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MARKET COMMENTARY

China funding markets: Yes, we can!

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The repo market in China has recently shown signs of stress with rising interest rates and volatility. What does it tell us about China?

In our view, the stresses are deliberately inflicted by a prudent People's Bank of China (PBOC) in a bid to prevent reckless lending in the interbank market. The authorities have the means at any time to end the stress, but in our view the Chinese authorities are likely to stay the course. This should be reassuring to investors.

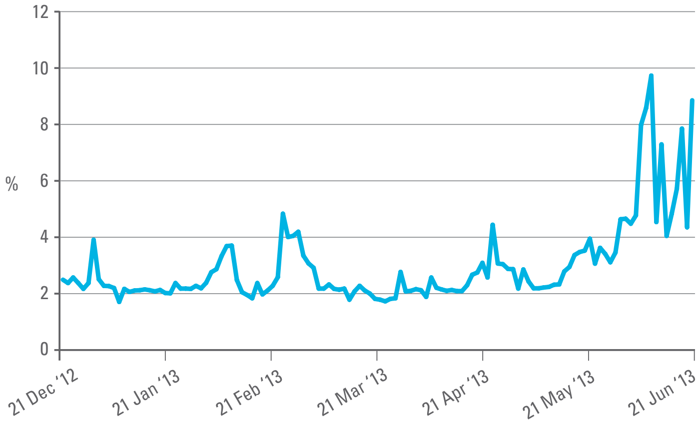
Discipline not recklessness: The Chinese authorities have the power anytime they want to inject liquidity into the interbank market to end the recent stress. They may choose to do so if the stresses increase further. However, so far they have opted not to intervene. This is because the stress in the Chinese reverse repo market over the past few weeks is part of the authorities' effort to reduce regulatory arbitrage by smaller and medium sized banks in the interbank market. As such, this is a prudent measure by the PBOC. Moreover, this tough love from PBOC is part of a broader shift away from credit-fuelled and export-led growth towards more sustainable domestic demand led growth. We are strongly encouraged by what we continue to see in China.

We see no systemic risk. The tightness in the interbank market discourages regulatory arbitrage by some smaller and medium sized banks. They bypassed 100% risk ratings on corporate loans by financing via reverse repos with larger banks, enabling them to reduce capital requirements on loans by nearly 75%. The authorities are rightly clamping down on this activity. A small number of mid-sized banks are affected.

Overall liquidity in the Chinese financial system is adequate. Broad money is growing faster than target (15.8% growth in M2 versus target growth of 13% in May). Deposits are growing faster than loans, so the loan-to-deposit rate is gently declining (64% in Q1 versus 65% in Q4). Chinese banks are liquid with average excess reserves of 1.5% with respect to required liquidity ratios (20% for large banks, 18% for smaller banks).

There are other reasons for the temporary liquidity squeeze. First, PBOC has gradually reduced deposits by 1.4% this year as part of a gradual tightening of policy amidst a solid economic backdrop and a likely pickup in activity in H2 2013. Second, FX inflows dropped sharply in May (to RMB 67bn from RMB 1.5trn Jan-May) as speculation over Japanese flows provided unfounded and Fed

Fig 1: **China interbank market 1 day repo rate**



Source: Bloomberg.

tapering talk intensified. Authorities have also rightly clamped down on FX inflows dressed up as export receipts. Seasonality has also played a part.

China is further ahead than any other country on the planet in terms of transitioning its economy from export to domestic led growth. This rotation to domestic demand led growth is being done in order to ensure that the overall economy can continue to grow when the CNY begins to strengthen significantly against the US Dollar. This strengthening becomes inevitable, in our view, when inflation begins to rise in the United States and HIDCs (Heavily Indebted Developed Countries) over the next few years. The rotation to domestic demand led growth will require greater reliance on interest rate management of the economy, which in turn requires a healthy interbank market. It is in this context that the tough stance adopted by the PBOC has to be understood.

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