

China Banks

Alert: Rise in Government Bond Yields, Reasons and Implications

Given the recent rise in China's govt bond yields (10Y has risen c100bps to 4.4% in the past six months), we spoke with market specialists to understand what it meant for banks. In summary, we believe this is a reflection of funding cost pressure on banks, which are shying away from investing in lower yielding assets. Higher government bond yields have led to higher corporate bond yields, and we believe to higher borrowing costs in the economy overall. Ironically, we believe banks benefit from this environment of higher interest rates (higher bond yields, interbank rates and lending rates) given their funding costs are largely anchored by the regulatory cap on deposit rates. Corporate bond yields are now comparable to banks' benchmark lending rates and this has led to a decline in corporate bond issuance activity - a sign that financing may be re-intermediated back to banks.

Reasons for rise in 10Y govt bond yield? The root cause of the rise in yields in 2H13, according to the specialists, is higher funding costs for banks, which are driving banks to higher yielding assets. Banks are favoring corporate over govt bonds (lower yielding assets). This is a similar phenomenon we see in lending behavior, with lending shifting away from low yielding assets like mortgages to small and micro enterprises. Banks' funding cost is rising in 2H13 due to PBOC policy (slowing M2 growth, tightening interbank liquidity) and the disintermediation of deposits by wealth-management products.

There does not seem to be a policy to drive up govt bond yields, because this will increase the borrowing cost of the govt and the MOF would be concerned. Also, higher govt bond yields will translate into higher borrowing costs in the economy, hurting growth. The govt bond market at the longer-end is active, but is usually unidirectional - everyone does the same thing and so the volatility gets amplified, according to the specialists. Liquidity has diminished in recent months as yields have risen (prices down). 10Y govt bond yield came off 13bp yesterday to 4.4%.

Where are corporate bond yields now? Corporate bond rates have not risen as much as govt bond yields in recent months. So the funding cost for corporates has not risen as much as govt bonds. But corporate bond yields are now similar to banks' benchmark lending rates (one-year AAA corp bonds yield 6.1% vs 6% for banks' one-year benchmark lending rate) and so there is little incentive for high-quality corporates to issue bonds if they could borrow from banks. Hence corporate bond issuance activity has fallen recently.

What would China's yield curve look like in liberalized environment? First, the rate liberalization that China is undergoing is largely unprecedented - given the size of China's economy and the level of control that China is coming from. The only comparable in recent history could be when the Southern European countries were included into the Euro - but that led to lower interest rates.

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The prevailing liquidity environment in which rates are being liberalized is a very important factor and determines how interest rates and the financial system react. Yield curves in a growing / developing economy should theoretically be steeper. China liberalizing its capital account and interest rates (the two go hand-in-hand) will over time lead to a steeper yield curve especially since short-end of the yield curve is being anchored by low global interest rates, according to the specialists.

In a complete open economy, three factors drive the level of long-term interest rates:

1. Potential growth rate of the economy;
2. Terminal inflation rate, which is an inflation rate which is non-growth negative; and
3. Term premium (which normally is positive if conditions #1 and #2 are met).

A back of the envelope calculation for any economy with, say, 6% long-term GDP growth rate and a terminal inflation rate of 3% = 9%. Term premium could be negative or positive dependent upon the output gap and position in the economic cycle.

In the case of China, the rate liberalization would mean higher rates as well, but the rise is likely to be gradual. Policy makers will likely allow the influx of foreign capital into domestic assets versus outward investments from domestic investors at a varied pace so that rates only adjust in a manner that is not very negative for growth.

Appendix A-1

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