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Demystifying China's RRR and Weekend Links

One of the more interesting phenomena in global macro is the inevitability of a risk-asset rally on a Chinese cut in the Required Reserve Ratio, despite the fact that RRR cuts provide no information on the policy stance and **do not necessarily indicate a policy easing**.

PBoC provided a handy explainer yesterday, which we'll use to clear up some of the mystery about why, and when the RRR **must be consistently cut**.

First, some basic money-creation math:

Bank Reserves x (1/RRR) = limit to M2

There is a chicken-and-egg feature to the loans vs. deposits question, but in my view the proper way of thinking about fractional reserve banking is that **loans create deposits**. The causal action (on a system-wide basis) is not someone depositing funds at the bank to be lent out. It is the act of the bank making a loan **by crediting the deposit account of the borrower** out of "thin air."

Loans create deposits. The limit to deposit creation is a function of the volume of bank reserves and the RRR. Therefore, **systemic lending capacity is constrained by the volume of bank reserves times 1/RRR** (the "money multiplier").

In China's policymaking structure, **the target variable is loan growth** (set at a level requisite with the investment plan and, increasingly, rollover requirements to prevent systemic risk). The loan growth target for 2020 has been established, but not disclosed.

The PBoC has two primary tools with which to hit that target: expansion of the pool of bank reserves and/or cuts to the required reserve ratio (i.e. expansion of the money multiplier on that pool of reserves).

Here's the PBoC explainer from Sina Weibo (via Google Translate), which provides important perspective on PBoC balance sheet management:

央行调统司司长阮健弘等：目前不适宜用大幅扩表的方式提供流动性
Original title: Ruan Jianhong, Director of the Central Bank's Department of Integration and Adjustment, etc .: It is currently unsuitable to provide liquidity by a substantial expansion

Let's dig in...

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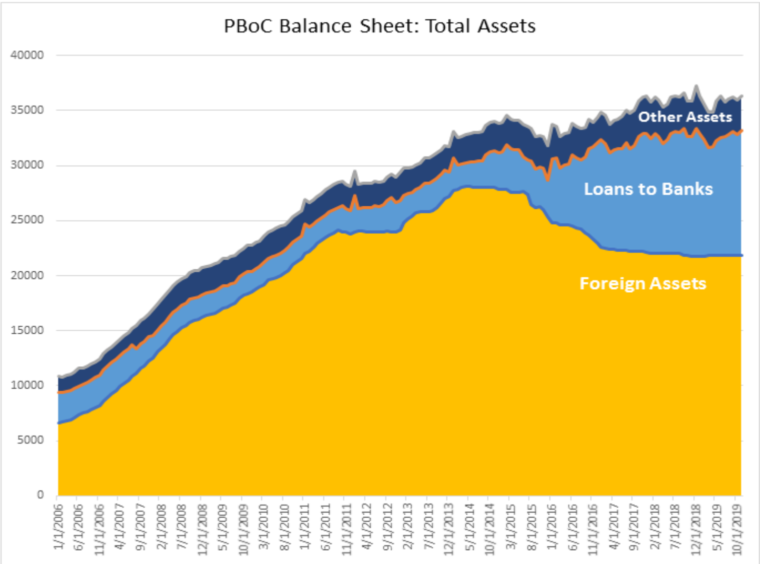
> *The matching of the growth rate of broad money (M2) and social financing scale with the growth rate of nominal gross domestic product (GDP) is an important basis for assessing liquidity. In the first three quarters of 2019, M2 increased by 8.4% year-on-year, and the scale of social financing increased by 10.8% year-on-year, supporting nominal GDP growth of 7.9%*

We can assume the targets are similar for 2020.

Next, PBoC notes that pool of banks reserves can altered by changes in either foreign (FX) or domestic asset holdings (loans to banks in various forms):

> *Means of adjusting the balance sheet include buying and selling foreign exchange, reverse repurchase, loans to financial institutions, and rediscounting.* ***Before 2012, the People's Bank of China mainly invested in liquidity by buying foreign exchange****. After 2012, foreign exchange inflows slowed, and the People's Bank of China invested liquidity through reverse repurchases, loans to financial institutions, and rediscounts.*

Here's a visual representation of that:



2013/14 marked a shift in the equilibrium condition of the RMB – from undervalued to overvalued – that had significant ramifications for Chinese monetary policy operations. **The days of "organic" balance sheet growth via accumulation of FX reserves are long gone**.

To avoid contraction of base money in light of the contraction in FX reserve assets, the PBoC expanded its holdings of domestic assets – loans to banks in various forms – to compensate.

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Recalling our money multiplier formula, PBoC has two options to generate the requisite growth in lending capacity: expand its balance sheet or cut RRR (to increase the money multiplier). Our PBoC messenger provides a helpful explanation of why **PBoC has little appetite for further balance sheet expansion**.

> ***It is currently unsuitable to provide liquidity by a substantial expansion*** *(emphasis theirs).*
>
> *Due to the large assets size of the People's Bank of China,* ***there are certain restrictions on the operation frequency of the further adjustment of the balance sheet****. At present, adjusting the liquidity by adjusting the statutory deposit reserve ratio is a suitable choice.*

They provide several reasons for this preference to avoid further "QE":

1) Optics

> *From the perspective of asset scale,* ***the People's Bank of China has become the world's largest central bank*** *with assets.*

2) Operational Complexity

> *At the end of September 2019, the People's Bank of China's claims on commercial banks reached 10.7T yuan. In order to maintain stable market liquidity, the People's Bank of China needs to continuously roll over the maturity debts of financial institutions. If we continue to adopt the method of expanding the balance sheet to provide liquidity, we need to further increase the operating frequency of the open market and refinancing business. In this case, the difficulty of managing the balance sheet will continue to rise.*

3) **RRR cuts provide liquidity to smaller banks** which may lack the requisite collateral to meet their liquidity requirements through PBoC lending facilities:

> *The scope of the general RRR cut policy includes all types of commercial banks, and the policy coverage is wider. The adjustment of liquidity by tools such as MLF focuses on large and medium-sized banks. In September 2019, among the MLF balances, large state-owned commercial banks accounted for 42%, joint-stock commercial banks accounted for 41%, urban commercial banks and rural commercial banks accounted for 14% and 3%, respectively; Of the balance of policy loans, policy banks accounted for 82%, and urban commercial banks and rural commercial banks accounted for approximately 3% and 7%, respectively.*

4) **RRR cuts involve a "permanent" injection** of liquidity

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> *The liquidity released by the adjustment of the statutory deposit reserve ratio is long-term and stable*

(Note: that one strikes me as silly. RRR cuts can be reversed just as easily as lending facilities could fail to be rolled over. But whatever.)

5) **RRR cuts are beneficial to banks' earnings** – the lower the RRR, the lower the proportion of expensive funding of the loan portfolio:

> *the use of policy tools such as reverse repurchase, reloan, and rediscount to adjust balance sheets requires financial institutions to bear the corresponding costs. The current 7-day reverse repo rate on open market operations is 2.55%, and the one-year MLF rate is 3.3%.*

So, it is clear that PBoC has little interest in expanding the scope of its lending programs. This leaves the **emphasis on RRR as the policy tool** that must be manipulated to hit loan targets established by the higher-ups:

> ***The adjustment of the statutory deposit reserve ratio will play an important role in optimizing the liquidity supply and structural reform of the supply side of service finance.*** *(emphasis theirs)*

Of course, it wouldn't be China if they didn't say something patently absurd to drive me up a tree:

> *Compared with other central banks, the People's Bank of China has more room to adjust the statutory deposit reserve ratio and is more operable.*

If I've heard this once, I've heard it 100 times. The PBoC has no more or less "room to ease" than any other central bank, despite an optically lofty required reserve ratio. Recall, that high RRR is sterilizing **the largest central bank balance sheet in the world**! A high RRR by no means indicates that monetary policy in China has been tight and the fact remains that **every central bank on the planet maintains the exact same "room to ease"** - which is to infinity. The only limits to central bank easing are currency debasement and inflation.

(If the BoJ or ECB have really reached a "limit to QE," then what in god's name is the rationale for not buying up the entire planet? That's the only rational course of action if demand for their non-interest bearing liabilities is, in fact, limitless. Who doesn't like free stuff?)

In conclusion:

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> ***The adjustment of the statutory deposit reserve ratio cannot be used to judge the "loose" and "tight."***

On to the links…

Iran

I claim no particular expertise, but this today note from Peter Zeihan lines up with my own less-robustly formed hunch that Iran is unlikely to respond in an escalatory manner: Another Round in the Middle East?

News out Friday afternoon that *Iran will launch legal measures at the international level to hold the United States to account* would seem to support that view.

Markets may revert to my preferred reflation trade scenario (with EM outperformance) as soon as Monday, unless the weekend brings signs of Iranian escalation.

Phase One and Two

This is what China envisions for Phase Two: they keep buying more beans, make no meaningful concessions on structural issues, and tariff rollback proceeds on an agreed schedule.

Global Times: Election, US Economy affecting Trump: expert

> *"**China does not yield on principle**," the source said, "but reading between the lines, China needs to watch how the deal is being carried out and adjust accordingly."*
>
> *"The US economy's downward pressure has also unnerved Trump," Gao said. "He desires to begin phase two trade talks with China to de-escalate a drawn-out trade conflict with China."*
>
> *But it was unlikely China would agree to move forward as Trump expected, the analysts said. "The philosophy of Chinese trade negotiators works like this: **We would like to judge whether to begin the phase two deal talks based on the implementation results of the phase on deal**," Gao said.*
>
> *"Meanwhile the US side prefers to implement the phase one deal and negotiate the phase two at the same time."*
>
> *Bai Ming, a trade expert close to the Ministry of Commerce, told the Global Times that*

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> *talks on phase two would center on more difficult topics such as industrial subsidies and high-tech policies, the known sticking points during previous dozens of rounds of talks.*
>
> *"Phase two talks still rely on the sincerity of the US.* ***They will be quite hard if the US insists on containing China****," Gao said.*

Begin Phase Two based on implementation results of Phase One?!? Huh? Phase One is nothing more than "China buys more stuff." So, isn't the implementation ball fully in their court? This verbiage suggests **China is expecting further tariff rollback as a goodwill gesture *during Phase one*.**

Meanwhile, I'm getting increasingly worried that Trump now just wants the whole issue to go away. He could just be blowing smoke here, but taken at face value these comments suggest he is looking for a quick conclusion to Phase Two. He can't possibly believe that China is going to relent on core issues, so the only motivation for pushing Phase Two is to engineer a retreat. SAD!
Remarks by President Trump Before New Year's Eve Celebration

> *THE PRESIDENT: On trade? We're very excited about trade. The China deal will be signed probably on January 15th. We put out a notice today. And I'll be going, at some point, to Beijing, to be with President Xi. We have a great relationship. And we'll be doing something reciprocal.*
>
> *But I think, more importantly, we'll be starting negotiations very soon on phase two. And I think phase two can be complete. A lot of people said, "Well, are you going to have phase two, or phase two and phase three?" I think we'll have phase two. I think that should complete it. But we'll be starting those negotiations very soon.*

Again, **there is no actual Phase one deal in a static, stand-alone sense**. China believes they're buying a lot more than a sliver of tariff reduction in return for buying a $100bn a year in stuff they don't need. I don't recall Taiwan being mentioned in the Phase One fact sheet…

China 'will honour' trade deal promises as talks progress 'in earnest'

> *Beijing will live up to its trade deal commitments but* ***Washington must also honour the one-China policy in relation to Taiwan****, according to China's ambassador to the United States. In an interview with Chinese state television CGTN on Saturday night, Cui Tiankai also dismissed talk of a new cold war as "very irresponsible".*

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One motivating factor behind Trump's Phase One capitulation was likely a credible threat by China to go to DEFCON 1 if the Dec 15th tariffs had gone into effect...
Does China's 'ambiguous' export control law contain trade war clues?

> *China is also sitting on an unreliable entity list, aimed at punishing companies alleged to have damaged Chinese interests. The list remains unpublished amid progression in the US trade talks, but former White House sources previously briefed the South China Morning Post that it was their understanding that* ***it would have been unleashed should the cancelled tariffs due on December 15 have entered force****. It is unclear what provisions this might contain, but it is possible that it could override existing trade and export laws, although many analysts think that this is* ***China's nuclear option****, with regard its trading relations with the US.*

Meanwhile, in a contiguous theatre, the existential battle for 5G supremacy continues…

China is overtly threatening economic consequences in an attempt to split the EU on Huawei...
China will take countermeasures if EU blocks Huawei: experts

> *…President Ursula von der Leyen voiced skepticism to German weekly magazine Der Spiegel on Friday over involving Huawei in Europe's 5G networks, amid concerns that its equipment may be used for spying by China.*
>
> *"If there's a risk that the data of civilians or companies can be tapped into on the basis of this law [national security law], then we can't accept that," von der Leyen said.*
>
> *"The influence of this statement on EU members is limited, as* ***they need to consider their economic and trade relationships with China*** *in their final decisions," Ma Jihua, a veteran industry analyst, told the Global Times on Sunday.*
>
> *Most EU countries will continue cooperation with Huawei because if they block the company, their technology and trade cooperation with China will be affected and their domestic economies will be harmed, Ma said.*

And **the London – Shanghai connect has been suspended** in response to the U.K.'s "unsatisfactory" political stances:
Exclusive: China halts British stock link over political tensions - sources

> *sources, who include public officials and people working on potential Shanghai-London deals, all said that politics was behind the suspension.*

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> *Two of them highlighted Britain's stance over the Hong Kong protests and one pointed to remarks over the detention of a now former staff member at its consulate in Hong Kong.*

A small win for China here perhaps…
China's Huawei gets India nod to participate in 5G trials

> *The Indian government has allowed Chinese telecom company Huawei Technologies Co to participate in trials for 5G networks, a company spokesman said on Monday.*

China Economy & Finance

An interesting dynamic in the stability-obsessed Chinese system of government is that **the more one screws up the more honorifics are bestowed** by the elite to rally support.

As China's Troubles Mushroom, Xi Collects a Special Title

> *During a two-day meeting that ended Friday, chaired by Mr. Xi,* ***the party's 25-member Politburo hailed his policies as visionary and described him as the renmin lingxiu, or "people's leader,"*** *a designation that directly echoes an accolade most closely associated with Communist China's founder Mao Zedong.*
>
> *The title doesn't give Mr. Xi any more authority than he already wields as the party's general secretary, his most powerful post. But the reverential tones in the Politburo's pronouncement—issued late Friday by state media—projects an aura of party unity behind Mr. Xi as he confronts wide-ranging economic and political challenges at home and abroad.*
>
> *Mr. Xi's aura of dominance, if not his power, appears to have receded as concerns mounted about China's slowing growth and a prolonged trade war with the U.S., as well as the continuing outbursts of anti-Beijing unrest in the semiautonomous Chinese city of Hong Kong.*
>
> *Now, Mr. Xi's crowning as "people's leader" seems aimed at conveying an air of legitimacy based on popular support from the masses, independent of the party and transcending any discord within the elite, said Wu Qiang, a Beijing-based researcher and former political-science lecturer at Tsinghua University.*
>
> *In a way, Mr. Xi is "invoking the name of the people to suppress discontent within the party," Mr. Wu said.*

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Good Rundown of December's Central Economic Work Conference here. Stability is the predominant objective, but China also needs to improve the "quality" of economic growth in order to sustain living standards without exacerbating already dire financial risk. These **goals remain fundamentally incompatible**, as improving the "quality" of economic growth requires innovation driven by entrepreneurial risk-taking amidst market forces. This in **an unresolvable conundrum** for the CCP.

China's 2020 Economic Agenda: Maintaining Stability Amid Flux

> ***Stability is the key theme of China's economic policy direction for next year****. In fact, the Mandarin Chinese word for "stability" (稳, wen) appeared a staggering 29 times in the official Xinhua report on this year's CEWC (Xinhua, December 12). Given the rising economic challenges domestically and an expected turbulent global environment next year, stability is necessary to ensure Party legitimacy and to avoid political unrest stemming from economic troubles. The Party will surely celebrate achieving a "moderately prosperous society" at the end of 2020 to remind the Chinese people of its role in poverty alleviation and improving living standards.*
>
> *Balancing sustained economic growth with increased financial and environmental risks will not be easy. Beijing is putting its faith in its New Development Concept centered around "quality growth." However, given the severe economic challenges that it faces,* ***Beijing may redouble its efforts to push an "ethnonationalist" ideology for legitimization****.*

SCMP picks up the same theme...
For economic reform to succeed, Beijing needs to learn to let go

> *...one thing is indisputable: policy inconsistencies and governance errors have contributed significantly to China's economic slowdown. The problem lies in the slow progress of structural reforms.*
>
> ***Long-term growth depends on the decentralisation of government authority, increased marketisation and greater economic liberalisation****, with the private sector gaining far more access to finance and other factors of production.*
>
> *Far from opening the way for progress on structural reform, the Chinese government's* ***excessive top-down interventions are reinforcing structural imbalances****. Indiscriminate and unpredictable top-down dictates hurt all businesses, but private companies suffer the*

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> *most. After all, state-owned enterprises enjoy powerful official protections, making them more likely to survive, despite their inefficiencies.*
>
> *Like an overprotective parent, **China's government needs to learn to let go**. Yes, a more conventional approach to macroeconomic management carries some risks. Companies might decide to accumulate excessive debt and banks might issue too much or too little credit. But the resulting fluctuations are likely to be largely temporary.*

Of course, the credit bubble – fueled by near-universal moral hazard – is too far gone for the CCP to "let go."

But never fear, NDRC tells us all is fine…
China takes novel approach to defending economic health with Q&A

> *The National Development and Reform Commission (NDRC), in a statement over the weekend, asked: Is China's growth really losing steam?; Are foreign businesses fleeing China?; Is China losing its place in the value chain?; and Is China's official economic data fabricated? According to the NDRC, the answer to all the four questions is "No".*

Like RRR cuts, selling muni bonds and approval of infrastructure process are ongoing facets of China's investment-led model of GDP-generation. **They signal nothing**.

China Muni Bond Sales Start Earlier Than Ever as Economy Slows

> *Eleven provinces and cities have already disclosed plans to sell more than 450 billion yuan combined of special bonds plans in the first quarter. Zhong Linnan, a fixed income analyst at Yuekai Securities Co., forecasts 1.7 trillion yuan to 2 trillion yuan of muni bonds will be sold through March; the total was 1.4 trillion in the first three months of 2019.*

This is the kind of story that really should make you **think twice if you have Chinese bank stocks in your portfolio**…
China boosts lending to small businesses despite risk

> *The Industrial and Commercial Bank of China, the nation's largest lender by assets, reported a 48% jump in outstanding small business loans in the first 11 months of the year, according to a press release. ICBC currently charges small companies as little as 3.9% interest, compared with the benchmark lending rate of 4.35%.*

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> *However, by the end of May, Chinese banks were also reporting a* ***5.9%non-performing loan ratio for small businesses****, according to the People's Bank of China, against 1.4% on loans to large companies.*
>
> *Even if the borrowers do not default, the increase in lending to small companies is often unprofitable. Many lenders are pricing small business loans at below the 8% average cost of funds for small business loans, according to Ji Shaofeng, a former official at the China Banking and Insurance Regulatory Commission.*
>
> *"****The Chinese government is sacrificing banking profits to rescue small firms****," said Mr Ji.*
>
> *The ICBC Branch in Dezhou, a city in Shandong province in China's east, provides such a large subsidy on its small business loans that it is equivalent to a cut of 60 basis points in its lending rate.*
>
> *"****We want to give out profits*** *to business borrowers as much as possible," said the branch, in a statement.*
>
> *To meet Beijing's lending target,* ***banks are forced to work with riskier borrowers****. A loan officer at the ABC branch in Ningbo said the lender was allowing borrowers with six overdue credit card payments over the preceding year and 12 credit checks — double the number of three overdue payments and six checks that were the limit a year ago.*
>
> *"Our top priority is to fill the lending quota rather than controlling risks," said the officer.*
>
> *Analysts said the proliferation of risky loans will lead to a surge in non-performing loans.*
>
> *"The current policy is making banks serve poorly managed firms," said Mr Ji. "It goes against market principles."*

Authorities are slightly softening of the personal and corporate "social credit" system, with grace periods being allowed to remediate bad scores. I guess it just occurred to them that **doxing every entity with a credit blemish might not be the smartest idea** in the current credit-risk averse environment.
China to offer grace period to discredited individuals: SPC

> *"The guideline offers opportunities to correct their wrongdoings, deterring them and urging them to take the initiative," he said.*

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> *The guideline was a systematic innovation in China's social credit system construction in the current economic context, Dong Dengxin, director of the Finance and Securities Institute at Wuhan University of Science and Technology, told the Global Times on Thursday.*
>
> *Downward growth pressure has pressured some companies that have difficulty in raising funds and cannot pay loans on time, Dong said.*
>
> *Immediate punishment would largely hit those firms whose executives do not deliberately exhibit discredited behavior while the grace period offers both creditors and debtors some leeway to address problems, which could help avoid a "clear cut" in addressing public dishonest conduct, Dong said.*

If your invested in EV companies globally, you might want to consider what China is doing and its potential to suppress industry profits globally...
China Has Whole Towns Focused Entirely on Making Electric Cars

Cool: an Ebay for garbage assets….
China's 'potash king' puts assets up for auction on Taobao

> *Alibaba's Taobao, one of the largest ecommerce businesses in the world, includes a court auction platform that has become a venue for sales of everything from shares in listed banks and Audis confiscated from arrested officials to distressed debt portfolios and even a national toothpaste brand.*
>
> *On Monday, an auction of more than 3,600 tonnes of indium ingots with a starting price of Rmb2.9bn failed to attract investors. The stockpile was once held by the state-backed Fanya Metals Exchange, which collapsed in 2015 following a major fraud incident.*

Latin America

An interesting perspective on Chile: political zeitgeist as a primary country risk...
Opinion | Latin America's 'Oasis' Descends Into Chaos

U.S. Warns Argentina That IMF Deal Threatened by Leftist Allies

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> *A senior Trump administration official said that sheltering former Bolivian President Evo Morales and engaging with Nicolas Maduro's regime in Venezuela crossed a red line and* ***could cost Argentina backing for new IMF funding*** *and investment in the Vaca Muerta shale fields. The official, who spoke on the condition of anonymity to discuss private talks, said while many of Fernandez's advisers are pragmatic and understand these risks, Vice President Cristina Fernandez's influence within the administration is steering him closer to leftist leaders shunned by the U.S.*
>
> *A senior Argentine official denied the U.S. would withdraw support for an IMF deal, adding that the topic was not brought up by American officials during Nielsen's visit to Washington last month.*

U.S. Politics

The problem for Bloomberg isn't just the potential conflict issues, but the fact that he's been doing the "full LeBron" on China for years...

Bloomberg's business in China has grown. That could create unprecedented entanglements if he is elected president.

> *Bloomberg, who is spending tens of millions of dollars of his own money to compete for the Democratic presidential nomination, has deepened his entanglements with that key U.S. adversary — forging close financial ties there while showering praise on the Communist Party leaders whose goodwill is required to play a role in that fast-growing market.*
>
> *The billionaire, whose core business sells financial information to investors, has led efforts since 2015 to make it easier for U.S. companies to trade in Chinese currency, a move embraced by China's largest banks.* ***He expanded one of his company's financial indexes, which could steer $150 billion into China while earning his firm an undisclosed amount in fees****.*
>
> *As Bloomberg has urged cooperation with China, questions have been raised about whether his news service has* ***held back from publishing information that would offend the Chinese leadership****, because of concern that the government would expel his employees.*
>
> *At first the company was praised for its willingness to produce tough reporting about the Chinese leadership. It won a prestigious Polk Award for its 2012 article about the family finances of Xi, who was then vice president. The company's terminal sales in China*

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declined, and the government imposed restrictions on Bloomberg News employees. Bloomberg's website was blocked from being viewed on mainland China.

But the following year, after Xi was elevated to the presidency, a follow-up investigation was not published. The New York Times reported at the time that Bloomberg's editors had refused to release the story as written because it would offend the Chinese leadership.

A Bloomberg manager was quoted as telling members of the Hong Kong bureau, "If we run the story, we'll be kicked out of China." A Bloomberg reporter suspected of leaking the information was suspended and left the company, joining the New York Times.

Bloomberg, who was then mayor of New York City, stressed at the time that he was not running Bloomberg LP and that his assets were in a blind trust. Still, he said Bloomberg's editors had assured him they had not censored the information.
After returning to run the company in 2014, Bloomberg was asked by CNBC whether his news service had "muzzled" reporters. He responded: "In China, they have rules about what you can publish. We follow those rules. If you don't follow the rules, you're not in the country."