CHINA Insights

OCBC Bank

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Highlights:

- **The latest RRR cut is the first universal RRR cut since April 2016.**
- **China has reckoned the increasing downside risk and sent the clearer signal that it is ready to run full steam if needed.**
- **The RRR cut is expected to save CNY20 billion finance cost for banks.**
- **A cheap and long term stable funding is the first step to restore banks' confidence to lend out.**
- **We expect China to cut RRR by at least another 150bps in 2019.**
- **The issuance of perpetual bonds by commercial banks to replenish capital together with RRR cut may be the right step to solve the root problem of breakdown of transmission mechanism from easing money to easing credit.**

PBoC announced to cut the reserve requirement ratio (RRR) for all banks in two stages in January by 100bps. This is the fifth RRR cut since 2018 and the first universal RRR cut since April 2016. However, PBoC announced that it will not roll over the maturing medium-term lending facility (MLF) in the first quarter of 2019 as a result of RRR cut.

The RRR is expected to unlock CNY1.5 trillion liquidity. After taking CNY1.2 trillion maturing MLF in the first quarter into account, the RRR cut will net inject CNY300 billion.

Meanwhile, together with the establishment of targeted medium term lending facility in December 2018 and the expansion of qualified criteria for targeted RRR cut, PBoC estimates to net inject CNY800 billion liquidity into the system. The RRR cut is expected to save CNY20 billion borrowing costs for banks.

The latest RRR cut will mainly serve two purposes. First, in the near term, it will help contain the money market volatility ahead of Chinese New Year holiday and support the holiday funding demand. The 50bps cut on 15 January will match the date for reserve payment while the other 50bps cut on 25 January will match both reserve payment and tax payment. We expect the RRR cut together with the TMLF and expansion of qualified criteria for targeted RRR cut for inclusive finance will total inject about CNY2 trillion ahead of the Chinese New Year holiday. This size is similar to CNY2 trillion liquidity injection in 2018 via the 30-day temporary facility contingent reserve allowance (CRA).

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Second, in the longer run, the universal RRR cut will provide cheaper and more stable long-term funding as compared to MLF and other open market operation tools. This may give banks more incentives to channel the money to the real economy, which is in line with China's initiative to support the funding demand from the small and private economies.

Since 2018, China has cut the RRR in a targeted way for four times. However, the marginal impact of targeted RRR cut has diminished significantly as China has refrained from a full-scale easing due to concerns that it may dampen its effort on the de-leverage campaign. Nevertheless, as the Chinese economy has decelerated recently amid the uncertainty from the US-China trade war, the latest universal RRR cut sent two important signals. First, China has reckoned that the downside risk of growth. Second, different from past two years that PBoC only use temporary tools to support holiday funding demand (TLF in 2017 and CRA in 2018), the current universal RRR cut has sent much clearer signal that China is able to run full steam to stimulate the economy if needed.

The effect of the latest universal RRR cut will depend on whether the easing money will be eventually channeled to the real economy, which will depend on the banks' risk appetite. In order to boost banks' confidence to lend out again, providing banks cheap and long term stable funding is the first step. The universal RRR cut is the right step in our view.

In addition, China's plan to allow the issuance of perpetual bonds by commercial banks to replenish their capital serves the same purpose. It seems that China is moving towards solving the root problem of the breakdown of monetary transmission mechanism from easing money to easing credit.

Looking ahead, we expect China to cut RRR further in 2019 by at least another 150bps for two reasons. First, China's RRR for larger banks will stand at 13.5% after the latest 100bps RRR cut. This ratio remains high in any standard. Second, as of end of 2018, the outstanding of MLF was at CNY4.9 trillion with CNY3.7 trillion maturing in 2Q, 3Q and 4Q. There is ample room for China to further cut RRR to replace the MLF to lower the borrowing costs to incentivize banks to lend further.

Last but not least, although the heightening expectation the Fed rate hike pause has capped the upside for USD, the heightening expectation on further monetary easing in China may keep RMB depreciation pressure alive. China has made two good bets on the Fed in the past month. First, China cut the TMLF rate ahead of Dec FOMC meeting and cut the RRR ahead of Fed Chairman Powell speech on the same day. Both bets pay off for now. However, we think the near-term pressure for RMB remains for two reasons. First, market may have underestimated the Fed rate hike probability. Second, China is expected to roll out more easing this year, which may further weigh down on the currency prospect.

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