China Flash

Risky interbank cash squeeze likely to ease

After allowing an interbank cash squeeze to intensify since June 6 (Chart 1), the People's Bank of China (PBoC) late yesterday signalled a readiness to provide liquidity and stabilize the market. The announcement has come as welcome news to China's equity market which had fallen by almost 20% since end-May on worries of slowing growth and, more recently, the impact of the intensifying cash squeeze on economic activity and bank profits. While still elevated, interbank interest rates have eased in the past two days and the equity market has stabilized. The cash squeeze appears to have been induced by the PBoC as a signal to banks to curtail shadow banking and other risky lending practices. Given the risks and drawbacks of this strategy (below), we expect the PBoC to stabilize interbank interest rates soon, albeit at a somewhat higher level than in the past.

- **PBoC statement seeks to calm investor concerns.** In a statement posted on its website after yesterday's market close, the PBoC said that the current liquidity crunch was initiated by a confluence of factors including fast credit growth (Chart 2), lower capital inflows, seasonal tax payments, and the meeting of monthly deposit reserve requirements. Importantly, the central bank has pledged to use a variety of monetary instruments to eliminate excessive volatility in the interbank market. The statement came just a day after the PBoC posted a notice to commercial suggesting that the liquidity squeeze would continue, which triggered a fall of more than 5% in the equity market on Monday, led by declines in banking shares.
- **Was it wise to tighten liquidity so abruptly?** While the effort to clamp down on shadow bank lending and risky lending practices is welcome, a strategy to "punish" banks that are short on liquidity has generated market volatility and could have a negative impact on already slowing economic activity if it persists too long. While some increase in the interbank rate may be warranted--the previous level of 3-4% may have been too low and created incentives for banks to rely excessively on short-term funding for long-term credit advances--the clampdown could be achieved and communicated more clearly through the implementation of regulatory and supervisory instruments. Moreover, the volatility generated in the interbank market risks undermining already slowing economic activity, reveals gaps in the PBoC's communication strategy, and could be a temporary setback in the transition toward market-based instruments of monetary control.

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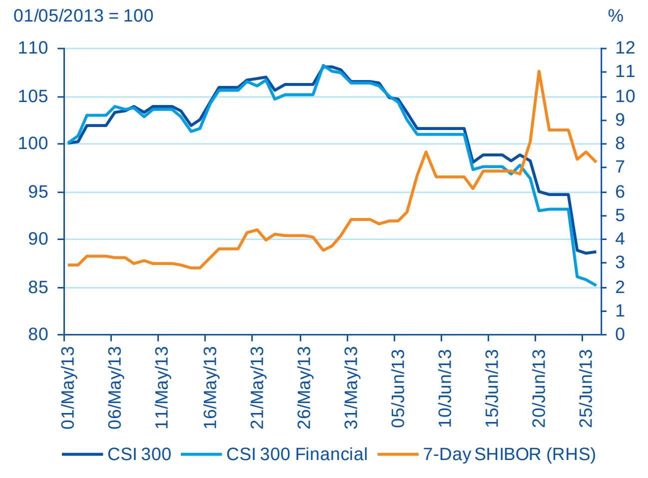
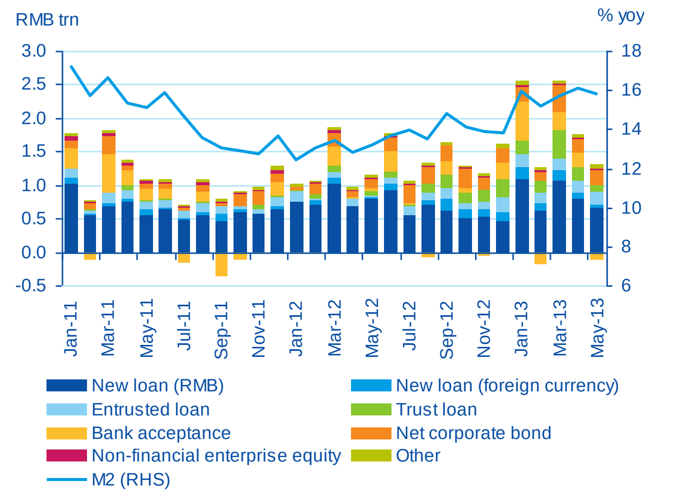
Chart 1
Credit squeeze drags down market sentiment



Source: Bloomberg, CEIC and BBVA Research

Chart 2
Credit and M2 growth remain high



Source: CEIC and BBVA Research

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