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THOUGHT FOR THE MONTH

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Decoding China's Monetary Policy Machinations

In April the People's Bank of China (PBoC) continued its hawkish strategy of shadowing Federal Reserve (Fed) Rate hikes, raising rates on two of its quasi-monetary policy tools. However, later the same week, the central bank announced a distinctly dovish reserve requirement ratio (RRR) cut. These apparently conflicting interest rate movements have increased market volatility and intensified uncertainty – especially for liquidity and treasury investors.

What happened?

The PBoC raised both its 1-year Medium Term Lending Facility (MLF) and its 14-day reverse repo rate by 5 basis points (bps) to 3.30% and 2.70% respectively (Figure 1A), increasing wholesale funding costs for commercial banks. Meanwhile the 1% RRR cut (Figure 1B) reduces the reserve ratio for large banks from 17% to 16% and for smaller banks from 15% to 14%. The RRR rate cut will release approximately CNY1.3trn, but given qualifying banks are initially required to use the funds to repay a maturing MLF of CNY900bn, the net liquidity boost will be modest and mainly impact smaller banks who do not have significant MLF loans. Nevertheless, large banks will also benefit from lower interest rate payments, as interest rates paid on reserves are significantly lower than those charged on MLF loans.

Figure 1: PBoC Monetary Policy Actions

Figure 1A: PBoC Interest Rate Corridor

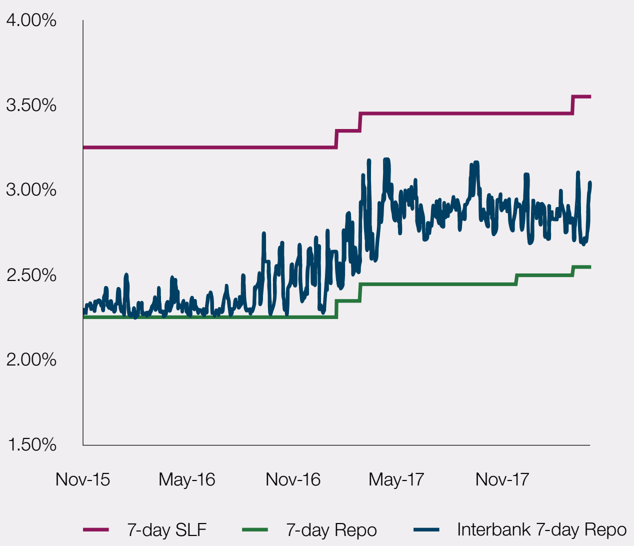
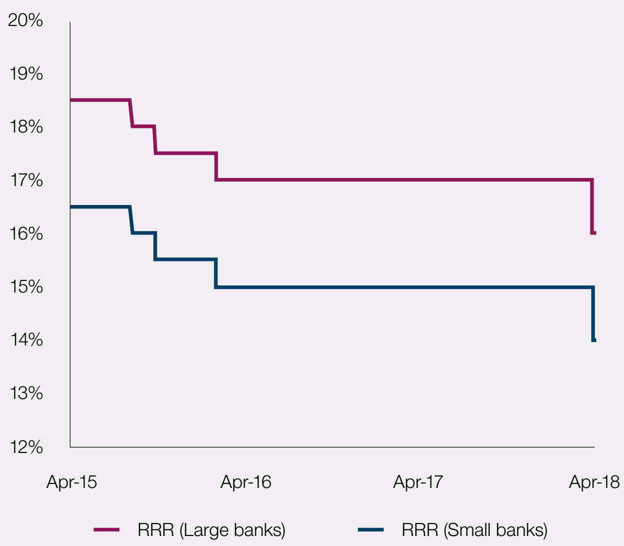


Figure 1B: PBoC Reserve Requirement Ratio (%)



Source: Bloomberg & JPMAM. As at 20th April 2018

While the PBoC stressed that the RRR cut did not imply a change in its monetary policy stance, the central bank has previously avoided altering benchmark rates or the RRR due to their strong signaling effect. Therefore, this RRR rate should, on face value, be considered a precautionary move given recent weaker economic data, rising trade tensions and a slowdown in inflation. Meanwhile the repo and MLF rate hikes continue to signal the central bank's desire to forestall capital outflows and encourage continued deleveraging.

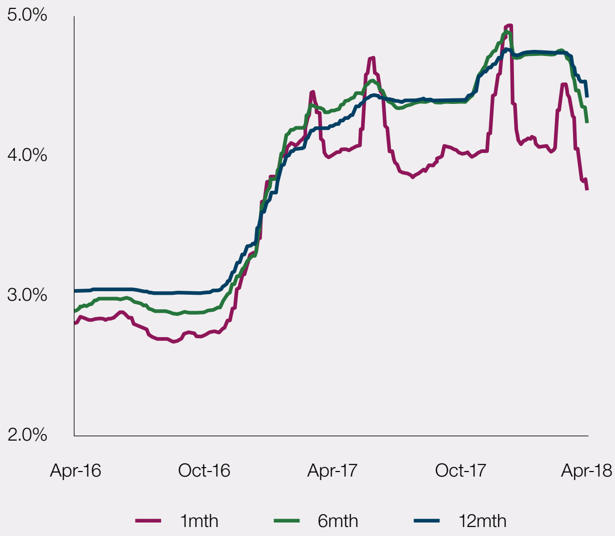
How will this impact treasury investors:

Market driven bond and Shibor yields (Figure 2) all moved lower following the RRR announcement and yield curves have also steepened as short dated yields have declined faster than longer dated yields. Meanwhile repo rates remained relatively high due to tight wholesale funding costs and longer maturity bond markets and equity markets both rallied on the dovish signal by the central bank.

Figure 2: Market driven interest rates

Figure 2A: Market Driven Interest Rates

Figure 2B: Shibor Rates



Source: HKMA, Bloomberg & JPMAM. As at 20th April 2018

For treasury investors the initial effect of the PBoC's actions will be limited, however the secondary implications could be substantial. While elevated repo rates may cushion the short term impact, it is likely that yields on fixed income investments will decline further. A further complication is the reported easing of informal interest rate policy guidance by commercial banks that could lead to higher deposit and lending rates. Nevertheless, high quality RMB money market funds should continue to offer attractive yields by extending duration, maintaining high cash balances by investing in repo and ensuring good security by diversification.

Outlook:

This action by the PBoC is an important additional step on the path towards a market based monetary policy regime. Historically the high RRR rate made commercial banks insensitive to changes in policy rates; however as the RRR is gradually reduced to a more suitable level for its role as a safety net rather than a monetary policy tool, the ability of the PBoC to adopt the 7-day repo rate as its operational target becomes more achievable.

Finally, with economic growth slowing and future regulatory changes expected to tighten monetary conditions, it is likely the PBoC will continue to use targeted policy and quasi-policy rates to adjust the quantity and cost of liquidity to achieve its multiple, and, sometimes conflicting, goals.

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