China: PBOC Signals Shift to Overnight Policy Rate and Broader Interest Rate Benchmark Reforms

Xinquan Chen
+852-2978-2418 |
xinquan.chen@gs.com
Goldman Sachs (Asia) L.L.C.

Bottom line:

At the Financial Street Forum on October 19, PBOC Governor Pan Gongsheng outlined further reforms to China's monetary policy framework, including a potential shift in the main policy rate from the 7-day reverse repo rate to the overnight reverse repo rate, greater use of DR001 as a benchmark for loan pricing, and the eventual retirement of legacy benchmark deposit and lending rates. The governor also announced five measures aimed at strengthening financial stability, improving bond market functioning, facilitating financial opening-up, and supporting technological innovation. We view these announcements as further steps towards a more price-based monetary policy framework and more effective monetary policy transmission. The potential shift to an overnight policy rate could effectively amount to a policy rate cut, depending on the level at which the new rate is set. However, given stronger-than-expected Q3 GDP growth and recently announced monetary easing measures, we maintain our baseline forecast of no policy rate or RRR cuts for the remainder of this year. For 2027, we expect further monetary easing, potentially delivered in part through the transition to an overnight policy rate.

Main points:

1. At the Financial Street Forum on October 19, PBOC Governor Pan Gongsheng outlined further reforms to China's monetary policy framework and announced measures for strengthening financial stability and improving market functioning. The Financial Street Forum in Beijing and the Lujiazui Forum in Shanghai are China's major annual financial policy conferences, serving as an important platform for senior financial regulators to communicate policy priorities and announce new measures. We summarize our key takeaways as below.

2. **The PBOC plans to make the overnight reverse repo rate its main policy rate.** Governor Pan noted that DR001 has effectively become the PBOC's operational target for short-term interest rates, while the current main policy rate remains the 7-day reverse repo rate (Exhibit 1). To better align the policy rate with the operational target, the PBOC will study a transition towards overnight reverse repos as its main open market operation instrument, with the overnight OMO rate eventually replacing the 7-day reverse repo rate as the main policy rate. The announcement follows earlier reforms to the short-term interest rate corridor and the PBOC's liquidity management toolkit. In June, the PBOC narrowed the interest rate corridor from 70bp to 50bp, with temporary overnight repo and reverse repo rates set at 25bp below and above the 7-day policy rate, respectively. The PBOC also introduced regular overnight reverse repo operations at the end of June, which have increasingly been used to manage seasonal liquidity pressures, particularly around

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month-end, quarter-end and tax payment periods. Gross overnight reverse repo operations increased from RMB900bn in June to RMB4.85tn in September, almost four times the volume of 7-day reverse repo operations in September. On a net basis, overnight OMO injections also exceeded those from 7-day and 14-day OMOs combined in September (Exhibit 2).

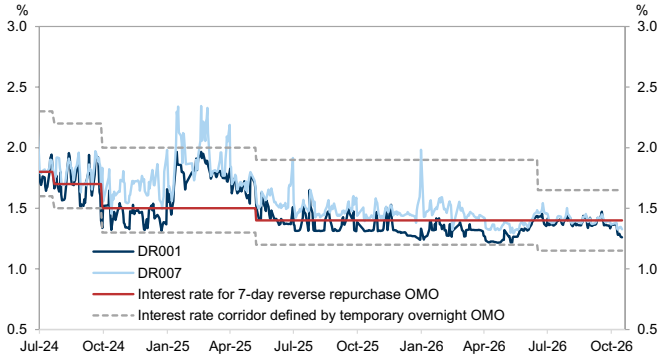
3. In our view, the transition to an overnight policy rate could also provide an opportunity for monetary easing. Although the PBOC has not officially disclosed the rate, we note a Bloomberg report in June which said the overnight reverse repo operation rate was set at 1.25%. If the PBOC were to adopt this rate as the new main policy rate, it would imply a 15bp reduction in the policy rate from the current 7-day reverse repo rate of 1.40%. Given better-than-expected Q3 GDP growth and the recently announced easing measures (see here and here), we continue to expect no policy rate or RRR cuts this year. For next year, the PBOC could potentially deliver part of monetary easing through a change in the main policy rate benchmark rather than a conventional cut in the policy rate.

4. **The PBOC plans to diversify loan pricing benchmarks beyond the LPR.** The Governor commented that financially stronger corporates may eventually be allowed to choose between DR001 and the LPR as the reference rate for floating-rate loans, while the LPR will continue to play an important role in pricing loans to smaller businesses and households. The PBOC also indicated that DR001 could be used as a pricing benchmark for bonds and financial derivatives, and plans to issue further policy guidance. In our view, this could strengthen the transmission from overnight money market rates to broader financing conditions over time. The PBOC also plans to retire the legacy benchmark deposit and lending rates. These rates have already been gradually replaced by market-based benchmarks in practice. The proposed reform would further formalize the transition towards market-based deposit and lending rate pricing, while the PBOC said it will continue to improve the LPR quotation mechanism.

5. Governor Pan also announced five measures aimed at strengthening financial stability, improving market functioning and supporting technological innovation. First, the PBOC will establish a liquidity backstop for non-bank financial institutions facing large-scale redemptions, designed to prevent a negative feedback loop between redemptions and bond market selloffs. The facility would be activated under specific circumstances involving systemic liquidity pressures, with eligible institutions required to meet macroprudential requirements and provide high-quality collateral. Second, the PBOC will expand access to its Standing Lending Facility (SLF) to locally incorporated foreign banks, extending coverage to all domestic deposit-taking institutions. Third, the authorities will enhance connectivity between the interbank and exchange bond markets to improve liquidity and price discovery. Fourth, the PBOC will pilot allowing eight offshore RMB clearing banks to conduct proprietary trading in China's onshore interbank FX market, facilitating greater integration between onshore and offshore RMB markets. Fifth, the PBOC will work with the Ministry of Science and Technology and other government agencies to issue guidelines on financial support for China's science and technology innovation centers.

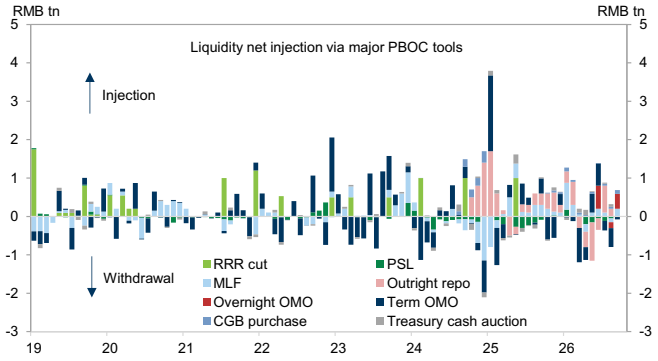
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Exhibit 1: The overnight repo rate for banks remained slightly below the policy rate



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 2: The PBOC conducted liquidity injection mainly through overnight OMOs in September



Term OMO: open market operation with a maturity longer than overnight (i.e., 7d/14d/1m pledged reverse repos); MLF: medium term lending facilities; PSL: pledged supplementary lending.

Source: CEIC, Goldman Sachs Global Investment Research

The China Economics Team

Andrew Tilton
+852-2978-1802
andrew.tilton@gs.com
Goldman Sachs (Asia) L.L.C.

Hui Shan
+852-2978-6634
hui.shan@gs.com
Goldman Sachs (Asia) L.L.C.

Lisheng Wang
+852-3966-4004
lisheng.wang@gs.com
Goldman Sachs (Asia) L.L.C.

Xinquan Chen
+852-2978-2418
xinquan.chen@gs.com
Goldman Sachs (Asia) L.L.C.

Yuting Yang
+852-2978-7283
yuting.y.yang@gs.com
Goldman Sachs (Asia) L.L.C.

Chelsea Song
+852-2978-0106
chelsea.song@gs.com
Goldman Sachs (Asia) L.L.C.

人在草木间