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China Macro View

Cost Normalization Calls for a New Policy Regime

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- **Cyclical and structural squeezes** – The resurging of money market rates in China recently is a mixture of a slow pace of fiscal spending by year-end and expectations on CPI pickup and Fed tapering, which are cyclical, and the crowding out effect due to credit dislocation and expected interest rate liberalization, which are structural. The rate surges are not the intended results of the central bank. The deregulation in the financial sector including internet banking and other shadow banking activities had reduced the effectiveness of PBOC's traditional instruments like base deposit rates, reserve requirement ratio and loan quota management. The PBOC would have to seek a new policy regime to provide short-term anchors to manage liquidity conditions. This should include a separation between risk-free interest rates and correct pricing of market risk premium. For the near term, we expect money market rates to remain at elevated levels though they could come off a bit after the Chinese New Year.

- **Slow year-end fiscal spending triggered high rates** – In past years, trillions of RMB were spent in the second half of December, and many were spent on conferences, off-sites and annual dinners. The pace of fiscal spending this year had been much slower than past years due to the anti-luxury spending stance of the Chinese government. The PBOC had used SLO (short-term liquidity operations) to provide liquidity to designated market participants. Different from the OMO (open market operations), SLO is often with terms of less than 7 days, and involving only 12 financial institutions with delayed information disclosure. The PBOC had to release the SLO transactions through its *weibo* account last Thursday in order to better communicate with the market.

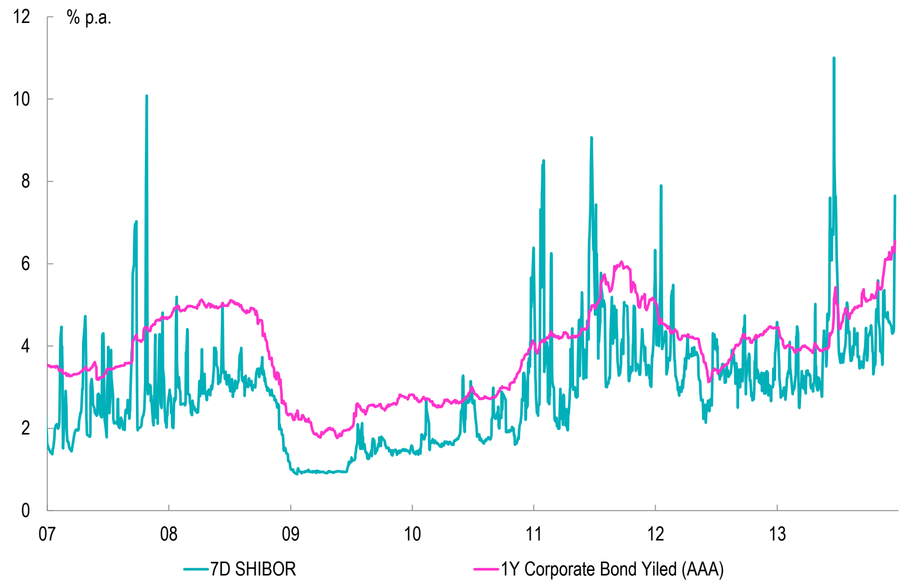
- **Transferring to a new policy regime and market infrastructure** – There is a need for regime shift in the Chinese monetary system. China is in the process of shifting from anchoring the base deposit rates to more market-based instruments, e.g., Shibor or reverse repo. This requires that local governments and SOEs be more responsive to the change of market rates, or be disciplined with hard budget constraints. Meanwhile, defaults and bankruptcy in financial markets should be enforced to avoid free riding on implicit government guarantees. This together with a more flexible FX regime should deter excessive speculation in the shadow banking sector.

- **Rates should remain at elevated levels in the near term** – Further higher rates should add downside risk on the Chinese economy in 2014. The PBOC will continue to manage liquidity conditions through SLO, and OMO if needed around the Chinese New Year. These actions would counter the cyclical forces and soften the market rates. But the PBOC may not be able to tackle this with the structural forces alone. The market rates could come off a bit after the Chinese New Year but may stay high until reforms are able to put the market infrastructure in place.

Cost Normalization Calls for a New Policy Regime

China's money market rates started to climb up again in recent weeks. The 7-day Shibor rose to 7.7% on Dec 20 (Figure 1). While it's still short of 11% in June, its surge had caused concerns in the market. Many thought it was the liquidity crunch in June repeated. The 1-year corporate bond yield, however, had already exceeded the level in June and reached 6.5%, about 2.5 ppts higher than that in 1H this year. Higher cost of capital is largely in line with our expectation. We noted in July that the cost of capital in 2H could be 1-2 ppts higher compared to that in 1H.[1]

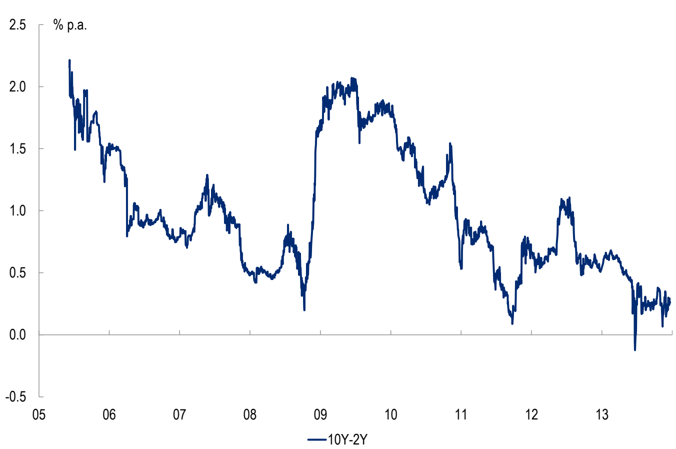
Figure 1. China Money Market Rates



Source: CEIC and Citi Research

The yield curves were flattening since June. The yield gap between 10-year and 2-year treasury bonds had achieved the lowest level since 2005 (Figure 2 and 3). The small gaps in late 2008 and 2011 had all caused the economic slowdown.

Figure 2. Yield Curve Flattening, Treasury Bonds



Source: CEIC and Citi Research

Figure 3. Treasury Yield by Tenors

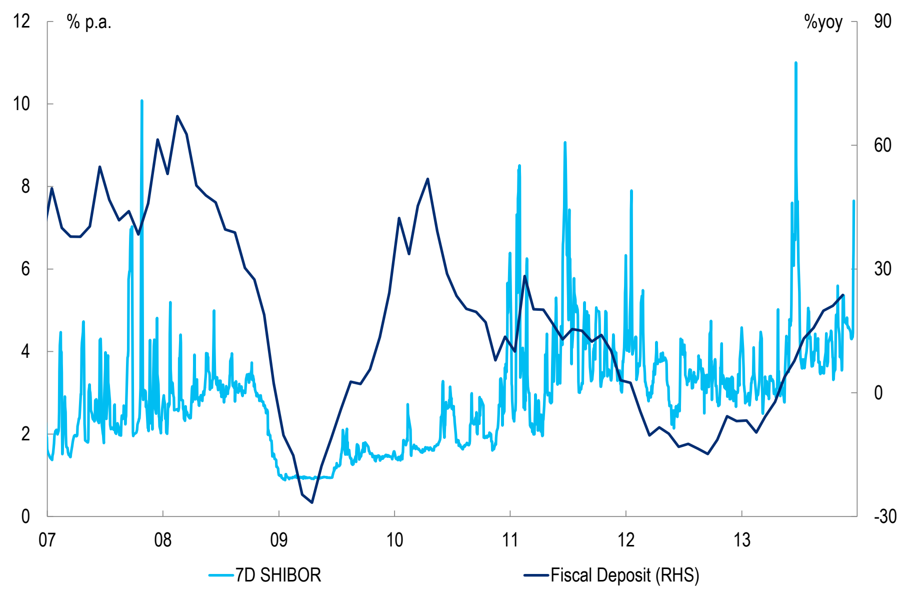
Source: CEIC and Citi Research

[1] See "Beijing Trip Note: Rising Cost of Capital Is a Concern," Citi *China Macro Flash*, July 16, 2013.

Cyclical and structural squeezes

A mixture of cyclical and structural factors had caused the year-end liquidity tightening. On the cyclical front, slower pace of fiscal spending had kept the fiscal deposits in the central bank. If the Ministry of Finance deposits the receipts with the central bank, it is not counted as the part of the monetary bank. Due to the initiatives on anti-luxury spending, many government entities were unable to spend the fiscal money as planned, and thus the expansion of the monetary base was slower than expected. In November, fiscal deposits in the PBOC went up 23.7% yoy, the fastest pace of growth since 2012 (Figure 4). This was achieved when fiscal revenue slowed down. The PBOC, which was expecting fast fiscal spending in the second half of December, did not inject enough liquidity into the economy and thus it had caused unexpected liquidity tightening.

Figure 4. Fiscal Deposits in the Central Bank vs. 7-Day Shibor

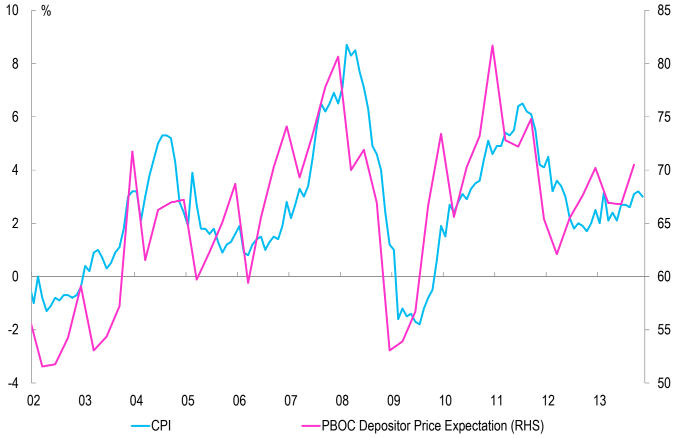


Source: CEIC and Citi Research

Another cyclical factor is relatively high expectation on CPI. According to the PBOC's quarterly depositors' survey, the price expectation was rising and it leads the headline CPI slightly (Figure 5). The CPI outlook could have partly explained the consistent pick-up of the 1-year corporate bond yield (Figure 6). We expect the headline CPI to step up towards 4% yoy by the end of 2014, which could lead to one rate high of 25 bps.

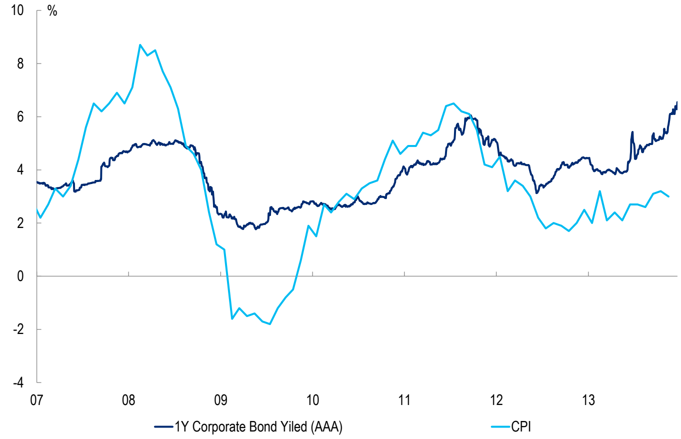
The third cyclical driver of high cost of capital is the Fed tapering, which was only confirmed last week. We do expect the QE3 could end in 3Q 2014, which may cause further capital outflows on the expectation of rising bond yields in the US and a stronger dollar. The tapering could have exacerbated the rate surge last week.

Figure 5. CPI Expectation Is Rising



Source: CEIC and Citi Research

Figure 6. CPI vs. 1-Year Corporate Bond Yield



Source: CEIC and Citi Research

On the structural front, rising cost of capital could be more persistant. Credit dislocation has created a “crowding out” effect in the credit market. When more credits are allocated to local governments and state-owned enterprises (SOEs), a significant part of the economy, e.g., small and medium-sized enterprises and consumers, were having much limited access to credit in the formal sector. This was exaggerated recently when the Chinese government was keen to defend 7.5% GDP growth.

The third plenum had reiterated the government stance of interest rate liberalization. According to our earlier estimation, full interest rate liberalization may lift the cost of capital by 2 ppts while everything else is equal. Recently, the government had also introduced tradable certificates of deposit, one step forward towards deposit rate liberalization.

Lastly, the liquidity crunch in June had pushed up the liquidity risk premium. Large financial institutions became more cautious when managing liquidity. The market rates rose alongside the fact that excessive reserves in the banking sector remain at Rmb1.5tn, not low compared to the same time in history.

PBOC’s Challenge: Regime Shift

While the structural reform is expected, cost normalization in the financial markets advanced ahead of the reform agenda. This is a challenge not only to market participants but also to the PBOC. The central bank would have to manage the market expectation and act timely to avoid another liquidity crunch, which is harmful to economic growth.

Traditional monetary policy instruments, like base deposit rates, reserve requirement ratio and loan quota are unlikely to manage liquidity conditions effectively. Deregulation in the financial market and innovations in internet banking and shadow banking sectors had limited the impacts of these instruments within a smaller segment of the financial market. How to re-invent a new policy regime that adapts to the new environment is critical for monetary authorities in China to move ahead of the market.

The central bank would have to abandon direct control on deposit rates and other quantitative measures, and move to a more market-based regime that centers on Shibor or reverse repo rates. These instruments reflect the true demand and supply in the credit market and thus the short end of the yield curve. In order to use these tools efficiently, the central bank needs to make its monetary policy targets more transparent and manage market expectation through better communications. More importantly, the independence of the central bank should also be improved to make monetary policy more credible.

In order to have a better functioning central bank, China needs to put the market infrastructure in place. First, the risk premium should be priced correctly. Because of implicit government guarantees, all money market rates were deemed risk-free. This had intensified market speculation and thus financial re-leveraging. Meanwhile, high market rates do not stop borrowing from local governments and SOEs that face soft-budget constraints. The financial excess in these sectors exacerbates the “crowding out” effects and may choke off the rest of the real economy. In order to price risk premium right, hard budget constraints should be enforced and defaults and bankruptcies in the financial market should be warranted.

Second, the FX regime should be more flexible to deter carry trade. On one hand, high interest rate spread between domestic and overseas markets invites short capital inflows. On the other hand, the RMB had been in the mood of one-way appreciation, which encourages speculation in the FX market. China’s monetary policy is fighting two battles at the same time, rising cost of capital hurting the real economy while capital inflows are adding pressures on inflation.

Rate outlook and implications

Further higher market rates from current levels are not the intended results of the PBOC. We expect PBOC to inject liquidity as needed to calm down the market. A liquidity crunch in June is unlikely to be repeated. The market rates may inch high during before the Chinese New Year in January, but could come off afterwards. The structural drivers should remain to keep the cost of capital at the elevated level throughout the next year and beyond.

High market rates should force de-leveraging among local governments and SOEs and thus slow investment growth in the infrastructure sector and SOE capex. Earnings squeeze should occur among highly leveraged sectors, and industrial consolidation should proceed. This is a necessary step to rebalance the Chinese economy. While the cost of capital should gradually be spread to local governments and SOEs through refinancing going forward, the private sector should see the cost of capital to normalize to the downside. Consumers who benefit from high return on deposits will improve their spending power to support growth. This will surely improve the efficiency of credit allocation and also the quality of growth.

Cost normalization will likely weigh on Chinese GDP growth in the near term. Tolerating somewhat slower growth accelerates this process. More importantly, while the economy de-leverages, reforms to boost demand and enhance productivity should speed up in order to invent new growth engines and ease the downside risk of the economy. The urbanization plan which will be rolled out shortly should generate reform dividends through *hukou* reform, land reform, and social securities reform.

Appendix A-1

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