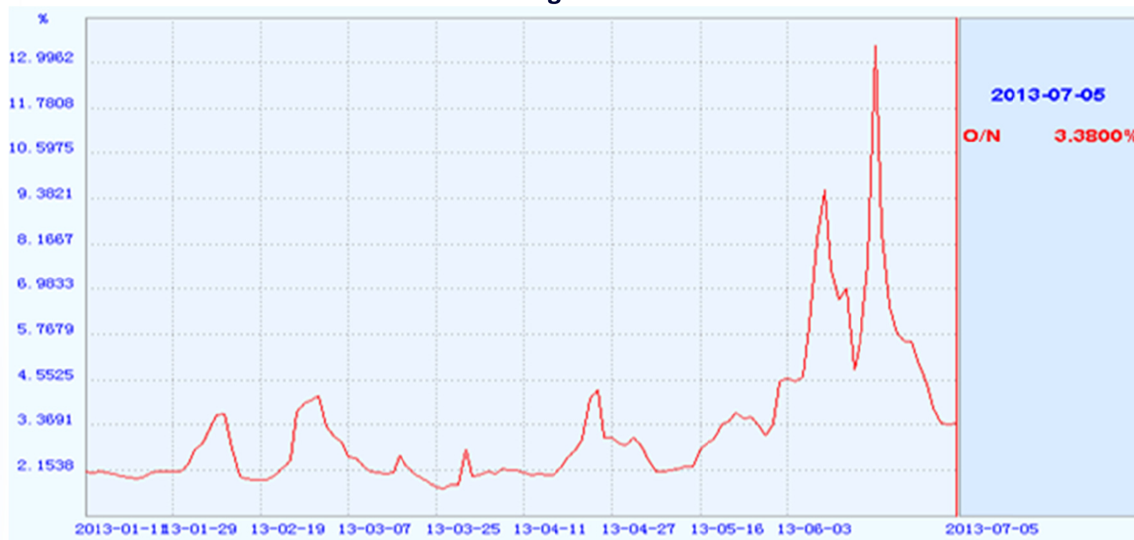
Jul 5, 2013

Dear clients and colleagues,

What's going on in China? Today the State Council reiterated it will maintain a prudent monetary policy while ensuring a reasonable supply of money and credit. The central bank announced yesterday that it would place 100 billion yuan ($16 billion) of deposits with commercial banks in July, the largest monthly total since November 2012. These reassurances came after a credit crunch that sent overnight Shibor (Shanghai Interbank Offered Rate) to a record high of 13.44% on June 20th. Today the rate dropped to 3.38%.

Shibor Overnight Rate



Source: National Interbank Funding Center

In a more mature economy such a spike would be "very scary", notes Tao Wang of UBS. In such economies, central banks set the interest rate at which they will provide funds to banks. If they keep this policy rate steady, then interbank rates can surge only if banks start to doubt each other's creditworthiness. In China, the central bank's provision of liquidity is more ad hoc. Some argue that short-lived cash crunches are not unusual.

Is this credit crunch the beginning of a financial crisis in China? We don't think so. Actually, we believe there was no incident. Below is the big picture:

- The trigger: On June 6th, a mid-sized bank failed to repay a loan to a major bank. Subsequently, several major banks closed large fund transfer services in major cities.

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- The central bank initially acted by not acting: Instead of easing the liquidity strain that had been developing since early June, the central bank sold bills on June 18th, withdrawing money from circulation, sending a signal that no help could be expected from the central bank if banks were short of money due to excessive lending.

- The official reasons given for the credit crunch: computer glitches and a large amount of withdrawals before the Dragon Boat Festival on June 12th.

- The real reasons we believe: new credit control initiatives, high poor-quality local government debt and shadow banking.

    1. New credit control initiative: Since March the government has rolled out several new policies to increase scrutiny on structures of interbank loans in order to rein in excessive short-term and speculative lending.

    2. Local government debt: At about 20 trillion yuan ($3.3 trillion), it accounts for 30% of China's GDP. The central bank chief Zhou Xiaochuan said in March that 20% of these debts are quite dangerous because these projects contribute no fiscal income.

    3. Shadow banking: Citi Research estimated it to be 28 trillion yuan. Many of the products are used to finance property developers and bonds issued by local government financing vehicles. One source of liquidity has been informal capital flows, but a new government policy that cracks down illicit capital inflows contributed to the liquidity shortage.

In summary, the central bank wants to limit moral hazard in both the official and shadow banking sectors. It allowed this cash crunch to happen and warned lenders to avoid raising short-term money to finance long-term loans.

We don't want to judge the Chinese central bank's way to punish banks. Allowing a cash crunch to happen may not be the ideal approach to curb credit growth. However, the usual way in developed countries to raise the policy rate is certainly not advisable in the current phase of economic slowdown in China.

What's our 2H outlook for China? Cautiously optimistic.

- Low visibility on macro policy: The new leaders have not made big moves. For now they seem to be putting the emphasis on reform adjustments, aiming for short-term pain and long-term gain.

- GDP growth: The official target of 7.5% in 2013 sounds reasonable. It started as a conservative target as usual, but as the economy recovers more slowly than expected, the figure should be closer to reality.

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- Inflation: CPI shall remain benign at about 2.5% due to poor domestic operation and weak imported inflation. PPI shall be slightly negative due to overcapacity in the manufacturing sector.

- RMB vs. USD: Appreciation should slow after the sharp increase in April and May. US economy performs better-than-expected.

- Stock market: Downside risk is limited. The fundamentals are good but policy fog does not signal any uptick yet.

Have a good week.

The Global Alpha team

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