Macro Strategy

DBS Focus

China: RRR cut signals PBoC still supportive

Group Research

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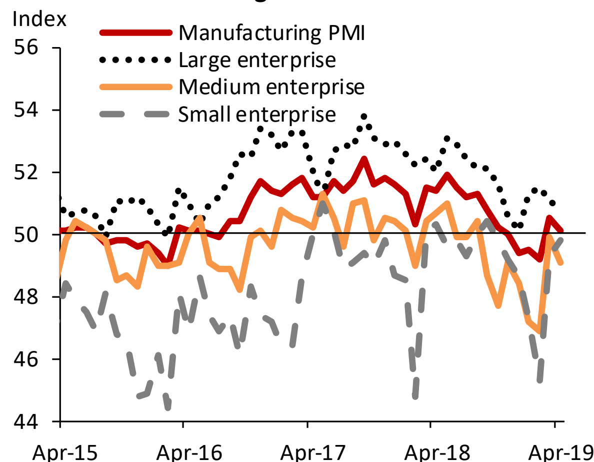
- *PBoC announced today that it would lower the required reserve ratio for around 1000 rural banks to 8%, effective May 15*
- *We expect the PBoC to inject more long-term liquidity via targeted tools. Broad-based easing cannot be ruled out if trade tensions escalate further*
- *Implication for our forecast: China cannot afford to prematurely normalise policy without choking its growth momentum*
- *Implication for investors: If US-China trade talks fail, the risk of more US tariffs on China's goods could lift USD/CNY above 7 and towards 8 in a full-blown war*

The People's Bank of China (PBoC) will lower reserve requirement ratio (RRR) for mid- and small-sized banks, effective May 15. Banks with assets lower than RMB 10bn will be subject to RRR of 8%. About 1,000 small banks will benefit from the cut that will release RMB 280bn to the banking sector.

Chart 1: Manufacturing PMI



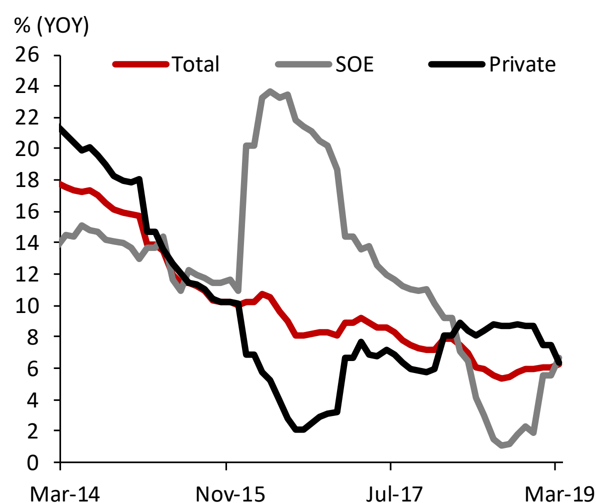
Source: CEIC, DBS

The latest policy move is in line with our expectation. While the better-than-expected 1Q GDP may offer some comfort, data volatility resulting from the Lunar New Year holidays has created considerable uncertainty about the underlying strength. Premature policy normalisation could risk choking off growth momentum.

Data released last week has indeed showed that stabilisation in China's economy is not assured. The National Bureau of Statistics (NBS) PMI came in lower than expected in April (see "China: Economy still fragile despite stabilisation policies"; April 30). Both small- and medium-sized firms have remained in the contractionary territory for 6-8 months (Chart 1). Industrial profits also declined in 1Q, while private investment slowed further in the first quarter despite accelerating headline FAI growth (Chart 2).

Arguably, the unusual timing of the announcement may be part of the response to the latest US tariff threat. On

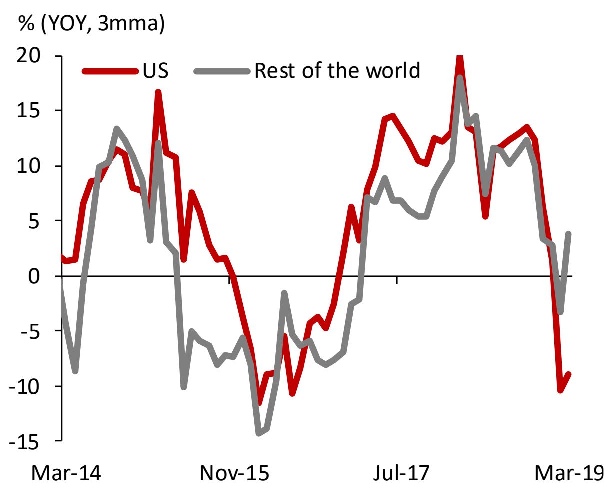
Chart 2: Fixed asset investment (Ytd)



Source: CEIC, DBS

Sunday, US President Donald Trump threatened to hike the tariffs on USD 200bn of Chinese goods to 25% from 10%, effective Friday. He also floated the possibility of extending a new 25% duty on another USD 325bn imports that are not currently covered. Based on our estimation, 25% tariffs on USD 200bn Chinese exports would add up to about a 1.0 percentage-point drag on GDP growth this year. Tariffs on all of China's exports to the US would increase the impact to about 1.5 ppt. Adding to the pressure is the faltering momentum amongst China's top export destinations. Global trade volumes fell in February, marking the fourth drop in six months. Aside from the seasonal spike last month, shipments to the US and the rest of the world have decelerated sharply since late last year (Chart 3).

Chart 3: Exports to US and rest of the world



Source: CEIC, DBS

We expect the latest RRR cut to push down the 7-day repo rate, which has increased 24bps since early April, and subsequently feed through to a further fall in average lending rates. Looking forward, PBoC will likely retain supportive stance, injecting more long-term liquidity via targeted tools such as targeted RRR cuts and TMLF. Broad-based easing cannot be ruled out if trade tensions escalate further.

CNY to depreciate past 7 vs USD if trade talks fail

Last December, we devised a simple model to estimate the impact on the Chinese yuan in the event that US-China trade talks fail (see "Effective link between tariffs and CNY"; December 13, 2018). Our back-of-the-envelope calculations showed that if the US increased tariffs to 25% from 10% on USD 200bn of China's goods, USD/CNY could rise to 7.30. A full-blown trade war which entails a 25% US tariff on the rest of China's goods could propel USD/CNY to 8. Needless to say, there would be a negative spill-over into other Emerging Asian currencies.

We have held our forecast for USD/CNY to trade towards 7 later this year. The US economy has held up better than its Chinese counterpart to the tariff war that started in 2H18. US growth expanded at/above 3% YoY for the third straight quarter in 1Q19 and eroded the dovish tilt in the Fed's pause stance. China's growth has stabilised at the same 6.4% rate as of 1Q19, thanks to fiscal and monetary policy stimulus to cushion its growth from supply-side pressures. After the one-off yuan devaluation in August 2015, USD/CNY has opened or ended each year either around 6.50 or 7.00. China probably favours a stable exchange rate premised on a current account balance around 0% of GDP, a slower but more sustainable 6-6.5% growth target this year, and a return to deleveraging when conditions allow.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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