China Flash

As interbank liquidity crunch begins to ease, underlying challenges and fragilities remain

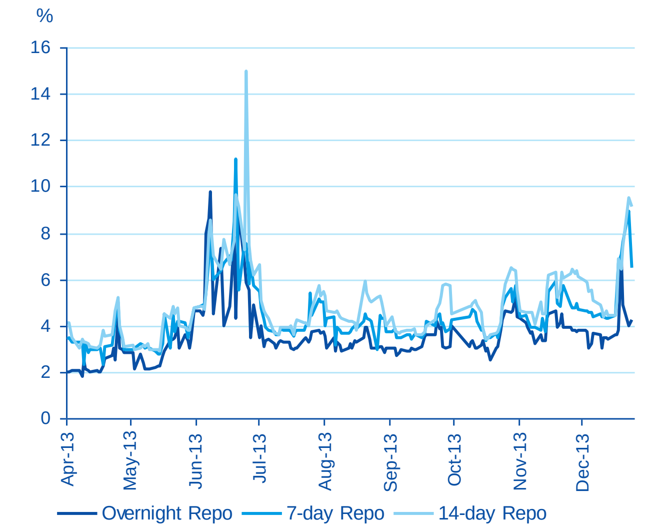
Jitters in China’s interbank market began to ease today following an episode of tight liquidity that began on December 19. Although they remain high, interbank interest rates declined today after the PBoC injected liquidity through reverse repos for the first time in three weeks. In our view, this latest episode of interbank market volatility – the second this year – reveals increasing difficulties the central bank faces in liquidity management amidst increasing financial sector complexity, volatile capital flows, and financial stress.

- **A spike in interbank rates in recent days has generated fears of another liquidity squeeze**, similar to the policy-induced one of last June (see Flash), when overnight rates spiked by around 800 basis points (Chart 1). While triggered by common factors such as end-of-quarter seasonality and an excessive dependence of some financial firms on short-term interbank liquidity (especially smaller banks), this time around the squeeze does not appear to have been policy-induced. To the contrary, the PBoC has been seeking to inject liquidity (RMB 300 billion) in well-publicized “short-term liquidity operations” or SLOs. Until today’s reverse repo operation (RMB 29 billion), these operations had failed to calm the market reflecting possible liquidity hording and market segmentation.
- **More fundamentally, the squeeze may reflect increasing difficulties of the central bank in managing liquidity** amidst increasing financial sector complexity, volatile capital flows, and financial stress, particularly among smaller banks starved for liquidity. The latter is being exacerbated by the rapid growth of shadow banking and money market funds (much of it generated by e-platforms) as savers seek higher returns in the presence of the existing deposit interest rate cap.
- **While the developments described above underscore challenges in the financial system, we do not expect the current tight liquidity conditions to become systemic.** This is due to the PBoC’s ongoing efforts to supply liquidity, as evidenced today, and the likelihood that seasonal demand will fall back to normal in January. Nevertheless, the volatility suggests that solutions to the rapid growth of shadow bank lending and maturity mismatches remain elusive. It also underscores challenges of containing interest rate volatility as liberalization proceeds and leads to an overall higher level of borrowing costs.
- **This recent episode of volatility follows otherwise positive developments over the past month in China's financial sector.** The month began on an upbeat tone with the release of continued strong economic data and the conclusion of the Third Plenum meeting with its ambitious outline of reforms. Such reforms include plans for interest rate liberalization, greater access of private banks, and the establishment of a deposit insurance scheme, all of which provide scope for optimism that pressing financial challenges will be met over the medium term.

Stephen Schwartz
stephen.schwartz@bbva.com.hk
+852 2582 3218

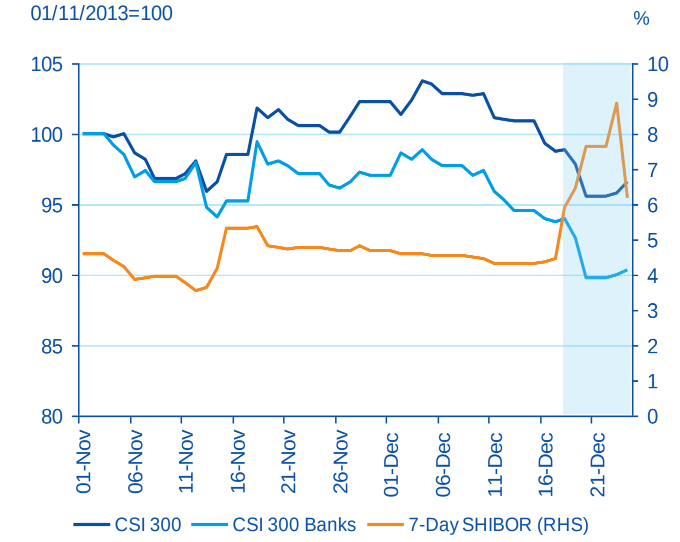
Fielding Chen
Fielding.chen@bbva.com.hk
+852-2582-3297

Chart 1
Interbank rates have spiked for the second time this year…



Source: Bloomberg and BBVA Research

Chart 2
…leading to stock market declines, especially bank shares



Source: Bloomberg and BBVA Research

BBVA RESEARCH
| 95/F, International Commerce Centre, One Austin Road West, Kowloon, Hong Kong | Tel.: +852 2582 3111 |
www.bbvaresearch.com