China: PBOC Changes Policy Rate to Overnight Benchmark

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Bottom line:

The PBOC announced open market operation (OMO) changes today, moving its policy rate from the 7-day to the overnight reverse repo rate, effective 2 November. It also announced that the current level of overnight reverse repo rate is 1.25%, 15bp lower than the 7-day rate of 1.40%, confirming earlier media reports. This transition aligns the PBOC's monetary policy framework closer to global central bank standards after Governor Pan Gongsheng's speech on October 19 signaling such a transition. The earlier-than-expected rollout followed recent credit flare-ups (notably Zhuhai Huafa) and fund redemption pressures. We see two implications from today's announcements: First, policymakers are watchful of credit risks and are likely to employ various tools to ensure ample liquidity and market stability. Second, combining weak economic fundamentals at present with the monetary policy framework transition, government bond yields and swap rates in China are likely to grind lower.

Main points:

1. What happened? Following Governor Pan Gongsheng's speech at the Financial Street Forum on 19 October that outlined further reforms to China's monetary policy framework, the PBOC announced major adjustments to open market operations (OMOs) today, effective 2 November. These measures include:

- Overnight reverse repo operations will be conducted on each business day via fixed-rate, quantity tenders. The PBOC officially announced that the current level of overnight reverse repo rate is 1.25%, 15bp lower than the 7-day rate of 1.40%, confirming earlier media reports. This change elevates the importance of overnight reverse repos in central bank liquidity operations.
- 7-day reverse repo operations will be adjusted to fixed-quantity, rate tenders with multiple-price awards, primarily conducted around key liquidity junctures such as tax-payment periods and month-ends. This change reduces the importance of the 7-day reverse repo rate in monetary policy operations since they now have fixed quantity instead of fixed rates.
- Other policy facilities that were previously priced by adding or subtracting a spread against the 7-day reverse repo rate—including temporary repos/reverse repos and repo facilities for foreign central bank-type institutions—will all be re-anchored to the overnight reverse repo rate, with the spread margins remaining unchanged. This change effectively made the overnight reverse repo rate the new policy rate.

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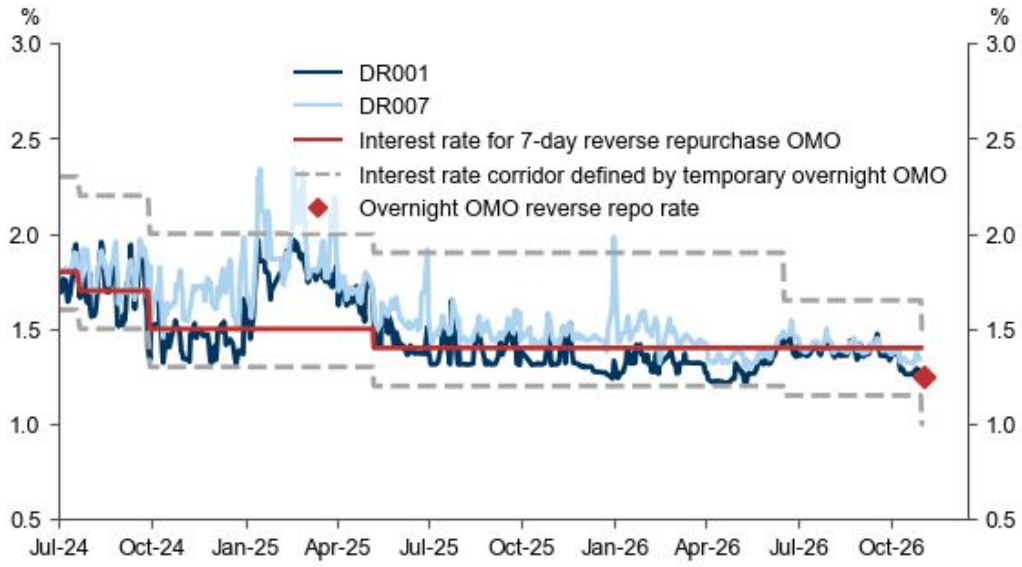


2. The new policy rate and new corridor: These measures suggest a PBOC policy rate transition from the 7-day to the overnight reverse repo rate, aligning with the Fed and ECB's use of overnight benchmarks. The interest rate corridor, defined by temporary repo and reverse repo rates, will shift from 1.15–1.65% to 1.0–1.5% accordingly (from +/-25bp around the 7-day reverse repo rate of 1.4% to +/-25bp around the overnight reverse repo rate of 1.25%; Exhibit 1). The next step would be to accelerate loan repricing against the interbank overnight interest rate (DR001) as suggested by Governor Pan earlier. Previously, 7-day liquidity injections to relieve single-day funding shortages often left excess liquidity on subsequent days, complicating cash management. Daily overnight injections through fixed-rate, full-allotment tenders allow the PBOC to add and withdraw liquidity without delay.

3. Why now? Although not a conventional 15bp policy rate cut, the transition effectively increases interbank liquidity and lower yields across the bond curve, all else equal. The timing is earlier than many market participants, including us, expected, as stronger-than-expected Q3 GDP reduces the pressures on policymakers to secure this year's growth target. In our view, recent Huafa credit risk and related mutual fund redemptions, as well as continued equity market weakness, may have prompted an earlier PBOC announcement, to support market sentiment and maintain stable liquidity conditions (note that Huafa is a leading local SOE conglomerate in Zhuhai city, Guangdong province). Rates markets appear to have started to price in the move since Governor Pan's speech at the Financial Street Forum.

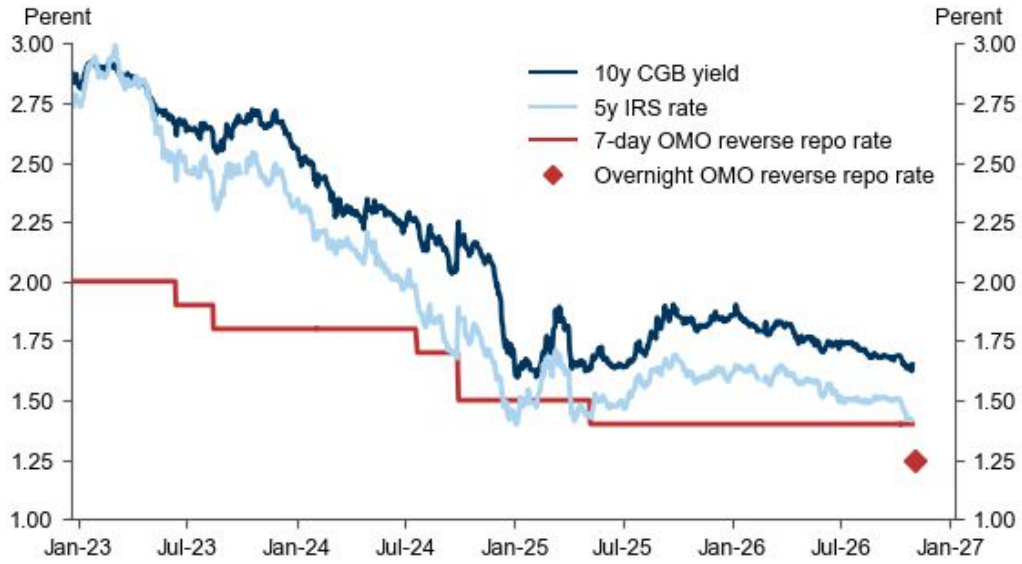
4. Implications for monetary policy and rates: Based on our client conversations, investors generally expect the 7-day reverse repo rate to decline to 1.30-1.35% on the back of the PBOC's changing policy rate, implying an effective policy rate cut of 5-10bp. As a result, further policy rate cut looks unlikely in the near term. That said, evolving domestic credit risk could increase the likelihood of an RRR cut, and the PBOC may also use its newly launched Bond-Market Non-Bank-Financial-Institution Swap Facility (BNSP) to contain risk spillovers. We see two implications from today's announcement: First, policymakers are watchful of credit risks and are likely to employ various tools to ensure ample liquidity and market stability. Second, combining weak economic fundamentals at present with the monetary policy framework transition, government bond yields and swap rates in China are likely to grind lower (Exhibit 2).

Exhibit 1: PBOC changes policy rate to overnight benchmark



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 2: Government bond yields and swap rates in China are likely to grind lower



Source: CEIC, Goldman Sachs Global Investment Research

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