PBoC Watch

Stepping up easing

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Economics - China

- Recent COVID flare-ups in a few large cities are increasing the pressure on an already slowing economy
- Beijing will likely add more stimulus to support growth
- We have revised our key policy rate forecast for 2022 to a 10bp cut, from no change previously

Regional Omicron outbreaks pose new challenges

Two weeks after a lockdown was introduced in Xi'an in December 2021 due to a Delta outbreak, the first local Omicron cases were identified in Tianjin, a port city with a population of 15m, and then in central Henan Province. So far, daily local new cases of COVID-19 in China remain low by global standards. However, Beijing is determined to maintain its zero COVID strategy, which means massive testing, lockdowns, and other stringent containment measures, further slowing the consumption recovery and adding more pressure on the already slowing economy.

With the new pro-growth focus, more easing is likely

This resurgence of cases will likely prompt China to add more stimulus to support growth. Beijing made it clear in the annual Central Economic Work Conference (CEWC) in December that the policy focus will shift from de-leveraging/de-risking to supporting growth. As we have highlighted in earlier notes, the likely measures include: i) the central bank easing its policy stance by cutting the reserve requirement ratio for banks by 100bps and boosting relending, leading to a modest pick-up in growth in total social financing; ii) the government increasing spending on infrastructure while lowering corporate taxes; iii) selectively loosening restrictions on property lending to put a floor under the property downturn; and iv) slowing the implementation of regulations to mitigate the negative impact on growth.

PBoC could step up stimulus by cutting the key policy rate by 10bp

Although we believe quantitative instruments will continue to be the primary choice for the PBoC, we now expect the central bank to add more stimulus by delivering a 10bp cut in key policy rates, most likely in the medium-term lending facilities (MLF) rate, which is most relevant to the real economy. A 10bp MLF rate cut would readily translate into a 10bp cut to the one-year loan prime rate (LPR), adding to the late December 5bp cut. A total of 15bp cuts to the one-year LPR would be half the size we saw at the onset of the pandemic. Besides driving down funding costs, a policy rate cut would also signal the PBOC's determination to bolster economic growth, lifting market sentiment.

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The case for a policy rate cut

- The 1-year LPR rate was cut 5bp to 3.80% in late December, following a 50bp broad-based RRR cut effective on mid-December
- Given mounting headwinds including regional flare-ups of COVID cases, we see an increasing probability of further rate cuts, in addition to easing via quantitative instruments
- We see the PBOC cutting the 1-year MLF rate by 10bp in H1 2022 to stabilize economic growth and lift market sentiment

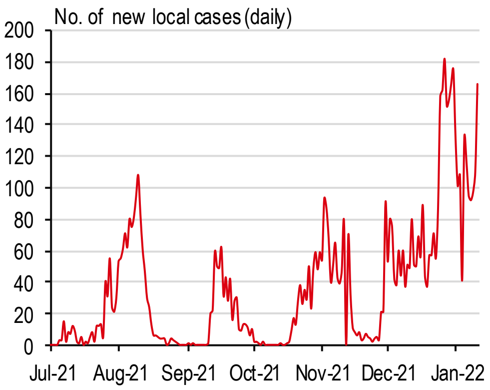
New year, new challenges

At the beginning of 2022, China is facing a resurgence of regional COVID-19 cases, with this wave of the virus looking likely to be the most challenging for the country since the initial pandemic shock:

- Starting from scattered virus outbreaks in the middle of December, the daily number of new local cases surged to 166 on 11 January (Chart 1).
- Compared to previous waves of the virus, this time cases are more widespread across provinces, as shown in Chart 2.
- This new wave is currently a mix of the Delta variant and the highly infectious Omicron variant. The government will likely impose more stringent social distancing measures to prevent local Omicron transmission, especially as Beijing is due to host the Winter Olympics in less than four weeks.

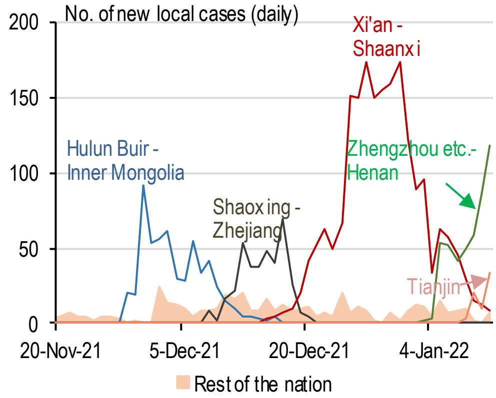
Local authorities in regions experiencing a virus surge such as Xi'an, Henan province, and Tianjin have mandated stringent lockdowns and social distancing measures. That said, we do not expect the virus surge to trigger a nationwide full lockdown, as happened in early 2020.

Chart 1: New COVID cases are rising fast…



Source: CEIC, HSBC

Chart 2: …but are relatively restricted within the affected cities

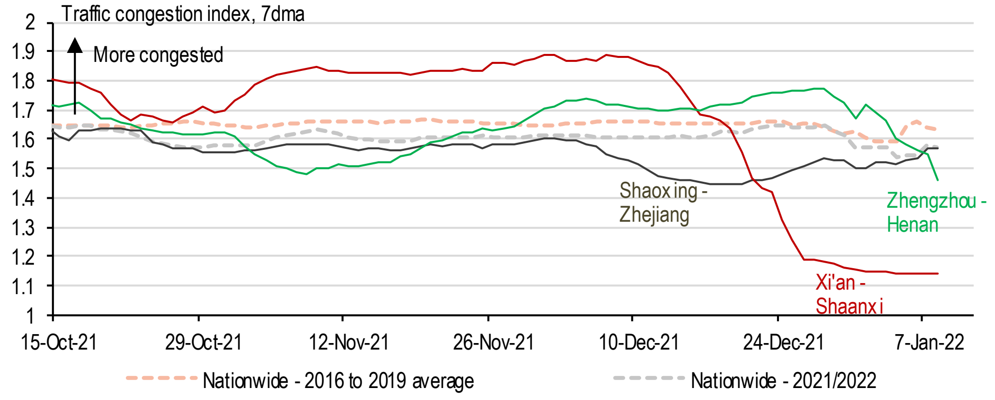


Source: Wind, HSBC

There has been a subtle change in the country's COVID strategy, from an absolute zero to a relative zero. Phrases like "dynamic clearing" have replaced zero tolerance in the official media, implying that governments will try to eliminate new local cases as quickly as possible (Gov.cn, 12 December 2021). The change reflects, to some extent, the challenge to maintain absolute zero cases in face of the much more contagious variant, as well as a slightly relaxed mentality to COVID-19 given widespread vaccination, compared to the onset of the pandemic.

Having said that, we believe economic growth is set to take a hit. Daily new cases are still rising and spreading to other parts of the country. More regions will likely notably tighten containment measures in the coming weeks. Considering that Chinese New Year (CNY) holidays are just around the corner (from 31 January to 6 February), regional lockdowns or travel restrictions may again interrupt people's travel plans for the holidays, as occurred in 2021.

Chart 3: Sharp declines in traffic in cities with a resurgence of COVID-19



Source: Wind, HSBC

Last year's experience suggests virus-containment measures can result in more uneven growth across sectors, while putting additional pressure on headline growth and employment. People remaining in the cities in which they work during the holidays helps to shorten the time to resume work in industrial production post the holidays, but at the same time this significantly dampens retail sales and offline services sectors. In 2021, the two-year compound annualised growth rate of real GDP was merely 5.0% in Q1, compared to 6.3% y-o-y growth in the same period of 2019 prior to the pandemic. The unemployment rate jumped to 5.5% in January-February 2021 from 5.2% at the end of 2020 as a result of the virus resurgence.

Rising challenges call for more policy easing

The virus resurgence comes at a time when China is already facing triple growth headwinds, as summarised in the communique from the Central Economic Work Conference:

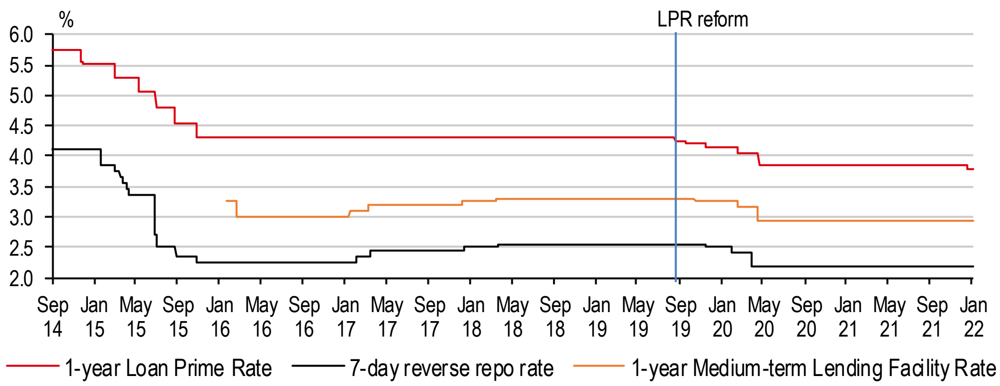
- Demand contraction: a sharp slowdown in construction investment due to a tightening of property lending
- Supply shocks: so far mainly caused by rising global commodity prices exacerbated by domestic energy consumption controls
- Weakening expectations: reflected in a recent drop in consumer confidence indices, and lacklustre PMI readings amid policy clampdowns across sectors.

Beijing has decided to shift the policy focus towards stabilising growth, with a goal of shoring up real GDP growth to above 5.5% ahead of the Party Congress in late 2022. In an earlier report, we highlighted the following expected easing measures:

- One the monetary side, we see two cuts in the reserve requirement ratio (RRR) for banks (50bp each time) and an increase in the relending quota to boost liquidity available for sectors of strategic importance – higher-end manufacturing and green projects – as well as small businesses suffering from the property slump in H1 2022.
- On the fiscal side, with the central government set to increase spending on technology and allow local governments to borrow more, we forecast the broadly defined fiscal deficit to increase by at least 1ppt to 7.3% of GDP in 2022 (2021e: 6.3%).
- We expect Beijing to adjust property financing policies to avoid a hard landing in the sector, and implement regulatory changes at a slower pace and in a more transparent manner, in order to mitigate the negative impact on economic activity.

But rising challenges from the virus resurgence call for more aggressive and broad-based policy easing, in our view. We now think the PBoC will introduce a 10bp cut to the one-year medium-term lending facility (MLF) rate, to bring down banks' funding costs and highlight the central bank's firm stance in support of the real economy. This would lower the one-year MLF rate from 2.95% to 2.85% by the end of 2022. Given that the one-year loan prime rate (LPR) is now anchored to the one-year MLF rate, a 10bp one-year MLF rate cut should effectively bring down the one-year LPR by around 10bps from 3.8% to 3.7%. Together with the 5bp LPR cut in December, the total reduction in the one-year LPR would be around 15bps during this easing cycle, about half of the size we saw during the initial virus hit in early 2020.

Chart 4: Key policy rate changes in recent years



Source: CEIC, HSBC

Key policy rate cuts would help lower banks' funding costs and therefore their lending rates. As we will explain in the following section, MLF rates serve as an important anchor for bank funding costs. A one-year MLF rate cut is thus key to bring down commercial banks' funding costs and give them more room to lower their lending rates to the real economy, especially to sectors serving as longer-term growth drivers such as high-end manufacturing and decarbonisation.

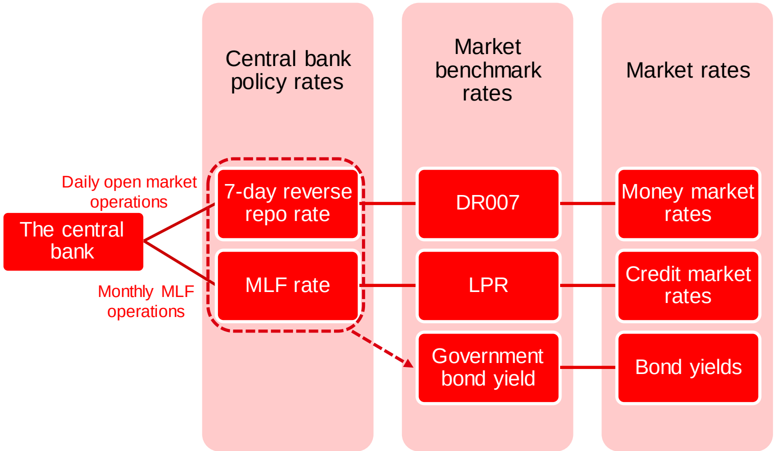
Moreover, key policy rate cuts would go a long way to show Beijing's determination to support growth, and thus help boost confidence. Credit demand is currently relatively weak amid multiple headwinds. Corporate demand for credit remains well below the average level of the previous three years. A lack of business credit demand means that regulators' quantity instruments haven't fully delivered the intended scale of easing. Banks are widely reported to be experiencing a difficult time extending more SME loans (Ifeng, 30 December 2021), even as the regulators have expanded their relending quota with lower funding costs. We believe a key policy rate cut is very much needed to shore up business and consumer confidence and boost credit demand.

New interest rate system in the shaping

Over the past decade, interest rate reform has been at the top of the PBoC's agenda, ie, shifting its monetary policy towards a price-based system from the quantity-based one. This means the central bank would rely more on an interest rate system to smooth out business cycles. The PBoC has attached great importance to building a market-based interest rate system. A recent milestone is the launch of a market-based reference lending rate in August 2019, using the Loan Primate Rate (LPR) set regularly by designated banks to replace the benchmark lending rates decided by the PBoC.

The variety of different types of rates in China could be confusing to central bank observers. We provide a structural review on China's interest rate system in this section, based on PBoC Governor Yi Gang's recent article on this matter[1].

Chart 5: China's interest rate system



Source: PBoC

First of all, it is important to understand the relationship between central bank policy rates, corresponding market benchmark rates, and other market interest rates. The PBoC determines its policy rates at both the short and long end, and guides market benchmark rates to oscillate around the policy rates with the same maturity, with the assistance of interest rate corridors. These policy rates and market benchmark rates then impact other market interest rates and bank lending rates through financial markets and the banking system.

Short-term policy rates: 7-day reverse repo rate and interest rate corridor
At the short end, the 7-day reverse repo rate is the key policy rate and the anchor for money market rates. Through daily open market operations, the PBoC manages interbank liquidity conditions to guide money market rates – especially 7-day banks-only weighted average repo (DR007) – to fluctuate around the policy rate.

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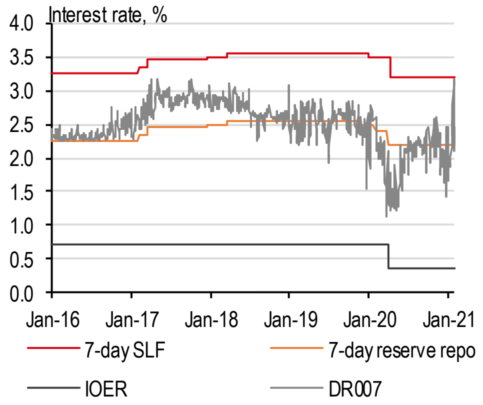
[1] See Yi Gang, China's Interest Rate System and Market-based Interest Rate Reform, *Journal of Financial Research* (Issue 9, 2021), http://www.pbc.gov.cn/en/3688110/3688172/4157443/4364384/2021102014082914468.pdf.

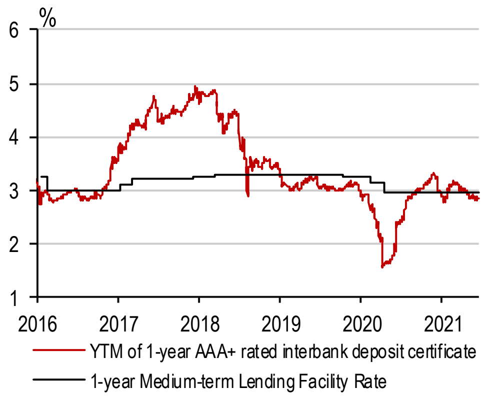
Meanwhile, the Standing Lending Facility (SLF) and the interest rate on excess reserves form the ceiling and floor of the interest rate corridor to mitigate excessive volatilities in DR007 (see Chart 6 and Table 1).

Chart 6: The PBoC's implicit interest rate corridor, with DR007 as the main short-term market benchmark rate



Source: Wind, HSBC
Note: SLF stands for Standing Landing Facility, and IOER stands for interest rate on excess reserves.

Chart 7: 1-year medium-term lending facility rate and yield-to-maturity of 1-year AAA+ rated interbank deposit certificates



Source: CEIC, HSBC

Medium-term policy rate: one-year MLF rate guiding banks' funding cost

The one-year medium-term lending facility (MLF) rate is the key medium-term policy rate, and the anchor for market interest rates at the longer end. The one-year MLF rate is currently at 2.95%, which represents banks' marginal funding cost to obtain medium-term capital from the central bank. The PBoC currently carries out MLF operations once every month in the middle of each month. The net volume of liquidity injection and the change in rates provides an important policy signal that guides medium-term market interest rates. As shown in Chart 7, the yield to maturity of the 1-year AAA+ rated interbank deposit certificate mean-reverted around the 1-year MLF rate over the past two years (except the period of the initial COVID-19 shock in early 2020). MLF rates in this way serve as an important benchmark for bank funding costs.

As a result, the MLR rate is also a key anchor for banks' LPR (1-year and 5-year) quotations. The LPRs that the PBoC releases once every month are based on quotations from 18 banks, which are required to quote loan rates offered to their best customers based on the PBoC's 1-year MLF rate with added premiums. Some tend to see LPRs the same as the old benchmark bank lending rate, which was solely determined by the PBoC. But, technically, in the new LPR system, the premium that banks add on to the MLF reflects banks' funding costs, ie, they should be determined by the market. Governor Yi's recent article confirms that the PBoC sees LPR as a market benchmark rate, rather than a policy rate.

The recent 5bp reduction in the 1-year LPR in December 2021 may not be significant in terms of the magnitude, but it has a symbolic meaning: LPR quotations move independently from the MLF policy rate change. The 5bp 1-year LPR cut followed the second 50bp across-the-board reserve requirement ratio cut in 2021. Combined with the rule adjustment on how banks set ceilings on deposit rates, the measures helped push down banks' funding costs to some extent.

Table 1: China's key interest rates

Interest rate	Current level	Details
Open market operation (OMO) rates	7-day: 2.2%	Short-term reverse repurchase operation interest rates.
Medium-lending facility (MLF) rates	1-year: 2.95%	The interest rate at which the central bank lends to the market for the medium term.
Standing lending facility (SLF) rates	7-day: 3.2% (= 7-day reverse repo rate + 100bps)	The interest rate at which the central bank provides short-term capital to financial institutions as demanded, which is the cap of the interest rate corridor.
Loan prime rates (LPR)	1-year: 3.80%; 5-year: 4.65%	The arithmetic average of loan rates provided for customers of best credit qualities by LPR quoting banks.
Benchmark deposit rate	1-year: 1.5%; current deposit: 0.35%	Interest rates published by the PBC as a guidance for commercial banks to set interest rates on customer deposits.
Interest rate on excess reserve (IOER)	0.35%	The rate at which the central bank makes interest payments on the excess reserves deposited by financial institutions, which is the floor of the interest rate corridor.
Interest rate on required reserve	1.62%	The rate at which the central bank makes interest payments on the required reserves deposited by financial institutions.
Shanghai Interbank offered rate (Shibor)	Overnight: 2%; 3-month: 2.35%	The arithmetic average of interbank offered rates quoted by banks with high credit ratings.
Sovereign bond yields	10-year: currently around 2.85%	The reference indicator for bond market interest rates generated through market transactions

Source: PBoC, HSBC

Quantity-based monetary tools still play a big role

Despite the progress in promoting reforms in price-based policy tools, the PBoC has still deployed various quantity-based tools during recent years. A key argument for deploying quantity-based policy tools and administrative controls is that they allow the central bank to manage credit growth in a more structural way. These measures facilitate the PBoC's efforts in guiding credit reallocation from low value-added and highly leveraged sectors (such as construction and heavy industries) to high value-added and more efficient sectors (such as high-tech manufacturing and high value-added services). Frequently used quantity and administrative measures include:

- Volume of OMO operation, MLF operation and reserve requirement ratio (RRR) adjustment: All these tools have been used to manage liquidity conditions. In particular, in recent years, the PBoC has rolled out targeted MLF operation and targeted RRR cuts to provide liquidity aid for smaller banks, as a way to increase lending to small businesses (see Chart 8).

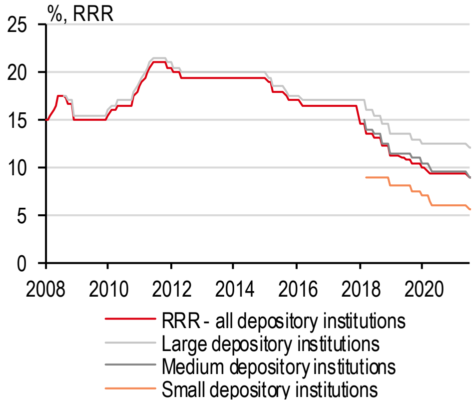
- Credit quotas: The PBoC agreed with the State Council an annual broad money (M2) and credit (total social financing) growth target every year, which were usually initially revealed in the Government Work Report released during the National People's Congress in March. Since 2018, Beijing has shifted its credit growth target from a specific quantity number towards descriptive guidance. Currently, the government emphasises that credit growth should trend in accordance with nominal GDP growth.

- Window guidance: The PBoC also gives advice and guidance to influence commercial banks' credit behaviour. Although it is not a binding order but a form of moral suasion, financial institutions generally oblige the central bank.

- Sector-specific policies and restrictions: Credit policies or restrictions have been used to aid structural adjustments in the economy. Depending on the government's objective in promoting or restricting certain sectors, credit policies or restrictions are called on to play a corresponding role. For example, banks have been told to restrict lending to property developers or mortgage lending in the recent years.

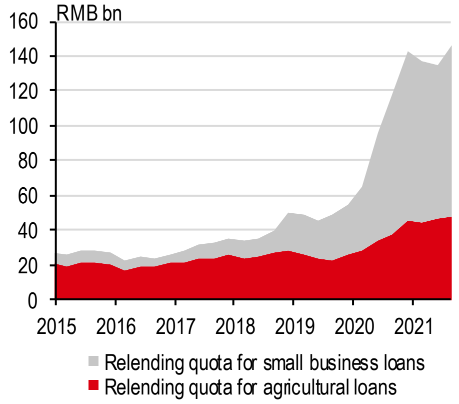
- Relending and rediscount quota: The PBoC provides funding at lower costs to banks for lending to rural sectors, small businesses, and green projects (see Chart 9).

Chart 8: RRR cuts have been frequently used as a tool to adjust liquidity conditions and overall policy stance



Source: CEIC, HSBC

Chart 9: Beijing notably increased relending quota for agricultural and small business loans in 2020



Source: CEIC, HSBC

Quantity instruments also played a big role in controlling liquidity growth during the last easing cycle amid the initial COVID-19 shock, even more than price-based instruments to some extent. As shown in Chart 4, China's overall policy rate adjustments have been very limited since 2016. Key policy rates – 7-day reverse repo rate and 1-year MLF rate – have only been cut by 30bps since the initial COVID-19 outbreak in early 2020, together with a 37bp cut in the IOER. Meanwhile, quantity-based tools have been deployed more often, such as net liquidity injections through reserve requirement ratio (RRR) reductions as well as an increase in the medium-term lending facility (MLF) and relending quota. As a result, market interest rates, which are more sensitive to actual liquidity conditions, trended in different directions to policy rates during that period. Later, even as policy rates were kept unchanged, market rates rebounded as the PBoC started to mop up liquidity in May 2021.

Moreover, the PBoC has also been using regulations and window guidance to control sector allocation since COVID-19. For example, the PBoC has required state-owned banks to increase new loans to SMEs by more than 40% y-o-y in 2020 and by more than 30% in 2021. Meanwhile, Beijing suppressed bank lending to the property sector through rolling out the Three Red Lines and restrictions on banks' property loan concentration ratio. As a result, poor financing conditions for homebuyers and developers eventually led to a slump in property sector data, which has dragged overall growth into another downswing.

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