BBVA | RESEARCH

China Economic Watch
04.09.2014

ECONOMIC ANALYSIS

The PBoC’s next steps

Le Xia /Jinyue Dong

Summary

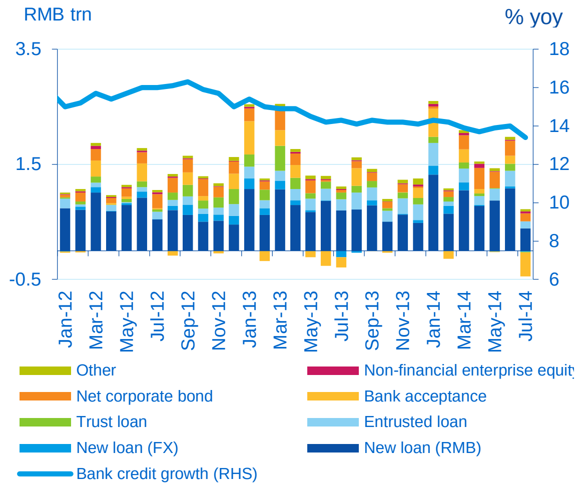
- China’s economic outlook has become uncertain again as credit growth in July plunged to a three-year low. Accommodative monetary policy is needed to sustain the economic growth within the target zone.
- We briefly take stock of available policy tools in the central bank’s toolkit. Interest rate adjustment is an important price-based tool while changes in required reserve ratio (RRR) are the quantity-based ones which were most frequently used. In addition, the PBoC has recently unveiled a set of unconventional tools to spur bank lending and sustain growth momentum.
- The authorities are expected to deploy more unconventional policy tools in the rest of the year because they are more flexible and “targeted”. In addition to boosting bank lending to infrastructure projects and SMEs, new measures should cater to reviving housing demand as well.
- Looking ahead, some conventional policies can be complementary to the unconventional ones in terms of resisting strong headwinds to growth. In this respect, we deem that RRR cuts, rather than interest rate cuts, are more suitable in terms of reducing financing costs of banks and enterprises.

Accommodative monetary policy is needed to counter with headwinds in 2H

Notwithstanding the better-than-expected GDP outturn of the second quarter, China’s economic outlook became uncertain again as credit growth in July plunged to a three-year low. New bank loans in July stood at 385.2 billion RMB in July (versus RMB 1079.3 billion in June), dragging the year-on-year growth rate of outstanding loans down to 13.3% in July from 13.7% in June. The total social financing (TSF), a broader gauge of aggregate credit including bank loans, bond issuance and shadow banking activities, collapsed to 273.1 billion RMB in July from RMB 1079.3 billion last month. Notably, the July TSF even fell below the amount of new bank loans, which, together with a relatively stable bond issuance in the past few months, pointed to a sharp contraction of the shadow banking sector. (Figure 1 and Figure 2)

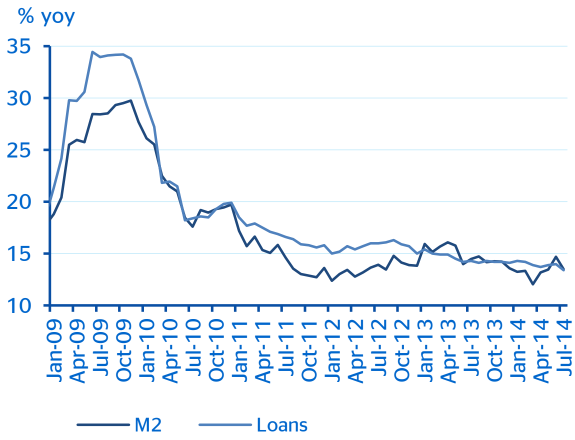
Barring certain seasonal effects stemming from banks’ mid-year “window dressing” behaviors, the plunged credit growth is in large measure attributed to a confluence of weak domestic investment demand and banks’ increasing risk aversion. Among all the components of domestic investment demand, the real estate sector, which accounts for around 20% of total investment, constituted the largest drag as housing sales stepped into a downward trajectory since the end of 2013. (Figure 3) Importantly, the decline in real estate investment cannot be offset by the government’s spending spree in infrastructure projects. Meanwhile, the knock-on effect of the subdued property market weighed on investment in the manufacturing sector, in particular for industries closely tied to housing demand such as steel, cement, non-ferrous metals and construction materials. (Figure 4)

Figure 1
Credit growth in July plunged to a three-year low



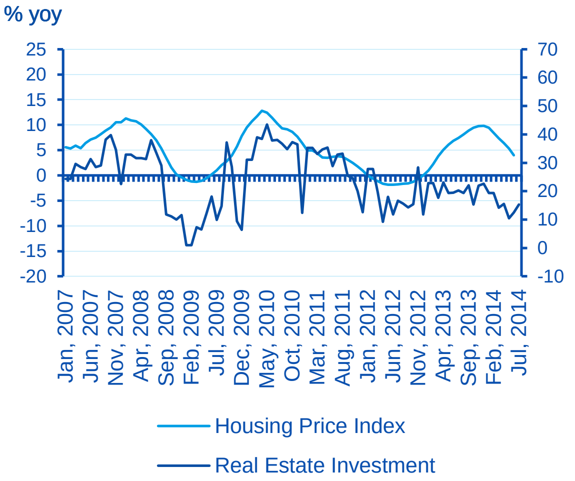
Source: CEIC and BBVA Research

Figure 2
Both M2 and loan growth dropped in July



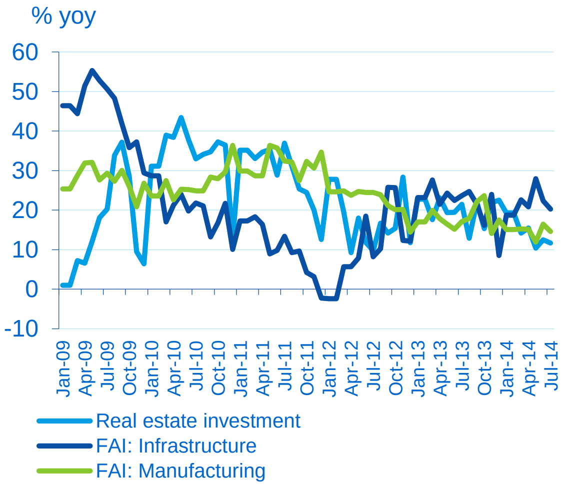
Source: CEIC and BBVA Research

Figure 3
Both housing sales and real estate investment have decreased since end-2013



Source: CEIC and BBVA Research

Figure 4
Moderation in investment is broad-based



Source: CEIC and BBVA Research

The shift of banks' risk appetite is also at play. After the several rounds of financial reforms since 1997, China's banks have now become much more commercialized than before. Having perceived the escalation of a number of financial fragilities over the past few years, banks deliberately started to claw back from some areas that they deemed to be associated with high risks. As such, the bubble-prone property sector and several industries suffering from over-capacity problems bore the brunt of the shift in banks' risk appetite.

These two factors could reinforce each other to create a vicious cycle. For instance, subdued property prices may raise banks' concerns over the housing market and thus cause them to charge more for mortgage loans. Rising mortgage rates dampen housing demand and lead to further declines in housing prices, which in turn reduce developer's willingness to increase their investment.In such a circumstance, the authorities need to continue its accommodative stance of monetary policy in the second half of the year to safeguard the official growth target of 7.0-7.5%. Indeed, Mr. Sheng Songcheng, a senior PBoC official projected that new bank loans of 2014 will amount to around RMB 9.5 trillion, equivalent to a 14% year-on-year growth of outstanding loans, while the TSF of 2014 could amount to RMB 18.5 trillion.

We believe that Mr. Sheng's projection has largely reflected the authorities' policy stance. It is noted that the projected 14% of credit growth for the full-year of 2014 is almost the same as the actual outturn through June, which, based on past experience, should be adequate to sustain an annual GDP growth of 7.0-7.5%.

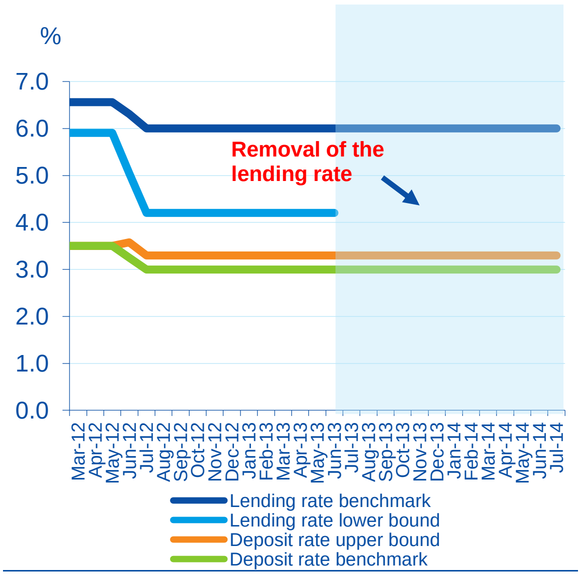
Now the uncertainties about monetary policy outlook are reduced to the question of what monetary policy tools the authorities are likely to adopt going forward, in pursuit of the targeted credit growth. Before forecasting the PBoC's policy choice, we can take stock of available policy tools in the central bank's toolkit.

Taking stock of the PBoC's policy instruments

Among all of the PBoC's monetary policy tools, policy rate adjustment is the most important form of price-based instrument. Unlike other central banks who only control some interest rates at the short tenor while allow the market to decide interest rates with long maturity, the PBoC used to stipulate a floor of lending rates and a cap of deposit rates at all the tenors. After several rounds of incremental reforms, now the PBoC has already lifted the lending rate floor and rendered more flexibility of deposit rates. (Figure 5)

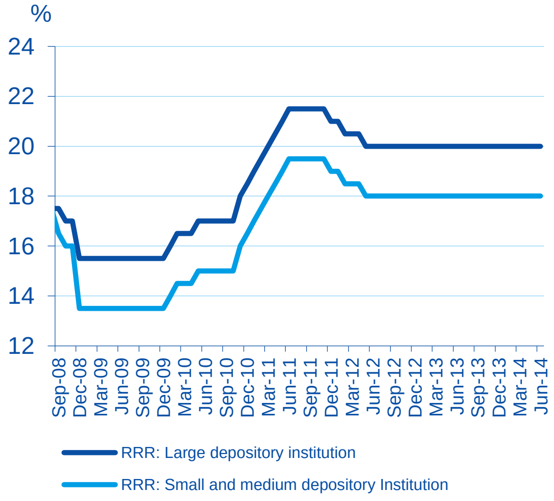
The adjustment of Required Reserve Ratio (RRR) is the most frequently used quantity-based monetary tool. Through RRR adjustments, the PBoC can directly inject or withdraw liquidity in the banking sector and thereby loose or tighten the monetary policy. Apart from being used as a monetary policy tool, RRR hikes have been employed as an effective sterilization instrument to soak up liquidity generated by the PBoC's FX market interventions. (Figure 6)

Figure 5
The PBoC removed the lending rate floor in 2013



Source: CEIC and BBVA Research

Figure 6
The RRR is still at a relatively high level



Source: CEIC and BBVA Research

Other conventional monetary tools include Open Market Operations (OMO, which serve to fine-tune money market liquidity via issuance of new Central Bank Bills and notes), the rediscount window and refinancing programs. Through the rediscount window, the PBoC purchases commercial bills from eligible financial institutions, equivalent to liquidity injection to the economy. Under refinancing programs, the PBoC directly makes loans with no collateral to qualified financial institutions.

In addition to the abovementioned conventional monetary policy tools, the PBoC has recently launched a set of unconventional monetary policies to boost bank lending and stimulate the economy: the Pledged Supplementary Lending (PSL) is a lending facility under which the central bank directly provides loans to banks for their re-lending; two "targeted" RRR cuts which are only eligible for banks that engaged in lending to the agricultural sector and SME customers. (See our 2014 Q2 China Outlook)

Unconventional tools are to be tilted toward the property market and SMEs

The authorities are expected to deploy more unconventional policy tools in the second half of the year. Compared with universal reduction in the RRR or interest rates, unconventional policy tools are more flexible and "targeted". That said, the conduct of certain unconventional monetary policies could effectively channel funds to the sectors that the authorities are keen to support. For example, the implementation of the PSL in the first half of the year has lent a great support to shantytown renovation projections and thus boosted infrastructure investment.

Nevertheless, the scope of additional unconventional measures is likely to be nuanced going forward. In addition to boosting bank lending to infrastructure projects and small and medium sized enterprises (SMEs), new measures could shift their focus to stimulating housing demand, where the PBoC has ample policy options. For instance, selective RRR cuts might be rolled out on the condition of banks' mortgage lending as well as their SME loans. The central bank can also set up a floor of growth for banks' mortgage loans and a cap on mortgage rates, in a bid to safeguard home buyers' access to relatively cheaper funding. In coordination with repealing other tightening measures on the property market such as Hukou-related purchase restrictions; the PBoC can lower the minimum down payment requirement (currently 30% for the first home and 50% for the second home purchase) to give banks more discretion in this aspect.

In addition, the PBoC is bound to beef up their "targeted" easing efforts through the rediscount window, refinancing programs and the PSL. These measures, however, need to be carried out with a higher degree of transparency. In doing so, the central bank should increase their communications with the market to avoid sending confusing signals to investors to create excessive market volatility.

RRR cuts are still preferable to interest rate cuts

Some conventional policies are also likely to be deployed given strong headwinds to growth. As mentioned in the previous section, the focus of new policy initiatives should be aimed to spur bank lending to break the vicious cycle between asset prices (especially property prices) and credit supply. Toward this end, the adopted policy tools must be in a position to reduce financing costs of banks and enterprises. We therefore deem that RRR cuts, rather than interest rate cuts, are more suitable tools to tackle this problem.

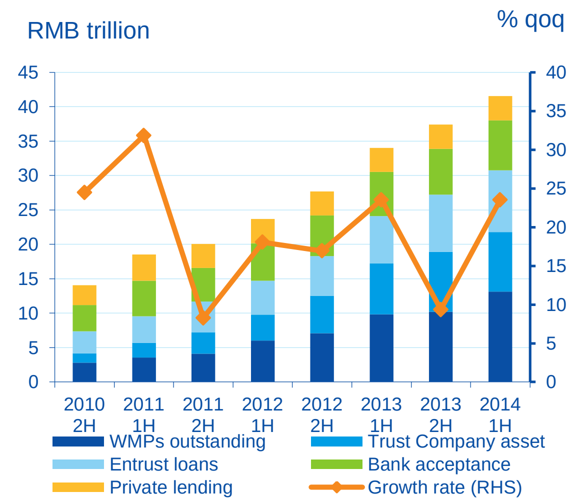
Indeed, the effectiveness of interest rate cuts has largely been limited by the ongoing financial liberalization. In June 2013, the floor of lending rates was officially lifted, which means that the adjustment in benchmark lending rates could not have an actual impact on the market-determined lending rates. Presumably, the reduction of deposit rates could lower banks' financing cost and incentivize them to lend more. This however has some serious side effects: it will reduce households' interest income earned from their deposit in banks and thus derail the much-needed economic rebalancing toward private consumption. Moreover, it could encourage households to siphon off their deposits from the formal banking sector to invest in high-risk shadow banking activities for better returns, which could not only increase the risk of shadow banking sector but also destabilize the interbank market. (Figure 7) As the volatility of the interbank market climb higher, banks are likely to become more conservative toward extending new loans.

Comparatively, the reduction in RRR seems more appropriate for tackling the credit decline caused by banks' lower risk tolerance. The high RRR requirement (up to 20% for large commercial banks) seems akin to an implicit tax as it forces banks to put aside a vast amount of money in their central bank accounts and to forgo higher returns which otherwise they can earn by making loans. The cut in banks' RRR is equivalent to lessening the tax burden on banks and could give more incentives for banks to make new loans. Moreover, the RRR cut can directly provide long-term stable funds to banks and in turn helps to reduce financing costs of borrowers with long maturity. This can especially benefit mortgage borrowers.

Besides the RRR cut, the PBoC can flexibly use open market operation to inject liquidity into the interbank market, so as to reduce and smooth out short-term interest rates. Indeed, with the interest rate liberalization proceeding, some short-term interest rates (such as 3M Shibor, overnight and 7-day repo rates) in the interbank market have increasingly performed the roles of benchmark interest rates since they are representative of actual funding costs of financial institutions. Now the 7-day repo rate has stayed within a range of 3.5%-4.0% after the two liquidity squeezes of last year. (Figure 8) Through liquidity injection, the central bank can guide the interest rate to decrease further, so as to lower banks' financing costs and spur them to lend more.

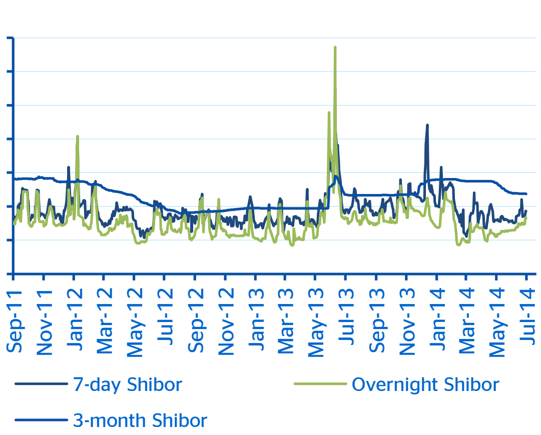
In summary, we believe that the PBoC will ramp up their easing efforts to spur bank lending and sustain growth momentum. Despite more unconventional monetary policy tools, we also project that the stronger headwinds to economic growth will entail a couple of cuts in the RRR in the rest of the year. By contrast, interest rate cuts might not be adopted given their limited effectiveness and unpalatable side effects.

Figure 7
The stock of the shadow banking sector was still high through 1H 2014



Source: CEIC and BBVA Research

Figure 8
Interbank interest rates can be lowered to spur bank lending



Source: CEIC and BBVA Research

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.