OBSERVATION

TD Economics

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CHINA CREDIT SQUEEZE: BETTER TO PREVENT THAN TO CURE

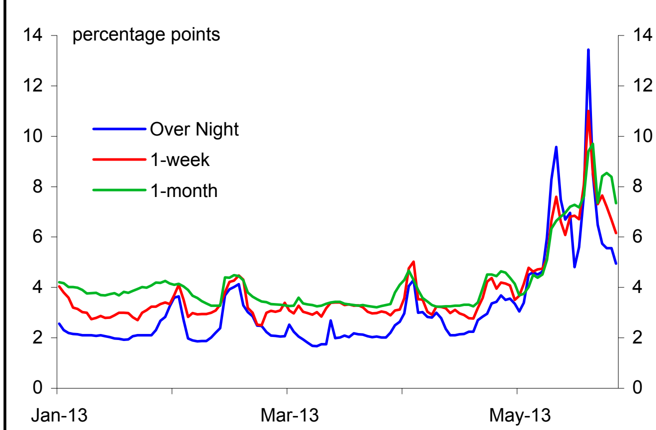
Highlights

- Chinese interbank lending rates spiked last week amid tight liquidity conditions. This week the Chinese central bank denied any responsibility in recent developments and tried to reassure financial markets that liquidity remains adequate and that it will continue to support banks that adhere to its macro-prudential guidance.
- External factors may have also played a role in generating tighter liquidity conditions in China. Both the Shanghai stock market and the renminbi showed signs of tension before jitters showed up in the interbank market.
- To the extent that the PBoC actually intended to show some tough love to Chinese banks by allowing interbank rates to rise, we see this as a positive development. It should encourage banks to strengthen their liquidity and risk-management practices.
- However, the process of unwinding the credit surge of recent years will take time and will likely lead to periods of financial volatility, given that China's financial system has not only grown in size, but also in complexity. One should never disregard the challenge of managing such a situation in an orderly fashion.

The Chinese interbank market has been under pressure in recent weeks. The overnight interbank interest rate has risen above 4.5% since the end of May, 200 basis points higher than its average level in the preceding five months. Last week it spiked to 13.5% and although it has since come down from those highs, it remains elevated. Market analysts and media commentators linked this surge in rates to a lack of liquidity triggered by the reluctance of the People's Bank of China – china's central bank, PBoC – to inject cash into the market. Further, the latter was attributed to a deliberate attempt by the PBoC to impart some discipline to Chinese banks and limit their risk-taking behavior.

The central bank countered those arguments by noting that, as of June 21st, excess reserves in the banking system stood at RMB 1.5 trillion, more than twice the level required to satisfy normal payment and clearing transactions in the Chinese financial system. Moreover, the PBoC claimed that the increase in rates was caused by various factors, including rapid loan growth, the payment of annual corporate income taxes ahead of a deadline, the payment of banks' required reserves, and additional cash demand due to the Dragon Boat Festival holiday. Regardless, the PBoC felt compelled to provide liquidity support to financial institutions "that are in compliance with macro-prudential requirements".

CHINA'S INTERBANK RATES SPIKE IN JUNE



Source: Bloomberg, TD Economics

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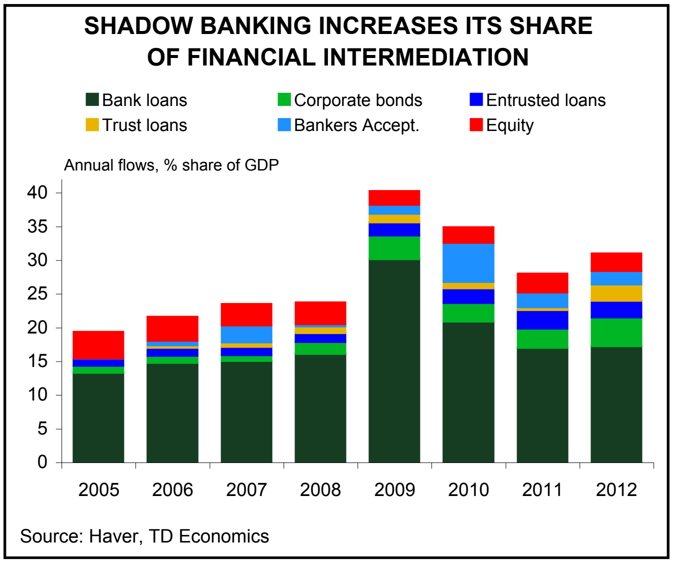


We believe that all the above-mentioned arguments have some merit. First, it is undeniable that Chinese authorities are trying to curb excessive risk-taking in the fast growing shadow banking system. Second, moving away from loan quotas and towards interest rate pricing as the main tool to grant loans has been a long-standing objective on the authorities' agenda.

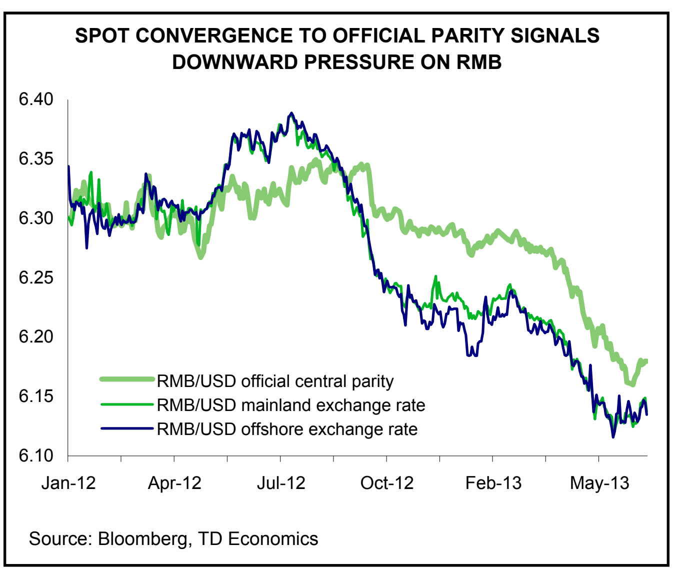
However, the PBoC's timing did overlap with a combination of other factors, including some external ones not mentioned by the central bank. This collision of events contributed to the tightening in interbank market conditions.

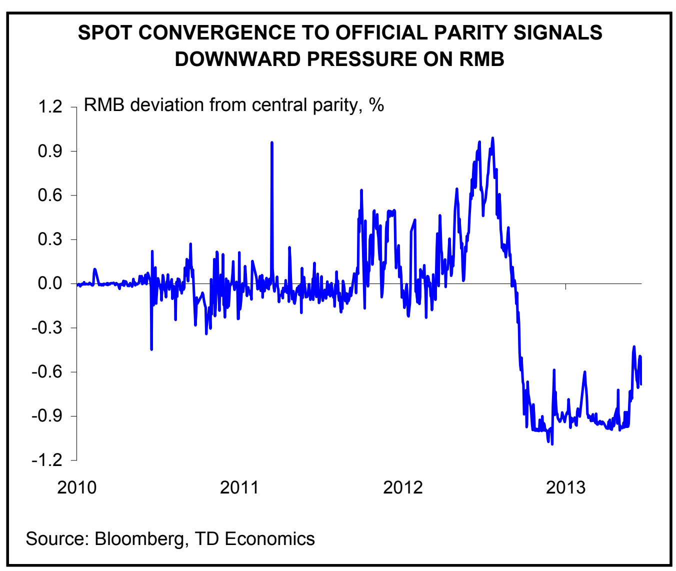
All in all, one has to commend the efforts of Chinese authorities to address mounting financial imbalances, even if this comes at a price of slower economic growth. At the same time, the risks of managing a smooth unwinding of the credit juggernaut of recent years should not be disregarded, even if one trusts the policy levers at their disposal.

Chinese authorities begin to address risks associated with burgeoning shadow banking activities

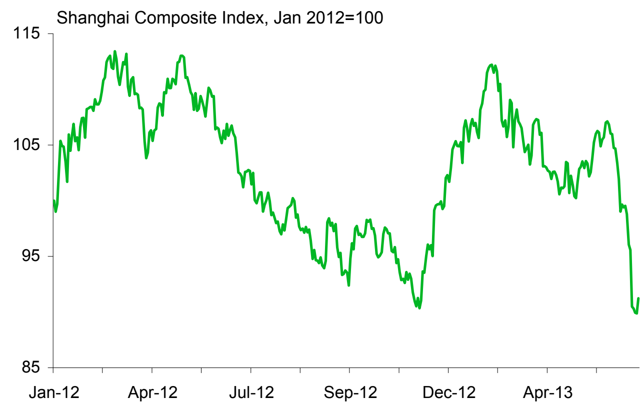
Chinese authorities shielded their economy from the impact of the 2008 global financial crisis by encouraging banks to extend massive amounts of credit. As a result, net new credit reached 40% of GDP in 2009. In 2010 and 2011, the central bank and the banking regulator sought to curb excessive credit growth to tame booming real estate activity that was leading to excessive price appreciation. This led to a deceleration in credit growth, with new credit falling to a still high 28% of GDP in 2011.

However, tighter regulatory oversight in traditional bank lending encouraged the development of non-traditional channels of credit intermediation. Chinese banks and other financial market participants set out to circumvent lending quotas, interest rate caps, prohibitions on local governments' debt issuance, and other restrictions. In doing so, they increasingly engaged in non-traditional credit intermediation activities – broadly referred to as "shadow banking". These include trust loans and entrusted loans, bankers acceptances, corporate bonds, etc. The issuance of these instruments has been facilitated by a surge in wealth management products (WMPs). These are similar in nature to mutual funds, insofar as they pool investors' money to buy a wide array of assets. WMPs are typically of short maturity and offer higher interest rates than bank deposits. These characteristics have made them very popular in China, even among small investors tired of earning negative real rates on bank deposits. There are no official statistics on the stock of



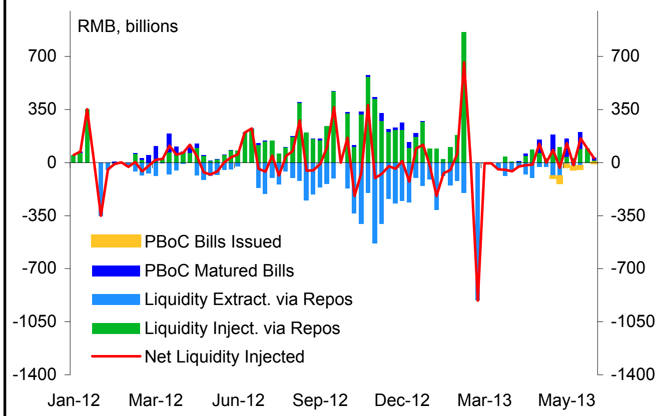


CHINESE STOCKS FELL AS INVESTORS REACTED TO TAPERING TALKS BY THE FED



Source: Bloomberg, TD Economics

PBoC HAS LESS LIQUIDITY TO MOP UP VIA OPEN MARKET OPERATIONS



Source: Bloomberg, TD Economics

outstanding WMPs, but some estimates put them at RMB 12 trillions, or roughly 23% of GDP.

This year, if total credit creation maintains the pace it has shown during January-May, new credit flows will end 2013 near 38% of GDP. Market commentators believe that the PBoC's awareness of this trend prompted it to send a tangible warning to Chinese banks that they should adhere to more prudent practices. The latest data shows that, even as Shibor rates remained well above normal levels, the central bank only injected RMB 25 billions via repos this week, a modest figure consistent with more normal market conditions.

But domestic conditions do not operate in a vacuum, external factors matter

There are other elements that might have contributed to the more stringent liquidity conditions in the Chinese interbank market. In particular, emerging markets have been selling off since Fed Chairman Bernanke signaled that a reduction of their quantitative easing program could begin in the coming months. This also had repercussions in China. As the accompanying charts show, both the decline in Shanghai's stock market and the recent reversal of the RMB appreciation trend that had been in place since February preceded the spike in rates in the interbank market. These two facts combined signal that capital flows turned less supportive of domestic liquidity in China as in most other emerging markets. A government crackdown on export over-invoicing – a backdoor channel for unauthorized capital inflows – during May might have exacerbated the decline in net capital flows into China. Unfortunately, confirmation of this will have to wait until the release of June's foreign exchange reserve position in early-August.

Bottom Line

All in all, to the extent that the PBoC actually intended to show some tough love to Chinese banks by allowing interbank rates to rise, we see this as a positive development. If banks cannot count on unconditional cheap liquidity support from the central bank, it should encourage them strengthen their liquidity and risk-management practices.

However, the process of unwinding the credit surge of recent years will take time and will likely lead to periods of financial volatility, given that China's financial system has not only grown in size, but also in complexity. Having a firm grip on a banking system that is dominated by state-controlled banks and a largely captive deposits' base gives Chinese authorities a good chance to dealing with potential troubles. But, one should never disregard the challenge of managing such a situation in an orderly fashion.

From a macroeconomic perspective, the reaction by the PBoC to recent developments in the interbank market indicates the willingness of the newly inaugurated administration to tolerate slower economic growth in exchange for addressing mounting financial imbalances and pursuing structural reforms. In the short-term, tighter credit conditions will likely lead to a further deceleration in economic activity, suggesting our 7.6% economic growth forecast for China this year may end up being optimistic.

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