Global Treasury Research

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Questions: Why did PBoC retap its RRR for foreign currency for the first time in 14 years?

Our replies:

- PBoC announced to raise reserve requirement ratio for foreign currency deposits by 2% to 7% effective from 15 June. This is the first RRR hike for foreign currency since 2007. The additional 2% reserve requirement ratio is expected to lock US$20 billion foreign currency liquidity in China's banking system.

- The two charts below are self-explaining why China decided to adjust its RRR for foreign currency for the first time in 14 years.

- Against the backdrop of PBoC's exit of direct currency intervention, the massive inflows have led to the rapid expansion of foreign assets in China's commercial banks' balance sheet after PBoC decided to keep its balance sheet relatively stable.

- As shown on chart 2, since the start of pandemic in 2020, foreign assets in China's financial institutions' balance sheets ballooned by more than CNY1.1 trillion to CNY7.49 trillion. In addition, foreign currency deposit in Chinese financial institutions has also increased by US$221.5 billion since early 2020 to more than US$1 trillion as shown on chart 1.

- Chinese financial institutions have become the first line of defense to absorb the excessive dollar liquidity in the system in the absence of PBoC's intervention.

- Nevertheless, there is increasing mismatch between foreign currency denominated assets and liability in the onshore market. For example, China's foreign currency loan growth has been stagnant recently. As such, financial institutions have to increase their allocation of their excessive dollar liquidity to offshore market. However, given declining China's overseas direct investment and rich valuation in equity and bond markets, the allocation of excessive dollar liquidity in the offshore market by Chinese financial instructions also hit the bottleneck.

- The increase of swap points due to widening yield differential between RMB and USD and potential risk of unwind of excessive dollar liquidity in the onshore market add additional pressure for RMB to overshoot. The latest announcement to mop up excessive dollar liquidity came out at the right time to prevent from the snowball effects.

- Overall, the lockup of US$20 billion excessive dollar liquidity is still relatively small. It is certainly not a game changer. However, we think the announcement sent a signal to the markets that there are enough tools in central bank's toolbox to curb RMB's one-way movement expectation even though PBoC has exited the direct intervention. Via narrowing the swap points, we think the RRR hike may have indirect impact to reset expectation on RMB's trajectory.

Chart 1: The growth of foreign currency deposits outpaced the growth of foreign currency loan

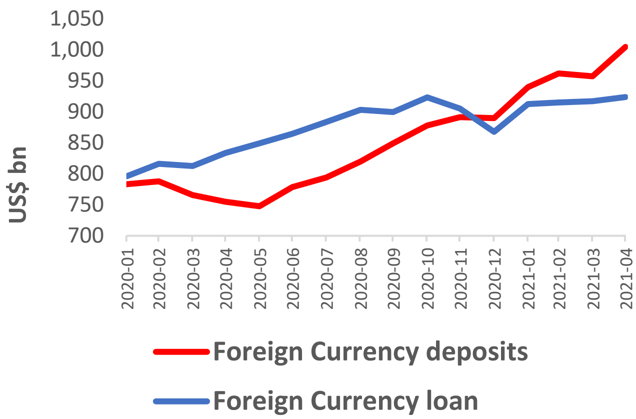

Chart 2: Commercial banks were forced to accumulate foreign assets