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China: The shift to a single policy rate framework

The transition to a focus on short-term policy rates helps to modernize the PBoC's policymaking.

- With no updates to the MLF rate since February 2025, the 7d OMO reverse repo rate has officially become the dominant policy rate. As the PBoC seeks to narrow the interest rate corridor, DR001 appears to have become a new targeted short-term interbank rate. Outright reverse repo and CGB trading are new policy tools to adjust liquidity and guide long-end rates.
- Although the PBoC's monetary policy framework is starting to resemble its global peers, it has much room for improvement. A commitment to unlimited lending at the ceiling of the corridor is still absent. Window guidance via setting major commercial banks' deposit rates remains crucial for policy transmission. The short-lived resumption of CGB trading suggests the PBoC's open market operations are still in a formative stage.
- Rates strategy: Under the new framework, the PBoC is equipped with more tools to inject/withdraw liquidity. Banks' deposit growth, market leverage and bond trading behavior, RMB movements, as well as bond supply are key factors behind market liquidity. We continue to hold a Jun-IMM 2s5s steepener.

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Executive summary

While fiscal policy is widely expected to play a more vital role in stabilizing growth, China's *monetary policy framework* is undergoing a substantial transition towards a western-style system that hinges on short-term policy rates. This is not an abrupt transition, as the PBoC has taken various steps over the past year, especially following Governor Pan's speech at the 15th Lujiazui forum in June 2024. With no updates made to the 1y MLF rate since February 2025, the 7d OMO reverse repo rate has officially become the dominant policy rate in China. As the PBoC seeks to narrow the interest rate corridor, DR001 appears to have become a new targeted short-term interbank rate. In addition, the resumption of CGB trading and the inception of the outright reverse repo have enriched the PBoC's toolbox to manage liquidity and guide longer-term market interest rates.

Still, China's monetary policy framework has much room for improvement. First, although the lower bound of the interest rate corridor is effective, the PBoC does not explicitly commit to unlimited lending at the "ceiling" of the corridor. Second, the transmission from the policy rate or short-term interbank rates to bank lending/deposit rates remains unclear, and window guidance via setting major commercial banks' deposit rates is still crucial. Third, the PBoC's open market operations are still in a formative stage, evidenced by its suspension of CGB purchases just months after its debut.

The MLF rate no longer serves its function as a policy rate

On 24 March, the PBoC revised the MLF rate bidding form to "multi-price bidding" from "single-price bidding"; this effectively removes the MLF rate from its role as a (medium-term) policy rate, which had been the case since 2014. On 27 March, Deputy Governor Xuan Changneng said the MLF rate is no longer considered a policy rate. The one-year MLF rate stood at 2.0% in February 2025, with no subsequent updates from the PBoC on this rate, despite *the latest round of rate cut on 7 May*.

Why phase out the MLF rate?

Over the past decade, the MLF has played a crucial role in expanding the monetary base and guiding medium-term market interest rates. In 2019, the MLF rate emerged as China's primary policy rate, as the PBoC set the LPR as the new benchmark lending rate and tied it to the MLF rate. However, as the MLF balance grew over time and swelled to a record high of RMB7.3trn by February 2024, its drawbacks become too significant to overlook. Operating as a "pledged repo", the MLF locks a substantial amount of CGBs at the PBoC, limiting the supply of tradable bonds in markets. Moreover, under the previous framework with two policy rates, there appears a lack of endogenous linkages between the 7d OMO reverse repo rate and the MLF rate.

A new and narrower corridor, a new targeted rate and new liquidity instruments

The interest rates for temporary overnight repo and reverse repo operations, which are set at 20bp below and 50bp above the 7d OMO reverse repo rate, have formed a new and narrower interest rate corridor. Although the PBoC has yet to carry out any of such operations, recent evidence suggests the DR001 has become the new targeted short-term market interest rate for the new corridor. Outright reverse repo (ORR) and CGB trading are new tools for the PBoC to fill part of the gap left by the MLF. According to the Q1 Monetary Policy Report, the PBoC's liquidity toolbox is enriched with various instruments, including 1) RRR cuts and CGB trading for long-term liquidity; 2) MLF, ORR and various structural lending facilities for medium-term liquidity, and 3) 7d OMO reverse repo, temporary overnight repo and reverse repo for short-term liquidity.

The PBoC's interest rate corridor is starting to resemble its global peers

With a clear short-term policy rate and narrower interest rate corridor, China's interest rate corridor is starting to resemble those of Western economies, especially that of the euro area leading up to the Global Financial Crisis. By providing liquidity through the Marginal Lending Facility (MLF), Deposit Facility (DF) and Main Refinancing Operations (MRO), the ECB aimed to steer short-term money market rates, the Euro Overnight Index Average (EONIA), towards the MRO rate. The PBoC's interest rate corridor is less similar to that of the Fed, which sets a narrow target range for the federal funds rate to ensure it moves within its corridor. Compared to the ECB and PBoC, the Fed's interest rate corridor does not rely on a policy rate for a specific lending facility to directly guide market interest rates. For the ECB's MRO and the PBoC's 7d OMO reverse repo, they both play a dual role of a policy rate and a liquidity management tool. That said, unlike its global peers, the PBoC does not explicitly commit to unlimited lending at the ceiling of the corridor.

The MLF no longer serves as a key policy rate

On 24 March, the PBoC made a material move by revising the interest rate bidding form for the medium-term lending facility (MLF) to “multi-price bidding” from “single-price bidding”; this effectively removes the MLF rate from its role as a (medium-term) policy rate, which has been the case since 2014. On 27 March, Deputy Governor Xuan Changneng made a few informative remarks on China’s monetary policy framework, including: 1) the PBoC is gradually shifting away from “quantitative objectives” and placing greater emphasis on the role of interest rate control (Figure 1); 2) the PBoC has designated the 7d OMO reverse repo rate as a policy rate (Figure 2), while the role of the MLF rate as a policy rate has been downplayed to avoid excessive policy signals and misguiding market expectations; 3) the adjustment to MLF operations to a multi-price bidding system means the MLF rate is no longer considered a policy rate. This marks the first official comment on phasing out the role of MLF rate as a policy rate since 2014.

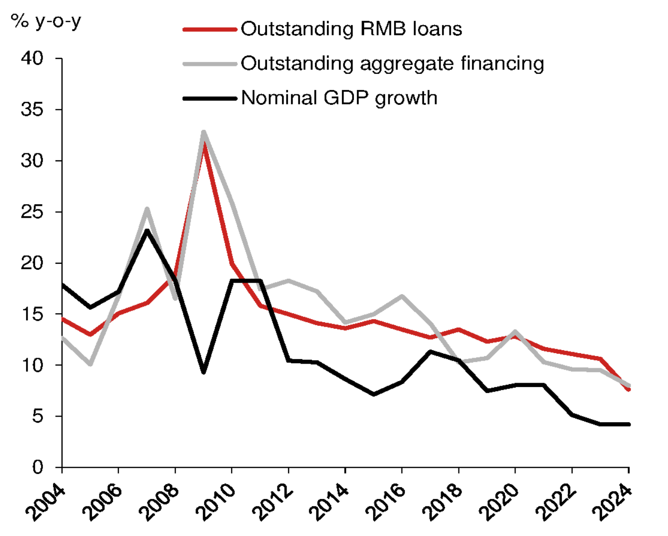
On 25 February, the PBoC conducted a RMB300bn MLF operation, with the MLF rate at 2.0%. On 31 March, alongside the release of monthly operation data for outright reverse repo (ORR) and CGB trading, the PBoC reported that the outstanding MLF balance stood at RMB4.16trn at end-March, with no information on the MLF rate reported. In the past, monthly outstanding MLF balance data were released on the first working day of the month that followed. The absence of the MLF rate, combined with the adjustment on the timing of the data release, indicates the MLF is now purely viewed as a liquidity tool.

Moving away from quantitative objectives

The monetary policy framework in most major developed economies is price-based. In those economies, the key central bank intermediate targets are interbank interest rates, which are, in turn, managed by target rates, interest rate corridors and OMOs, but this is not the case in China. Here, the key intermediate target is credit growth, and the best measure of credit growth is outstanding aggregate financing (AF) growth, which is defined as the growth of all credit to the non-financial sectors including governments.

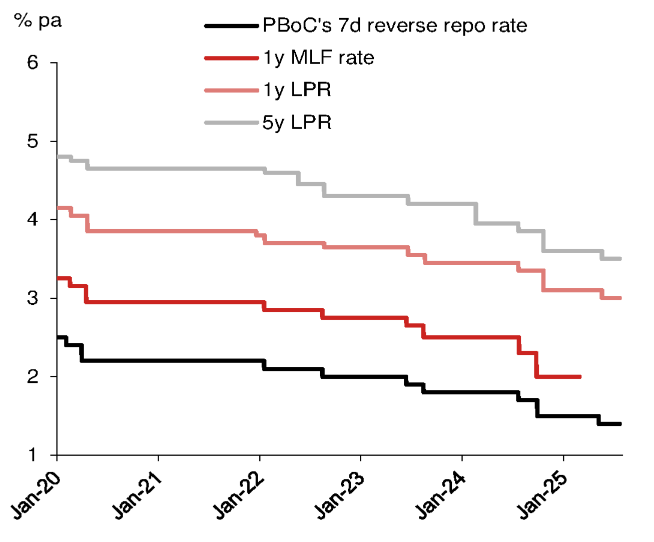
However, the focus on quantitative targets has been downplayed in recent years, especially in 2024. At the Lujiazui Forum on 19 June 2024, Governor Pan criticized banks for their intention to inflate loan data and their obsession with scale expansion. To address those issues, the PBoC worked with the NBS to adjust the accounting method of the financial sector GDP and rectified banks’ behavior of luring depositors with manual interest subsidy. The impact of these measures was significant. Growth of outstanding bank loans slumped by 3.0pp to 7.6% y-o-y at end-2024 from end-2023, with the pace of slowdown at its fastest since 2011. AF growth slowed less significantly, by 1.5pp to 8.0% y-o-y at end-2024, thanks to a surge in government bond issuance, while the flat annual nominal GDP growth at 4.2% in 2023-24 suggests the PBoC is paying less attention to quantitative objectives for credit growth.

Fig. 1: A sharp slowdown in outstanding loan growth in 2024



Note: Nominal GDP growth in 2020-21 was presented with average growth in these two years to smooth out Covid-led distortions and reflect trend growth.
Source: PBoC, Wind, Nomura Global Economics.

Fig. 2: China's benchmark lending rates



Note: No subsequent updates on the MLF rate since February 2025.
Source: Wind, Nomura Global Economics.

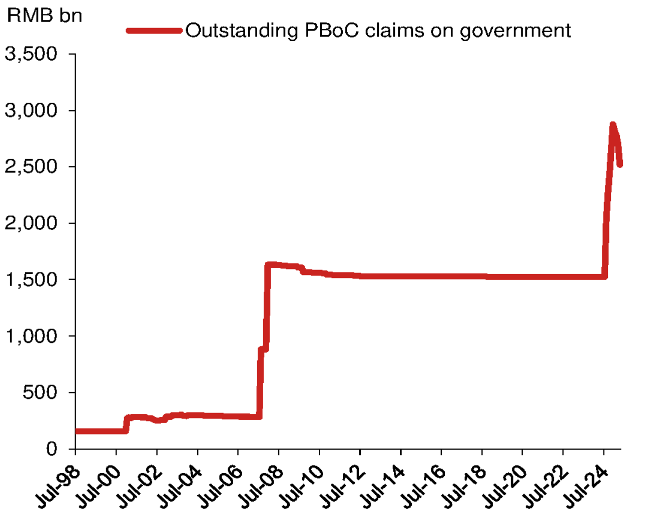
Not an abrupt reform

Over the past year, the PBoC has already taken several steps to reform its monetary policy framework. These steps include the designation of the 7d OMO reverse repo rate as the main policy rate and a tweak in its bidding form, an attempt to narrow the interest rate corridor, the resumption of CGB trading, the introduction of ORR and a large drawdown of the MLF balance. We provide a summary of key events in this regard:

- In March 2024, a new book that compiles President Xi's thoughts on China's financial sector was published. In the book, some comments made to financial cadres at the Central Financial Work Conference (CFWC) on 30 October 2023 *caught wide attention from markets* . These comments include "it is necessary to enrich the monetary policy toolbox", and "the PBoC must gradually increase the trading of CGBs in its open market operations". These instructions led to a resumption of CGB trading in August 2024, after being halted for two decades.
- On 19 June 2024, at the annual Lujiazui Forum, PBoC Governor Pan Gongsheng delivered a speech entitled, *China's current monetary policy stance and the evolution of its future framework* , and made several groundbreaking statements. First, Mr Pan said the PBoC will consider refining its official policy rates and will define the short-term rate (7d OMO rate) as the "main policy rate", and reduce the role of other rates as policy rates (namely, the 1yr MLF rate). Second, Mr Pan said that, in order to improve the monetary transmission mechanism, the PBoC may have to make efforts to narrow the interest rate corridor. Third, echoing President Xi's comments at the CFWC, Mr Pan confirmed that the trading of CGBs by the PBoC in the secondary market will become a new method for creating base money. In retrospect, Mr Pan's speech at the Lujiazui Forum preceded several major reforms.
- On 1 July 2024, the PBoC decided to borrow CGBs from primary dealers of open market operations in coming periods.
- On 8 July 2024, the PBoC announced that it will carry out *temporary overnight repo or reverse repo operations* , depending on the market situation during working days between 16:00 and 16:20. Interest rates for the temporary overnight repo and reverse repo will be set at 20bp below and 50bp above the 7d OMO reverse repo rate, respectively, as their operations will be conducted through "quantity bidding at a fixed interest rate". The announcement came shortly after Governor Pan said the PBoC will designate the 7d OMO reverse repo rate as the main policy rate and seek to narrow the interest rate corridor.
- On 22 July 2024, the PBoC announced *a 10bp cut to 7d OMO reverse repo rate* , alongside 10bp cuts to both 1yr and 5y loan prime rate (LPR). The bidding form was officially revised to "quantity bidding at a fixed interest rate" from "interest rate bidding", although the interest rate was mostly unchanged due to its role of policy rate. On the same day, the 1yr MLF rate was left unchanged until 25 July, when it was lowered by 20bp. A larger cut at a later timing than LPR, which is the benchmark lending rate in China, suggested the MLF's role of policy rate was fading.
- Also, on 22 July 2024, in order to increase the supply of tradable bonds, the PBoC announced that banks with the demand for selling medium- to long-term bonds could apply for a temporary reduction or exemption of collateral when obtain MLF funding.
- In August 2024, the PBoC finally restarted trading CGBs (Figure 3), with a net purchase of RMB100bn. According to the PBoC's balance sheet data, its claims on the central government (mainly CGBs) increased by RMB500bn in August, which suggests the PBoC might have borrowed RMB400bn in CGBs from markets. The PBoC net purchased a total of RMB1.0trn in CGBs in August-December 2024, before its trading of CGBs was suspended in January 2025, as the PBoC has been concerned about *falling CGB yields* .
- On 28 October 2024, the PBoC unveiled the outright reverse repo to enrich its monetary policy toolbox. The policy tool is carried out once a month, with a tenor of no more than one year. The operation will be conducted in the form of "fixed-quantity, interest rate bidding and multi-price bidding". Unlike pledge repos, which is the operation model for MLF and the mainstream model of China's money market, collateral under the outright reverse repo will not be frozen in the account of the fund lenders and could be circulated in the secondary market. From October 2024 to May

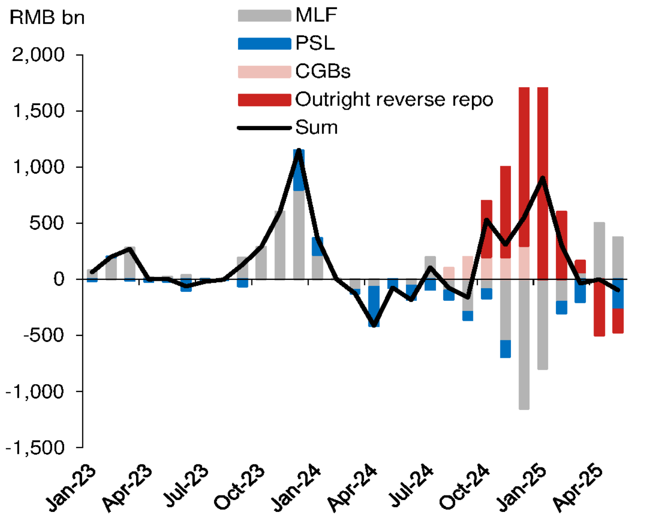
2025, the balance of outright reverse repo increased by a staggering RMB4.4trn (Figure 4), while the MLF balance dropped by RMB1.8trn.

Fig. 3: PBoC resumed CGB trading in August 2024



Source: Wind, PBoC, Nomura Global Economics.

Fig. 4: PBoC's liquidity injection via various tools



Source: PBoC, Wind, Nomura Global Economics.

Why phase out the MLF rate?

Over the past decade, the MLF has played a crucial role in expanding the monetary base and guiding medium-term market interest rates. For more than 10 years following the turn of the century, the PBoC's purchases of FX were its major channel to increase base money (Figure 5). However, the massive capital outflows in 2014-16 forced the PBoC to use other new instruments to expand its monetary base, with the MLF a major option. In 2019, MLF rate emerged as China's primary policy rate, as the PBoC tied the loan prime rate (LPR) to it and established the LPR as the new benchmark for bank lending rates. However, as the balance of MLF grew over time and swelled to a record high of RMB7.3trn by February 204, its shortcomings become too large to overlook.

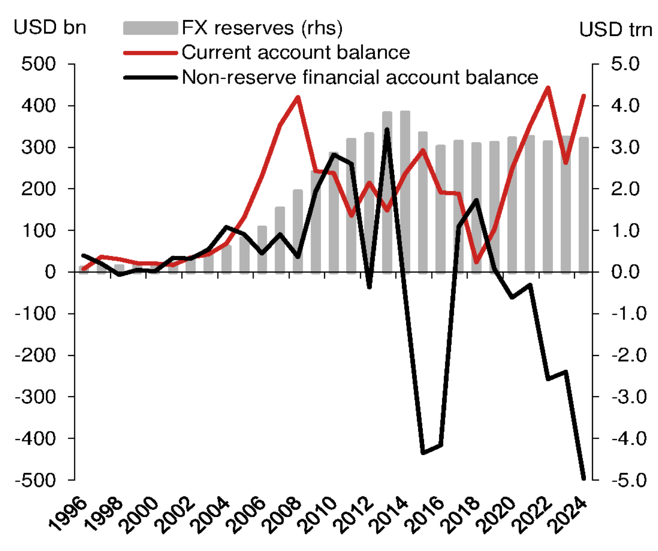
MLF, operating as a "pledged repo", limits the supply of tradable bonds
The collateral pledged by banks to secure MLF funding from the PBoC is locked at the central bank and cannot be traded in markets. Since a significant portion of MLF collateral consists of CGBs, the PBoC ends up holding a substantial amount of CGBs that cannot be traded, which hinders the development of China's bond markets. Other liquidity tools, such as pledged supplementary lending (PSL), relending/rediscounting face similar issues. The introduction of the outright reverse repo, which allows funding lenders to trade collateral in markets, aims to fix this issue and increase the supply of tradable bonds.

According to the PBoC's Q3 2023 Monetary Policy Report, banks hold 64% of outstanding CGBs, while this share is less than 7% in the US and Japan. At end-February 2024, when the MLF balance peaked (Figure 6), outstanding CGBs reached RMB30.0trn, while the total outstanding amount of MLF, PSL, relending/rediscounting was about RMB15.0trn. In other words, a large scale of CGBs have been purchased by banks and, in turn, pledged to the PBoC against borrowing, with a sizeable part of CGBs not traded in markets.

According to remarks made by former PBoC Governor Yi Gang in 2021, China's CGBs, especially long-term ones, have a relatively low turnover ratio, with that of 10y and longer CGBs less than 100% and much lower than the 530% in the US. On market pricing, the average bid-ask spread in China's CGB market is notably wider than in the US.

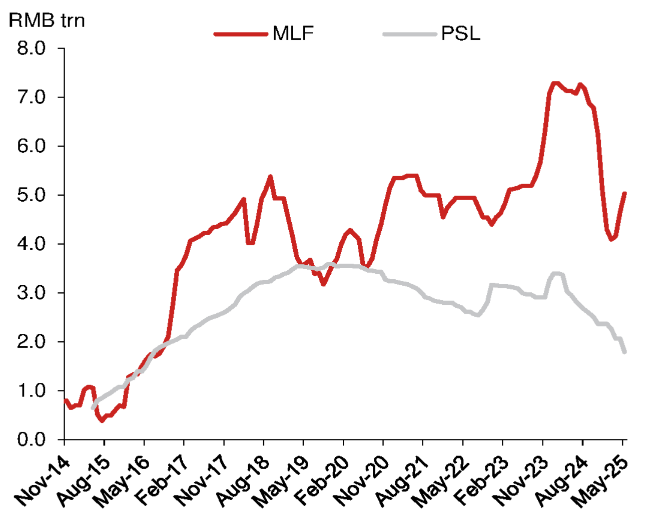
Mixed signals from the two-tier policy rate system
Under the previous two-tier policy rate system, which is featured by the 7d OMO reverse repo rate as the short-term policy rate and the 1y MLF rate as the medium-term policy rate, there appears a lack of linkage between these two policy rates. Throughout most of 2020-23, these two policy rates moved in lockstep. However, *on 15 August 2023*, the PBoC delivered a 10bp cut to the 7d OMO reverse repo rate but a larger 15bp cut to the 1y MLF rate, sending a confusing policy signal to markets. Moreover, the pass-through from the 1y MLF rate to the LPR is not completely effective. For example, despite the 15bp cut to the 1y MLF rate on 15 August 2023, the 5y LPR (the benchmark for mortgage rates) was unexpectedly left unchanged in August until a 25bp cut later in February 2024.

Fig. 5: Massive capital inflows in 2000s



Source: PBoC, Wind, Nomura Global Economics.

Fig. 6: Outstanding amount of MLF and PSL



Source: PBoC, Wind, Nomura Global Economics.

New tools to manage longer-term liquidity

Since the MLF rate is no longer considered a policy rate, MLF becomes a pure quantity-based policy tool. However, its role as a liquidity tool could also be downplayed in the future, due to the collateral drawback from its operation form of "pledged repo". To fill the gap left by the MLF and stabilize base money, the PBoC will need to rely more on outright reverse repo and CGB purchases, especially due to limited room to cut the RRR (Figure 7).

ORR and CGBs: New liquidity tools to replace MLF

Compared with the MLF, the ORR offers greater flexibility, as it transfers ownership of the pledged securities to the PBoC, allowing the PBoC to trade the securities. The purchase of CGBs is even simpler, with no collateral involved at all. The funding term for MLF is one year, whereas ORR, since its debut in October 2024, has been conducted only in 3m and 6m tenors. When the ORR was unveiled on 28 October 2024, the PBoC made it clear that the tenor of the ORR is no more than one year. The funding term for CGBs is far more flexible, as it could fully depend on the maturity of CGBs acquired.

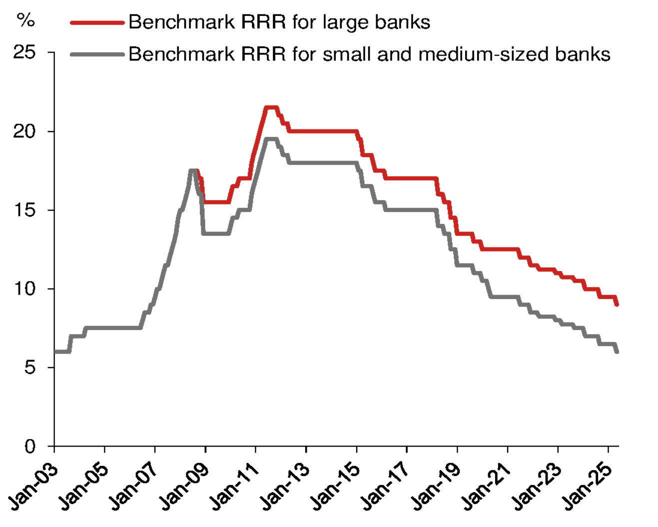
Regarding their impact on market interest rates, the MLF and ORR will have a larger impact on short-end rates, due to their focus on shorter durations (3m, 6m and 1y), while the impact of CGB purchases depends on the duration of CGBs acquired. Moreover, trading CGBs would help the PBoC maintain more stable interbank rates, as it could directly trade with banks instead of just using fixed rate reverse repos and repos. In August 2024, the PBoC re-entered the bond market by selling long-term bonds and buying short-term bonds, with a net purchase RMB100bn, underscoring its intent to steepen the yield curve at that time.

The substitution away from MLF/PSL to ORR and CGBs is evident. From October 2024 to May 2025, a total of RMB4.4trn in funding was injected via the ORR. The PBoC net purchased a total of RMB1.0trn in CGBs in August-December 2024, before the suspension in January 2025. By contrast, the outstanding MLF balance dropped by RMB2.2trn from end-July 2024 to end-May 2025. As PSL faces a similar collateral drawback, its outstanding amount shrank by RMB938bn over the same period.

Supply constrain is a hurdle for the PBoC's purchases of CGBs

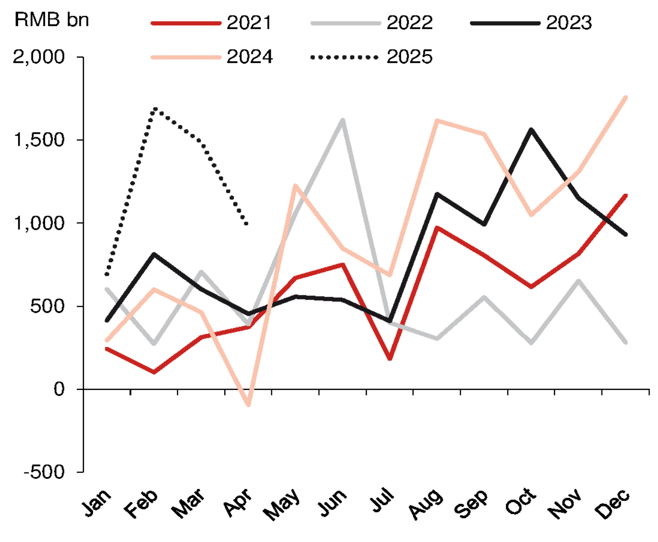
However, CGB purchases may face some constraints, especially when bond supply is scarce or unstable (Figure 8). Relying on CGBs to manage base money and liquidity conditions requires consistently large and steady bond issuance to prevent unintended swings in bond yields. China's bond market is still in a formative stage. The turnover ratio of CGBs is relatively low, and the bid-ask spread is relatively wide. The PBoC's shift to an increased reliance on CGB purchases requires better coordination with fiscal policy. Indeed, at a policy briefing on 14 January, Mr Zou, who was then the director of the Monetary Policy Department and is now the deputy governor of the PBoC, suggested that factors, including low issuance of CGBs, alongside the need to avoid disrupting investors' allocation needs, mitigate market fluctuations and ensure the long-term stability of the bond market, led to the suspension of the PBoC's purchases of CGBs.

Fig. 7: Benchmark RRR for large banks vs smaller banks



Source: Wind, Nomura Global Economics.

Fig. 8: Volatile government bond supply



Note: Data refer to net government bond financing under AF.
Source: PBoC, Wind, Nomura Global Economics.

Two interest rate corridors

China's official interest rate corridor is structured with the 7d SLF rate as the ceiling and the interest rate on excess reserves (IOER) as the floor. Through daily OMOs, the PBoC aims to guide short-term market rates, particularly the DR007, to move around the policy rate of the 7d OMO reverse repo rate, within the corridor. However, this corridor appears too wide to be meaningful, prompting the PBoC to introduce a new, narrower corridor in mid-2024, with the overnight repo rate as the ceiling and the overnight repo rate as the floor. Although the PBoC has yet to carry out any overnight repo or reverse repo operations, DR001, rather than DR007, appears to have become the new targeted short-term market interest rate subject to the new interest rate corridor.

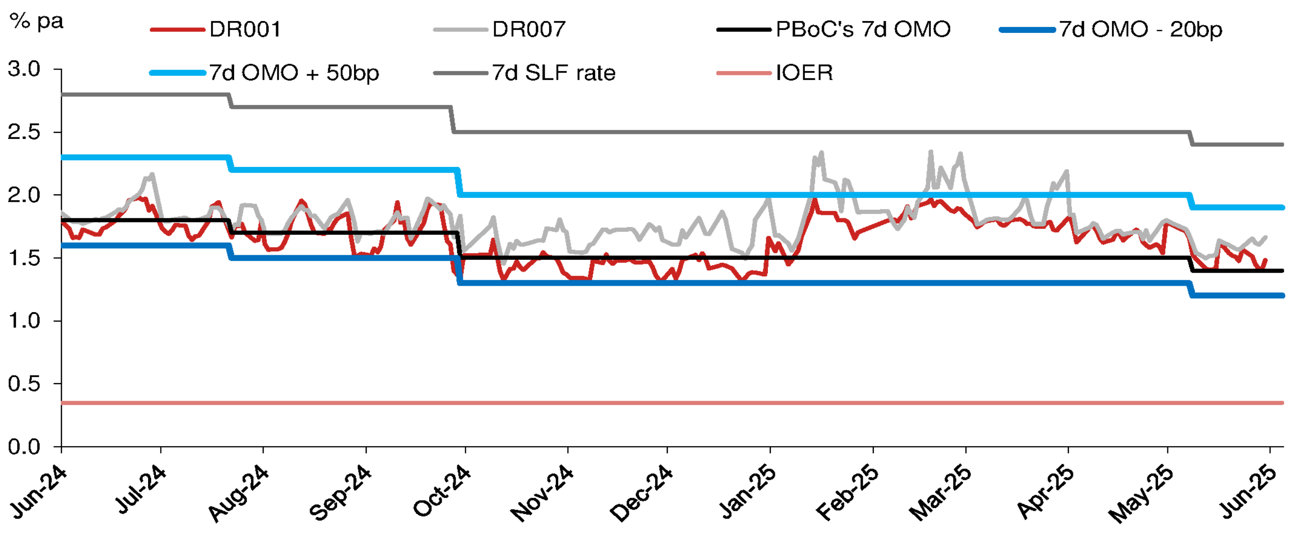
The "official" corridor

The current official interest rate corridor, according to the PBoC, is the range between the 7d SLF rate and IOER. The SLF is a tool used by the central bank to provide short-term funds to financial institutions on demand, and the PBoC sets the 7d SLF rate at the 7d OMO reverse repo rate plus 100bp. The IOER is the rate at which the central bank makes interest payments on the excess reserves deposited by financial institutions. Currently, the range of the official interest rate corridor is 205bp, with IOER and the 7d SLF rate at 0.35% and 2.40%, respectively (Figure 9). Through daily OMOs, the PBoC aims to guide short-term interbank rates, especially the 7d repo rate for depositary institutions (DR007), to move around the policy rate of 7d OMO reverse repo, within the interest rate corridor. However, the corridor has two major deficiencies. First, it is simply too wide to be meaningful. Second, while the lower bound is effective, the PBoC does not explicitly commit unlimited lending at the upper bound.

A new and narrower corridor

On 19 June 2024, Governor Pan said the official corridor is too wide and a narrower corridor is needed to signal a clearer target to assure the market. On 8 July 2024, the PBoC announced that it would carry out temporary overnight repo or reverse repo operations, depending on the market situation during working days between 16:00 and 16:20. Interest rates for the temporary overnight repo and reverse repo were set at 20bp below and 50bp above the 7d OMO reverse repo rate. We believe this much narrower band of 70bp represents the PBoC's latest effort to narrow the interest rate corridor. Although the PBoC has yet to carry out any overnight repo or reverse repo operations, the overnight repo rate for depositary institutions (DR001), rather than DR007, have moved within the new interest rate corridor, which means DR001 might have become the new targeted short-term interbank rate.

Fig. 9: Two interest rate corridors



Source: PBoC, Wind, Nomura Global Economics.

Interest rate corridor: The PBoC versus its global peers

As the 7d OMO reverse repo rate becomes the dominant policy rate, a new and narrower interest rate corridor is in the making, China's interest rate corridor starts to resemble those of Western economies, especially that of the euro area leading up to the Global Financial Crisis (GFC). The ECB's interest rate corridor is composed of three key interest rates:

- The Deposit Facility (DF) rate, which is the interest rate banks earn on overnight deposits placed at the ECB and the lower bound of the corridor.
- The Marginal Lending Facility (MLF) rate, which is the interest rate banks pay to borrow overnight loans from the ECB and the upper bound of the corridor.
- The Main Refinancing Operations (MRO) rate, which is the interest rate banks pay to obtain weekly borrowings from the ECB and the middle point of the corridor.

By providing liquidity through the MLF, DF and MRO, the ECB aims to steer short-term money market rates, particularly the Euro Overnight Index Average (EONIA), towards the MRO rate. The width of the corridor was about 200bp prior to 2008.

As China's overnight repo rate, overnight reverse repo rate, 7d OMO reverse repo rate and DR001 are analogous to the DF rate, MLF rate, MRO rate and EONIA, respectively, in the euro area, the PBoC's interest rate corridor functions more like that of the ECB, especially prior to the GFC. After the GFC, like many other central banks in advanced economies, the ECB conducted large-scale lending operations and asset purchases, with liquidity provided beyond the volume required to satisfy reserve requirements. As a result, the market clearing interest rate settled closer to the floor of the ECB's interest rate corridor, which is the DF rate. To regain control over short-term market rates, the ECB adopted a fixed-rate full allotment (FRFA) for MRO, which allows banks to access unlimited liquidity against eligible collateral at a fixed rate (see *Box: The evolution of ECB operational framework*).

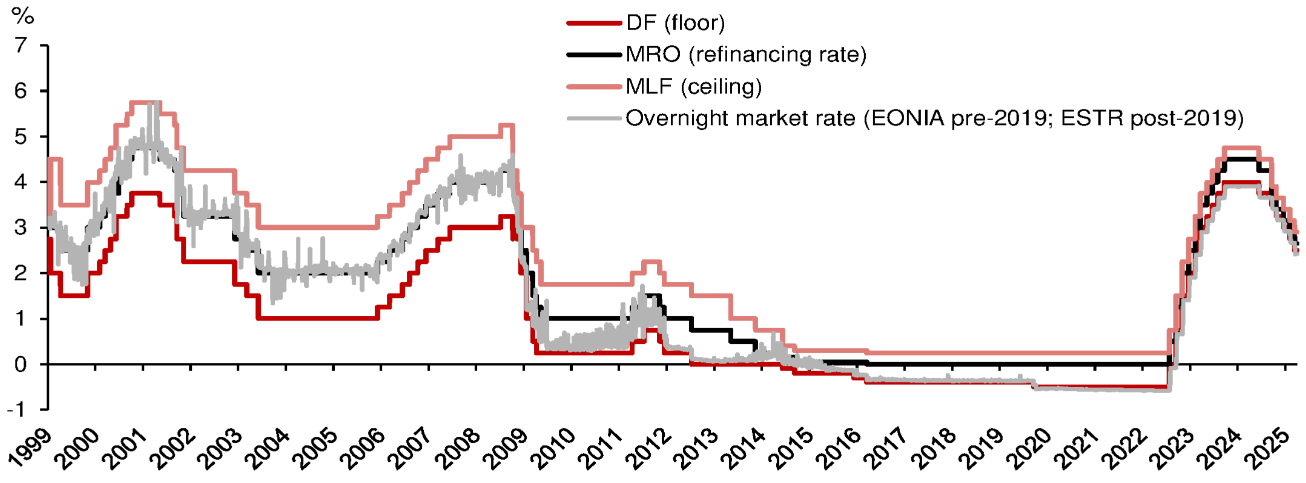
The PBoC's interest rate corridor is less similar to that of the Fed. In the Fed's interest rate corridor, the current upper bound is the interest rate on reserve balance (IORB), the lower bound is the interest rate on overnight reverse repo purchase agreement (ON RRP), and the Fed sets a narrow target range for the federal funds rate (FFR) to ensure it moves within the corridor. Compared to the ECB and PBoC, the Fed's interest rate corridor is simpler, as it does not rely on a policy rate for direct lending to banks and guiding market interest rates. For the ECB's MRO rate and the PBoC's 7d OMO reverse repo rate, they act as both a policy rate and a liquidity management tool.

Fig. 10: Interest rate corridors in selected central banks

		PBOC	ECB	FED	BOJ
Corridor	Key rate	7-day OMO	Main refinancing operations rate	Fed fund target rate range	Uncollateralized overnight call rate
	Ceiling	OMO + 50bp	Marginal lending facility rate	Inteterest rate on reserve balance	Complementary lending facility rate
	Floor	OMO - 20bp	Deposit facility rate	Overnight reverse repurchase rate	Complementary deposit facility rate
Corridor gap		70	30	15	25
Targeted market rate		DR001	ESTR	EFFR	TOAR

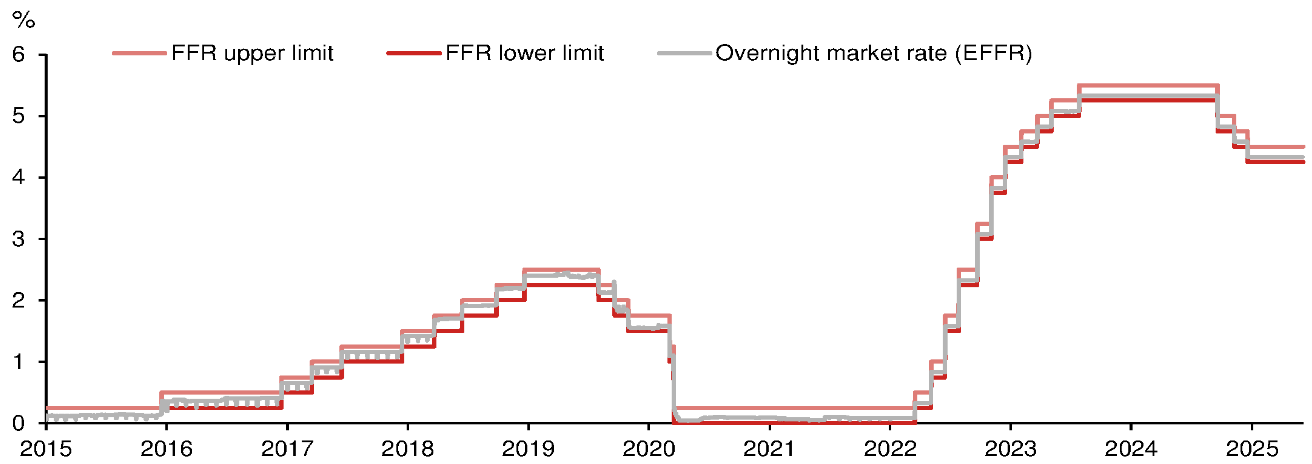
Source: Nomura Global Economics.

Fig. 11: ECB interest rate corridor



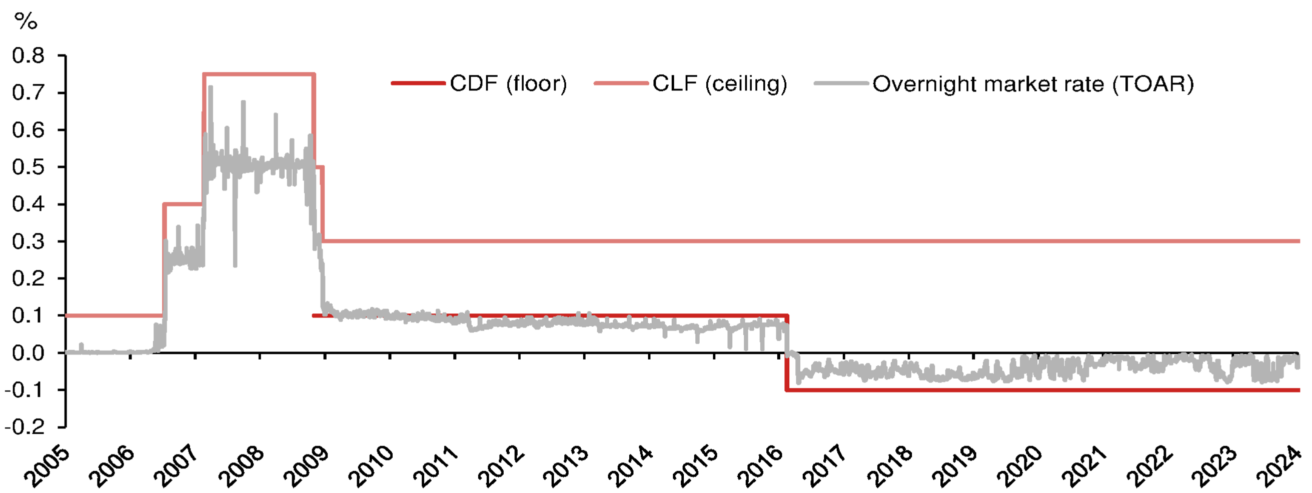
Source: Wind, Nomura Global Economics.

Fig. 12: Fed funds corridor



Source: FED, Nomura Global Economics.

Fig. 13: BOJ interest rate corridor



Source: BOJ, Nomura Global Economics.

Box: The evolution of ECB operational framework

Since the introduction of the euro in 1999, the ECB's operational framework for effecting monetary policy has undergone a significant transformation, though the three key policy interest rates have remained unchanged. These rates are defined as: (1) the Deposit Facility (DF) rate, which governs overnight deposits that banks place with the ECB at a pre-set interest rate and are the primary tool for steering monetary policy as of March 2024; (2) the Main Refinancing Operations (MRO) rate, which applies to weekly borrowing by banks from the ECB against broad collateral at a predetermined rate set above the DF rate; and (3) the Marginal Lending Facility (MLF) rate, which provides overnight credit to banks against broad collateral at a rate positioned above the MRO rate. Over the past 25 years, the ECB's approach to managing these rates and the broader monetary environment has evolved in response to changing economic conditions, shifting from a corridor system to a de facto floor system.

Pre-2008 corridor system

Prior to the GFC, the ECB operated within a corridor system designed to steer short-term market rates, such as the Euro Overnight Index Average (EONIA), toward the MRO rate, which served as the corridor's midpoint. This framework relied on the ECB's provision of liquidity through operational instruments, primarily via auction-based MROs. The ECB estimated the aggregate liquidity needs of the banking system and supplied the requisite reserves, maintaining a corridor width averaging 200 basis points between the DF and MLF rates. This wide spread encouraged interbank market activity—where banks lend to and borrow from one another – while keeping the ECB's balance sheet relatively lean. Effective steering of the market rate within the corridor, with some tolerance for volatility around the MRO, depended on two critical conditions: first, a robust understanding and predictability of banks' autonomous liquidity requirements; and second, an efficient interbank money market capable of redistributing liquidity among banks.

Post-2008 shift to a floor system

The 2008 GFC disrupted this framework. The interbank market effectively froze, as banks ceased lending to one another and began hoarding liquidity, driving interbank funding costs sharply higher. To regain control over short-term market rates, the ECB transitioned to a fixed-rate full allotment (FRFA) tender procedure, allowing banks to access unlimited liquidity against eligible collateral at a fixed rate. This shift fundamentally altered the operational framework: liquidity provision was no longer solely determined by the ECB's estimates but became demand-driven, reflecting banks' preferences. Consequently, the system evolved into an abundant reserve or "floor" system, where the short-term market rate gravitated toward the DF rate, the lower bound of the corridor. Following the initial crisis in 2008, the overnight market rate briefly rose above the MRO during a period of stabilization but collapsed again in 2011 amid the sovereign debt crisis. This evolution, illustrated in Figure 11, highlights the ECB's transition from a corridor system pre-2008 to a de facto floor system thereafter.

Unconventional policies and excess liquidity

As policy rates approached the zero lower bound, the ECB introduced unconventional measures, including asset purchase programs. The Pandemic Emergency Purchase Programme (PEPP), launched in 2020, drove excess liquidity in the euro area to a historic peak of nearly €4.7trn by mid-2022. During subsequent monetary tightening efforts, the ECB began reducing its balance sheet, resulting in a decline in excess liquidity of approximately €1.5trn by 2024. This contraction reflects a deliberate effort to drain excess reserves and recalibrate monetary conditions.

Recent adjustments and future directions

In March 2024, the ECB announced a refinement to its framework, reducing the spread between the DF and MRO rates from 50bp to 15bp. This adjustment aims to enhance the attractiveness of MRO borrowing by narrowing the cost differential between central bank refinancing and deposit remuneration, potentially encouraging a greater reliance on MROs. The decision underscores the ECB's ongoing efforts to adapt its operational tools amid changing liquidity dynamics. However, whether the ECB should fully revert to a corridor system, restoring the pre-2008 emphasis on steering market rates within a defined range, or maintain a variant of the floor system that has prevailed since the crisis, remains an open question.

Deposit rates remain crucial for policymaking

Despite the PBoC's extensive efforts to streamline policy rates, form a western-style interest rate corridor and rectify banks' practices of attracting deposits with manual interest subsidies, the transmission from the policy rate to bank deposit rates remains elusive. Bank deposit rates are still heavily controlled by regulators. To incentivize banks to lower lending rates and protect their net interest margins, window guidance on deposit rate cuts is provided to six major state banks and 12 national joint-stock banks, while small local banks might have some discretion on setting their own deposit rates, as small banks in general are at a disadvantage to larger peers in attracting deposits.

Reforms to bank deposit rates since the spring of 2022
The interest rate reform in 2019 only involved bank lending rate, with no actions on deposit rates. To align with the new LPR regime, in June 2021, China's self-discipline mechanism for market interest rate pricing, a regulatory body under the PBoC's window guidance, announced a revision to deposit rate pricing rules. Specifically, the new rules cap bank deposit rates pricing from a "multiple of benchmark deposit rates" to "benchmark rate +/- some basis points (bp)".

LPRs were lowered a few times after the reform in 2019, while benchmark deposit rates were left unchanged at 1.5% for an extended period of time. To reduce banks' cost burden, in April 2022, the PBoC set up a new mechanism to link deposit rates with 10y CGB yields and the 1yr LPR. As the LPR is attached to the PBoC's policy rate, we believe the mechanism enables the PBoC to regain control of bank deposit rates, in addition to guidance on the upper limit of deposit rates. Following this reform, major state-owned banks started to cut benchmark deposit rates in *mid-September 2022*, followed by smaller banks. This marked the first such cut in benchmark deposit rates since 24 October 2015.

On 8 June 2023, state banks announced a broad range of cuts to their deposit rates at different tenors, which were followed by *a 10bp cut to the 7d OMO reverse repo rate* on 13 June 2023. The earlier cut to deposit rates clearly suggests that deposit rates remain crucial for policy making, as banks will only lower lending rates if they are able to lower deposit rates. Since September 2022, there have been seven rounds of LPR cuts, which were accompanied by seven rounds of despite rate cuts.

Seven rounds of deposit rate cuts since the reform in spring 2022
Since the reform in April 2022 to link deposit rates with 10yr CGB yields and 1yr LPR, there have been seven rounds of deposit rate cuts.

- On 19 May, state banks announced a new round of deposit rate cuts, following the 10bp cut to 7d OMO reverse repo rate on 7 May. Interest rates for demand deposits were lowered by 5bp to 0.05%, while interest rates for 3m, 6m, 1yr and 2yr time deposits were lowered by 15bp to 0.65%, 0.85%, 0.95%, 1.05%, respectively, and for 3y and 5yr time deposits, interest rates were lowered by 25bp to 1.25% and 1.30%, respectively. On 20 May, both the 1y and 5y LPR were lowered by 10bp. Compared to the 10bp LPR cut in July 2024, this deposit rate cut was slightly larger in scale. For example, the interest rates for 1y and 5y time deposits were lowered by 10bp and 20bp, respectively, in July 2024, while in May, they were lowered by 15bp and 25bp. The larger cut to deposit rates highlights regulators' intent to protect banks' net interest margins.
- *On 18 October 2024*, interest rates for demand deposits were lowered by 5bp to 0.1%, while those for 3m, 6m, 1yr, 2yr, 3yr and 5yr time deposits were lowered by 25bp to 0.8%, 1.0%, 1.1%, 1.2%, 1.5% and 1.55%, respectively. This round of cuts was announced after a 30bp cut to the 1yr MLF rate, a 20bp cut the 7d OMO reverse repo rate on 27 September, and a 25bp cut to both 1y and 5y LPR.
- *On 25 July 2024*, following *the 10bp cut* to the 7d OMO reverse repo rate, 1yr LPR and 5y LPR on 22 July, interest rates for 3m, 6m and 1y time deposits were lowered by 10bp to 1.05%, 1.25% and 1.35%, respectively, while those for 2yr, 3yr and 5y time deposits were lowered by 20bp to 1.45%, 1.75% and 1.80%, respectively, with a 10bp cut also made to large-scale certificates of deposit.
- *On 22 December 2023*, interest rates for 1y (or less), 2y, 3y and 5y time deposits were lowered by 10bp, 20bp, 25bp and 25bp, respectively, to 1.45% (only for 1yr), 1.65%, 19.5% and 2.0%, with larger cuts made to large-scale certificates of deposit (25bp cut for 2y and 30bp cut for 3y). This round of deposit rate cuts made room for

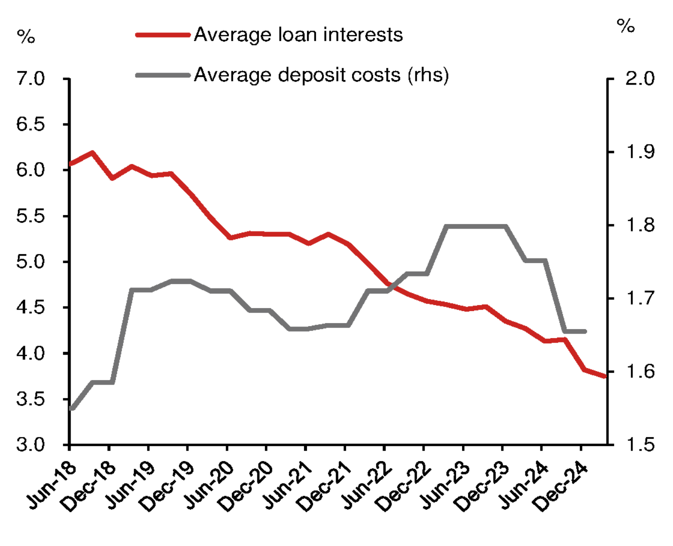
the 25bp cut to 5yr LPR on 20 February 2024.

- *On 1 September 2023*, interest rates for 1y, 2y, 3y and 5y time deposits were lowered by 10bp, 20bp, 25bp and 25bp, respectively, to 1.55%, 1.85%, 2.20% and 2.25%. This round of cuts was mainly undertaken to allow banks to reduce existing mortgage rates. According to estimates from the PBoC, during the adjustment of existing mortgage rates in September-December 2023, interest rates for over RMB23trn of outstanding mortgage loans were lowered by an average of 73bp to an average level of 4.27%.
- *On 8 June 2023*, interest rates on demand deposits were lowered by 5bp to 0.20%, while interest rates for 2y, 3y and 5y time deposits were lowered by 10bp, 15bp and 15bp, respectively, to 2.05%, 2.45% and 2.50%. The deposit rate cut was followed by *a 10bp cut to the 7d OMO reverse repo rate* on 13 June 2023.
- *On 15 September 2022*, interest rates on 3y time deposits were lowered by 15bp, while those for other tenors were lowered by 10bp, which marked the first such cut since 24 October 2015. This cut was made after *the 10bp cut* to both the 7d OMO reverse repo rate and 1yr MLF rate on 15 August 2022.

Deposit rate cuts have had little impact on lowering banks' funding costs
The seven rounds of deposit rate cuts since mid-2022 have had a limited impact on banks' average deposit costs. According to our estimates, the average deposit cost of listed banks was stuck in a narrow range of 1.6-1.8% during 2021-24 (Figure 14) for a few reasons: 1) the rates that banks pay on existing deposits (which are also much larger) are not deducted, as the lower deposit rates will only be applied to new deposits, 2) thanks to the unpromising return from risky assets, households have gradually shifted savings from demand deposits to time deposits (instead of equity market etc.) to secure a higher rate amid previous rounds of cuts, and 3) before April 2024, some banks offered manual interest subsidies to attract households' savings and enlarge their deposit base, but such behavior has been curbed by the PBoC, so it is less of a concern now.

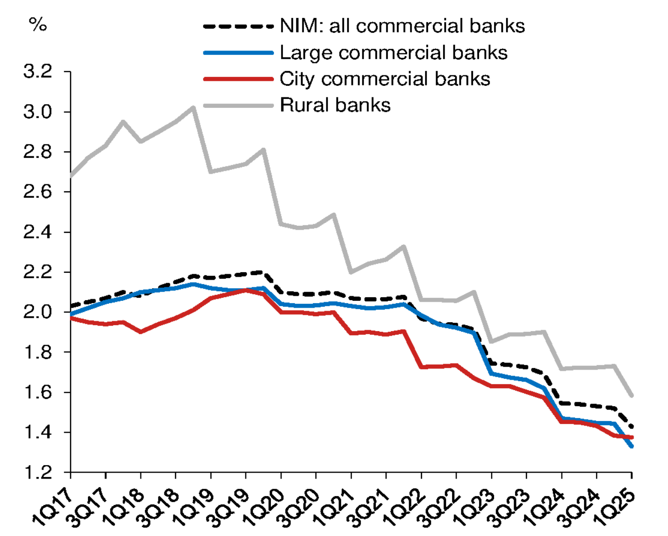
Squeezed margins: Shrinking the profitability of banks
Sticky deposit costs, combined with repeated loan interest rate reductions, have heavily squeezed bank profitability. Net interest margins (NIMs), the gap between loan revenue and deposit costs, have been shrinking. According to the National Financial Regulatory Administration, commercial banks' weighted average NIM dropped to a record low of 1.43% in Q1 2025, from 1.54% in Q1 2024, 1.74% in Q1 2023 and 1.97% in Q1 2022 (Figure 15). At the March NPC meeting, Beijing approved RMB500bn in special central government bonds to inject capital at the six state-owned banks, but smaller banks still grapple with low capital buffers. The narrowing NIMs make the implementation of rate cuts challenging for the PBoC.

Fig. 14: Bank's average deposit cost and loan interests



Note: Deposit costs is the average of that reported by ICBC, CCB, ABC, CMB, PAB and PSBC.
Source: Wind, Nomura Global Economics.

Fig. 15: Bank's NIM by bank type



Source: WIND and Nomura Global Economics.

Fig. 16: Adjustments on bank's deposit rates since 2015

Adjustment Date	Demand deposit	3 month	6 month	1 year	2 year	3 year
May 2015						
Bechmark deposit rate (%)	0.35	1.10	1.30	1.50	2.10	2.75
Upper limit on deposit rate (%)						
Big banks	Benchmark * 1.4					
	0.49	1.54	1.82	2.10	2.94	3.85
Small & medium banks	Benchmark * 1.5					
	0.53	1.65	1.95	2.25	3.15	4.13
June 2021						
Upper limit on deposit rate (%)						
Big banks	Benchmark + 10bp	Benchmark + 50bp				
	0.45	1.60	1.80	2.00	2.60	3.25
Small & medium banks	Benchmark + 20bp	Benchmark + 75bp				
	0.55	1.85	2.05	2.25	2.85	3.50
April 2022						
The PBoC guided banks to refer to 10-yr treasury bond yields and 1-yr LPR to reasonably adjust deposit interest rates, and encourage small and medium banks to lower their upper limit of deposit rates by 10bp. This move effectively grants the PBoC greater control over deposit rates, on top of the existing guidance on the upper limit of deposit rates.						
On April 25, many state-owned and joint-stock banks lowered their upper limit and listed deposit rates by around 10bp, with 2-yr and 3-yr terms being the primary maturities.						
According to the PBoC monetary policy report, during the last week of April, the weighted average interest rate for new deposits was 2.37%, down 10bp from the previous week.						
September 2022						
On September 15, the six largest banks and China Merchants Bank announced a reduction in their listed deposit rates, with the interest rates for 3-yr deposits lowered by 15bp, that for 1-yr and 5-yr deposits lowered by 10bp, and that for demand deposits lowered by 5bp. This is partly in reponse to the rate cut in in August. On 22 August, the PBoC lowered 1-yr and 5-yr LPR by 10bp and 15bp, respectively.						
On September 16, joint-stock banks such as CITIC, Everbright, Minsheng, Ping An, Shanghai Pudong Development Bank, China Guangfa Bank, and China Huarong Bank also announced rate cuts, with demand deposit rates generally cut by 5bp, and the interest rates for various tenors of time deposits cut by 10-50bp.						
According to PBoC monetary policy report in 3Q 2022, the weighted average deposit rate in September was 2.30%, down 14bp from early April.						
April 2023						
This round of deposit rate cut is a catch-up adjustment conducted by small and medium-sized banks that did not performed rate cuts in September 2022, starting from some regional lenders in the southern province of Guangdong in the first week of April and followed by rural commercial banks and credit unions in Hubei and Henan.						
This round of rate cuts is limited to some local banks in certain regions, rather than a nationwide interest rate reduction. The degree of rate cuts varies among different regions and banks. For example, Guangzhou Bank lowered 3-yr and 5-yr deposit rates by 5bp; Guangzhou Chenghai Rural Bank lowered time deposit rates by 5-15bp across tenors; Henan LuoShan Rural Commercial Bank lowered the interest rate for 1-yr, 2-yr, and 3-yr deposits, respectively, by 35bp, 30bp and 45bp, and some banks in Hubei province claimed that they had restored deposit rates to pre-Spring Festival levels, with reductions between 5-15bp.						
May 2023						
In early May, three joint-stock banks, Zhejiang Commercial Bank, Hengfeng Bank, and Bohai Bank announced a reduction in their listed deposit rates, with the largest reductions in the rates for 3-yr and 5-yr deposits, which have both fallen below 3%. The three mentioned joint-stock banks have lowered their demand deposit rates to 0.25%, while the rates for 1-yr, 2-yr, and 5-yr deposits have all decreased to 1.85%, 2.40%, and 2.95%, respectively.						
On 11 May, according to Reuters, the Interest Rate Self-regulatory Mechanism (IRSRM), a regulatory body overseen by the PBoC, urged all banks to lower the ceilings on the rates of "agreement" and "call" deposits, with a 30bp cut for the "big four" state-owned banks and a 50bp cut for other banks, effective 15 May. This type of deposit products account for ~10% of total bank deposits.						
June 2023						
In early June, 10 village banks (including Wuhai Bank in Inner Mongolia, Luohu Lanhai Rural Bank in Shenzhen, Mongolian Bank, Jindu Rural Bank in Dujiangyan, and Hengfeng Rural Bank in Tonglu) announced deposit rate cuts, with the rates for 1-yr deposits lowered by 5-10bp, the rates for 3-yr deposits lowered by 10-24bp, and rates for 5-yr deposits lower by 5-30bp. After the rate cuts, the rates for 5-yr deposit products of the above-mentioned banks have basically fallen below 4%.						
According to Securities Times, on 8 June, large state-owned banks will cut their listed deposit rates, with the rates for demand deposits lowered by 5bp, the interest rates for 2-yr time deposits lowered by 10bp, and the interest rates for 3-yr and 5-yr deposits lowered by 15bp. On 20 June, the PBoC lowered 1-yr and 5-yr LPR by 10bp.						
September 2023						
On 1 September, all six state-owned large banks cut 1-yr, 2-yr, 3-yr and 5-yr deposit rate by 10bp, 20bp, 25bp and 25bp, respectively, to 1.55%, 1.85%, 2.20% and 2.25%. And almost all joint-stock banks also announced similar cuts to their deposit rates. On 21 August, the PBoC cut 1-yr LPR by 10bp.						
In late October, rural commercial banks and village banks cut 1-yr, 3-yr and 5-yr deposit rate by 10bp to 40bp.						
December 2023						
On 21 December, according to Guangzhou Daily, large state-owned banks will cut their deposit rates by 10-30bp from 22 December. Interest rates for 1y (or less), 2y, 3y and 5y time deposits will be lowered by 10bp, 20bp, 25bp and 25bp, respectively, with bigger cuts to large-scale certificates of deposits (25bp cut for 2y and 30bp cut for 3y).						
In early January, small and medium banks lower depositi rate 1-yr, 3-yr and 5-yr by 5-45bp.						
July 2024						
On 25 July, all six state-owned large banks announced to cut listed deposit rate across tenor. Rates for demand deposit were cut by 5bp to 0.15%. 3-month, 6-month, and 1-yr rate were cut by 10bp to 1.05%, 1.25% and 1.35%, respectively. 2-yr, 3-yr and 5-yr rate were cut by 20bp to 1.45%, 1.75%, and 1.80%, respectively.						
October 2024						
On 18 October, all six state-owned large banks announced to cut listed deposit rate across tenor. Rates for demand deposit were cut by 5bp to 0.1%. 3-month, 6-month, 1-yr, 2-yr, 3-yr and 5-yr rates were cut by 25bp to 0.8%, 1.0%, 1.1%, 1.2%, 1.5% and 1.55%, respectively.						
May 2025						
On 20 May, all six state-owned banks announced a new round of cuts to deposit rates. Interest rates for demand deposits were lowered by 5bp to 0.05%, for 3m, 6m, 1yr and 2yr time deposits were lowered by 15bp to 0.65%, 0.85%, 0.95%, 1.05%, respectively, and for 3y and 5yr time deposits were lowered by 25bp to 1.25% and 1.30%, respectively.						

Source: PBoC, Wind, Nomura Global Economics.

Fig. 17: China's benchmark lending rate adjustments

Date	7d reverse repo rate	7d SLF	1yr MLF	1yr LPR	5yr LPR
3 Feb 20	-10bp				
17 Feb 20			-10bp		
20 Feb 20				-10bp	-5bp
30 Mar 20	-20bp				
15 Apr 20			-20bp		
10 Apr 20		-30bp			
20 Apr 20				-20bp	-10bp
20 Dec 21				-5bp	
17 Jan 22	-10bp	-10bp	-10bp		
20 Jan 22				-10bp	-5bp
20 May 22					-15bp
15 Aug 22	-10bp	-10bp	-10bp		
22 Aug 22				-5bp	-15bp
13 Jun 23	-10bp	-10bp			
15 Jun 23			-10bp		
20 Jun 23				-10bp	-10bp
15 Aug 23	-10bp	-10bp	-15bp		
21 Aug 23				-10bp	
20 Feb 24					-25bp
22 Jul 24	-10bp	-10bp		-10bp	-10bp
25 Jul 24			-20bp		
25 Sep 24			-30bp		
27 Sep 24	-20bp	-20bp			
21 Oct 24				-25bp	-25bp
8 May 25	-10bp	-10bp			
20 May 25				-10bp	-10bp

Source: PBoC, Wind, Nomura Global Economics.

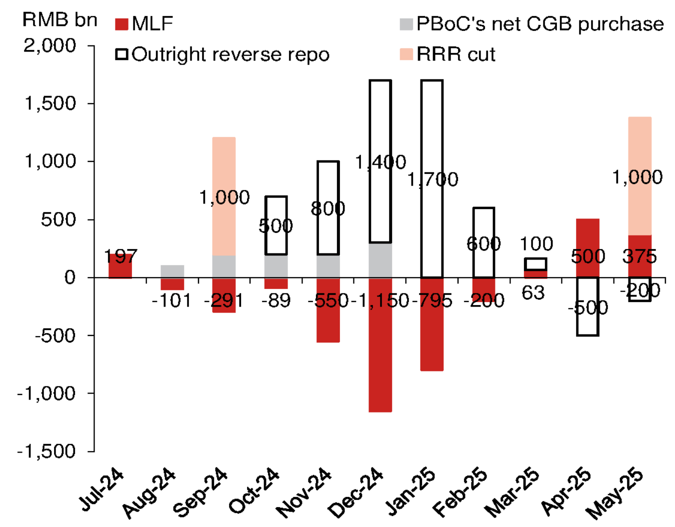
Rates strategy: Implications from the change in monetary policy framework

The PBoC's monetary policy toolbox

Figure 18 reflects the changes in the PBoC's use of liquidity injection tools since H2 2024. Recall that the PBoC introduced **CGB operations** in August 2024 and **outright reverse repos (ORR)** in October 2024. In November 2024 to January 2025, when there were large MLF maturities, the PBoC injected more liquidity via ORR and net CGB buying. The latter was *suspended* in January 2025 though, as it would inevitably lead to lower rates, especially at the front end of the curve. Then, in April and May 2025, when ORR maturities were picking up, the PBoC conducted a larger net injection via MLF. Thus, instead of looking at each monetary policy tool separately, we should view them as a whole to evaluate the PBoC's liquidity stance.

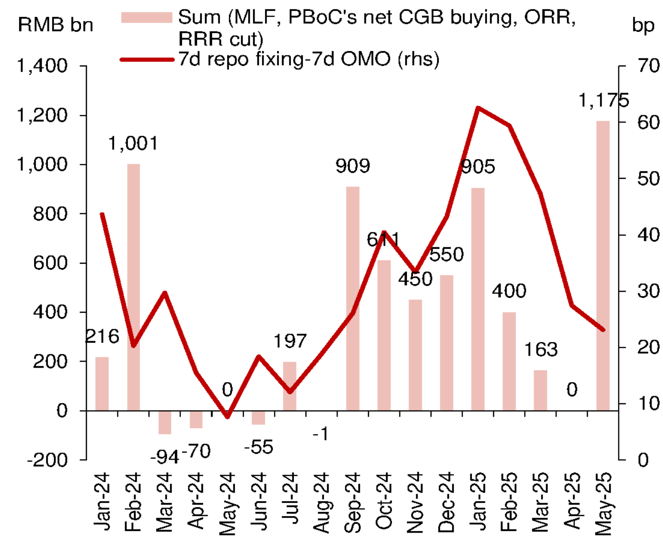
In Figure 19, we take the sum of 1) net injection via ORR, 2) net MLF injection, 3) the RRR cut and 4) net CGB purchases, and compare the number with the 7d repo fixing – 7d OMO rate spread. Generally speaking, since the start of 2024, these two data series display a quite positive correlation. This likely indicates that, for most of the time, the PBoC was reacting to funding tightness with ample liquidity injection, rather than trying to guiding rates lower by injecting more liquidity than necessary to the market. In May 2025, the situation was slightly different, as the PBoC net injected RMB1.175trn of medium- to long-term liquidity and brought the 7d repo fixing further down to just 23bp above 7d OMO rate (from 27bp in April). Considering most of the liquidity was from a 50bp RRR cut (equal to ~RMB1trn of liquidity; Figure 20), we think this was mainly to ensure sufficient liquidity amid elevated government bond supply in May to September.

Fig. 18: The PBoC's monthly liquidity injection



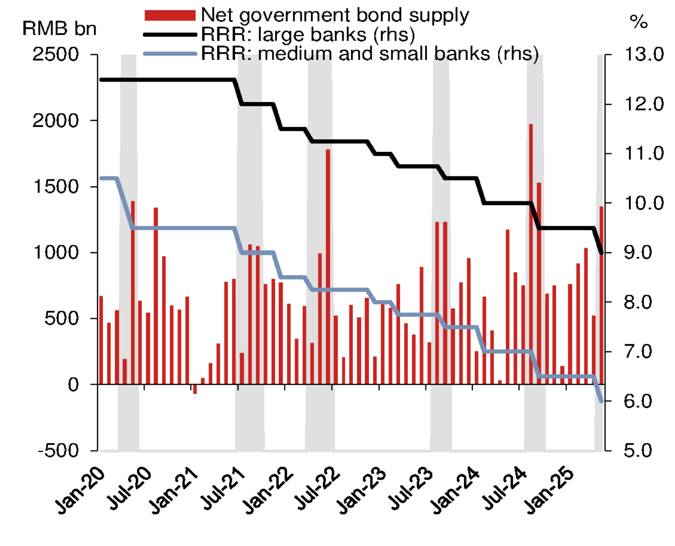
Source: The PBoC, Wind, Nomura

Fig. 19: Liquidity injection and 7d repo fixing



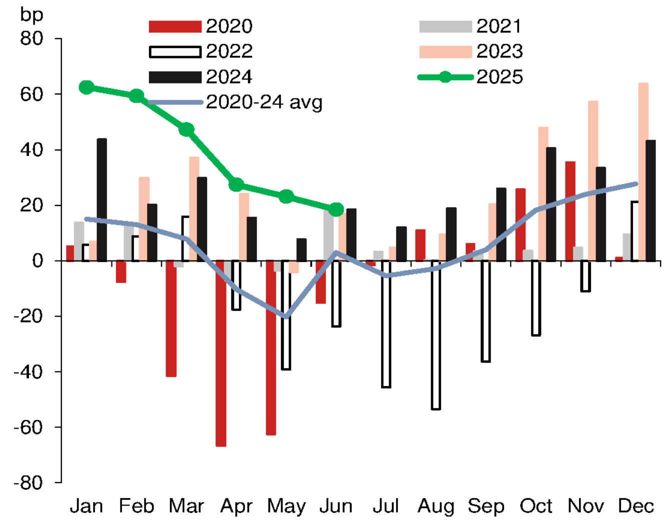
Source: The PBoC, Wind, Nomura

Fig. 20: Net government bond supply and RRR cut



Source: Wind, Nomura

Fig. 21: 7d repo fixing - 7d OMO rate (monthly average; 2020-25)



Source: Wind, Nomura

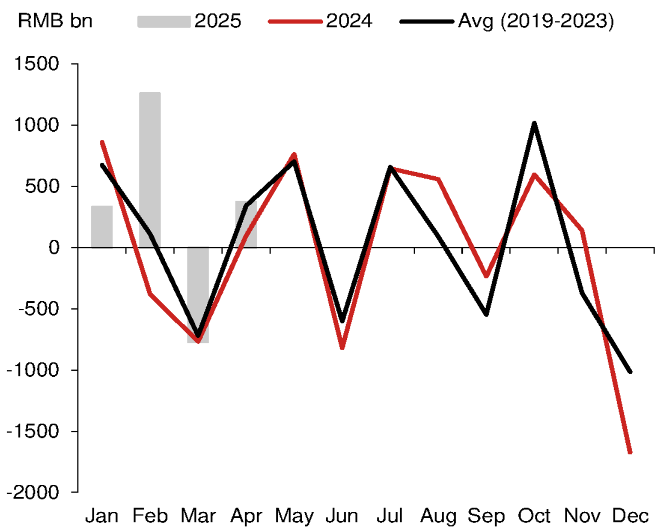
Liquidity: What are the key drivers?

Liquidity, as measured by monthly average spread between 7d repo fixing and 7d OMO rate, has come off to ~25bp in April-May from an average of 56bp in Q1 (Figure 21). This is largely in line with our expectation of 25-35bp in Q2, but closer to the low end of the range of our forecast. As we flagged in our *chart alert*, liquidity could tighten in June on much larger NCD maturities, but at the same time we also expect the PBoC to keep liquidity sufficient and stable via a combination of monetary policy tools – OMO and MLF injection, ORR, or the resumption of CGB trading (buy front-end and sell long-end bonds).

In the first two working days of June, the 7d repo fixing dropped to 1.58-59%. Watch out for the PBoC's liquidity stance starting from next week, as government bond supply is set to pick up amid a surge in NCD maturities. Tax payment and month-end seasonality could add further pressure in the second half of this month.

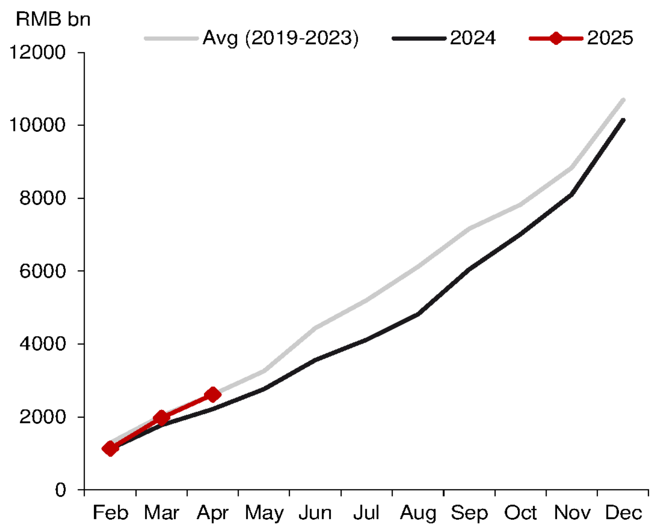
In January-April 2025, fiscal deposits were much higher than what had been the case over the same period in previous years, thanks to RMB1.5trn of local government special refinancing bond supply (half was issued in February; Figure 22). Note that, if government bond proceeds are not spent after being received from markets, they turn into fiscal deposits at banks. At the same time, expenditures from government-managed funds were not rising as fast (higher than in 2024 but similar to 2019-23 average levels; Figure 23). Should expenditure numbers catch up, it could indicate the government is speeding up spending the proceeds of special bond issuance from previous months. This could alleviate the funding tightness in the market as well.

Fig. 22: Fiscal deposits



Source: Wind, Nomura

Fig. 23: Expenditure from government-managed funds

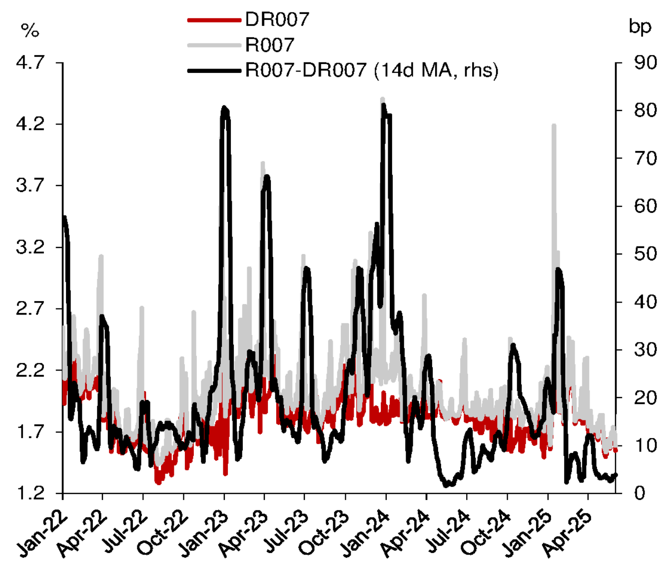


Source: Wind, Nomura

Banks versus non-bank FIs

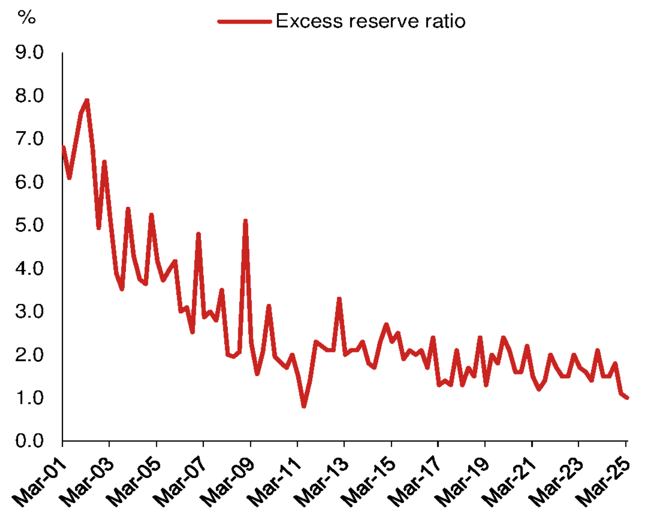
The spread between R007 and DR007 tells us whether non-bank financial institutions (non-bank FIs) face more serious funding issues than banks (yes, if spreads widen). After the PBoC rectified the behavior of luring depositors with manual interest subsidies in April 2024, a few rounds of deposit rate cuts (in July and October 2024, and May 2025), and also thanks to China's interest rate self-disciplinary mechanism (which requires demand deposit rates for non-bank FIs to refer to 7d OMO rate), the R007-DR007 spread stayed in a 0-50bp range for most of 2024 and 2025 YTD with low volatility (Figure 24). This stands in sharp contrast to previous years, when the spread could surge to above 80bp across quarter-end and year-end.

Fig. 24: The R007–DR007 spread



Source: Bloomberg, Nomura

Fig. 25: Banks' excess reserve ratio

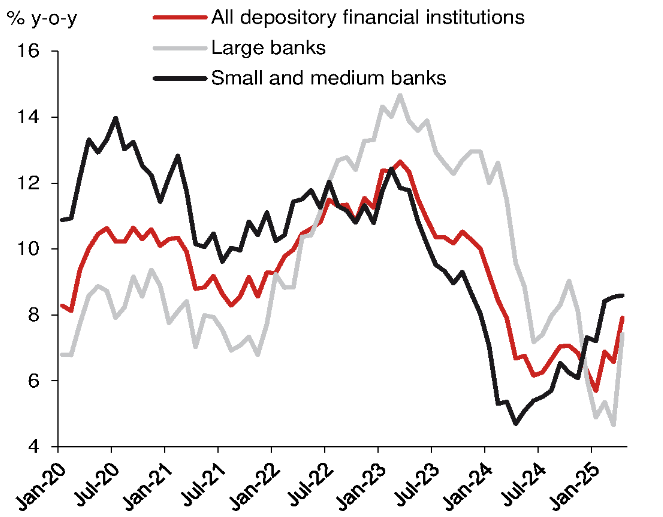


Source: Wind, Nomura

For banks, a sharp decline in deposit growth in 2023 and 2024, and a large outflow of non-bank FI deposits in December 2024 caused them to face tight funding from time to time (Figures 26 and 27). Sometimes, non-bank FIs might even become the liquidity provider to banks (when the R007–DR007 spread is very close to 0). That said, **the issue of a lack of funding/liabilities seems to have improved in recent months, as we start to see a rebound in bank deposit growth.**

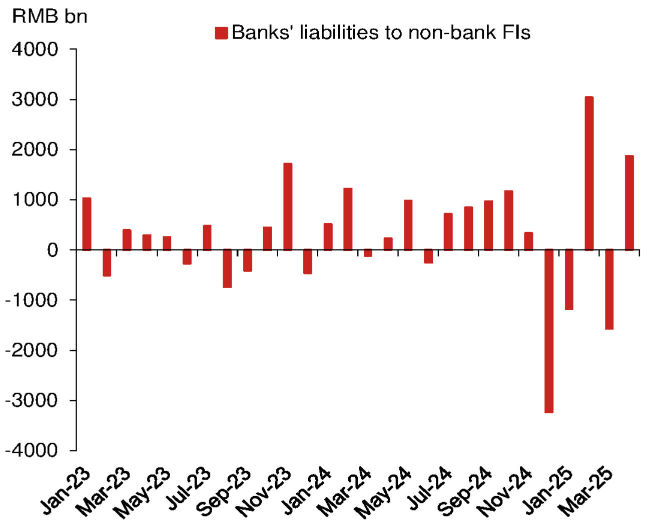
At end-Q1 2025, banks' excess reserve ratio dropped further to 1.0%, the lowest since Q2 2011 (Figure 25). This, and *the PBoC's temporary bond buying suspension* , may also explain why large banks reduced their bond holdings from February to May, as shown in Figure 28. On NCDs, the maturities are set to surge to RMB4.2trn in June from a monthly average of RMB2.3trn in January-May, exerting further pressure on money market rates (Figure 29). Accordingly, despite *10bp of 7d OMO rate cut and a 50bp blanket RRR cut* earlier in May, 1y AAA NCD yields actually moved up by 5bp from the low of 1.66%.

Fig. 26: Bank deposit growth



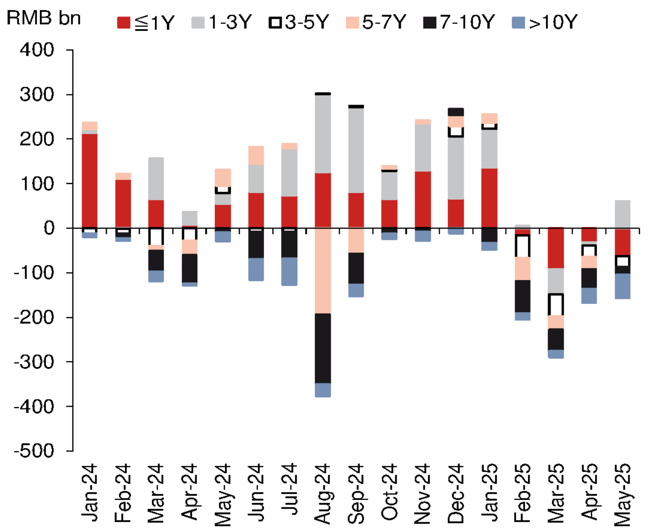
Source: Wind, Nomura

Fig. 27: Bank liabilities to non-bank FIs



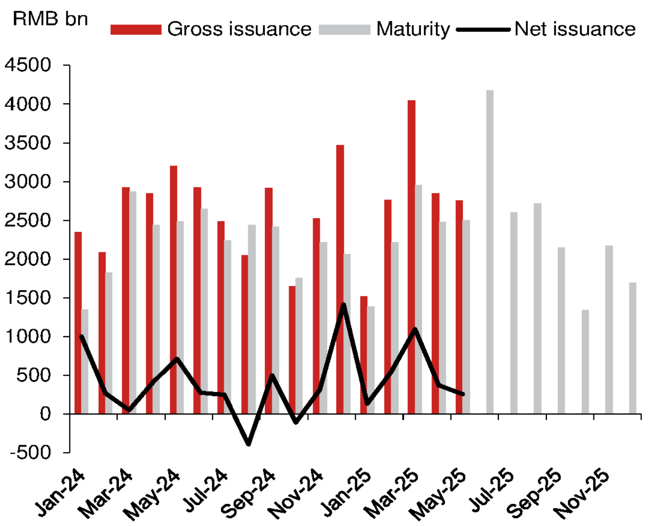
Source: Wind, Nomura

Fig. 28: Large banks' net CGB and PFB buying



Source: iData, Nomura

Fig. 29: NCD supply and maturities

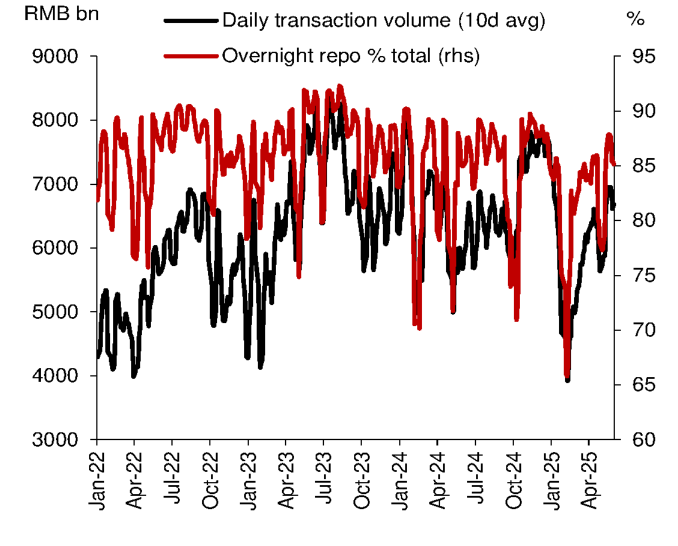


Source: Wind, Nomura

Market leverage and bond trading behavior

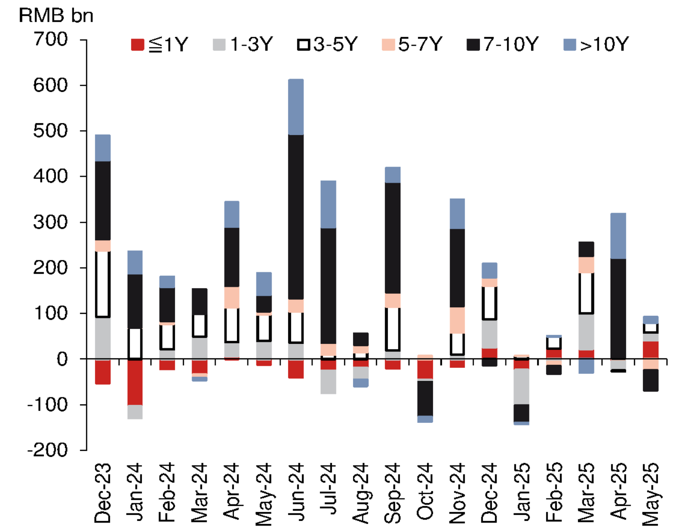
We use daily repo transaction volumes to gauge financial leverage in the market (higher volume means higher leverage; Figure 30). A lower R007 means lower financing costs and thus potentially higher market leverage/borrowing, which could spur onshore fund bond purchases, especially on the long end (Figures 31 to 33). As this moves against the PBoC's preference for a steeper yield curve, **too high market leverage can eventually lead to a rise in funding costs and hence a wider spread between the 7d repo fixing and the 7d OMO rate.** An increase in market leverage in May and June MTD poses some upside risk to the 7d repo fixing. However, this has yet to be shown in aggressive bond buying behavior in the secondary market.

Fig. 30: Repo transaction volume and % of overnight repo



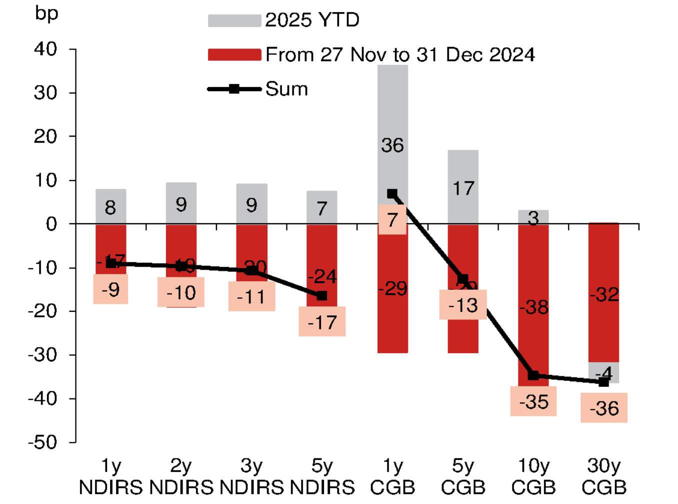
Source: Wind, Nomura

Fig. 31: Onshore funds and other fund products' net CGB and PFB buying



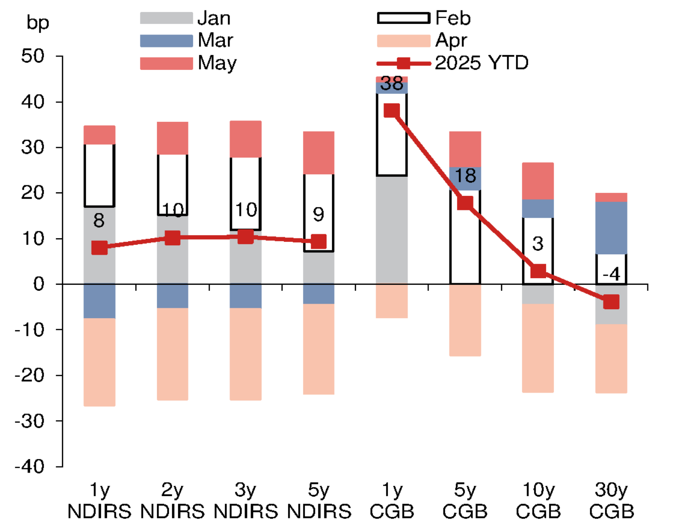
Source: iData, Nomura

Fig. 32: Change in swap rates and CGB yields



Source: Bloomberg, Nomura

Fig. 33: 2025 monthly change in in swap rates and CGB yields - tenor breakdown



Source: Bloomberg, Nomura

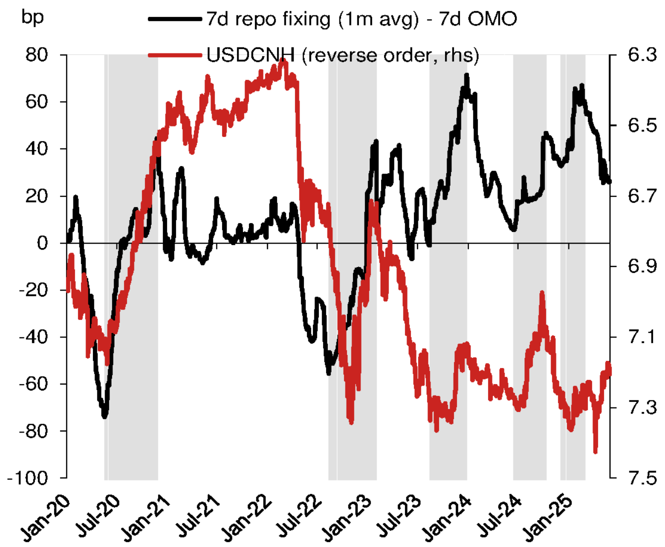
RMB movements and perception

In May-November 2020, August 2022-January 2023, August-December 2023, June-October 2024 and December 2024-February 2025, the spread between the 7d repo fixing (1m avg) and the 7d OMO surged (Figure 34), but in all cases, this occurred after CNH depreciated quickly against USD and/or reached fairly weak levels (i.e., ~7.30).

Note that, in 2020 and 2022, the spread widened by ~100bp (from around -60bp to 40bp). This is because the PBoC allowed the 7d repo fixing to stay below the 7d OMO rate at the beginning, due to weak economic growth during Covid-19 and lockdowns. Later, following a period of sharp RMB depreciation, the PBoC started to adjust the 7d repo fixing to defend the currency. Since 2023, the spread seldom went into negative territory and was only temporarily below zero prior to rate cuts in June and August 2023.

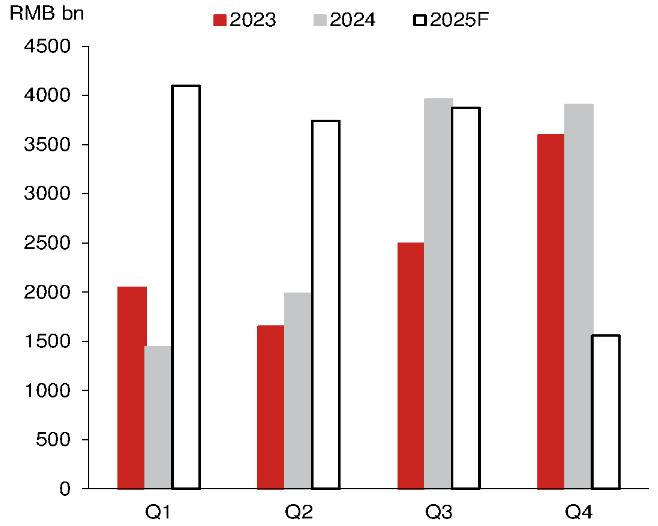
With CNH currently around 7.20 thanks to the deescalation in US-China trade talks, the PBoC would be more comfortable allowing the spread between the repo fixing and the policy rate to stay at current levels.

Fig. 34: 7d repo fixing and RMB movements



Source: Bloomberg, Nomura

Fig. 35: Quarterly net government bond supply - 2025 vs. previous years



Note: For LGB supply, we include LGSRB (local government special refinancing bond) issuance here as well.
Source: Wind, Nomura

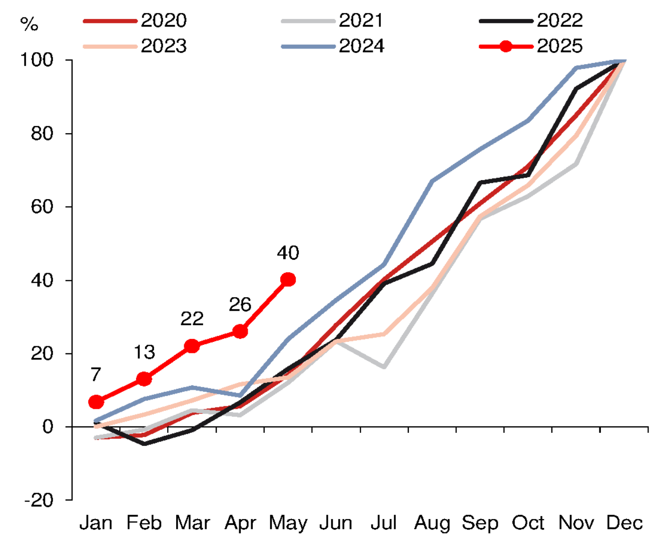
Bond supply

Looking at previous years, when there was large and concentrated bond supply (May 2020, August-September 2021, May-June 2022, August-September 2023 and August-September 2024), the PBoC tended to inject liquidity via RRR cuts to ensure smooth funding in the market (Figure 20). We believe the RRR cut delivered in mid-May served a similar purpose.

According to our estimate, government bond supply should remain elevated until September (Figure 35). As the room for another near-term RRR cut is limited (our economics team forecasts another 50bp in Q4), **we expect the PBoC to be more proactive in liquidity injections via OMOs, ORR, MLF or restart net CGB buying.**

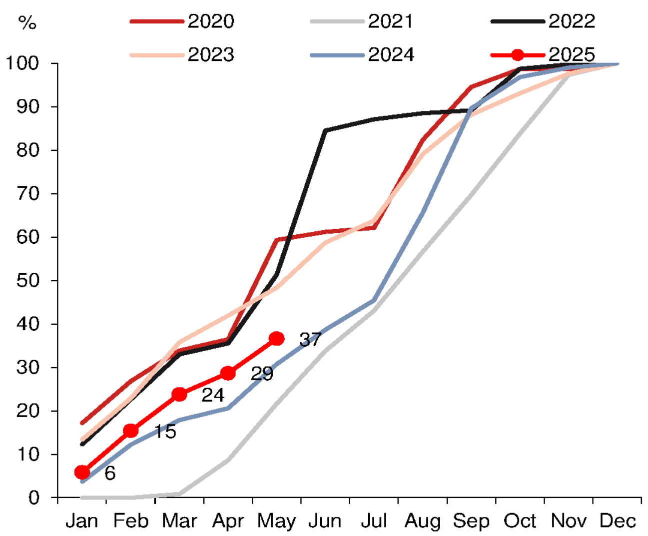
While LGB issuance supply in 2025 YTD looks similar to previous years' average, that of CGBs has been very fast (Figures 36 and 37). **If government bond issuance accelerates further in coming months, it may spur market expectations of an extra bond quota in Q4 (note the high base in 2023-24).**

Fig. 36: Net CGB issuance as % of full-year financing quota



Source: Wind, Nomura

Fig. 37: Net LGB issuance as % of full-year financing quota



Source: Wind, Nomura

Rates strategy

China rates have traded in a very narrow range over the past two weeks. After the long-expected monetary easing measures delivered in May, market focus will likely turn to fiscal and other policy supports. Our economics team expects Beijing to ramp up stimulus in *H2* to get close to its 5% GDP growth target. Also, as mentioned in the above sections, government bond supply should remain high until at least end-Q3. We continue to hold a **Jun-IMM 2s5s steepener** at a conviction level of 3/5, and we **look to pay outright** but prefer to wait for some meaningful positive news (for example, further tariff reductions/concrete stimulus) or more attractive valuation (if 5y swaps trade back to the low end of the range, which is close to 1.40%) before re-initiating such a trade.

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