26 Apr 2024

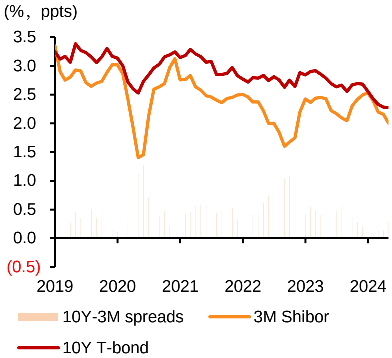
CMB International Global Markets | Equity Research | Economic Perspectives

China Policy

PBOC CGBs trading is not Chinese version of QE

Bingnan YE, Ph.D
(852) 3761 8967
yebingnan@cmbi.com.hk

Frank Liu
(852) 3761 8957
frankliu@cmbi.com.hk

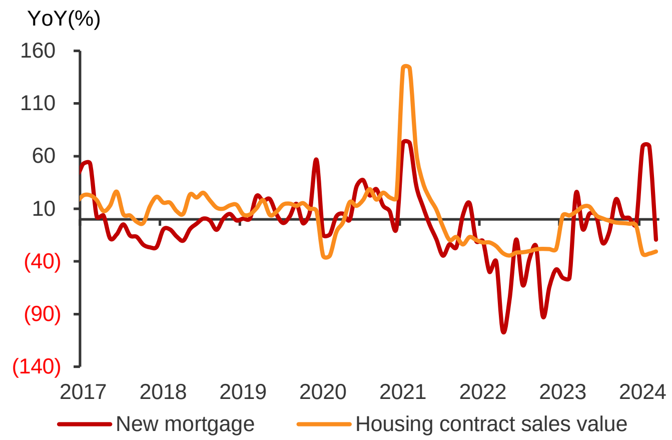


The PBOC's recent remarks indicate its growing concern about financial system pressure caused by the relentless decline of long-term bond yields. But we do not think the central bank will target to push up long-term yields as the excessively low yields are mainly due to continuing deflation pressure, risk aversion sentiment and weak credit demand. Artificially driving up long-term yields amid weak economic fundamentals may cause market turmoil and further harm economic prospect. The PBOC's response to possible direct trading of central government bonds (CGBs) in future should not be considered as the Chinese version of QE. We believe it is only a change of liquidity management tools and may offer the central bank a higher control over short-term interest rates. Given the prevailing deflation pressure and excessively low long-term rates, reducing short-term policy rates seems more crucial than implementing QE in China. Looking forward, the PBOC may expand liquidity supply to moderately lower money market rates. As the property market continues to plummet, the central bank may further lower mortgage rates especially for first-home and second-home buyers to boost housing demand. To protect banks' NIMs, the central bank may guide banks to further reduce deposit rates before possible mortgage rate cuts. As loan contract rates for SOEs and large enterprises are so low, the PBOC is reluctant to further cut LPRs. As China's deflation pressure remains while the US inflation may continue to beat expectations in the near term, US dollar may remain strong against renminbi. We can only see the turning point when the US inflation noticeably declines while China sees a noticeable reflation.

- **PBOC is growing uncomfortable about the relentless declines in long-term T-bond yields.** The PBOC has ramped up its verbal pushback against the continued declines in long-term government bond yields this week as it warned banks and insurance companies with heavy long-duration bond positions may face losses with a possible reversal of long-term rates. The central bank was also concerned that the excessively low yields of long-term bonds may not be able to cover their funding costs as the term spreads significantly declined. We believe the PBOC's public comment is just sending a warning instead of pursuing an increase in long-term yields as a policy target. The central bank had warned the market twice in the past several months, but long-term yields continued to decline. Unlike the A-share market with many noisy traders, the bond market with large financial institutions as players should be more efficient. The relentless decline of long-term yields is mainly due to continuing deflation pressure, risk aversion sentiment and weak credit demand. Without assertive and aggressive policies to stabilize real estate and defy deflation, long-term yields are unlikely to see a sustained reversal. We do not think the central bank will artificially push up long-term yields amid weak economic fundamentals as this move could cause market turmoil and further harm economic prospect. The right policy option should be further cuts in short-term policy rates instead of driving up long-term yields.
- **Direct trading of CGBs do not mean Chinese QE.** The PBOC also responded to recent market discussion of potential T-bond trading in the secondary market after a comment by President Xi Jinping spurred speculation of possible QE in China. The PBOC said China would stick to normal monetary policy and its possible trading of T-bonds is completely different from the QE operations conducted by others. The US and ECB launched QE after their policy rates dropped to the zero lower bound. Chinese banks' 7D repo rates, widely considered as the short-term policy rates, still reached around 2%. Given the prevailing deflation pressure and excessively low long-term bond yields, lowering the short-term policy rates seems more crucial than implementing QE in China.

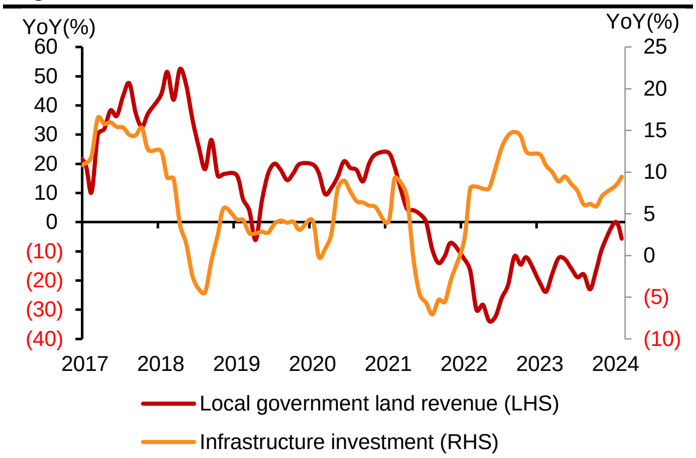
- **Direct trading of CGBs is a change in liquidity management tools instead of policy direction or target.** Currently, the PBOC mainly uses repo or reverse repo agreements in open market operations due to limited supply and illiquidity of short-term government bonds in China. At end-1Q24, PBOC's claims to banks through repo & other refinancing operations reached over RMB15tn while its holding of government bonds only amounted to RMB1.5tn. In future, the PBOC may gradually shift to direct CGBs trading for liquidity management. However, it would merely reflect a change in the operational tool, not necessarily a policy shift or a material change on its balance sheet size as the nature of liquidity provision remains unchanged. Direct CGBs trading, however, would increase the liquidity of short-term government bonds and enhance PBoC's control over the short-term T-bond rates.

Figure 1: Growth of new mortgage & housing sales



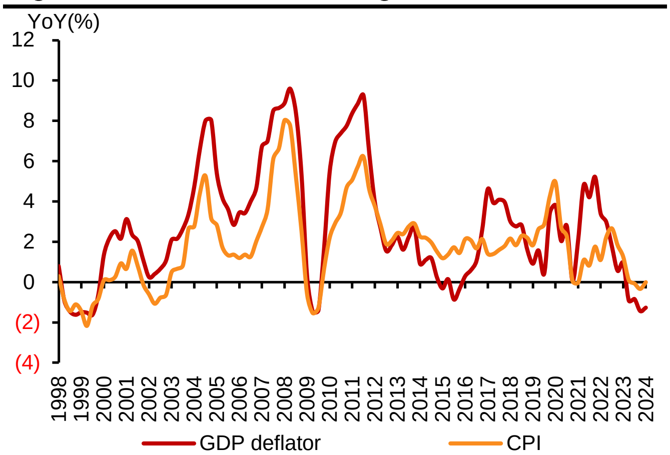
Source: Wind, CMBIGM

Figure 2: Land market & infrastructure investment



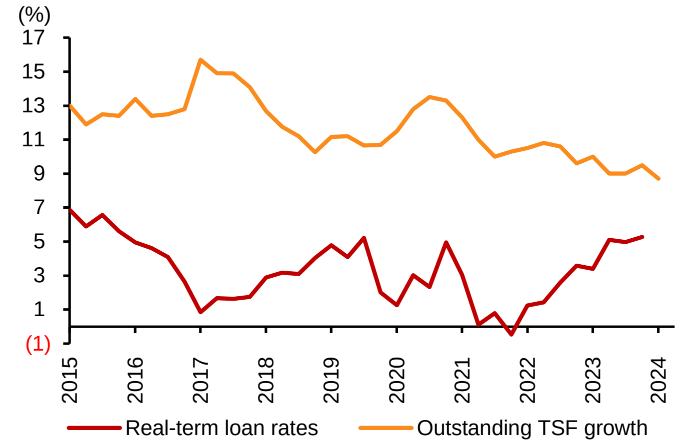
Source: Wind, CMBIGM

Figure 3: GDP deflator & CPI growth



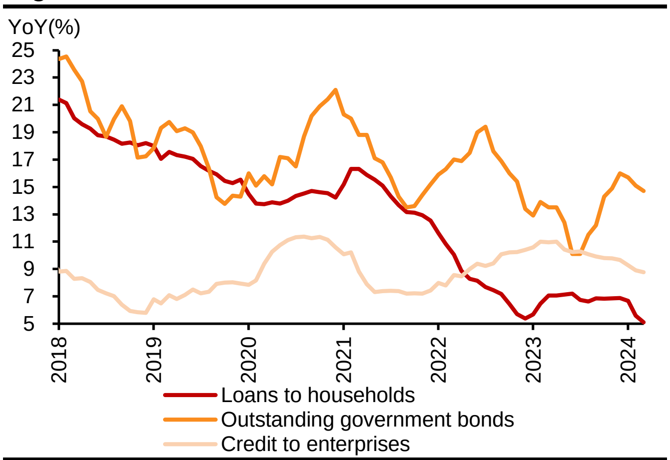
Source: MoF, CMBIGM

Figure 4: Real-term loan rates and TSF growth



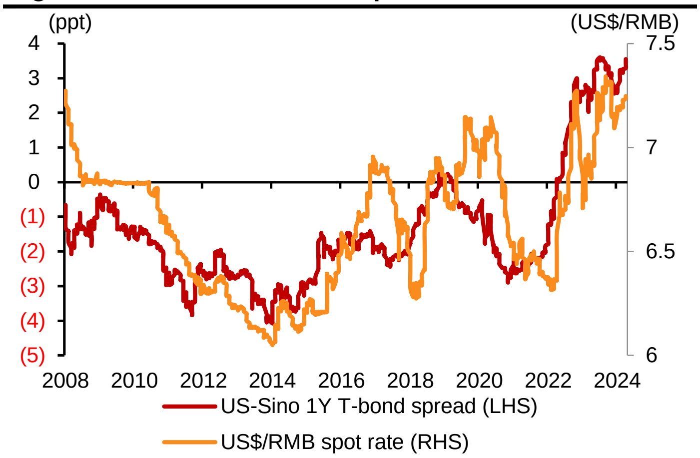
Source: MoF, CMBIGM

Figure 5: Growth of credit to real sector



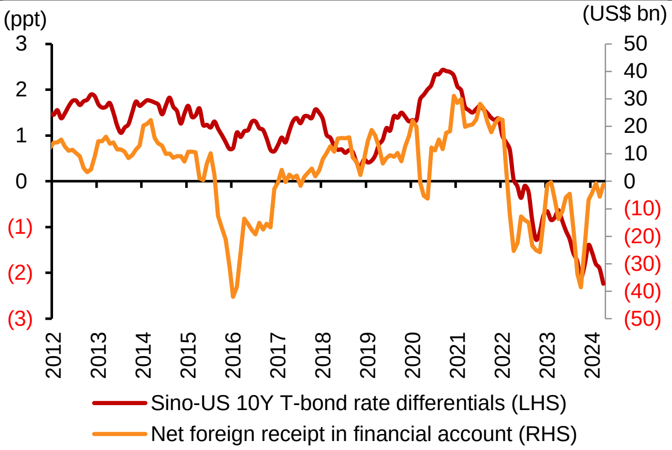
Source: Wind, CMBIGM

Figure 6: US-China interest spreads & RMB



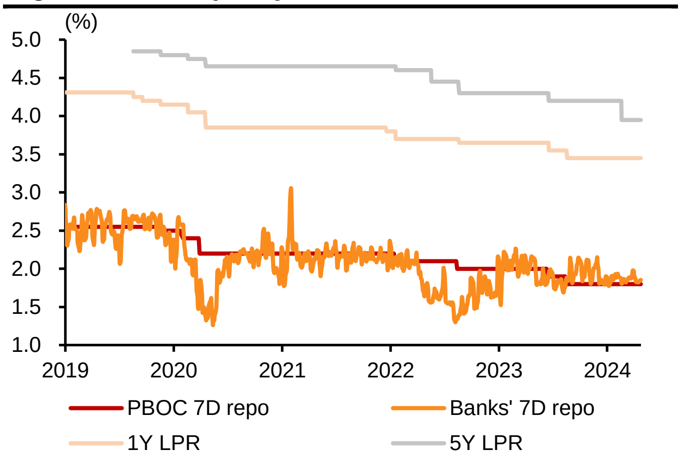
Source: Wind, CMBIGM

Figure 7: China-US interest spreads & net foreign receipt



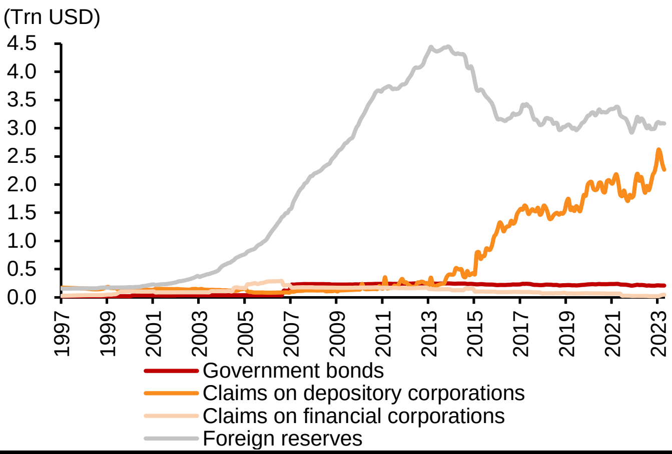
Source: Wind, CMBIGM

Figure 8: PBOC policy rates



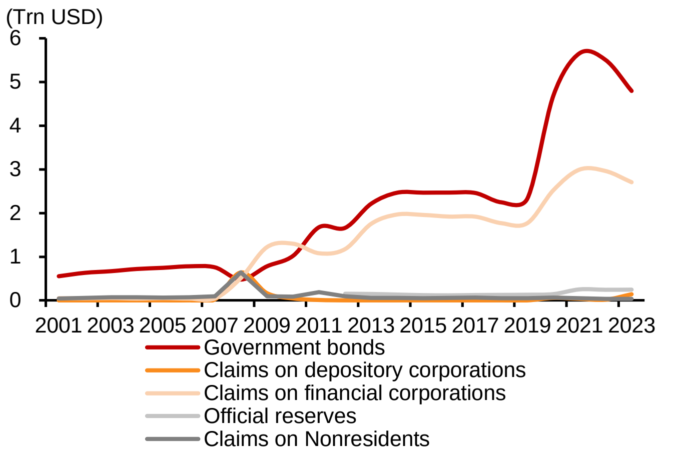
Source: Wind, CMBIGM

Figure 9: Breakdown of PBOC assets



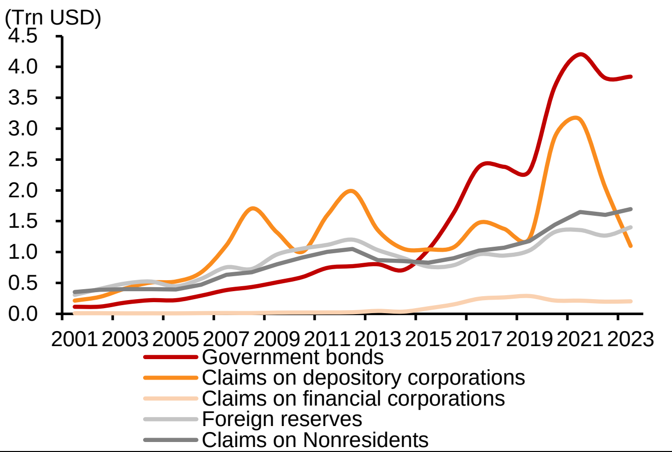
Source: Wind, CMBIGM

Figure 10: Breakdown of FED assets



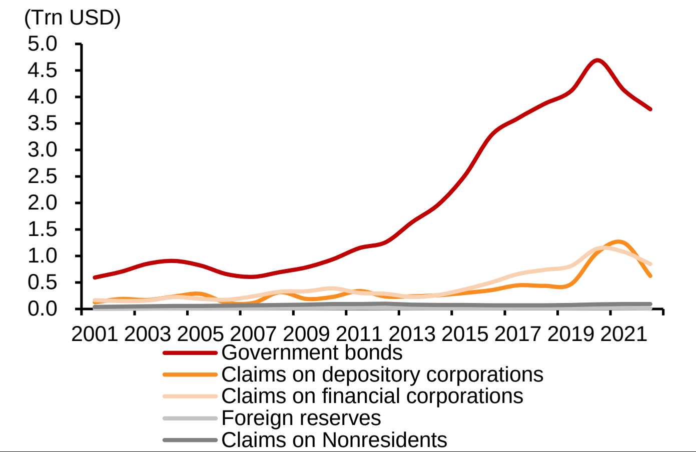
Source: Wind, CMBIGM

Figure 11: Breakdown of ECB assets



Source: Wind, CMBIGM

Figure 12: Breakdown of BOJ assets



Source: Wind, CMBIGM

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Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

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