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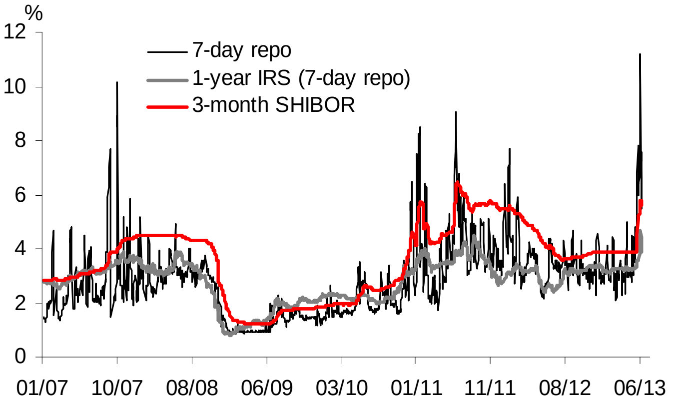
# China: implications of tighter liquidity and deleveraging

- The recent spike in interbank money market rates reflected seasonal factors, the impact of tightened supervision of interbank bond transactions and shadow banking activities, and a sharp slowdown in capital inflows/FX carry trades
- While the liquidity squeeze has eased, helped by PBoC's pledge to maintain market stability, we believe China's multi-year deleveraging of the financial system will continue, consistent with the new leaders' goal to rebalance the economy away from reliance on credit-driven investment
- Tighter liquidity/credit conditions and higher funding costs will likely pose downside risks to growth and increase default risks. However, we think that short-term pain is inevitable as China adjusts to achieve sustainable, balanced growth
- Concern about growth, credit and policy risks and global financial volatility will likely weigh on Chinese markets in the short-term. Longer-term, we remain positive on China's economic prospects and associated investment opportunities

## Interbank market jitters

The recent spike in interbank money market rates compounded investor worries over a further slowdown in the Chinese economy and sent the Shanghai Composite index down sharply (by 15% as of 25 June from its end-May level.) The 7-day repo rate surged to a record 12% on 20 June, compared with an average of 3.5% in May. The 3-month SHIBOR jumped to 5.8% on 20 June after staying steady at 3.9% in H1 2013, and the overnight SHIBOR also soared to 11.4% on 20 June from 4.5% at end-May. Bill discount rate also saw an abrupt rise to above 6% from 4% prior to the recent liquidity crunch.

**Surge in interbank rates**




Source: Bloomberg.

We think several factors contributed to the significant tightening of interbank liquidity since end May. These include: (1) seasonal liquidity demand for tax and deposit reserve payments, cash hoarding by banks to meet quarter-end capital requirements and holiday cash demand; (2) tightened supervision of interbank bond transactions; (3) a crackdown on shadow banking activities and (4) a large decline in capital inflows. Capital inflows have slowed sharply since May given the government's effort to rein in export over-invoicing/FX carry trade activities, on the back of global financial market jitters that have triggered emerging market (EM) fund outflows on Fed QE tapering concerns.

## Policy focus on risk control

There were a number of occasions in the past when interbank market rates spiked due to either seasonal factors or funding pressures. At these times, the authorities were generally quick to inject liquidity. This time the People's Bank of China (PBoC) did not step in to ease liquidity promptly or significantly. Instead, the PBoC has sent a strong message to banks to control their activities on interbank bond repo transactions and non-standard credit products in wealth management products. Many smaller banks, which cannot compete with big banks in obtaining deposits, have used interbank funding extensively to fund lending and bond purchases. These activities have resulted in a duration mismatch and high leverage, exposing these banks to liquidity and interest rate risks. The PBoC has stressed that the overall liquidity is adequate (and we agree on this, judged by the excess reserve ratio and the still-high money supply growth) and urged banks to control risk of credit expansion and strengthen their liquidity and balance-sheet management.

Despite its tougher stance, the PBoC has provided liquidity support to some financial institutions to stablise the money markets after the recent jitters. As a result, the interbank market has showed some signs of stabilisation with short-term rates retreating from their 20 June highs, albeit staying well above the levels prior to the recent run up. The PBoC pledged to continue implementing prudent monetary policy and to maintain money market stability by using a range of instruments. We think this shows the authorities' goal to engineer an orderly, not abrupt, deleveraging and that they are mindful of the potential risks of a liquidity crunch and distortions of the financial markets for financial and economic stability.

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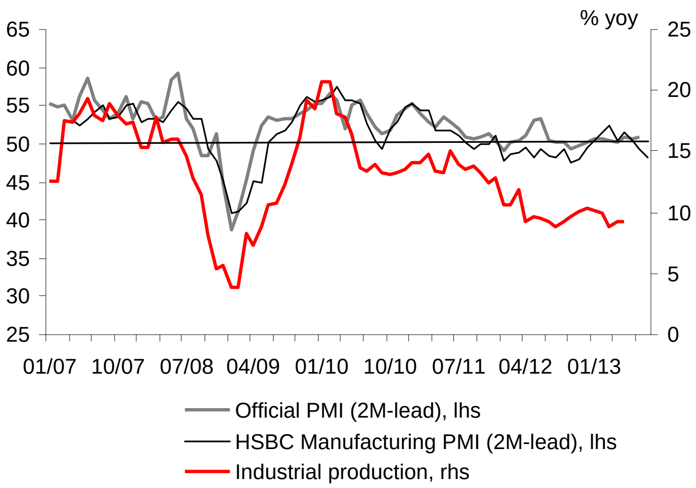
While the fear of a liquidity/credit crunch has eased, particularly as the seasonal factors fade, we think banks will likely become more cautious in stretching their lending capacity, gearing down the pace of credit expansion, following the recent market jitters. We believe containing financial risks will remain a key policy priority and the government will continue its efforts to rein in excesses in the financial system. The stock of the government's total social financing (TSF) credit climbed to over 180% of GDP by end-2012 from 125% of GDP at end-2008, based on our estimates. This rapid build up in leverage leaves no room for complacency.

The government faces the challenges in striking a balance between the need to prevent an excessive debt build-up and the need to support economic growth. The new leadership is more focused on risk control and structural reforms than higher growth, in our view, provided that growth remains at a "socially acceptable" pace (e.g. 7-7.5%) and labour market conditions stay broadly stable. This is consistent with the goal to rebalance the economy toward less reliance on credit-driven investment. The authorities have tightened regulation over shadow banking activities, rules on interbank assets and lending to local government financing vehicles as well as property policies. This is the start of a multi-year deleveraging process, in our view.

## Downside growth risks

We think credit growth will likely slow and the cost of credit will likely rise. Tighter (or less accommodative) liquidity/credit conditions pose downside risks to China's economic growth, which has been weaker than expected, especially given China's highly leveraged economy. Recent macro data e.g. PMI, industrial production, electricity generation, property & manufacturing fixed asset investment (FAI), newly started FAI projects, housing starts, and auto sales, etc. have signaled on-going weakness.

**Manufacturing PMI vs. Industrial production**




Source: CEIC, Bloomberg.

Property and infrastructure investment has driven China's growth in recent quarters. Deleveraging of the financial system would slow investment, especially infrastructure spending which has largely been financed via shadow banking activities. Many LGFVs rely on new debt issuance just to pay the interest on their outstanding debt because they still generate negative operating cash flows. Most developers appear to be well-funded, despite increased capex/land banking, given solid and on-track contracted sales and capital raising year-to-date. However, some smaller and highly-geared developers may face pressures. Less financing support and/or higher funding costs could affect their activities and have a negative impact on the property sector, on top of risks of tightening of administrative measures.

The external environment has not been supportive given still weak eurozone growth and the volatility in global financial markets. Any downside risks to EM growth from persistent capital outflows or the risk of a significant re-pricing of EM yield spreads would also mean risks to China's growth outlook given the increasing importance of EM export markets.

The recent interbank market jitters add to the tail risk regarding the authorities' ability to manage an orderly deleveraging of the financial system without causing disruptions to the markets, banking system or the real economy. While the reigning-in of shadow banking would hurt the funding chain and could lead to some cases of individual defaults emerging and a rise in bad debts, our baseline case is that the government could avoid an escalation of stress in the financial system. It holds major stakes (and control) in many banks and has fiscal firepower.

Near term, we see growth likely slowing further and we think achieving the 7.5% target for this year is becoming challenging. However, we expect growth moderation to be a managed transition to a more sustainable and balanced growth, in line with the government's long-term target of 7% over the next few years. The government has pledged to boost credit support for industries defined as strategic and deemed important from an employment perspective, with more efficient allocation of capital and targeted credit support in mind.

## Investment implications

We think concern about Chinese growth outlook reinforced by the government's more hawkish monetary/credit policy signals will likely continue to weigh on the domestic financial markets in the coming months. The liquidity catalyst for the equities market that many investors may have become accustomed to over the past few years has probably come to an end, at least in the near term. The volatility in the global financial markets and unfavourable EM capital-flow momentum could, potentially, exacerbate investors' negative reaction to any cyclical volatility or policy uncertainty. The recent cuts in consensus GDP forecasts may keep corporate earnings sentiment weak in the near term. Despite the current low valuation (more so after the recent sell-off), there appears no near-term catalyst for a sustained market rebound, given that reform-driven re-rating potential is likely to take time to be realised. That said, from a micro level, we see the value in selective corporate names with strong fundamentals (in equities and CNH/USD credit).

Despite the short-term pain from deleveraging, from a longer-term perspective, the more prudent policy stance should help China avoid systemic financial crisis, and lay the foundation for a longer term valuation re-rating of the market. We remain positive on China's long-term economic growth prospects and see long-term investment opportunities, particularly in the areas of economic rebalancing and structural/market-based reforms.

**Renee Chen**
*Macro & Investment Strategist*
HSBC Global Asset Management

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