Economic Analysis

China cut Required Reserve Ratio to stimulate growth: more monetary easing measures lying ahead

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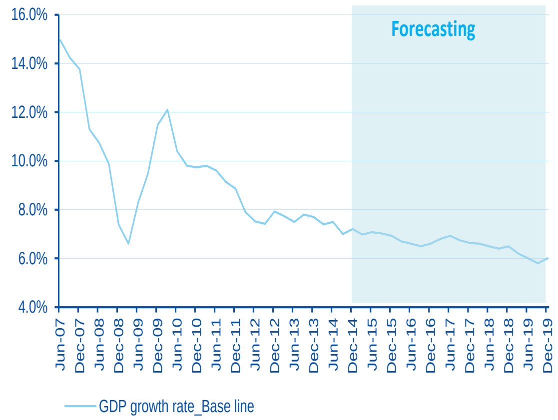
Yesterday, the People's Bank of China (PBoC) cut the required reserve ratio (RRR) universally, effective from February 5th. It is the first time of a universal RRR cut since May 2012, trimming the RRR by 0.5 percentage points to 19.5 percent. The move is expected to release RMB 600-700 bn in the financial sector, enabling banks to extend more credit in support of the real economy. Meanwhile, the PBoC announced an additional RRR cut of 0.5 percentage point for city commercial banks and non-county-level rural commercial banks to encourage their lending to small and medium enterprises (SMEs). On top of it, the Agricultural Development Bank of China, one of policy banks focusing on financing in rural area, can enjoy an extra cut of 4 percentage points for its RRR, reflecting the authorities' emphasis on the agricultural sector. All in all, the RRR cut indicates that the PBoC has already shifted to a loosening policy stance amid the intensifying concerns of the economic slowdown. We anticipate more (conventional and unconventional) monetary easing measures to be implemented in the coming months, which is to help this year's growth stabilize at around 7.0% as we projected.

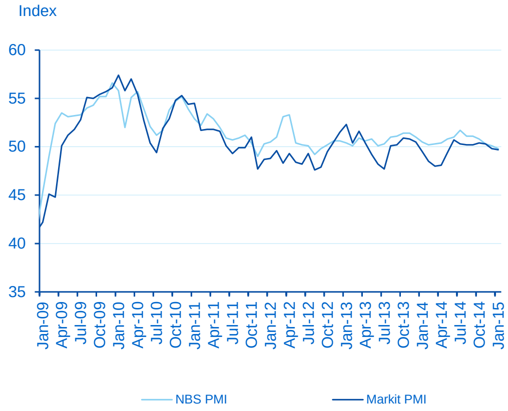
- **The RRR cut was triggered by the recent lacklustre economic performance.** On the heels of a 7.4% decade-low growth outturn in 2014 (Figure 1), China's economy continues to decelerate, reflected by the recently announced January PMI which was unexpectedly slipped into a contraction territory of below 50 (49.8 versus consensus: 50.2, Figure 2). Other activity indicators also show that the slowdown in the world's second-largest economy is sharper than anticipated, prompting the PBoC to join its international counterparts in loosening monetary policy.
- **We anticipate that the RRR cut will be an effective measure to spur growth, while some caveats are noteworthy.** We estimate that a 0.5 ppt cut in the RRR is equivalent to injecting liquidity of RMB 660 bn to the banking sector, taking into consideration of the selective RRR cuts for small banks and the Agricultural Development Bank of China as well. This move will enable banks to extend more and cheaper lending to their corporate clients and boost domestic demand. Moreover, it also sends a clear signal to the market that the authorities will commit to the pro-growth initiatives to avert a hard-landing. On the other hand, it is noted that the RRR cut might add financial risks if loosening credit aggravates asset bubbles instead of providing financial support for the real economy.
- **The cut could add certain short-term depreciation pressure on the RMB exchange rate.** However, we don't believe that China's authorities have been ready to see a new round of large-scaled depreciation in the currency, especially amid the increasing pressure of capital outflows. China registered a capital account deficit of 96 bn USD in 2014, compared with a surplus of USD 326.2 bn in 2013 (Figure 3). That said, the PBoC could increase their intervention in the FX market to sustain the RMB exchange rate and thereby curb capital outflows.
- **Looking ahead, we anticipate more conventional monetary easing measures in 2015.** As predicted in our China Flash of the PBoC's policy outlook, the cut in the RRR, along with the interest cut last November, is likely to set off a series of conventional monetary loosening measures this year. In particular, we project that the PBoC will cut interest rates twice in the first half of the year. In the meanwhile, there will be at least additional cut in the RRR between now and the end of 2015.

Figure 1
China's growth expanded at its slowest pace in the past couple of decades in 2014



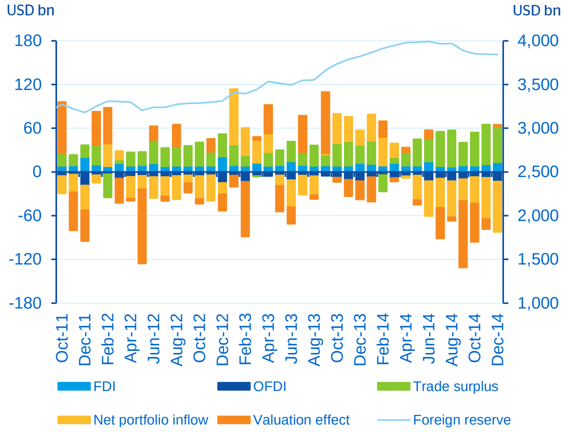
Source: CEIC and BBVA Research

Figure 2
The RRR cut was mainly promoted by recent economic slow-down



Source: CEIC and BBVA Research

Figure 3
Capital outflow becomes significant in 2014



Source: CEIC and BBVA Research