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FX Hotspot

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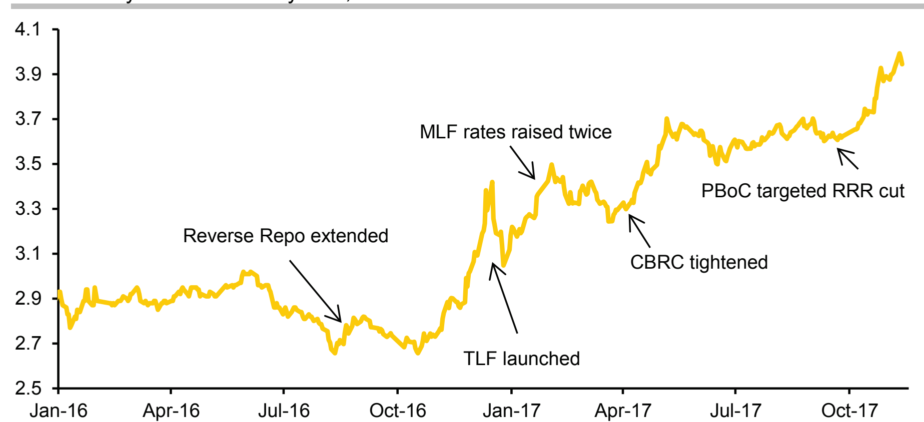
China's deleveraging: Slow but underway

The recent spike of China's onshore interest rates has caught a lot of attention among investors. In our view, this reflects the deleveraging effort by the Chinese authorities. As the central bank has conducted the deleveraging in a careful and deliberate approach, a disorderly deleveraging, such as "cash crunch" in 2013, is unlikely to repeat. Of course, the tradeoff of the deleveraging is that the growth could be undermined over the near term. Regarding the FX market, as long as the interest rates remain elevated, the FX hedging for the importers will be increasingly costly.

CHART 1: **China's interest rates have been rising since Q4 2016**

China's 10-year CGB bond yields, in %



Source: Bloomberg, Commerzbank Research

China's onshore interest rates are on the rapid rise. Notably, the benchmark 10-year government bond yields breached above the psychological level of 4% this week (Chart 1), up more than 140bps over the past year. In the meantime, there are signs of liquidity tightness in the inter-bank market. For instance, the 3-month Shanghai Interbank Offering Rate (SHIBOR), picked up to above 4.50% this week, the highest in three years, while it was only about 3% at the beginning of this year. The surge of the interest rates has brought about serious concerns among investors. We also received a lot of requests from our clients, and we would like to answer the most frequently asked questions as follows:

What happened?

In fact, the market interest rates have been rising since Q4 2016 (Chart 1). In our opinion, this reflects a deliberate change of the policy focus: the authorities attempt to increase the cost of funds to conduct a gradual deleveraging in the financial sector. Various indicators suggest that China's financial leverage has picked up rapidly since the global financial crisis, with debt piling up dramatically as a result. In order to reduce the risks embedded in the financial excesses, the Chinese authorities have shifted the policy orientation to "bubble deflating" since late 2016, with a focus on financial sector and property market.

Over the past week, the central bank conducted sizable liquidity injection, which is seen as a move to ease the concerns among investors. In fact, this is not the first time. The PBoC conducted a temporary cut to reserve requirement ratio (RRR) among the big state banks in January 2017 when the rates were surging. In late September, facing the liquidity squeeze, the PBoC also announced a targeted RRR cut. However, once the market fears eased, the central bank would swiftly withdraw the excess liquidity from the market. That said, the liquidity injection at this junction intends to smooth out the excessive volatility; hence does not indicate any change of the policy orientation.

For important disclosure information please see page 4 and 5.

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Who designed the policy?

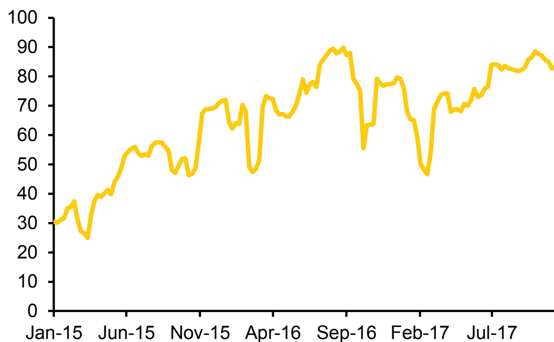
We believe that the PBoC is the coordinator of the financial deleveraging policies, with support from other regulators. Over the past few quarters, the central bank gradually increased the cost of funds via open market operations (OMOs). In August 2016, the PBoC has started to extend the tenor of reverse repos, which actually raised the ceiling of the inter-bank interest rates. The market interest rates, as a result, picked up in the following months, albeit at a moderate pace. In Q1 2017, the PBoC hiked the rates of OMOs twice by 20bps in total. In April, the banking regulator rolled out several policies to clamp down the financial leveraging and arbitrage activities. (Chart 1) Clearly, all these measures are designed to target the high financial leveraging.

What is financial leveraging?

One of the most popular leveraging trades takes place in the onshore bond market. Specifically, a trader buys bonds, and uses bond repurchase agreement (repo) to get funds (normally in overnight tenor), and buys bonds again. By repeating these activities, this position can leverage up to 10 times, thus duplicating the carry gains.

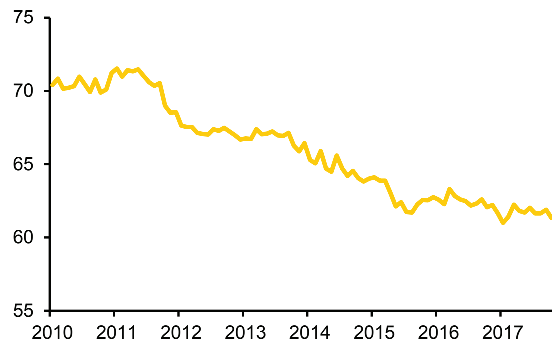
In order to eliminate such dangerous game, the central bank decided to hike the funding cost, which had taken some effects, as we did see some position unwinding in the first half of this year. However, the leveraging ratio of the bond market rebounded in Q3, as suggested by trading volume of bond repos (Chart 2). In other words, the risk-taking behavior does not really change among the financial institutions. As a result, the interest rates lean towards the upside.

CHART 2: **Bond leveraging rebounded in Q3 2017**
Bond repo trading volume, 4-week rolling sum, in CNY, trn



Source: WIND, Commerzbank Research

CHART 3: **Funding sources of banks are more diversified**
Deposits as percentage of total assets, in %



Source: WIND, Commerzbank Research

What's the difference compared with "cash crunch"?

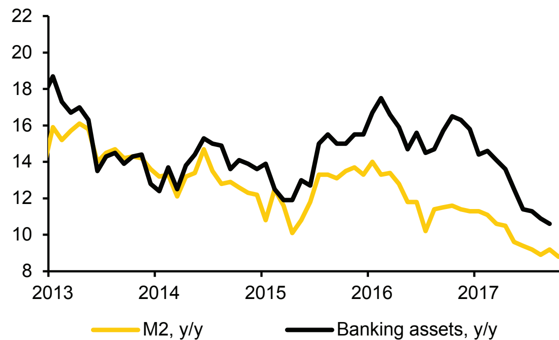
The recent bond rout recalls many of the "cash crunch" in 2013. During May and June 2013, the central bank pushed up the inter-bank funding costs aggressively to punish the shadow banking activities. Nonetheless, the PBoC had to step up massive liquidity injection in late June 2013 as signs of financial crisis had emerged after banks stopped lending to counterparties. This time round, the authorities have cautiously designed the deleveraging measures, suggesting that they intend to avoid a disorderly deleveraging.

The overall market environment has changed compared with that a few years ago. In China's financial sector, one phenomenon worth noting is that banks' funding sources have become more diversified. Over time, the deposits have played a decreasingly important role in banks' funding structure. Data suggest that the deposit/asset ratio fell to 61% by October 2017 (Chart 3), versus more than 70% in 2010-2011. In this case, the banks have to rely on wholesale funding resources, especially inter-bank borrowing and certificate of deposits (CDs), to support the asset growth.

In fact, there is a widening gap between M2 (deposit) growth and banks' asset growth since 2013. Despite constantly slowing M2 (deposit) growth, China's commercial banks still expanded the balance sheet aggressively during 2014-2016 (Chart 4). That said, the wholesale funding filled the gap. As the banks rely more on funding pool in the inter-bank market,

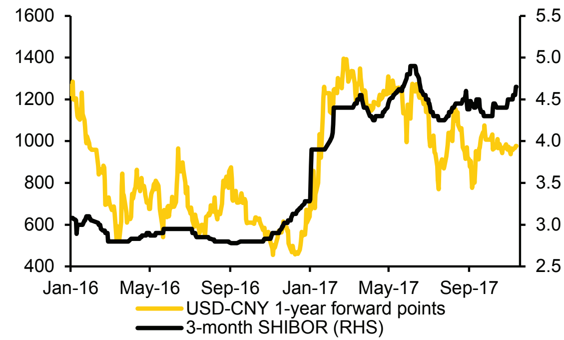
it makes sense for the PBoC to conduct the deleveraging via market-oriented instruments, such as OMOs. Indeed, thanks to the effort over the past year, the banks' asset growth has significantly moderated since the beginning of this year.

CHART 4: **A widening gap between M2 and banks' assets**
Bank asset growth vs M2 growth, y/y, in %



Source: WIND, Commerzbank Research

CHART 5: **FX Hedging will be most costly for importers**
USD-CNY 1-year forward points, in pips vs 3-month SHIBOR, in %



Source: ChinaMoney, Bloomberg, Commerzbank Research

What's next?

All told, the Chinese authorities have been seriously concerned about the debt problem and financial leveraging. As the debt level still stands above the warning level, the "deleveraging" will likely intensify in the coming year. We can draw a few market implications from here:

First, the tradeoff of deleveraging is that the growth could be undermined in the near term. However, this is a necessary cost, as China must strike a balance between growth, debt and leverage.

Second, more stringent financial regulations will be implemented to push forward the "bubble deflating". We believe that the banking regulator will continue to tighten the capital requirement policies for commercial banks. As a result, Chinese banks need to strengthen their capital positions via equity and bond issuance in the future.

Third, regarding the FX market, the elevated interest rates indicate that the there is an upside bias in USD-CNY forward points, implying higher hedging costs for importers (Chart 5). For corporates with USD payables, it makes sense to pay the USD-CNY forward points on dips.

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