Method in the madness: The logic behind the PBoC's underwhelming monetary policy

Over the last few weeks, with economic headwinds mounting, the relatively restrained monetary policy approach of China's central bank (PBoC) has left some scratching their heads.

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Key takeaways

- Clearly, the PBoC's overarching priority is to lower the cost of financing for end-borrowers – particularly SMEs and other companies that have been hit hard by the recent resurgence of COVID-19 and associated lockdowns.
- But to do this, officials need first to lower the cost of bank funding and protect banks' balance sheets – especially those of smaller, city-level commercial lenders, under pressure from mounting bad loans – before offering more broad-based support to corporate borrowers.
- To start, the PBoC has focused on reducing banks' reserve requirements. On April 15, it cut most banks' reserve ratio requirement (RRR) by 25 basis points (bps). At first glance, the April RRR cut appears to have injected far less liquidity into the banking system than the two RRR cuts last year, which freed up RMB 1.2 trillion and RMB 1.0 trillion worth of funds, respectively.
- However, unlike the previous two cuts, the April cut was not paired with a decline in the medium-term lending facility (MLF). Instead, in April, the PBoC boosted its relending quota by RMB 340 billion. Taken together, this represents an RMB 890 billion increase in liquidity available to banks in April, compared to the net injections of RMB 600 and RMB 750 associated with the two cuts last year.
- The PBoC has also recently looked to lower deposit rates for small banks, with small banks in April reportedly urged to reduce the interest they pay on deposits by 10 bps.
- In a vacuum, this might seem to be a strange move – as small banks use higher deposit rates to increase their competitiveness against larger ones. However, it looks to us as if this is an effort by the PBoC to push small banks' funding costs down in anticipation of broader cuts to lending rates for end-borrowers.
- The upshot of all these moves is that the PBoC is looking to lower lending rates more proactively than many investors think. The problem is that the central bank first wants to ensure that banks are inoculated to such an adjustment via lower funding costs.
- Still, much of the short-term groundwork has been laid thanks to the most recent RRR cut and additional moves to lower small banks' funding costs. In the short term, then, we anticipate that lending rates for end-borrowers in China (as measured by the loan prime rate (LPR)) will decline by about 10 bps in May.
- But this isn't the end of the story. The PBoC will undoubtedly continue lower lending rates throughout 2022, and gradually step-up monetary support for the economy, with central authorities sending ever-clearer signals about the imperative to support growth.

- However, the critical dynamic that investors need to keep in mind is that the PBoC will continue to face considerable constraints in lowering the cost of capital to boost growth – with bank profitability the chief and ongoing concern.
- To us, this is the clearest explanation for the PBoC's seeming reluctance to offer more aggressive policy support at this time – and it should serve as a reminder to investors of the unique constraints that Beijing is operating under this year.

Over the last few weeks, the monetary policy approach of China's central bank (PBoC) has left some scratching their heads. As economic headwinds – from COVID-19 lockdowns to logistical and supply chain challenges to upstream inflation – continue to mount, China's monetary authority has remained remarkably muted in its approach to stimulus, especially when considering the ambitious "around 5.5%" GDP growth target that officials have targeted for the year.

This apparent disconnect between official growth ambitions, growing economic challenges, and the current policy stance has developed in large part because monetary officials need to thread a very fine policy needle. Indeed, any effort by the PBoC to lower lending rates for end-borrowers will only be viable insofar as the monetary authority can also protect net interest margins and profitability for banks – especially smaller, city-level commercial lenders. As such, officials need first to lower the cost of bank funding and protect banks' balance sheets before offering more broad-based support to corporate borrowers.

Taken together, the PBoC's recent moves represent an increasingly proactive policy stance in supporting the economy. Still, the challenge for most investors is that these moves are often viewed in isolation – so the total amount of monetary support is obscured. More importantly, perhaps, it is unclear whether the PBoC's recent spate of moves will be enough to jolt the economy out of its funk.

With so much at stake, it is critical to understand the exact nature of – and rationale behind – the PBoC's seemingly timid approach to policy support. We lay out some of the key dynamics behind this approach below.

RRR cuts in context

Clearly, the PBoC's overarching priority is to lower the cost of financing for end-borrowers – particularly SMEs and other companies that have been hit hard by the recent resurgence of COVID-19 and associated lockdowns.

The problem, however, is that a unilateral reduction in lending rates by the PBoC would negatively impact bank profits, which banks need to replenish their capital. As we explained in our October 2020 report, "China's state-led banking sector recap is hitting serious speed bumps," few banks can currently replenish tier-one capital by selling equity, leaving retained earnings as their only option.

What's more, while it hasn't shown up in official data, bank asset quality is unquestionably under pressure. Economic growth is sluggish; efforts to rein in the property market are hurting developers, construction sector employment, and local government finances; and rolling COVID-19 lockdowns are taking a toll on consumption. Given these challenges, a range of borrowers are under increasing financial pressure – so banks desperately need to maintain healthy profits to replenish the capital that's being eroded by mounting bad loans.

Given this reality, China's monetary officials have to first lower the cost of bank funding before looking to lower banks' lending rates – to preserve bank capital at a particularly challenging time. And that is precisely what officials have been looking to do in recent weeks.

What's happened so far

The PBoC can do three things to cut bank funding costs and ensure that a future reduction in lending rates doesn't negatively impact bank profits. It can cut the reserve requirement ratio (RRR), push down deposit rates, or cut the rate it charges on funds it lends out via the medium-term lending facility (MLF). We have seen clear movement on the first two options in recent weeks – and are likely to see action to lower the MLF lending rate in the coming months.

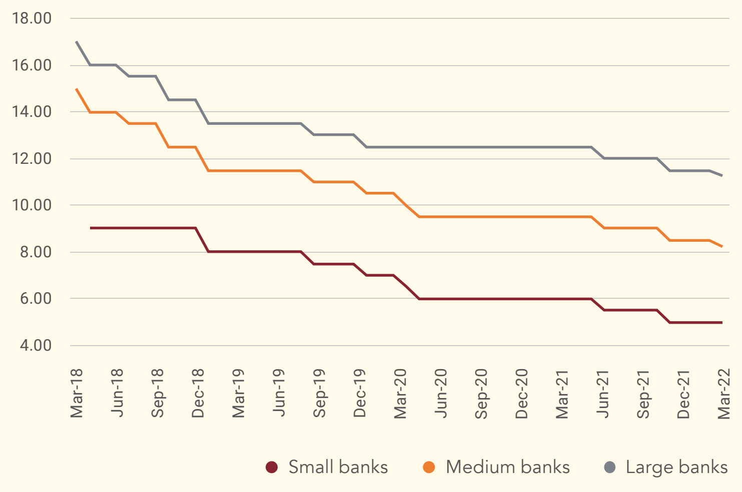
To start, the PBoC has focused on reducing banks' reserve requirements. Specifically, on April 15, the PBoC cut the RRR for most banks by 25 basis points (bps). Notably, that was half the amount of the previous two cuts in December and July 2021 – and we explore the reasons for such a seemingly paltry cut below.

The PBoC said that the cut, which went into effect on April 25, is designed to:

- Increase long-term, stable funding available to banks
- Give financial institutions the resources to support small firms severely affected by the pandemic
- Reduce banks' funding costs

Additionally, the recent RRR cut does not apply to banking institutions for which the RRR is already 5% or lower [Fig. 1], but for city and rural commercial banks that operate in a single province, RRRs were cut by an additional 25 bps.

Fig. 1 - Reserve requirement ratio by bank type



Source: CEIC

At first glance, the April RRR cut appears to have injected far less liquidity into the banking system than the previous two RRR cuts. After all, the 25 bps April cut will return only RMB 530 billion worth of funds to banks. In contrast, the PBoC cut the RRR by 50 bps in December and July, freeing RMB 1.2 trillion and RMB 1.0 trillion worth of funds, respectively.

However, it's necessary to realize that in all three cases, the RRR cuts were part of a broader package of measures. In both July and December 2021, the RRR cuts were accompanied by a retrenchment of outstanding funds lent out by the PBoC under the MLF. Consequently, in July, the overall net injection of liquidity was only RMB 600 billion, and in December, it was RMB 750 billion.

Meanwhile, in April, there was no offsetting decline in the MLF. Instead, the PBoC boosted its relending quota by RMB 340 billion. When taken together with the RRR cut, that represents an RMB 890 billion increase in liquidity available to banks. The upshot is that this most recent – and seemingly small – RRR cut will be much more supportive in terms of liquidity and credit creation than either of the RRR cuts that took place in 2021.

Window guidance on deposit rates

In addition to freeing up liquidity – and thereby reducing bank funding costs – through RRR cuts, the PBoC has also recently looked to lower deposit rates for small banks.

Importantly, while the central bank has direct control over the RRR and MLF, its influence over deposit rates – the single biggest determinant of bank funding costs – is quite complicated. That's why the April 18 move – reported by Caixin – to push down small bank deposit rates will be highly consequential.

According to the reporting, in mid-April, the banking industry body responsible for managing deposit rates asked small banks to reduce the interest they pay on deposits by 10 bps. The industry body – overseen by the PBoC – apparently wants small banks to apply the cut to large deposits and large certificates of deposit. Citing unnamed sources, Caixin said the reduction isn't compulsory, but banks that make the adjustment will gain points on their macroprudential assessments by the PBoC, which are used to determine banks' overall performance and underlying risks.

In a vacuum, this adjustment to deposit rates might seem to be a strange move. Small banks find it far more difficult to attract deposits than their larger peers, which is why they are permitted to offer higher deposit rates. As such, reducing the deposit premium they can offer should undermine their competitiveness and potentially compel them to find creative – and potentially risky – new funding sources. However, it looks to us as if this is an effort by the PBoC to push small banks' funding costs down in anticipation of broader cuts to lending rates for end-borrowers.

Setting deposit rates

Here, a little bit of history is in order. In June 2021, the PBoC changed how the upper limit on bank deposit rates is determined. Previously, the PBoC set a benchmark rate, and banks were permitted to offer depositors individual rates at a certain percentage above the benchmark. National banks were allowed to offer rates up to 1.4 times the benchmark, but smaller banks were allowed to offer more.

However, as of June last year, the deposit rate ceiling was set at a predetermined number of bps above the benchmark – rather than as a percentage premium to the benchmark. Now, large banks can set rates at a 50-basis-point premium, and small banks at a 75-basis-point premium. The rationale behind the change was that the deposit rate curve was too steep, with small banks, in particular, allowed to offer unsustainably high returns on long-term loans. The reform flattened the rate curve, lowering long-term rates and raising short-term rates.

The net effect of this change was to bring down banks' overall funding costs. According to the PBoC, the weighted-average interest rate of banks' new time deposits in December was 2.30%, down 19 bps from May, before the change. In January, Sun Guofeng, director general of the PBoC's monetary policy department, said that the decline in deposit rates – alongside last year's RRR cuts – paved the way for the loan prime rate (LPR) – the benchmark lending rate – to decline 5 bps in December and a further 10 bps in January.

However, the problem now is that the PBoC needs to find avenues to further push down deposit rates for small banks – since the broader structural reform to deposit rates from 2021 has already made its full impact on bank funding costs. Additionally, last year's reduction in bank funding costs has already fully transmitted into a decrease in corporate lending rates – with little additional room to push lending rates down now, at least without further easing for bank funding rates.

To set the groundwork for an anticipated further reduction in the MLF for corporate borrowers, small banks have already started cutting deposit rates – as they have been requested to do – with Reuters reporting on Sunday that Industrial Bank and China Zheshang Bank have made the reduction.

For now, we suspect that the PBoC is focusing most of its attention on small banks when it comes to lowering their funding costs because profits at China's large banks have been particularly robust lately. Indeed, China's large banks posted breakneck profit growth in 2021. Some – like ICBC and Bank of Communications – saw their fastest profit growth in a decade. And while that performance is unlikely to be repeated in 2022, for the time being it means that Beijing is less concerned about larger banks' ability to manage bad loan provisions.

Pressure on profits will be felt far more acutely by small banks, which are finding it more difficult to replenish their capital. This is exactly why these banks are being asked to preemptively reduce their funding costs by lowering the rates they pay out on deposits. What's more, on Friday, the banking regulator (CBIRC) hinted at its broader concern around small bank profits when it flagged an intention to use more special-purpose bonds to recapitalize small and medium-sized banks – a measure it first employed in 2020.

Lending rates will fall, but bank profitability remains the critical constraint

The upshot of all these moves is that the PBoC is looking to lower lending rates more proactively than many investors think. The problem is that the central bank first wants to ensure that banks are inoculated to such an adjustment via lower funding costs – which is an ongoing project, as we explained above.

Still, much of the short-term groundwork has been laid thanks to the most recent RRR cut and additional moves to lower small banks' funding costs. In the short term, then, we anticipate that lending rates for end-borrowers in China (as measured by the LPR) will decline by about 10 bps in May. Such a move would be comparable to the downward adjustments to these rates that we saw in December and January.

In the larger context, a 10 bps fall in rates would represent a pretty small decrease in the cost of capital for companies – especially considering the economic headwinds that China currently faces. But this isn't the end of the story. The PBoC will undoubtedly continue lower lending rates throughout 2022, and gradually step-up monetary support for the economy, with central authorities sending ever-clearer signals about the imperative to support growth.

However, the critical dynamic that investors need to keep in mind is that the PBoC will continue to face considerable constraints in lowering the cost of capital to boost growth – with bank profitability the chief and ongoing concern. To us, this is the clearest explanation for the PBoC's seeming reluctance to offer more aggressive policy support at this time – and it should serve as a reminder to investors of the unique constraints that Beijing is operating under this year.