before (banks used to offer 30% discount for mortgage rates). Too tight credit to the mortgage market not only aggravated housing affordability problem (especially for those first-time buyers) but also increased the risk of a sharp decline in housing prices. We anticipate that a reduction in the RRR can effectively alleviate the excessive tightening in the mortgage market for it can provide long-term funding to banks. In this sense, the RRR reduction is preferable to other policy tools focusing on short-term liquidity injection, such as reverse repo and short-term liquidity facility (SLF).

- **Third, the RRR tool should be deployed in coordination with the authorities' efforts to clamp down on shadow banking activities.** One of China's financial fragilities is the rapidly growing shadow banking sector, which primarily stems from banks' off-balance-sheet businesses. Now the shadow bank sector has become so important to China's corporate sector (we estimate that around one-quarter of corporate financing comes from the shadow banking sector), that any attempt to bluntly unwind it could lead to a serious credit crunch and even a systemic financial crisis. In our opinion, the only feasible way to tackle the shadow banking problem is to allow banks to gradually bring their off-balance-sheet businesses back to their books, so that the regulator can better monitor them. However, bank loans are much more liquidity-consuming than those off-balance-sheet activities. By reducing the RRR, the regulator could provide more liquidity support for banks to accelerate the process of winding up shadow banking lending.

- **Last, the RRR reduction can facilitate the deepening of interest rate liberalization.** Interest rate liberalization was on the top of the authorities' reform agenda unveiled by the Third Plenum last November. Having fully liberalized lending rates last year, the next important step should be to abolish the current cap (10% above benchmark rates) imposed on deposit rates. However, banks have been stubbornly against it over concerns that liberalization of deposit rates could squeeze their interest rate margins (NIMs) and dent their profitability. The RRR reduction can provide more loanable funds for banks and therefore helps to increase their profits. In this context, the authorities could leverage the RRR reduction to alleviate the adverse impact of interest rate liberalization on banks' profitability, so as to reduce their resistance to the deepening of interest rate liberalization.

- **In conclusion, the RRR, as a monetary policy tool, has its own advantages in providing stable, cheap and long-term funds to banks.** Against the backdrop of economic slowdown and less capital inflows, it could play a very important role in reviving growth, mitigating shadow banking risks and facilitating interest rate liberalization. Therefore, we project that the authorities will lower the RRR in the coming months, which might come in the form of a universal RRR cut for all banks or a more "targeted" one applicable to a certain group of banks.

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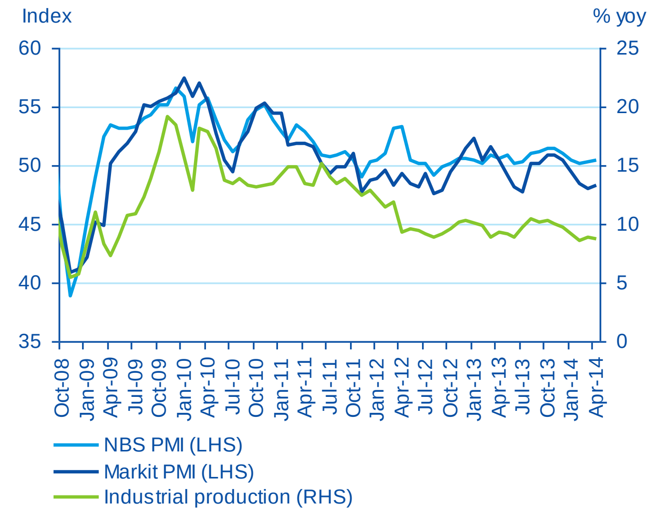
Chart 1

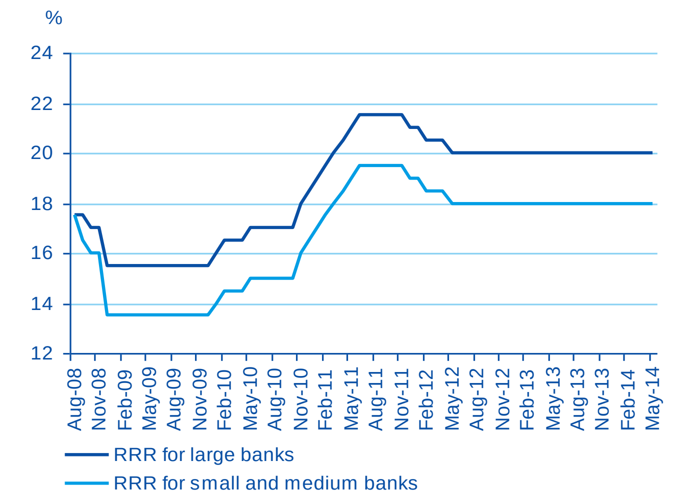
Weak growth momentum with some early sings of recovery



Source: CEIC and BBVA Research

Chart 2

Ample room for RRR easing



Source: CEIC and BBVA Research