CHINA ECONOMIC UPDATE OCTOBER 2017

Repurposing an old tool – a new life for the Required Reserve Ratio

NAB Group Economics

Since it adopted a more modern approach to monetary policy in late 2015, it looked like the People's Bank of China had little use for its older policy tools – such as the benchmark lending rate and required reserve ratio (RRR). The latter had remained unchanged since February 2016, but was repurposed at the end of September – with a goal of boosting lending to China's financially neglected small business sector.

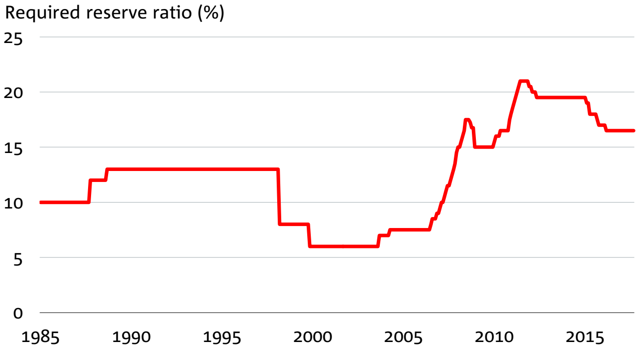
CHANGE IN APPROACH LEFT THE RRR BEHIND

Until November 2015, China's monetary policy was managed on a quantity basis – controlling the amount of money in circulation to influence (among other things) the growth of bank lending – rather than the price (interest rate) approach adopted by most advanced economy central banks. One of the key tools in the quantity approach was the required reserve ratio (RRR) – the share of deposits that banks must hold as reserves – as changing the rate influences the capacity of banks to lend.

For example, between June 2006 and June 2008, the PBoC increased the RRR by 1000 basis points – from 7.5% to 17.5% – in part to address inflation concerns during the period (with the CPI peaking at 8.7% yoy in February 2008). In contrast, the central bank cut the RRR six times between the start of 2015 and February 2016, as growing capital outflows strained domestic liquidity.

CHINA'S REQUIRED RESERVE RATIO

Despite recent cuts remains relatively high



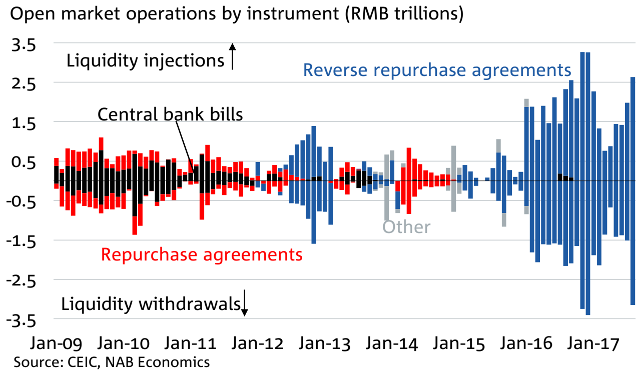
Sources: CEIC, NAB Economics

However, from November 2015 the PBoC switched to a price-based approach to monetary policy – targeting short term interest rates. In a large part, this was due to the evolution of China's financial sector – that has become increasingly complex and interconnected due to a wave of financial reform in recent years. The old monetary policy approach led to sharp spikes in interbank rates during periods of peak short term demand – posing greater risks for banks that were increasingly relying on these markets for funding.

Following the shift, the PBoC increasingly influenced liquidity via open market operations along with the short term Standing Lending Facility and Medium-term Lending Facility. This has given the bank greater flexibility to manage short term interest rates (compared with the blunt nature of its older tool box).

OPEN MARKET OPERATIONS

PBoC has become more active since late 15



Source: CEIC, NAB Economics

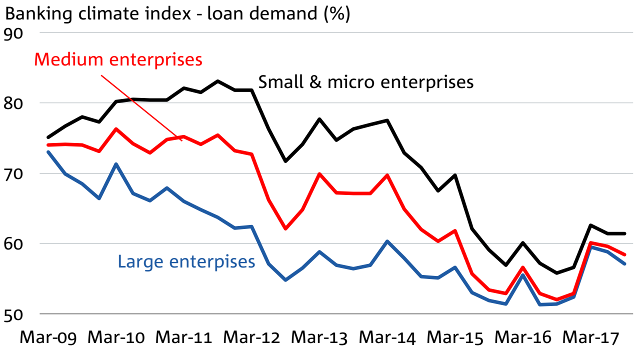
Date **October 2017** | Author **Gerard Burg** – Senior Economist – Asia

A NEW ROLE FOR THE RRR – CHANGING LENDING INCENTIVES

One of the key challenges facing smaller firms in China is access to finance. Large state-owned banks have always preferred to lend to large state-owned enterprises (SOEs), due to long standing relationships and strong political connections. According to the IMF, SOEs account for over half of China's total corporate debt but less than 20% of industrial value added. Business surveys – such as the PBoC's Banking Climate Index – consistently show that smaller firms have the strongest demand for loans, however due to their weaker access to traditional bank finance, these demands are frequently met by the shadow banking sector. As a result, smaller firm funding is likely to be at higher cost and may face a greater mismatch between the maturity of the loan and the investment (as many shadow banking products are very short term).

CHINESE FIRMS LOAN DEMAND

Small firms consistently the strongest



Sources: CEIC, NAB Economics

At the end of September 2017, the PBoC unexpectedly announced a cut to the RRR – the first since February 2016. The bank stated that this change was designed to encourage more small loans (under 5 million yuan) to small firms, individual proprietors and certain key sectors (agriculture, innovation, education and assistance to the poor).
This policy change differed significantly from previous occurrences. First, the change isn't scheduled to occur until 2018, meaning that banks have plenty of time to prepare. Secondly, it consists of two distinct cuts, with different eligibility requirements depending on the banks' end of 2017 balance sheets. The first RRR cut is 50 basis points – which for a large depository institution would cut the ratio from 17% to 16.5% – provided that at least 1.5% of their total outstanding loan balance or their newly added loans for the previous year are directed towards the targeted firms. According to some estimates, all of China's large banks and around 90% of small to medium sized banks are likely to exceed this threshold (Reuters).

The second RRR cut is an additional 100 basis points, which requires at least 10% of lending to be directed to the targeted firms. While far fewer banks currently meet this threshold, they have almost three months to adjust – meaning there is a profitable incentive to rapidly expand lending to small business over this period.

CONCLUSION

At a high level, the repurposing of the RRR is a positive move – providing banks with a direct incentive to improve access to finance for an under-represented section of Chinese business. That said, it will be some time before we see how successful this change will be. For example, it is unclear whether this measure is a one off, or if future incentives will be offered (given that the RRR remains comparatively high). Similarly, it is unclear if banks will expand lending up to the threshold requirement, or will continue past this level. As has been seen with other reforms in recent years, achieving long term change can be difficult.

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