China cuts reserve ratio to support growth[1]

Following the People's Bank of China (PBoC) announcement to cut Chinese banks' reserve requirement ratios (RRR) after the close of Asian markets on Wednesday, 4 February 2015, Manulife Asset Management's Equity and Fixed Income specialists share their insights on the implications for markets.

After undertaking a number of monetary policy easing measures in 2014, the PBoC moved to cut the percentage of deposits banks must set aside as reserves by at least 50 basis points (bps), lowering the ratio for major banks to 19.5% on 4 February 2015 from the previous 20%. This is the first cut in the RRR since May 2012 and is estimated to free up about RMB600 billion (US$96 billion) in liquidity, according to an estimate by Australia & New Zealand Banking Group[2] and comes as policy makers look to lessen capital outflows and boost economic growth.

Weaker economic data

Economic data published last month showed that China's economy grew at its slowest pace in 24 years in 2014 as gross domestic product (GDP) expanded 7.4% for the year, down from 7.7% in 2013 and slightly below the government's unofficial target of 7.5%. The government's official manufacturing purchasing managers' index (PMI) also fell to 49.8 in January, falling below 50 for the first time in two and the half years to suggest a contraction in manufacturing activity. Meanwhile, China's services sector grew at the slowest pace in six months in January, according to the HSBC services PMI, which came in at 51.8, down from 53.4 in December.

The RRR cut is the latest in a line of monetary easing measures undertaken by the PBoC to stimulate economic growth. In November 2014 the PBoC surprised markets by cutting its benchmark lending rate by 40bps while deposit rates were lowered 25bps. The deposit rate cap was simultaneously raised to 120% of the benchmark rate from the previous 110%. In addition, the PBoC injected about US$126 billion in liquidity into the market via a "medium-term lending facility". This follows attempts over the past year to boost economic growth via more targeted measures that have included increased fiscal spending in areas such as railway transportation and urban renewal and selective monetary policy loosening to boost financing for certain provinces and sectors.

Further cuts likely

Kai Kong Chay, Senior Portfolio Manager for Greater China Equities with Manulife Asset Management says the RRR cut is not likely to have a real impact on the equity market as the move was anticipated, but is an overall positive for the market going forward.

According to Chay, "The rising risk of deflation, weak factory and services readings, slowdown and overcapacity in property and an effective clampdown on stock-market speculation helped trigger the cut. The RRR cut is part of a continued shift towards pro-growth policies and China still has room to cut interest rates further as borrowing costs remain relatively high despite low inflation. Overall, the cut should help improve market and business sentiment.

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[1] All data sourced from Bloomberg as at 5 February 2015.
[2] http://www.bloomberg.com/news/articles/2015-02-04/china-cuts-banks-reserve-ratio-in-liquidity-move-to-spur-growth

"The reduction in the RRR is expected to boost the supply of loans as capital outflows and weakness in manufacturing suggest the slowdown in the economy is deepening and the cut, which reflects the amount of cash banks must set aside, was deemed necessary on concerns the slowdown has yet to reach the bottom."

Chay believes that this latest move could be the first among a package of targeted stimulus measures in 2015 as policymakers look to take a more aggressive stance on stimulus than previously expected. Further interest rate and RRR cuts are possible in 2015, in addition to the possibility of further moderate liquidity injections.

Impact on fixed income markets likely limited

Fixed income markets were also relatively calm following the announcement, indicating investors had also anticipated the move as onshore bond yields dropped by an average of 5bps.

Paula Chan, Senior Portfolio Manager and Chinese bond market specialist with Manulife Asset Management, commented on the move, "The impact for onshore Chinese bonds was limited as short-end interest rates remain tight – the seven-day repo rate is currently at 4.40% – and this has limited a fall in long-end bond yields. We expect further RRR cuts and benchmark interest rate cuts in 2015 due to weaker economic data, foreign exchange outflows and a relatively high real interest rate. The move also had no direct impact on the CNH – 'dim sum' or offshore – bond market as CNH bonds are currently impacted by the short-end funding rate and bond supply/demand dynamics.

"In terms of the USD/renminbi (RMB) exchange rate, with the compression of interest rate differentials between China and the US, we expect the RMB will weaken moderately over 2015."

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