What you need to know about short-term volatility in China

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One on One with Jason Yat Sing Pang

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Q **Jason, we saw the money market rates in China spike in mid-December 2013, with the 7-day repurchase rate increasing from 4.5% in early December to 8.5% on 20 December before gradually returning to 4.8% the week of 6 January 2014. Can you please give us some background on this short term volatility and perhaps touch on a few of the causes?**

A There have been two notable spikes in the one-week repo rate in 2013. The first one was on the 20 June and the second was on 20 December. There are usually two to three headlines every year about liquidity squeezes, and 2013 was no exception. We attribute two major reasons behind the price action:

- First and foremost, seasonality plays a large factor in the Chinese liquidity system. June and December are typically key periods where banks raise cash levels to meet regulatory reporting requirements and financial account reporting. Deposit rates and money market rates typically rise during these periods and tend to normalise shortly afterwards as cash is released back into the banking system.
- Secondly, the one-week repo rate was also pressured this year due to a delayed intervention by the People's Bank of China (PBOC). In prior years, the central bank has always been earlier in terms of response to provide liquidity via open market operations, but this year we have seen a delay which resulted in the spike. Having said that, they did intervene after which we saw liquidity move back to a more normal level.

Q **So this is the second instance of liquidity constraints that have made headlines in 2013 – last time we saw short term rates reach these levels was in June 2013 – is there a particular reason why the PBOC hasn't stepped in as quickly to facilitate liquidity in the market as it has done in the past?**

A On a forward looking basis, we think the liquidity landscape is due for some structural changes over time and it will represent some volatility in 2014 for short term interest rates. In fact, we suspect the recent liquidity reduction has been by and large intentional.

A key thing to keep in mind is that China's policy framework does not follow an interest rate driven model like the rest of Asia. Instead it uses a quantity-based framework and a toolset of open market operations, repo rates, and M2 money supply for policy adjustments. The most important point here is that the Third Plenum actually includes a broader guidance to shift from a money supply framework into one that is based on interest rates.

To move into this model, it involves a few things:

1) Setting of certain market driven interest rate mechanisms
2) And result of that; weaning of markets from a flush liquidity system, particularly the banking system

In order for a market-driven and interest rate-driven policy to work, the current system has to change – i.e., liquidity needs to be reduced. The recent liquidity squeezes in the news headlines are actually an attempt to reduce the banking system reliance and control leverage particularly in the shadow banking and private wealth management products.

The key thing to note is that PBOC is not intentionally inducing a liquidity crisis. It is simply trying to control selective sectors of lending, and prepare the markets for an interest rate-based policy going forward. This is one of their policy tools, and hence, technically speaking, they are in control of what is needed in terms of liquidity and could quickly adjust it if needed to relieve the markets – which we already saw a few times last year.

Our best case outlook for 2014 is that there will continue to be headlines on the liquidity conditions, but we do not expect systemic stress at this point in time.

Please note that these actions are steps towards a more sustainable policy structure. A lot of banks have been using the short-term rates to fund longer term liabilities, and hence there's a duration mismatch of their balance sheets. The recent actions should help rebalance these issues. We also expect the PBOC to intervene should they see risks of a liquidity squeeze flow-through into the real economy.

Q **With the Chinese New Year coming up at the end of January, can we expect any further volatility or do we expect that the Chinese money markets have now returned to normal?**

A Yes, expect volatility during Chinese New Year. It is a festive season in China where cash levels are drawn down in the financial system. If the PBOC is to follow their roadmap, we should not expect a reversion of this tightening trend in 2014, and we should still expect liquidity squeezes at four junctures next year:

a) Chinese New Year (February)

b) Golden week: both of these due to increased consumer spending and cash deployment (October)

c) June and December due to the need to meet certain cash levels from a regulatory standpoint.

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Q How does this volatility in short term rates impact the money market instruments that an RMB money market fund would typically invest in?

A In terms of money market instruments available for onshore China money market funds, it is similar to other money markets. The curve is currently inverted with 3 months at 4.6% and 1 year at 4.18% – and the 3 month Treasury bill actually has a similar yield to the 10 year government bond. As a result of the recent repo rate increases, yields have come under pressure and there are likely to continue to be periods where they are expected to be volatile. We have witnessed two particular things which we think are noteworthy:

a) Deposits, Commercial Paper (CP), and Certificates of Deposit rates have increased. The bigger banks have been raising cash while offering better yield levels and smaller banks have also had to increase deposit / CP issuance rates to attract funding.

b) Credit differentiation. In the past, due to very flush liquidity conditions, spreads between weaker credits and stronger credits were typically low. As of now, we have seen companies with poorer fundamentals or weaker ratings starting to issue at higher rates. As an example, the onshore rated AAA short dated bonds were trading roughly at a spread of 170 bps over central government bonds in December 2012. As of the end December 2013, the spread was 210 bps, i.e., a 40 bps spread widening already. Credit differentiation is likely to continue for 2014.

The message in this case is quite simple, short duration is the preferred fixed income strategy and credit quality selection becomes increasingly important for onshore investments. For money market funds, the preferable strategy is to maintain higher liquidity levels in short dated repo instruments through 2014 given the bearish bias towards rates.

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