

China Economic Comment

Yes PBC Did ! ... Inject Liquidity Quietly

Economics

China

PBC confirmed injection of liquidity through PSL and MLF

PBC's Q3 monetary policy report finally disclosed the use of a new 3-month lending facility that injected RMB 769.5 billion into various banks in September and October, and an unknown amount of PSL for policy banks.

Anything but RRR cut

The central bank has been innovative with liquidity management instruments to avoid general RRR cuts in the face of weaker FX inflows, as RRR cut could easily be misunderstood as a sign of big monetary stimulus. We think PBC will continue to avoid RRR cuts unless there are persistent large FX outflows.

Rate cut likely data dependent

Liquidity operations and 200 bps drop in interbank rates have reduced bank lending rates only marginally. We think lower growth and inflation next year warrants 3 benchmark rate cuts to lower real financing costs. However, such cuts will be data dependent, and PBC's stance suggests low probability of a rate cut in 2014.

PBC confirmed injection of liquidity through PSL and MLF

After weeks of unconfirmed media reports, PBC in its third quarter monetary policy report disclosed information on a new type of liquidity injection it conducted back in September. The Medium-term Lending Facility (MLF) is PBC's latest invention of base money supply tool, providing 3-month liquidity to a set of banks using treasury bonds, central bank bills, policy bank bonds and other high quality corporate bonds as collaterals. PBC disclosed that it injected RMB 500 billion and 269.5 billion in September and October, respectively, at an interest rate of 3.5% rate with 3-month maturity.

PBC also confirmed that it had provided funding support to policy banks (mainly the China Development Bank) for projects such as shanty town renovation through Pledged Supplementary Lending (PSL), and had guided PSL rate lower in September. However, the central bank did not specify the size of PSL nor the interest rate, and it has not been possible to deduce the amount from the changes in the balance sheets of the PBC or CDB.

These measures, according to the report, have offset a shrinking FX inflow and kept base money growth stable. Indeed, this point is validated in the data shown in Figure 1. Details of recent new liquidity management tools are summarized in Figure 3 at the end.

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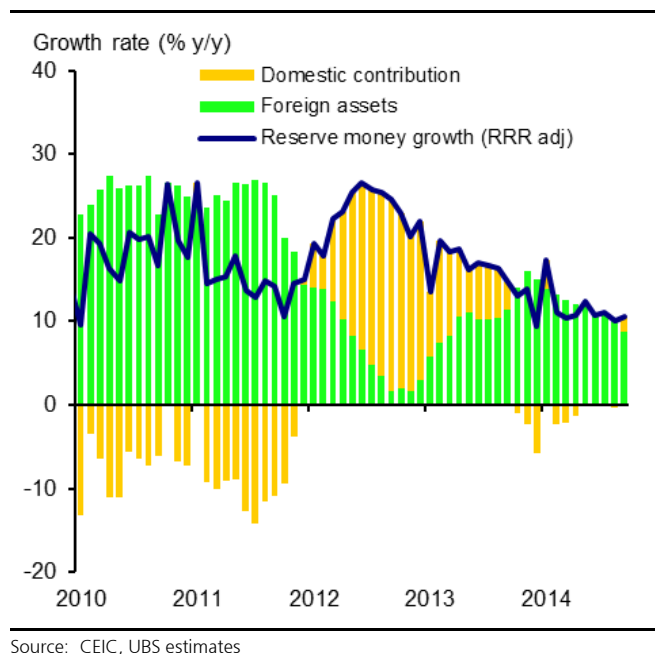
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Figure 1: Base money growth has remained stable so far this year



Anything but RRR cut

It is clear from PBC's liquidity operations in the past year that the central bank is prepared to be extra innovative with liquidity instruments to avoid resorting to general RRR cuts. We think an important reason could be that RRR cuts could easily be misunderstood to be tools of general easing, which the government wants to avoid. Another important reason, as has been explained by PBC officials in various forums, is that the PBC wants to hold RRR relatively high to maintain a "tight balance" of liquidity, so as to increase the effectiveness of their liquidity operations.

Given such operations, even though RRR cuts may be desired from the perspective of creating more transparent and stable liquidity expectation and reducing distortive behaviours from banks, we expect the PBC to continue to use other liquidity management tools. Of course, if China experiences persistent large net FX outflows, the chance of general RRR cuts will increase significantly.

Rate cut likely data dependent

In its third quarter monetary policy report, the PBC acknowledged the short-term drag on economic growth from the property downturn, but also pointed out potential improvement in medium-term growth quality and the lack of labour market pressure. This suggests that indeed the PBC and the government have become more tolerant growth deceleration and that major monetary stimulus is unlikely in the near future. Indeed the report said that policy should "avoid over-stimulus in order to not aggravate structural distortions and debt burden".

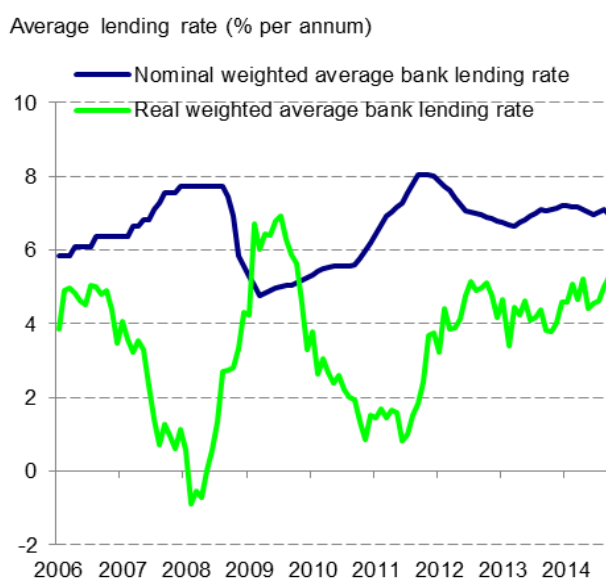
Nevertheless, the PBC report said that monetary policy would increase "flexibility" and maintain a "neutral and appropriate" monetary and financial condition, as it downplayed inflation concerns. In our view, these subtle changes may imply that PBC is prepared for policy adjustment down the road if necessary, and we think such changes will be data dependent.

As if to echo the government's call for lowering financing cost and market calls of rate cuts, the PBC report highlighted the decline in weighted average lending rate from 7.09% in August to 6.97% in September. However, the average lending rate is still marginally higher than the 6.96% in June. Moreover, while bill discount rates have come down more notably in

recent months as a result of ample inter-bank liquidity and lower short-term market rates, the average bank lending rate (as compared to bill discount rates and mortgage lending rates) stood at 7.33% in September, compared with 7.44% in August and 7.26% in June.

Clearly, PBC's liquidity operations and lowering of interbank rates (7-day repo rate has dropped 200 bps so far this year) have had very little impact on lowering bank lending cost. Moreover, real interest rate, adjusted for CPI inflation, has continued to rise (Figure 2). As we pointed out in our earlier report (See [Weak Data Tests Government Policy Resolve](#), September 15), this is because 2/3 of credit in the system are priced off benchmark rates despite the progress in interest rate liberalization.

Figure 2: Real lending rate is climbing up



Source: PBC, CEIC, UBS estimates

Since we expect China's growth to slow further due to the ongoing property adjustment and inflation to decline as a result of lower commodity prices and excess capacity, we think corporate cash flow will be hampered by weaker revenue growth and rising real cost of debt services. As such, we think the PBC needs to cut benchmark interest rates to more effectively lower the cost of financing in the economy, and indeed expect 3 cuts by end 2015.

However, the latest PBC policy report suggests that the central bank (1) does not seem to predict falling inflation, and (2) has instead emphasized on the (marginal) impact of liquidity operations on lending rates. This seems to suggest a relatively low probability of a rate cut in December 2014.

Figure 3: PBC's recent new liquidity management tools

	PSL (Pledged Supplementary Lending)	SLF (Standing Lending Facility)	MLF (Medium-term Lending Facility)
Time of introduction	Reportedly created in Q2 2014. Formally confirmed by PBC in November, though the exact timing, size and interest rate of this operation still unknown.	Officially created in early 2013	Officially created in September 2014
Recent operations	PBC acknowledged in Q3 Monetary Policy Report that it has used PSL to provide funding support to policy banks (mainly CDB) for shanty town renovation, and has lowered PSL rates in September. Media reports claimed that CDB received RMB 1 trillion from PBC via PSL in Q2 2014.	PBC employed the SLF tool several times in 2013. In 2014, PBC injected liquidity through SLF to big commercial banks and regional small & medium financial institutions before the Chinese New Year. There has been no SLF operation since Q2.	PBC injected RMB 500 billion and RMB 269.5 billion through MLF in September and October 2014, respectively, to State owned banks, joint-stock banks, large city banks and rural commercial banks.
Tenor	Reportedly 3 years	1-3 months	3 months, can be rolled over upon maturity
Interest rate	Reportedly 4.5%	likely 3.5%-4% range (no official disclosure)	3.5%
Size of latest operation	Reportedly RMB 1 trillion	An accumulative RMB 340 billion in Q1 2014	RMB 500 billion in September; RMB 269.5 billion in October
Target banks	Reportedly policy banks and commercial banks. So far only policy banks (CDB) received PSL.	Originally large commercial banks and policy banks. Early 2014, a pilot was initiated for small & medium financial institutions	Qualified commercial banks and policy banks
Purpose	A collateralized form of on-lending facility with conditions of collateral adjustable. PBC has used it as a new channel of base money supply, and intends to improve credit allocation through this targeted liquidity provision. It could also help develop a new policy rate in the future.	A regular monetary policy tool to improve liquidity management, meeting financial institutions' large amount of liquidity demand with duration of 1-3 months.	A new and regular monetary policy tool to supply base money over medium term, improve liquidity management, and guide market interest rates.
Collaterals	reportedly CDB loans	High-quality bonds and credit assets, e.g. government bonds, PBC bills, policy banks' financial bonds, high-quality corporate bonds, etc.	High-quality bonds, e.g. government bonds, PBC bills, policy banks' financial bonds, high-quality corporate bonds.

Source: PBC, UBS estimates

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