



China's required reserve ratio cut will nudge Australia along

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China's central bank governor, Zhou Xiaochuan, recently said that we shouldn't be too worried about the country's economic slowdown. That's because, compared with other major economies, China still had considerable scope to inject macroeconomic policy stimulus if it was needed.

The following day he decided that it was. On Sunday the People's Bank of China (PBC) announced that it would cut the Required Reserve Ratio (RRR) for banks by one percentage point. The RRR is the percentage of deposits that banks must hold for safekeeping and which they cannot lend out. So a cut in that percentage means they can lend more. It followed a reduction in the RRR by 0.5 percentage points in February.

The shift to a more relaxed monetary policy stance attracted extra attention because the PBC usually makes adjustments in smaller increments. It's a bit like when the Reserve Bank of Australia (RBA) cuts interest rates by 0.5 percentage points when the consensus forecast was for only 0.25.

But keep in mind that prior to the move the RRR was 19.5%. That level is extremely high by international and Chinese historical standards. A decade ago it was less than half that. What this means is that even though the change was large, the current RRR of 18.5% remains conservative and there's ample scope to go further.

That said, more rapid credit growth comes with its own risks, namely that quality might be sacrificed for quantity. As a result, expect that future moves will still be made cautiously.

It's been estimated that the latest cut will release between 1 trillion - 1.5 trillion Renminbi of new credit into the economy. That sounds like a lot but it needs to be put into some perspective. Loans in China's banking system have been growing by around that amount each month this year. So what the RRR cut has effectively delivered is a shot in the arm equivalent to an additional month's worth of bank credit. That's more finesse than cannonball.

Still, for Australia it's welcome news for two reasons.



First, contrary to fears in developed countries like Australia that monetary policy may have lost its effectiveness, it still packs a punch in China.

When the RBA cuts interest rates, it does so hoping that consumers and investors will respond to cheaper borrowing costs by increasing their spending. But the PBC's policy levers are more direct. It supplements cuts to the RRR by exercising "window guidance". That's a fancy way of saying that the PBC instructs banks – particularly the big state-owned lenders – how much more they should lend, to whom and for what purpose.

Secondly, if the Chinese authorities are true to form, most of the new credit will be used to fund new investment in infrastructure and construction. That's what we saw when growth slowed sharply in response to the global financial crisis in 2008-09. Research by the RBA last year found that investment in China absorbs more than twice as much Australian value-added output as Chinese household consumption. This is because investment makes more intensive use of the natural resources that Australia excels at in digging up out of the ground.

A declining RRR will be supported by other steps. According to Caixin, a leading independent financial publication in China, the PBC has also just decided to inject \$64 billion into two of the country's policy banks, China Development Bank and the Export-Import Bank of China. These injections are intended to support Chinese President's Xi Jinping's plans to build a New Silk Road that will span the region and require much greater levels of infrastructure investment. The Asian Infrastructure Investment Bank that Australia recently joined as a Founding Member is part of the funding solution for the same vision.

But for all this good news, the latest policy manoeuvres shouldn't be seen as a panacea for iron ore prices, which are down by 60% since last January.

That's because Chinese demand hasn't been the main factor behind the slump to begin with. You need to look no further than the massive expansion in supply by the big Australian miners for that.

Off an already high base the Department of Industry and Science says that in 2014 China's imports of iron ore grew by another 69 million tonnes. Yet this was more than matched by a 138 million tonne jump in Australian exports. The forecast is for the growth in supply to outstrip the growth in demand for the foreseeable future.

Moves like those taken by China this week will help to make that gap smaller. They'll give the Australian economy a bit of a nudge along as they do so.

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