Creating Opportunities

Economic Watch

China | Understanding the interbank liquidity crunch and the policy intentions

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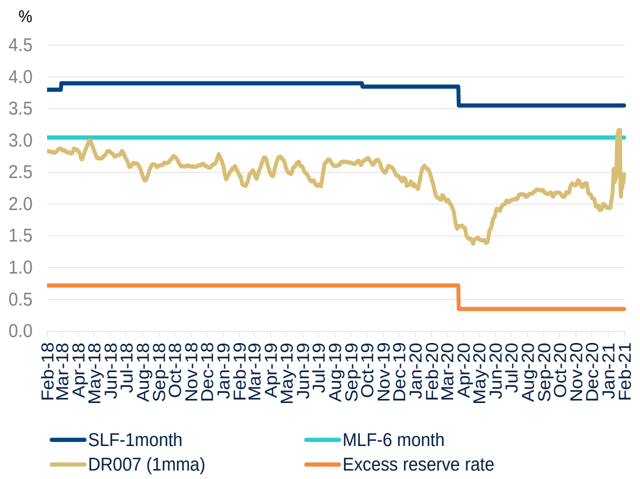
China's interbank market experienced a surprising liquidity crunch at end-January, again, raising the market concern of an early exit of accommodative monetary policy measures amid an accomplishment of a V-shape recovery and the PBoC's long-lasting tensions to curb financial risks. The move also spilled-over to a recent stock and bond market sell-off as the doubt of the central bank's true intentions accumulated.

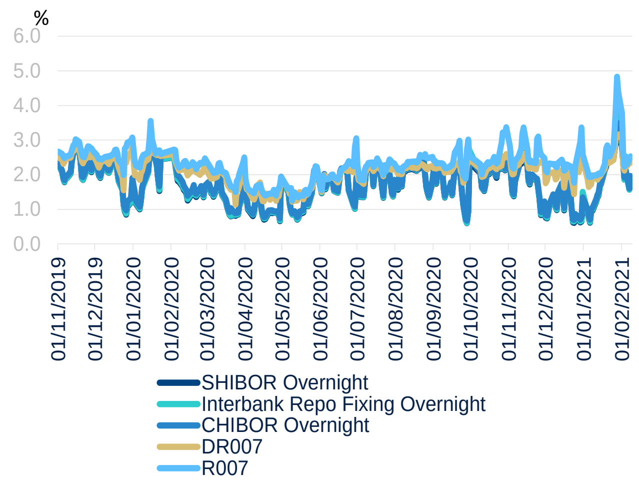
Looking at the interbank rate data, during the pre-Lunar New Year holiday, normally regarded as an ample liquidity period, the overnight repo rate (DR001) surprisingly jumped by 60bps from 2.44% to 3.04%, touching the upper bound of Standing Lending Facilities (SLF) interest rate under the newly formed monetary corridor system; the 7-day repo rate (DR007) jumped from 2.26% to 3.05%, compared to the OMO policy rate of 2.2% and the upper bound of 7-day SLF interest rate of 3.20%. (Figure 1 and 2) The interbank market suffering was further compounded by the PBoC's withdraw of RMB 78 billion liquidity through Open Market Operation and withdraw of RMB 40.5 billion through only partial extension of medium-term lending facilities (MLF) at end-January, which is deemed to be the last straw that killed the camel. Coincidentally, the PBoC's Monetary Policy Committee official, in the recent public speech, again, raised the authorities' concern of financial bubbles in A-share and H-share markets which is decoupling with economic growth plunge. His talk was deemed as a signal of monetary policy tightening evaluation.

Figure 1. **THE RECENT INTERBANK MARKET RATE SPIKE UNDER CHINA'S NEW CORRIDOR MONETARY POLICY FRAMEWORK**



Source: CEIC and BBVA Research

Figure 2. **A SYNCHRONIZAED HIKE ON VARIOUS INTERBANK MARKET RATES**



Source: CEIC and BBVA Research

What drove the recent interbank liquidity crunch? Policy intention or monetary mechanism failure?

Apparently, all of these stylized facts seem like to point to a policy turnaround, from accommodative measures to continue to underpin post-pandemic growth recovery to start the tightening cycle to curb recent soaring stock market and other financial risks as well as to deal with the long-lasting structural problems. Indeed, we cannot exclude the reason that the PBoC wanted to alert and cool down the recent soaring stock markets by straining the interbank liquidities, which is just the historical replay of what the PBoC did in 2013. But it is just that. Beyond this, we do not see any other policy intentions of a sharp turnaround of accommodative measures.

Before we move to dwelling on the underlying reasons of the recent interbank turmoil, what we would like to reassure here is that as we emphasized in our recent China Economic Watch: What will be the monetary policy stance in 2021?, neutral and accommodative monetary policy "without a sharp turnaround" will certainly be the main stance in 2021 until the global economy is freed of pandemic shade. As we discussed in this previous report, under the global economic slowdown, the escalating China-US tensions, and the already historical high interest rate differentials between China and other countries, deflationary environment and RMB appreciation trend, it is not necessary to start the tightening cycle at all at the current moment.

As we know, curbing systematic financial risks only through hiking policy rate itself is quite problematic. Depending on monetary policy to address financial risk concerns has been an academic debate for decades, but not an actual central bank policy practice. Actually, hiking policy rate is simply a necessary but not sufficient condition of curbing asset bubbles and deleveraging. A broader scope of structural reform approach is indeed needed. Instead, the authorities preferred to implement macro-prudential policies to address asset bubble concerns.

Instead of sticking to the point that the PBoC intentionally cooled down the recent soaring market, as most market participants did, there are many other factors which could contribute to the recent interbank market liquidity crunch. Chief among them is that the current newly constructed monetary policy framework makes it difficult for the PBOC to accurately predict liquidity demand on a high-frequency basis under the current challenging and complicated market environment. (see our previous China Economic Watch: China | Monetary policy: New framework, new stance)

Under this monetary corridor system, the new policy target is the pledged 7-day interbank market rate while the rates of Standing Lending Facility (SLF) and excessive deposit reserves constitute the upper and lower bounds of the "corridor" respectively. The central bank will frequently conduct open market operation (OMO) to align the policy rate target with policymakers' desired level. Currently the main policy tools of OMO include 7-day, 14-day and 28-day repo (and reverse repo), which function to withdraw (or inject) liquidity from (into) the money market. In particular, one important character of this corridor system is that the PBoC's liquidity operations more likely are based on continuously fine-tuned model and calibrated operations, which is sometimes indeed deviate from the desirable level as they expect thus lead to large volatilities in interbank interest rates.

The market analysts provided abundant reasons recently to confuse the PBoC's OMO calibrated model under the money corridor framework, which have quite lot of technical details and probably not necessarily to dwell on here. Except for the seasonal factors such as tax payment period, banks' lending peak at the beginning of the year, pre-Lunar new year holiday cash demand etc., there are also some new factors: the increasing business of foreign exchange sale by commercial banks to exporters amid a strong RMB appreciation expectation and capital outflow through southbound Stock Connect Scheme, which have drained the market liquidities, etc.

All in all, except for curbing the recent stock market soaring, we would rather interpret the recent interbank liquidity crunch as a potential failure of the PBoC's interest rate corridor and liquidity operation model with technical difficulty in predicting liquidity demand accurately.

In fact, the reality this week exactly proves our hypothesis: in response to the liquidity crunch and the spike in interbank rates, the PBoC fine-tuned its operation model and injected RMB 200 bn liquidity ($30.93 billion) this week through seven-day reverse repos to make sure sufficient liquidity before China's Lunar New Year Holiday, dispelling the market worries of an early exit of accommodative monetary policy.

Summary

Regarding the recent interbank market liquidity crunch, we tend to believe there are two important underlying reasons: the PBoC's intention to alert the recent soaring stock market bubbles as what they did in 2013, and more importantly, the temporary failure of the newly formed monetary policy corridor system and the central bank's calibrated liquidity operation model under the recent complicated and challenging market environment. However, the interbank market interest hike does not suggest a sharp turnaround of the accommodative monetary policy stance so that we maintain our prediction as what we did in our recent China Economic Watch: What will be the monetary policy stance in 2021?, that neutral and accommodative monetary policy stance will maintain given the ongoing growth uncertainties and lingering challenges this year.

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