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China | The changing role of RRR in new monetary policy framework

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Summary

- The recent two unconventional cuts in banks' Required Reserve Ratio (RRR) suggest that the monetary authorities set out to dethrone RRR from its previous role of a monetary loosening or tightening tool. Instead, the PBoC now seems to use RRR cuts for liquidity management purpose, complementary to the newly established "interest rate corridor system".

- Historically, RRR adjustments play a dual role as both a monetary policy and liquidity management tool. More importantly, these two roles were not in conflict with each other given the persistently large-scale capital inflows and trade surplus.

- As China's monetary policy framework is now migrating to an "interest rate corridor system", the traditional quantitative tools such as RRR adjustments have to give their way to new price tools. Moreover, new external and domestic macro environment, including increasing capital outflows and stagnant trade surplus, as well as domestically rampant shadow banking activities, also call for the functional change of the RRR.

- Some caveats are noteworthy in the change of the RRR's role: the PBoC might lose the ability to actively intervene the market liquidity if RRR decreases significantly; banks' capacity to withstand external shocks could deteriorate as lower RRRs means less cushion against external shocks; a fast decreasing RRR might give the market a wrong signal of monetary tightening and affect the effectiveness of policy conduct.

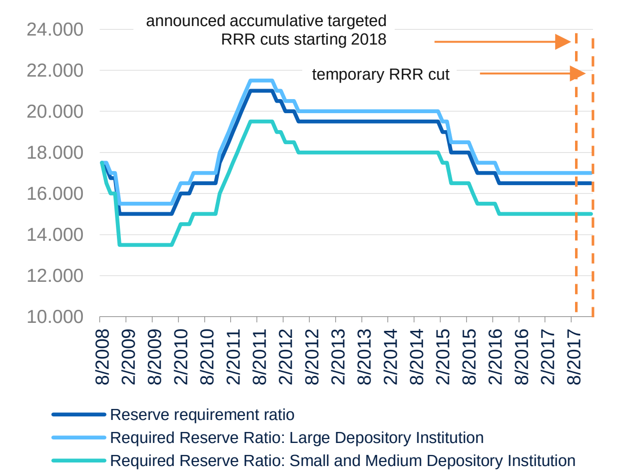
Recent unconventional moves of the RRR

On the last trading day of 2017, the People's Bank of China (PBoC) announced a temporary arrangement to help banks overcome the seasonal end-year liquidity crunch and to smoothen the volatility in the money market. The key element in the new arrangement is to temporarily lower banks' RRR by up to 2% with a maximum term of 30 days.

Such a move of banks' RRR is quite rare in China. As one of important and powerful weapons in the central bank' arsenal, every adjustment of the RRR in the past has been permanent in nature. It echoed another unconventional use of the RRR at end-September 2017 when the PBoC announced that, effective from 2018, a bank can enjoy a 50bps cut in its RRR as long as its loans extended to the agricultural sector and small business exceeds 1.5% of (i) its outstanding loan balance; or (ii) its newly added loans, for the previous year. Moreover, if a bank's loans to the designated “inclusive finance” groups exceed 10% of its total loan balance, it can enjoy additional RRR cut up to 150 bps. Market analysts estimated that more than 90% of Chinese banks are qualified for a 50bps cut in 2018 based on their 2017 performance. As a result, this move of the RRR looks like a universal one.

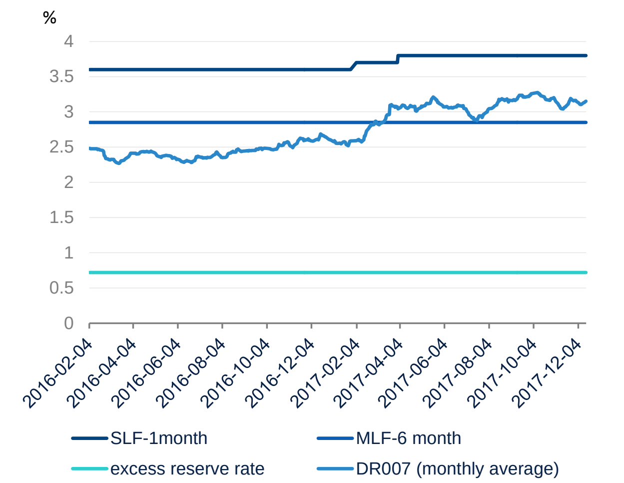
Combining these two recently unconventional cuts of the RRR together, we feel that the monetary authorities have started to take a systemic approach to change the role of the RRR among their policy tools. In particular, the authorities tend to downplay the importance of the RRR as an effective monetary loosening or tightening tool applied frequently in the past. Instead, the PBoC now seems to use the RRR cut as a liquidity management tool complementary to the newly established monetary framework featuring the interest rate corridor system. (Figure 2)

Figure 1 Two recently unconventional RRR cuts



Source: CEIC and BBVA Research

Figure 2 The newly established monetary policy “corridor system”



Source: CEIC and BBVA Research

The glorious history of the RRR

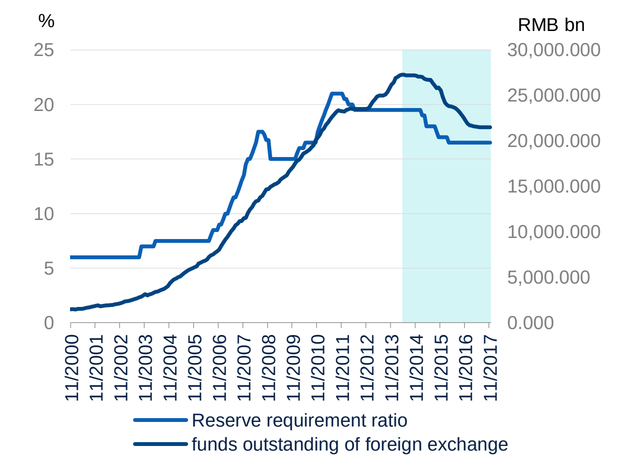
In mechanism, a RRR cut will lead to liquidity injection to the financial sector while a RRR hike will withdraw liquidity from the financial market. As such, the market interpreted RRR cuts as signals of monetary loosening and RRR hikes as signals of policy tightening. It is noted that the adjustment of the RRR doesn’t lead to the change in the central bank’s balance sheet, which is different from open market operation (OMO) or Quantitative Easing (QE), although they all function to manage the available liquidity in the financial sector.

RRR used to be an important monetary policy tool in China’s monetary framework. The frequency of its usage was higher than that of official policy rate. During the period of 2000-2017, the PBoC adjusted the RRR by 46 times while moved the policy interest rate by 26 times. The PBoC’s favoring of the RRR adjustment is well justified:

First, a large amount of SOEs were notoriously insensitive to the price signals in the credit market. On the contrary, the adjustment of available amount of credit, through liquidity management, has proved to be effective. Second, according to some scholars' research, the adjustment of the RRR seems more granular than interest rate adjustment under certain circumstance. As a result, the PBoC preferred to use the RRR adjustment so as not to bring too large shocks to the financial market. Last but not least, during the most time between 1994 and the second half of 2013, China's Balance of Payment (BOP) had twin surplus under both current and capital account. Therefore, the RRR adjustment can function as a sterilization tool for the central bank, which not only sent the signals of the authorities' monetary policy stance but also helped the central bank to maintain the stability of exchange rate. (Figure 3)

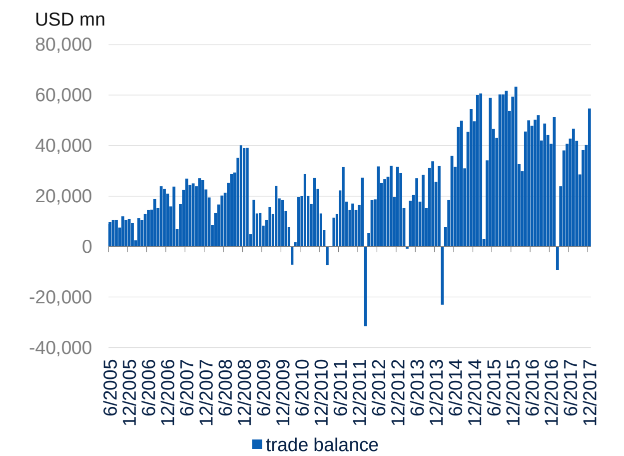
All in all, under the previous monetary policy framework, RRR plays a dual role as both a monetary policy tool and liquidity management tool. More importantly, these two roles are not in conflict with each other given the persistently large-scale capital inflow and trade surplus.

Figure 3 The co-movement between RRR and FX position



Source: CEIC and BBVA Research

Figure 4 Trade surplus shrank due to economic rebalancing



Source: CEIC and BBVA Research

New monetary policy framework calls for the change of the RRR's role

As China's monetary policy framework is migrating to a new one centering on price tools, the role of the RRR is set to change. Such a process is also expedited by the change of the external environment. Starting from the second half of 2013 and especially after August 2015, the cross-border capital movement in China has turned net outflows compared to net inflows previously. At the same time, China's trade surplus has gradually diminished over the past few years as the country's economy is balanced towards domestic consumption. (Figure 4) As the BOP has become more balanced, the RRR's additional function of sterilization seems redundant in terms of policy conduct.

Meanwhile, as the authorities' primary target shifted to clamping down shadow banking activities and maintaining financial stability, the central bank needs to maintain a delicate balance of its monetary policy stance: on the one hand, they need to continue their regulatory tightening to squeeze the ballooning shadow banking sector while on the other hand find new ways to inject liquidity to the inter-bank market to maintain the market interest rate at a reasonable level and ensure the financial stability. Under such a circumstance, it is natural for PBoC to take the RRR as a pure tool of liquidity management. As we discussed in the previous section, the use of the RRR will not lead to the change in the size of the central bank's balance sheet.

The PBoC is currently trying to transit from signaling the market by quantity tools (i.e. RRR adjustment) to price tools (by adjusting policy rate through the monetary "corridor system") in the way of establishing the new monetary policy framework. Under such a "corridor system", the movement of new policy rate target will be confined to a specific range, the "corridor". In particular, the upper bound of the "corridor" are the interest rates of Standing Lending Facility (SLF) with the tenors of overnight, 7-day and 1-month, which are charged by the PBoC on short-term liquidity borrowing of qualified commercial banks. In addition to the SLF, the central bank has other liquidity injection tools with longer tenors of 3-month, 6-month and 1-year, namely the Medium-term Lending Facility (MLF). At the lower bound of the "corridor" is the interest rate which the central bank pays on banks' excessive reserves. As such, banks can withdraw liquidity from the money market at the lower bound of the "corridor" when the money market interest rate falls below this level.

The new policy rate target is the pledged 7-day interbank market rate (DR007). As designed, the movement of the policy rate target should be effectively confined to the "corridor" because otherwise banks will directly go to the central bank for their liquidity borrowing (at the upper bound) or lending (at the lower bound). In the meantime, the central bank will frequently conduct open market operation (OMO) to align the policy rate target with policymakers' desired level. Currently the main policy tools of OMO include 7-day, 14-day and 28-day repo (and reverse repo), which function to withdraw (or inject) liquidity from (into) the money market.

In practice, the PBoC also adopted several steps to foster the pledged 7-day repo rate as the new policy rate. For instance, in responding to the US FED interest rate hike in March, June and December respectively, the PBoC raised the reverse repo rate (which is the central bank open market operation rate) by 10 bps in March and 5 bps in December. Correspondingly, DR-007, which is deemed to be the policy rate, also increased significantly in March and December together with the increasing of the open market operation rate.

Still some challenges ahead…

However, some caveats are noteworthy in the change of the RRR's role:

First, the PBoC might lose the ability to actively intervene the market liquidity if RRR decreases significantly, as sufficient reserve is the foundation for the central bank to conduct liquidity management; Second, banks' capacity to withstand external shocks could deteriorate and even dampen investors' confidence as lower RRRs means less cushion for financial market stability; and last but not least, a quick decreasing of RRR might give the market a wrong signal thus confuse the market that the PBoC is changing the monetary policy stance from tightening to easing, which is not consistent with the on-going financial deleveraging and macro-prudential management.

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