

Market Commentary

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China: U-turn of monetary policy ahead?

- The latest [State Council meeting](#) in China strongly surprised markets by mentioning a Reserve Requirement Rate (RRR) cut in the context of supporting SME financing, given the recent PPI-CPI squeeze on profits which especially hurts SMEs.
- In addition, [a former PBoC official](#) Mr. Sheng Songcheng (former head of the PBoC's Financial Survey and Statistics Department) was quoted by Bloomberg) that cutting rates could be reasonable in H2.
- The news could also hint at the next week's release of Q2 GDP growth to be weaker than expected.
- Together, this led to strong market speculation about a U-turn of China's monetary policy. Given the news, we expect a targeted RRR cut for SMEs soon, but no broad-based easing of monetary policy. However, the rather rapid decrease in the Total Social Financing (TSF) growth rate is likely to soften, going forward. We expect the PBoC to hold its medium-term lending facility (MLF) rate constant this year.

Yesterday, China's State Council strongly surprised by mentioning an RRR cut. In addition, a former PBoC official suggested a rate cut in H2. Markets wonder whether these remarks are already signals for a U-turn in monetary policy and if so, what reasons might have played a role in the background? So far, the PBoC has decreased the growth rate of the wide credit aggregate "Total Social Financing" (TSF) rather rapidly by about 2.6 pp from its peak in last October, in order to bring it back from the 2020 expansionary course to a neutral stance. Accordingly, the credit impulse has already turned negative.

The State-Council mentioning of an RRR cut was not directly related but came in the context of supporting SMEs against the backdrop of a strong rise in input costs. This PPI-CPI squeeze will hurt their profits. While this group of enterprises had traditionally been disadvantaged in terms of access to credit compared to state-owned enterprises, the government and PBoC have already given special support to them in the past. This makes a targeted RRR cut for SMEs likely. However, a broader cut can also not be completely excluded. Typically, the PBoC follows the suggestions of the State-Council, but not always (swiftly).

The State-Council's mentioning could also signal that Q2 GDP growth (to be released on July 15) could be disappointing. There will be some frictions due to the temporary shut-down of the Yantian port (Guangdong) in June, China's largest container terminal amid a Covid-19 outbreak. The terminal is responsible for about 5% of global freight. But as these frictions are temporary they do not necessarily warrant a permanent measure. It could also be the case that the recovery of private consumption, which

lagged behind so far, continues to disappoint. As SMEs provide the bulk of jobs, the RRR cut could also be meant to support employment in order to advance income and consumption.

Would the latter line of reasoning then already amount to a U-turn in monetary policy? We do not think so. The PBoC is expected to follow a neutral stance this year. This is also the sensible thing to do after strong credit growth last year which increased the non-financial sector-debt to GDP ratio by more than 20 pp. Rate cuts and monetary easing would jeopardize any consolidation. Moreover, it would give confusing signals to the deleveraging process in the real estate and shadow banking sectors. However, we expect the slowing of TSF growth to proceed much less rapidly in H2, given that a rate of 10.0-10.5% (currently 11%) by the end of the year would already be broadly in line with nominal growth. Finally, real GDP growth is still expected at 8.4%, compared to the official target of 6% in 2021. Quarterly growth rates (we expect Q2 growth at around 8% after 18.3% in Q1) will necessarily slow due to the easing of base effects.

China 10-year government bond yield responded significantly to the news with a decrease by about 10 bps. Stock markets dropped slightly while the Yuan exchange rate to the US-dollar did not move much.



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